



MEMORANDUM

DATE: 5/24/2013

TO: Mayor and Council Members

FROM: Richard Miranda
City Manager

SUBJECT: Fitch Rating General Obligation, Highway User Revenue Fund, and Water Obligations Ratings

Honorable Mayor and Council Members,

Fitch Rating issued their ratings on the upcoming General Obligation (GO), Highway User Revenue Fund (HURF) and Water Obligations bonds. The rating level did not change for any of the bonds, but Fitch lowered the outlook on the GO bond from stable to negative. The rating and outlook applies to the new issue and all outstanding GO and Certificates of Participation (COPs) debt.

The report recognized the City's fiscal improvements, such as cost cutting and liquidity levels, "city's cost cutting efforts have been notable"; however, the ongoing structural imbalance is a major factor in the outlook change. The report states: "Maintenance of the current rating level is predicated on the city's ability over the next two years to develop and implement a credible plan to close its chronic budget gap in a reasonable timeframe and with recurring measures".

The rating reports are attached to this memorandum. Fitch, as is standard protocol, issued a press release regarding the rating and outlook change.

We expect ratings from Standard and Poor's and Moody's shortly, which will be communicated to you when they are received.

RM/KG/jw

Attachments:

Fitch GO Rating Letter

Fitch HURF Rating Letter

Fitch Water Obligations Letter



Fitch Rates Tucson, AZ GOs 'AA'; Outlook to Negative

Ratings Endorsement Policy

23 May 2013 4:06 PM (EDT)

Fitch Ratings-Austin-23 May 2013: Fitch Ratings assigns an 'AA' rating to the following city of Tucson, Arizona (the city) general obligation bonds (GOs):

--\$20 million GO bonds, tax-exempt series 2012-A (2013);
--\$26.7 million GO refunding bonds, federally taxable/State of Arizona tax-exempt series 2013B.

Both series are scheduled for a negotiated sale the week of June 10. Proceeds from series 2012-A (2013) bonds will finance street improvements in the city. Series 2013B proceeds will be used to refund outstanding GOs for annual interest savings.

In addition, Fitch affirms the following ratings:

--\$209.1 million GO bonds outstanding (pre-refunding) at 'AA';
--\$266.5 million certificates of participation (COPs) outstanding at 'AA-'.

The Rating Outlook is revised to Negative from Stable.

SECURITY

The GO bonds are secured by an unlimited ad valorem tax levied against all taxable property in the city. The COPs are secured by lease payments from the city to the trustee, subject to annual appropriation by the city.

KEY RATING DRIVERS

ONGOING FINANCIAL CHALLENGES: Projected fiscal 2013 results will reverse most of the buildup in reserves gained over the past three years. A structural imbalance persists, driven primarily by increasing outlays for employee benefits and the recent drop in economically sensitive revenues.

LIQUIDITY CONCERNS: Operating liquidity, while improved, remains weak and a credit concern.

MANAGEABLE DEBT; WEAK PENSION FUNDING: Debt levels remain affordable and the pace of GO and COP debt repayment is well above average. All three pension plans for Tucson employees are underfunded, and contributions for the state-sponsored police and fire plans are very high.

ECONOMIC RECOVERY UNDERWAY: A number of indicators suggest Tucson's economy is in the early stages of recovery. The regional economy remains diverse and relatively stable, with a good mix of higher education, military and government employment.

RATING SENSITIVITIES

ABILITY TO RESOLVE IMBALANCE: Maintenance of the current rating is predicated on the city's ability over the next two years to develop and implement a credible plan to close its chronic budget gap in a reasonable timeframe and with recurring measures.

CREDIT PROFILE

Tucson is located in southern Arizona and is the state's second largest city, with an estimated population of 525,000.

FINANCES PRESSURED

The current fiscal 2013 projection is for a general fund operating loss (after transfers) of roughly \$16 million, which will erase most of the buildup in reserves that occurred from fiscal 2010-2012. The expected loss occurs despite improvement in economically sensitive revenues - both local sales tax and state shared revenues are projected to register gains for the year.

Spending pressures continue, despite a concerted effort in recent years to curb outlays. General fund spending declined by more than 15% from fiscal 2009 to fiscal 2012, but increasing personnel costs (led by pension contributions) contributed to a spending increase and subsequent anticipated operating loss in fiscal 2013. The estimated fiscal 2013 year-end unrestricted general fund balance is 9% of spending, which Fitch considers somewhat weak given the volatility of the city's revenue base.

Liquidity remains weak despite some improvement in fiscal 2012; general fund cash and investments at year-end totaled roughly \$15 million or about 15 days of spending. This amount is down from a recent peak of \$87.9 million in fiscal 2007.

Tucson relies heavily on economically sensitive sales tax and state shared revenues for operations, and the weakness in these revenue sources during the recession has been a major contributor to the city's financial pressures. Local sales tax revenues typically make up roughly 40% of general fund revenues, and they slid by more than \$35 million (or 18%) from fiscal 2007-2010. State shared revenues, which make up roughly 25% of general fund revenues, registered a steep 28% decline from fiscal 2008-2012.

Local sales tax receipts registered a modest gain in fiscal 2011 and a stronger 5% increase in fiscal 2012. State shared sales tax revenue climbed a comparable amount. This improvement, along with recurring budget adjustments, offset continued weakness in state shared income tax revenue and contributed to the improved operating results in fiscal 2011 and 2012. Locally generated revenue gains continue in fiscal 2013, with sales taxes expected to increase another 4.5% from the prior year.

The city's cost cutting efforts have been notable, including the elimination of nearly 1,100 positions (20%) since fiscal 2009, salary freezes, benefit adjustments, city-wide department spending cuts, and various revenue enhancement measures. The proposed fiscal 2014 budget contains another gap of roughly \$15 million and includes modest pay increases for city employees. Local sales tax revenues are budgeted for another 5% increase.

The city plans to close the budget gap with a debt restructuring - one of several one-time measures used to close budget gaps in recent years; other measures, all evidence of the ongoing structural imbalance, have included use of reserves and asset sales. The city also is pursuing additional revenue sources, including the annexation of a commercial tract that contains an auto mall and a program to identify unlicensed businesses in the city that are not paying city sales tax and bring them into compliance.

DEBT MODERATE; PENSION FUNDING WEAK

Including street and highway user revenue debt and COPs, both direct and overall debt levels of the city are moderate. In addition, amortization of tax supported debt is well above average at nearly 85% retired in 10 years despite recent debt restructurings. The new-money series of GO bonds represent the first installment of \$100 million narrowly approved by voters last year for street improvements. The GO refunding bonds will refinance \$23.8 million of outstanding GO bonds for annual savings; the debt repayment schedule is not extended with the refunding.

The city maintains a single-employer pension program for non-uniformed personnel, and the city and uniformed staff contribute to state-sponsored public safety retirement programs for police and fire retirees. The city's plan had a funded ratio of 64% as of June 30, 2012, and using a more conservative 7% investment rate assumption the estimated funding level drops to a weaker 59%. The public safety retirement plans were each roughly 50% funded as of June 30, 2012; the funding levels drop to only about 45% using a 7% investment assumption.

Fitch notes the weak funding levels for all programs as a negative credit factor. The public safety plans are hampered by a less than one-to-one ratio of active-to-retired employees. Contribution rates for both plans are very high, and further anticipated increases will maintain pressure on the city's finances. The city recently made adjustments to the local non-uniformed plan (which is the largest of the three) that are projected to stabilize contribution amounts and improve the funding ratio over time.

In addition, the city contributes to post-employment medical benefits on either a percentage of premium basis or a flat-rate basis (depending on certain retirement program parameters), and finances these costs on a pay-go basis. Total carrying costs for fiscal 2012 (debt and benefit contributions) represented 21% of governmental spending.

ECONOMIC RECOVERY UNDERWAY

Tucson is the second largest city in Arizona. Growth of the city's residential base has slowed from its peak in 2001, when it recorded 3,800 single-family home permits; only 360 new housing permits are projected for fiscal 2013, but that number is up from 240 issued in fiscal 2011. Home prices also are showing improvement, with the most recent median and average sale prices registering double-digit percentage increases from a year ago.

Services, military, higher education and government are the area's prominent employment sectors. The military presence in the Tucson area is substantial with the U.S. Army Intelligence Center, Fort Huachuca, and Davis-Monthan Air Force Base. Public sector employment is led by state and local government agencies and public and higher education, including the University of Arizona main campus, which employs roughly 12,000. Raytheon Missile Systems is the largest private employer in Tucson, also with a staff of 12,000. Management and local media report that the anticipated effects of federal sequestration on the Tucson economy are expected to be manageable, but with the large number of government and civilian contract workers in the local workforce some effect is likely.

Public and private investment in downtown Tucson has accelerated in recent months, due in part to the new street car rail system that will extend from downtown to the university campus (scheduled to begin operations in 2014). Management reports nearly \$800 million invested in various projects since 2008, with another \$90 million projected for 2014.

Unemployment levels historically have been below those of the state and nation, and the most recent monthly numbers are consistent with that trend. The March 2013 rate of 7.3% was down from 8.1% recorded in the same period last year, and was below both the state (7.8%) and U.S. averages (7.6%) for the month. However, local employment totals were down for the 12-month period ending in March, suggesting some departures from the workforce.

Contact:

Primary Analyst
Steve Murray
Senior Director
+1-512-215-3729
Fitch Ratings, Inc.
111 Congress Ave., Suite 2010
Austin, TX 78701

Secondary Analyst
Julie Seebach
Director
+1-512-215-3740

Committee Chairperson
Amy Laskey
Managing Director
+1-212-908-0568

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight, and the National Association of Realtors.

Applicable Criteria and Related Research:

--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

Applicable Criteria and Related Research:

Tax-Supported Rating Criteria
U.S. Local Government Tax-Supported Rating Criteria

Additional Disclosure

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Fitch Rates Tucson, AZ's Sr Lien Highway User Revs 'AA'; Outlook Stable Ratings

Endorsement Policy
23 May 2013 10:36 AM (EDT)

Fitch Ratings-Austin-23 May 2013: Fitch Ratings has assigned an 'AA' rating to the following bonds of Tucson, Arizona:

--\$34.3 million senior lien street and highway user revenue refunding bonds, tax-exempt series 2013A;
--\$23.2 million senior lien street and highway user revenue refunding bonds, federally taxable/State of Arizona tax-exempt series 2013B.

The bonds are scheduled for a negotiated sale the week of June 10th. Proceeds will be used to refund outstanding senior lien and junior lien street and highway user revenue bonds for near-term savings.

In addition, Fitch affirms the following ratings:

--\$44.9 million in outstanding senior lien street and highway user revenue bonds (pre-refunding) at 'AA';
--\$65.4 million in outstanding junior lien street and highway user revenue bonds (pre-refunding) at 'AA-'.

The Rating Outlook is Stable.

SECURITY:

The senior lien bonds are secured by a priority lien on highway user taxes and other taxes, fees and charges collected by the state and returned to the city for street and highway purposes. The junior lien bonds are secured by a subordinate lien on the same pledged revenue stream.

KEY RATING DRIVERS:

SOUND COVERAGE, REVENUE GROWTH: Debt service coverage remains solid, despite a downturn in revenues and state re-direction of highway monies during the recession. Pledged revenues are on track for a 10% increase in fiscal 2013, which will be the first positive year-over-year result since fiscal 2008.

NO FURTHER BORROWINGS PLANNED: The city has no remaining highway user revenue bond authorization, and no plans to return to voters in the near term for additional authorization.

ADDITIONAL STREET FUNDING AUTHORIZED: Tucson voters last year narrowly approved a \$100 million general obligation (GO) bond authorization for street projects, eliminating the need for future restructurings of highway user debt (after this offering). These borrowings have been done recently to free up money for pay/go street projects.

RATING NOT CAPPED BY GO: Fitch believes pledged taxes fall within the definition of 'special revenues' under Chapter 9 of the U.S. Bankruptcy Code; therefore, the rating is not capped by the city's GO rating.

RATING SENSITIVITIES:

REVERSAL OF REVENUE GAINS: Renewed economic weakness in Arizona likely would lead to another decline in pledged revenues, which would pressure debt service coverage on Tucson's highway revenue bonds. Such weakness also may prompt the Arizona legislature to resume its recent practice of diverting highway revenues for related state program needs in response to recessionary pressures and ongoing state budgetary challenges. This practice also reduced the pledged revenue stream.

CREDIT PROFILE

Tucson is located in southern Arizona and is the state's second largest city with an estimated population of 525,000.

SOUND DEBT SERVICE COVERAGE

Coverage remains healthy despite a decline in pledged revenues from fiscal 2008-2012, due to weak economic conditions that impacted gasoline tax and motor vehicle registration and license fees. Revenues also were affected by the state legislature's periodic re-allocation of monies into and out of the Arizona Highway User Revenue Fund (from which funds are distributed to counties, cities and towns for street-related projects).

Another factor that has affected Tucson's highway user revenue stream is the population and point of origin consumption-driven distribution formula for these revenues. Tucson has experienced less rapid population growth than other Arizona cities in recent years, which contributed to the drop in revenue collections for the city.

Fiscal 2012 pledged revenues of \$37.2 million represent a sizable 25% decline from fiscal 2008 totals. Using these audited fiscal 2012 revenues, maximum annual debt service (MADS) coverage on both senior lien bonds and all highway user revenue bonds (including the \$20.7 million junior lien bonds outstanding after this transaction) remains sound at 2.1x. The coverage climbs to 2.35x using fiscal 2013 projected revenues of \$40.8 million. If realized, this total would represent a nearly 10% increase from the prior year.

ADDITIONAL STREET FUNDING APPROVED

Tucson has no street and highway user revenue bonding authority remaining, and the city has no immediate plans to seek additional voter authorization. As has been done several times recently, the series 2013 bonds will defer principal repayment scheduled for fiscal 2014 to provide funds for city street and highway capital projects. Despite these restructurings, the pace of debt retirement remains rapid--all highway user bonds are amortized by 2022.

Tucson voters last year approved \$100 million in GO bond authorization for street projects. Management reports that this new funding source will eliminate the need for any further highway user debt restructurings for near-term pay/go funding.

PLEGGED REVENUE COMPONENTS

Highway user tax revenues consist of motor vehicle fuel taxes, motor vehicle registration fees, motor vehicle licenses taxes, motor carrier fees, motor vehicle operator's license fees, and other miscellaneous fees and revenues. Highway user tax revenues are collected by the state and deposited into the state highway user fund until distributed.

Arizona cities and towns receive 27.5% of highway user tax distributions. One-half is distributed to cities and towns on the basis of population in proportion to all cities and towns in the state. The remaining one-half is distributed, first, on the basis of county origin of sales of motor vehicle fuels within the state, and second, to cities and counties on the basis of population in proportion to all cities and towns in the county. Arizona cities with populations exceeding 300,000 (including Tucson) also receive a 3% allocation for certain street and highway purposes. Due to the improving economic conditions in Arizona, the legislature reportedly has no plans to divert highway user revenues for other programs in fiscal 2014 to alleviate budget pressures. Fitch's expectation is that any future state diversions would not be large enough to materially affect coverage on Tucson's highway user revenue bonds.

SATISFACTORY LEGAL PROVISIONS

Legal provisions provide adequate bondholder protections. They include an additional bonds test of 2.0x MADS for senior lien bonds and a 1.5x MADS ABT for junior lien bonds. Following the required deposits for debt service payments, surplus highway user revenues are used by the city for capital projects and for staffing, maintenance and contractual expenses related to streets and highways.

Contact:

Primary Analyst
Steve Murray
Senior Director
+1-512-215-3729
Fitch Ratings, Inc.
111 Congress Ave., Suite 2010
Austin, TX 78701

Secondary Analyst
Julie Seebach
Director
+1-512-215-3740

Committee Chairperson
Amy Laskey
Managing Director
+1-212-908-0568

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight, and the National Association of Realtors.

Applicable Criteria and Related Research:
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--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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U.S. Local Government Tax-Supported Rating Criteria

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Fitch Rates Tucson, AZ's Water Revs 'AA'; Outlook Stable Ratings Endorsement Policy

22 May 2013 12:56 PM (EDT)

Fitch Ratings-Austin-22 May 2013: Fitch Ratings assigns the following rating to the city of Tucson, Arizona's (the city) bonds:

--Approximately \$23.8 million water system (the system) revenue obligations, series 2013 'AA'.

The obligations are scheduled to sell via negotiated sale the week of June 3. Bond proceeds will be used to fund improvements and extensions to the city's water system and pay costs of issuance.

In addition, Fitch affirms the rating on the city's outstanding bonds as follows:

--\$452 million in outstanding water system revenue bonds and obligations at 'AA'.

The Rating Outlook is Stable.

SECURITY

The bonds are payable from a pledge of and first lien on the net revenues of the system on parity with the outstanding water revenue bonds and obligations.

KEY RATING DRIVERS

ADEQUATE FINANCIAL METRICS: The financial profile of the city's water system has shown some improvement in the last three fiscal years, particularly in terms of liquidity. Although still below Fitch's category 'AA' rating median levels, liquidity is projected to gradually improve over the forecast period. Total debt service coverage (DSC) is projected to remain above 1.4x.

RISING DEBT PROFILE: Despite rapid amortization, sizeable debt plans will weaken the system's debt profile over the next five years, although system leveraging is expected to remain acceptable for the rating level.

SUFFICIENT WATER SUPPLIES: Extensive planning has ensured water supply is adequate to meet long-term needs.

AFFORDABLE RATES: System rates are affordable at 0.8% of median household income (MHI).

LOW AREA WEALTH LEVELS: Service area wealth levels are below average, but are offset in part by the diversity of the economy and relatively affordable cost of living.

RATING SENSITIVITIES

MAINTENANCE OF FINANCIAL PROFILE: Pressure on DSC or liquidity would likely lead to negative rating action given that margins are already relatively thin for the rating level.

INCREASED DEBT BURDEN: Increased debt beyond expected levels could pressure the rating given the already weak debt profile.

CREDIT PROFILE

ADEQUATE FINANCIAL PROFILE

Financial performance came under pressure in fiscal years 2008 and 2009 as a result of modest rate hikes that did not keep pace with rising operating costs and a steep decline in impact fee collections. Large outlays of working cash and debt issuance for capital projects also exerted pressure on the system. As a result, fiscal 2009 ended with just \$2.5 million in cash on hand, or 11 days, down from 132 days in fiscal 2006.

In response, the city imposed rate hikes that averaged 8.6% annually from fiscal 2009 through 2013 to help ultimately boost coverage levels to 1.6x on a senior lien basis and 1.5x on an all-in basis in fiscal 2012. Fitch notes that the city has a policy of maintaining 1.75x senior-lien DSC on a cash basis, in accordance with the master indenture. Using this calculation method, senior lien DSC was 1.9x in fiscal 2012 and the city has consistently adhered to this policy.

Reserves, though still low for the rating level, also improved to 90 days cash on hand in fiscal 2011 and to 127 days cash on hand in fiscal 2012. An 8.3% rate increase is in effect for fiscal 2013 and annual rate hikes of 8.3% are projected for the following five fiscal years.

Given the annual declines in water consumption since fiscal 2008, the rate increases are forecast to just maintain DSC at similar levels through the forecast period. Fitch estimates reserves will gradually increase to over 200 days cash on hand by fiscal 2016 as the city plans to debt-finance a substantial portion of its capital plan.

INCREASING DEBT BURDEN

The debt load per customer continues to increase as the system implements its comprehensive capital improvement plan (CIP) to ensure ample water supply and treatment

capacity for its service area. For fiscal years 2013 - 2017, the CIP totals \$340 million, favorably a decrease from the \$410 million CIP put forth in 2009. The city expects to issue debt for 58% of the CIP which will help to somewhat preserve working capital and liquidity. Outstanding debt per customer is projected to remain above Fitch's category 'AA' rating medians given anticipated future debt plans.

ADEQUATE WATER SUPPLY

The water system provides potable water to about 709,000 residents, or 85% of the population within the Tucson metropolitan area. Potable water supplies are derived from groundwater and renewable Colorado River water delivered via the Central Arizona Project (CAP).

Tucson's Clearwater Renewable Resource Facility (Clearwater) diverts all of the city's purchased CAP water to recharge basins and then recovers a blend of CAP and native groundwater for treatment and distribution.

Clearwater, which began operations in 2001, is a critical component of Tucson's future water supply plans. With completion of phase 2, which is under way, officials anticipate that the system will provide the vast majority of potable supplies, allowing the city to minimize its groundwater pumping. The city also maintains sizable recycled water distribution capabilities.

SERVICE AREA

Tucson, located in south central Arizona, is the second largest city in the state. The economy is anchored by military, government, higher education, medical, and tourism enterprises. The city's unemployment rate, measured at 7.3% in March 2013, ranked slightly above the county (6.8%), although below state (7.8%) and national (7.6%) levels.

City wealth levels are 25% - 30% lower than those of the state and nation, but Fitch believes the credit risk is largely offset by the diversity of the economy and relatively affordable cost of living. Furthermore, despite the low area wealth levels and recent housing market downturn, collections for the system remain satisfactory, with approximately 5% of accounts in delinquent status at any one time and less than 1% reaching the point of service shut-off.

Contact:

Primary Analyst
Julie G. Seebach
Director
+1-512-215-3740
Fitch Ratings, Inc.
111 Congress, Suite 2010
Austin, TX 78701

Secondary Analyst
Steve Murray
Senior Director
+1-512-215-3729

Committee Chairperson
Amy Laskey
Managing Director
+1-212-908-0568

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's U.S. Municipal Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:

--'Revenue-Supported Rating Criteria' (June 12, 2012);
--'U.S. Water and Sewer Revenue Bond Rating Criteria' (Aug. 3, 2012);
--'2013 Water and Sewer Medians' (Dec. 5, 2012);
--'2013 Outlook: Water and Sewer Sector' (Dec. 5, 2012).

Applicable Criteria and Related Research:

Revenue-Supported Rating Criteria
U.S. Water and Sewer Revenue Bond Rating Criteria
2013 Water and Sewer Medians
2013 Outlook: Water and Sewer Sector

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