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Summary:

San Diego Public Facilities Financing Authority, California San Diego; Water/Sewer

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Credit Profile

San Diego Pub Facs Fincg Auth, California

San Diego, California

San Diego Pub Facs Fincg Auth (San Diego) wtr rev bnds ser 2009B

Long Term Rating

AA-/Stable

Affirmed

Rationale

Standard & Poor's Ratings Services affirmed its 'AA-' long-term rating on San Diego, Calif.'s senior-lien water revenue bonds, issued by the San Diego Public Facilities Financing Authority. The outlook is stable.

The rating is based on our view of the water system's:

- Large, diverse customer base anchoring the San Diego regional economy;
- Strong liquidity position, with unrestricted cash and investments representing 426 days of operating expenses on hand at fiscal-year-end 2012 (June 30, 2012); and
- Planned rate increases over the next two years after over two years with no increases.

These strengths are offset by our view of the system's:

- High exposure to wholesale water costs, with imported water representing 85% to 90% of total system supply; and
- Projected decline in debt service coverage (DSC) to near 1x in fiscal 2014, as calculated by Standard & Poor's, excluding rate stabilization fund withdrawals, though coverage is projected to improve in 2015 due to the rate increases.

The bonds are secured by installment payments, which are backed by net revenues of the city's water system. The bonds have a reserve, funded at the lesser of 10% of proceeds, 125% of average annual debt service, and maximum annual debt service (MADS). A rate covenant requires the city to generate system net revenues that provide at least 1.20x DSC on the senior-lien bonds and 1.0x on senior and subordinate bonds. Rate stabilization fund withdrawals can be included in this calculation. As of June 30, 2012, the city had \$644 million in senior-lien debt outstanding and \$221 million in subordinate-lien debt.

San Diego (population: 1.32 million) anchors the large and diverse San Diego County economy. The regional economy consists of various high-technology clusters, including biotech and telecommunications, combined with concentration in the tourism, military, and defense industries. Its economic base is also anchored by higher education and major scientific research institutions, including the University of California-San Diego, San Diego State University, Scripps Research Institute, the Salk Institute for Biological Studies, and the San Diego Supercomputer Center. The U.S. Navy

and the U.S. Marine Corps also have a significant presence in the region. We consider the city's median household effective buying income strong, at 113% of the national average in 2012.

The system provides water to customers within San Diego, in addition to serving four wholesale customers. The customer base is very diverse, in our view, with the top 10 representing 12% of total operating revenue in fiscal 2012. About 10% to 15% of system supply comes from local sources. The remainder is purchased from the San Diego County Water Authority (CWA). The CWA purchases the majority of its water from the Metropolitan Water District (MWD) of California, which derives its supply from the Colorado River and the State Water Project. The system has substantial storage capacity through its nine reservoirs. The city's policy is to maintain at least 7.2 months of emergency supply in storage, in case of any disruption in imported water. The system can treat raw water at its three treatment plants. The city also purchases treated water from the CWA.

With most of its supply coming from imported sources, the system is exposed to increasing wholesale water rates. Between 2009 and 2013, untreated water from the CWA increased at an average rate of 11.2%. The CWA's rate for untreated water with the transportation charge is currently \$807 per acre foot. We believe these costs will likely continue to rise, requiring the city to increase water rates to keep pace.

Customers are billed monthly along with sewer and stormwater charges. The city charges a flat monthly base rate plus a tiered volume-based rate. The city last increased rates in March 2011. San Diego is currently undergoing the public notice process for two rate increases of about 7 to 8% each on Jan. 1, 2014 and Jan. 1, 2015. The proposed rates include some restructuring of the usage-based tiers, with higher rates for higher use. The city determined these rate increases under a cost-of-service study it commissioned. With the system's exposure to increasing wholesale water costs, we believe future rate increases will likely be necessary to maintain stable financial metrics. Under the cost-of-service study, even with these increases, DSC is projected to decline from recent past levels.

The system's finances have been generally strong over the past three years, the city projects a decline in DSC in fiscal 2014 before it improves in fiscal 2015. In fiscal 2012, operating revenue totaled \$408.1 million, up 9.9% over 2011. Operating expenses, including operating transfers and excluding depreciation, were up 8.6% in fiscal 2012, totaling \$307.5 million. Net revenues, including net operating income and nonoperating revenue, totaled \$114.1 million in fiscal 2012, providing senior and subordinate-lien DSC of 3.04x and 1.72x, respectively, as calculated by Standard & Poor's. In fiscal 2011, senior- and subordinate-lien DSC was 3.26x and 1.77x, respectively. The city's rate covenant allows for inclusion of capital grants and rate stabilization fund withdrawals and exclusion of rate stabilization fund deposits for DSC calculations, leading to differing reported coverage. Based on figures from the cost-of-service study, we estimate total (senior and subordinate) coverage, without including rate stabilization fund withdrawals, to decline to 1.47x in fiscal 2013 and, based on projected figures, to decline further to about 1.0x in 2014 before improving due to the rate increases. Although we view this decline as a weakness, we believe the system's strong liquidity position provides some financial flexibility during a period of lower coverage. Under the city's calculations, DSC is projected at 1.25x in fiscal 2014 due to the inclusion of an \$18 million rate stabilization fund withdrawal.

The system's liquidity position is strong, in our view. As of June 30, 2012, the water fund had an unrestricted cash balance of \$359.1 million, representing about 426 days of operating expenses on hand. As of June 30, 2013, the balance is lower but still strong at \$331 million. The city has a reserve policy of maintaining at least 70 days of cash in

an operating reserve, 6% of annual water purchase costs in a secondary purchase reserve, \$5 million in an emergency reserve, and \$20.5 million in a rate stabilization fund.

According to the cost-of-service study, San Diego is planning \$88.4 million in capital projects in fiscal 2014 and \$98.6 million in 2015. The largest category of projects in both years is pipeline rehabilitation. Under a compliance order from the California Department of Public Health, the city is required to make certain capital improvements to its treatment and distribution systems to correct certain operational deficiencies. The cost-of-service study capital plan includes this work. The city plans to fund the program with funds on hand, state loan proceeds, ongoing revenues, and capacity fees. No additional revenue bond debt is currently planned.

Outlook

The stable outlook reflects our anticipation that San Diego will set rates to cover increasing wholesale water costs and generate adequate-to-good DSC while maintaining stable liquidity. Under the cost-of-service study, coverage is projected to decline in fiscal 2014. If coverage, excluding rate stabilization fund withdrawals, falls to near or below 1x for multiple years, we could lower the rating. If coverage and liquidity are strong over the next two years, we could raise the rating.

Related Criteria And Research

- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008

| Ratings Detail (As Of September 18, 2013) | | |
|---|------------|----------|
| San Diego wtr rev rfdg bnds ser 2010A | | |
| <i>Long Term Rating</i> | AA-/Stable | Affirmed |
| San Diego Pub Facs Fincg Auth, California | | |
| San Diego, California | | |
| San Diego Pub Facs Fincg Auth wtr rev rfdg bnds ser 2009A | | |
| <i>Long Term Rating</i> | AA-/Stable | Affirmed |

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