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City Manager's Office

SENT TO COUNCIL:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Julia H. Cooper

SUBJECT: **2012 ACTION BY FITCH RATINGS RELATED TO THE NORMAN Y. MINETA SAN JOSÉ INT'L. AIRPORT**

DATE: July 24, 2012

Approved

Date 7/25/12

INFORMATION

On July 20, 2012, Fitch Ratings ("Fitch") downgraded its rating on outstanding $1.4 billion of City of San José Airport Revenue Bonds (the "Bonds"). Specifically Fitch downgraded the Bonds from "A-" with a negative outlook to "BBB+" with a stable outlook. The rating report is attached to this memorandum.

Fitch listed the following rationale for the rating action:

> *--Competitive Air Service Area: The airport has an over 90% origination and destination traffic base but is exposed to competition from nearby San Francisco. As a result, enplanements have historically been volatile and are at levels last seen in 1995. The airport also has a moderately concentrated carrier base with Southwest (rated 'BBB-' by Fitch) accounting for approximately 50% of traffic in 2011.*
>
> *--Low to Moderate Pricing Power: The airport's hybrid use and lease agreement allows for adequate cost recovery. However, the airport is reliant on the solid performance of volume sensitive parking and PFC revenues to keep the CPE reasonable. The airport is planning on utilizing a $26 million reserve and unspent 2007 bond proceeds to defease outstanding 2007 airport debt to keep the CPE at $12 but airline costs are exposed to this financial plan and could jump to over $18 in five years if traffic levels and thus volume sensitive revenues remain depressed.*
>
> *--Moderate Debt Structure: The airport has very limited financial market exposure, with $48 million in subordinate commercial paper outstanding and all senior debt fixed rate. That said, the airport has a highly back-loaded debt structure with a significant jump in annual debt service 20 years out. The bonds do have a 2017 call date and the airport intends to restructure the debt to eliminate the increase.*

--Declining Coverage, Elevated Leverage, Limited Operating Flexibility: San Jose has leverage of approximately 11x as a result of the recently completed $1 billion terminal area improvement plan (TAIP). While the airport's unrestricted cash position of $164 million is high the airport will likely use a majority of these resources over the next five years to mitigate airline rate increases. Management has been very aggressive in reducing costs but will be hard pressed to achieve further savings if volume sensitive revenues stagnate or decline.

--Limited Near-term Infrastructure Renewal: San Jose has a recently completed terminal complex, rental car facility, and other airfield and roadway improvements allowing for very limited capital needs in the near term. This is important as there will be limited funding generated from revenue over the next five years given the full allocation of PFC, CFC and concession revenue to offset airline rates and charges.

IMPACT OF RATING DOWNGRADE

The most direct impact of the rating downgrade will be an increase in the fees charged by the Airport's letter of credit banks to support its commercial paper program. The fee associated with the Wells Fargo letter of credit will increase by approximately $50,000 per quarter as a result of the action. There will be no increase in the fees charged by the Airport's two remaining letter of credit banks (Bank of America and JPMorgan).

SUMMARY OF RATINGS

The current ratings from Moody's, S&P, and Fitch are summarized below for your reference:

	Moody's	S&P	Fitch
Airport Revenue Bonds	A2	A-	BBB+

As required by the City's continuing disclosure agreements, and its letter of credit and reimbursement agreements, notification of the rating agency action will be provided to the financial markets within the deadlines specified.

/s/
JULIA H. COOPER
Acting Director of Finance

For questions, please contact Julia H. Cooper, Acting Director of Finance at (408) 535-7011.

Attachment

Fitch Downgrades $1.4B of San Jose, CA Airport Rev Bonds to 'BBB+'; Outlook Revised to Stable

Ratings Endorsement Policy
20 Jul 2012 5:03 PM (EDT)

Fitch Ratings-New York-20 July 2012: Fitch Ratings downgrades to 'BBB+' from 'A-' the rating on the city of San Jose, California's (SJC) approximately $1.4 billion in outstanding airport revenue bonds. The Rating Outlook on all bonds is revised to Stable from Negative.

The downgrade to 'BBB+' reflects SJC's leverage and revenue profile which will be subject to an elevated dependence on volume sensitive customer facility charge (CFC), passenger facility charge (PFC) and concession revenues. The airport's leverage is expected to remain at approximately 11 times (x) over the next five years. While this level is just outside the upper range for other 'A' category airports, it is Fitch's view that SJC's volatile enplanement base, competitive air service area and dependence on volume driven revenues and backloaded debt service profile makes the leverage inconsistent with 'A' category risk. The airport is working to keep the cost per enplanement (CPE) at approximately $12 but this level will likely increase by several dollars absent significant growth in enplanements or the use of other resources over time.

KEY RATING DRIVERS:

--Competitive Air Service Area: The airport has an over 90% origination and destination traffic base but is exposed to competition from nearby San Francisco. As a result, enplanements have historically been volatile and are at levels last seen in 1995. The airport also has a moderately concentrated carrier base with Southwest (rated 'BBB-' by Fitch) accounting for approximately 50% of traffic in 2011.

--Low to Moderate Pricing Power: The airport's hybrid use and lease agreement allows for adequate cost recovery. However, the airport is reliant on the solid performance of volume sensitive parking and PFC revenues to keep the CPE reasonable. The airport is planning on utilizing a $26 million reserve and unspent 2007 bond proceeds to defease outstanding 2007 airport debt to keep the CPE at $12 but airline costs are exposed to this financial plan and could jump to over $18 in five years if traffic levels and thus volume sensitive revenues remain depressed.

--Moderate Debt Structure: The airport has very limited financial market exposure, with $48 million in subordinate commercial paper outstanding and all senior debt fixed rate. That said, the airport has a highly back-loaded debt structure with a significant jump in annual debt service 20 years out. The bonds do have a 2017 call date and the airport intends to restructure the debt to eliminate the increase.

--Declining Coverage, Elevated Leverage, Limited Operating Flexibility: San Jose has leverage of approximately 11x as a result of the recently completed $1 billion terminal area improvement plan (TAIP). While the airport's unrestricted cash position of $164 million is high the airport will likely use a majority of these resources over the next five years to mitigate airline rate increases. Management has been very aggressive in reducing costs but will be hard pressed to achieve further savings if volume sensitive revenues stagnate or decline.

--Limited Near-term Infrastructure Renewal: San Jose has a recently completed terminal complex, rental car facility, and other airfield and roadway improvements allowing for very limited capital needs in the near term. This is important as there will be limited funding generated from revenue over the next five years given the full allocation of PFC, CFC and concession revenue to offset airline rates and charges.

WHAT COULD TRIGGER A RATING ACTION:

--As noted, San Jose airport operates in a competitive air service area. San Francisco Airport (SFO) is approaching peak market share for Bay-area traffic and Fitch expects that over time, San Jose volume will return as well, growing volume sensitive CFC, PFC and concession revenues. Sustained growth should ease leverage and operating pressure and could lead to positive rating movement. The increased competition does mean that for the same rating financial metrics should be better than comparable airports.

--Significant underperformance in CFC, PFC or concession revenue without offsetting expense reductions that leads to either an uncompetitive CPE or an increase in leverage (net debt to cash flow available for debt service).

SECURITY:

The bonds are secured by net revenue of the airport, including operating grants, facility rents, and CFC collections on rental car transactions. The commercial paper notes are secured on a subordinate basis.

CREDIT UPDATE:

Since the precipitous drop in traffic at SJC, airport management has worked to manage airport operations and airline costs in the face of a traffic base much lower than originally forecast. By reducing maintenance and operating costs from a high of $119 million in fiscal year (FY) 2009 during the final stage of construction to a low of approximately $72 million in FY 2012, and by strategically using approximately $32 million in unspent bond proceeds the airport has been able to keep the CPE just under $12, as represented to the airlines.

However, given the significant reduction in operating expenses further successful cost containment may be difficult. In Fitch's view, underperformance in traffic could lead to a more rapid use of cash balances or a needed increase in airline charges, something management would prefer to avoid. Currently, airline revenues represent approximately 30% of total revenues. The remainder represents PFC revenues and draws on balances ($43 million available as of June 30, 2012), CFC revenues, and concession and parking revenues. While the airport's CFC revenue is volume sensitive, rental car companies are required to increase their contributions if CFCs are insufficient to cover rental car facility costs, including allocated debt service. The airport has approximately $26 million in reserve funds and $75 million in remaining 2007 bond proceeds which it may use to defease outstanding 2007 series debt to help maintain a $12 CPE. However, stagnant volumes could cause accelerated draws and ultimately require increases by 2017.

SFO, which is located 48 miles to the west, is the dominant airport serving the bay area and is reaching its historical market share of bay area passenger traffic. At some point SFO will begin to experience congestion, meaning SJC is well placed to pick up the overflow. Over time, this should help the airport to bring down leverage and improve financial flexibility. In addition, the airport is in the process of developing an RFP for the private development of 44 acres on the Westside of the airport. Management is expecting an additional $1 million to $2 million in additional annual revenue once a developer has been selected.

SJC's 2013-2017 capital plan totals $347 million, of which $215 million is allocated for 2013 and is funded by the Revenue Bond Proceeds and PFC funds.

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Additional information is available at 'www.fitchratings.com'. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

Applicable Criteria and Related Research:

--'Rating Criteria for Infrastructure and Project Finance', July 12, 2012;
--'Rating Criteria for Airports', Nov. 28, 2011.

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