Moody's Investors Service

New Issue: Moody's assigns A1 to Philadelphia, PA's $400M 2015 Water and Sewer Revenue Bonds; outlook stable

Global Credit Research - 19 Mar 2015

Affirms A1 on outstanding debt; A1 applies to $1.85B of debt, post-sale

PHILADELPHIA (CITY OF) PA WATER AND SEWER ENTERPRISE
Combined Water & Sewer Enterprise
PA

Moody's Rating

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Moody's Outlook STA

NEW YORK, March 19, 2015 --Moody's Investors Service assigns a rating of A1 to the Philadelphia Water and Sewer Enterprise, PA's $300 million Series 2015A and $100 million Refunding Series 2015B Water and Wastewater Revenue Bonds. The outlook is stable. Concurrently, Moody’s affirms the A1 rating on the utility’s outstanding water and sewer revenue bonds. Post-sale, the utility will have $1.85 billion of senior lien revenue bonds (excluding state revolving fund loans) outstanding.

SUMMARY RATING RATIONALE

The A1 rating incorporates the water department's large and diverse service area, stable operating profile, narrow but consistent debt service coverage, and manageable debt burden. The rating also recognizes the utility’s heavy capital needs including those associated with a Commonwealth DEP consent order and agreement, implying a likelihood of increasing debt and potential pressure on coverage levels unless the city continues its solid history of consistent annual rate increases.

OUTLOOK

The stable outlook reflects the city’s willingness to continue investing in its system, increasing user rates annually, and maintaining ample operating liquidity. The city’s ability to maintain adequate coverage levels will be a key factor in its rating going forward.

WHAT COULD MAKE THE RATING GO UP

Improvement in debt service coverage to levels more consistent with peers

Ongoing improvements in service base

WHAT COULD MAKE THE RATING GO DOWN
Failure to increase rates commensurate with incremental increases in debt service

Significant narrowing of debt service coverage from current levels

STRENGTHS

Large and diverse service area

Solid liquidity

Demonstrated willingness to increase user rates

CHALLENGES

Commonwealth DEP consent order and agreement implying likely increase in capital needs

Heavy capital investment requirements

Debt service coverage somewhat narrower than peers

RECENT DEVELOPMENTS

The utility reported a solid year in 2014, with Moody's-adjusted debt service coverage of approximately 1.4 times, and maintenance of ample operating liquidity with 289 days cash on hand.

The newly formed independent rate-setting board is yet to propose its first rate schedule. The existing rate schedule runs through 2015 and remains in effect.

DETAILED RATING RATIONALE

SERVICE AREA AND SYSTEM CHARACTERISTICS: LARGE AND DIVERSE SERVICE AREA

The Philadelphia Water and Sewer Enterprise (the "water department") serves a large and diverse urban and suburban base consisting mainly of the City of Philadelphia (A2 stable).

The water department operates a water system with about 470,000 accounts. The system's three treatment plants treat water from the Delaware and Schuylkill Rivers, and distribute it to a population of about 1.76 million (the city plus around 211,000 people in the suburbs).

The wastewater system serves a larger area: the system's 530,000 accounts encompass a population of more than 2.3 million people, including 10 mostly suburban wholesale customers. The wastewater system's three treatment plants all discharge into the Delaware River.

Philadelphia's demographic profile is below-average: the median family income in the city is equal to 72% of the US median, and the poverty rate is high at 26.5%. As of the end of 2014, the city unemployment rate was 6.2%, relative to the US rate of 5.6%.

We use Philadelphia's demographic statistics as a proxy for the water department's socioeconomic profile; however, the overall profile is stronger than these numbers, as it includes wealthier suburbs in Montgomery (Aa1 stable), Bucks (Aaa stable), and Delaware (Aa1) Counties.

Further, the city has a substantial institutional presence that provides stability to the local economy and to consumption. Among the water department's 10 largest customers, aside from the city itself and the city's school district and public housing authority, are the University of Pennsylvania (Aa2 positive), the federal government of the United States (Aaa), Honeywell Inc. (A2 stable), Temple University (Aa3 negative), and the University of Pennsylvania Health System (Aa3 stable).

The city has been growing, and the outlook for the water department's user base is favorable overall.

DEBT SERVICE COVERAGE AND LIQUIDITY: NARROW BUT CONSISTENT DEBT SERVICE COVERAGE; AMPLE LIQUIDITY

The city's commitment over the past decade to increasing rates consistently has led to debt service coverage that is stable, although narrower than most peers.
In 2014, the city's Moody's-adjusted net revenues covered debt service by approximately 1.4 times; coverage has been between 1.3 times and 1.6 times in each of the past five years. In this report, we evaluate coverage based on Generally Accepted Accounting Principles, with a few adjustments; the water department also reports figures on a "legally enacted" basis that is more cash-focused. These two bases often differ year-to-year. According to the city's calculation, senior-lien coverage on the legally enacted basis in 2014 was 1.22 times.

A key challenge facing the water department going forward is the prospect of higher debt because of capital needs, including those under a state consent order (see debt section below).

The water department's financial forecasts show coverage of around 1.3 times most years.

Liquidity

The water department's liquidity is ample, and a key strength for its credit quality. Operating cash balances at the end of fiscal 2014 totaled roughly 289 days cash on hand, which is above-average. These cash balances include unrestricted cash (73 days) plus cash in two accounts: the residual fund and the rate stabilization fund. As the city can transfer cash from either of these two funds back into operations, we consider it to be usable liquidity and include it in days cash on hand.

The city's long-term projections show cash remaining above 225 days through 2021.

DEBT AND LEGAL COVENANTS: DEBT BURDEN LIKELY TO GROW; WEAK LEGAL COVENANTS

The water department's roughly $2 billion of debt is manageable, but likely to grow due to heavy capital needs. The existing debt structure is front-loaded, which can mitigate future increases in expected debt service.

The current debt portfolio is equal to 2.8 times revenues, and net funded debt is equal to 69% of net fixed assets, which is moderate.

The department entered into a consent order with the Pennsylvania Department of Environmental Protection in June 2011 to address stormwater overflows. The 25-year agreement is expected to cost $2.4 billion (in nominal dollars), and will focus primarily on converting impervious surfaces into green space to better absorb stormwater and reduce overflows.

The department's six-year capital improvement program, which reflects the consent order as well as other capital needs, totals $1.8 billion, and is 80% debt-funded. Estimated borrowing of more than $250 million a year implies a likely increase to the water department's debt burden.

The water department's existing debt service faces a small cliff in 2018, as debt service decreases from more than $200 million in 2018 to $160 million in 2019. This gap is likely to be filled with new debt service from the department's debt funding.

Debt Structure

The debt portfolio consists mostly (86%) of fixed-rate bonds, but also includes Pennsylvania Infrastructure Investment Authority (PennVest) loans (8%) that are on parity with the senior lien bonds, and two series of variable rate bonds (6%). Of the $112 million of variable rate debt, $60.4 million is unhedged. The remainder is backed by a liquidity facility and a swap.

Debt-Related Derivatives

The department is party to a fixed-payer swap to hedge $51.6 million of its variable rate debt

Legal covenants

The legal covenants governing the department's senior lien bonds are moderately weak. The senior lien rate covenant is 1.2 times, and the total debt service covenant is 1 times (although the department currently has no subordinate debt). However, the indenture permits the inclusion of transfers from the rate stabilization fund in net revenues, meaning the department could use prior-year surpluses to meet its covenant.

The additional bonds test is to comply with the rate covenant.

The debt service reserve fund requirement is maximum annual debt service; additionally, the department by ordinance requires that any surety in a debt service reserve fund be rated Aa or higher.
A $67 million surety policy with Assured Guaranty Municipal Corp. (A2 stable) is not eligible to be included in the reserve requirement. Thus, the department has a debt service reserve fund cash-funded at MADS, plus the surety policy. Effectively, the debt service reserve fund is funded at 1.3 times MADS.

MANAGEMENT AND GOVERNANCE: STRONG MANAGEMENT; NEW RATE-SETTING BOARD

The department's management has increased rates consistently, and the department keeps a healthy amount of operating cash on hand. The department's financial projections run through 2021.

Until last year, the water department commissioner had the authority to set rates, and raised rates consistently: user rates increased at least 5% each year since 2009. The commissioner also established rates according to a four-year schedule, with the latest rates scheduled through 2015. Last year, the city council established an independent rate board with authority over rates; the new board's willingness to increase rates sufficient to maintain adequate coverage levels will be a key factor in the water department's rating going forward.

KEY STATISTICS

- Type of System: Water and Sewer
- Asset Condition (remaining useful life): 23 years
- System Size (O&M): $354.7 million
- Service Area Wealth, Median Family Income (City of Philadelphia): 72.4%
- Total Debt Service Coverage (2014): 1.4x
- Days Cash on Hand: 289 days
- Debt to Operating Revenues: 2.89x
- Rate Covenant: 1.2x senior lien
- Debt Service Reserve Requirement: MADS

OBLIGOR PROFILE

The Philadelphia Water Department provides water and sewer treatment service to the City of Philadelphia and some of its surrounding suburbs.

LEGAL SECURITY

The department's bonds are secured by a senior lien on the net revenues of its water and sewer systems. The bonds are on parity with PennVest state revolving fund loans. The department currently has no subordinate debt.

USE OF PROCEEDS

Proceeds from the 2015A bonds will be used to fund capital investments. Proceeds from the 2015B bonds will be used to currently refund a portion of the department's 2005A bonds and advance refund a portion of its Series 2007A bonds.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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