Fitch Rates Philadelphia, PA's $185MM 2010C & D Water & Sewer Revs 'A+'; Outlook Stable

Ratings
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Fitch Ratings-New York-12 July 2010: Fitch Ratings takes the following action on Philadelphia, Pennsylvania's revenue bonds (the city):

--$11.2 million water and wastewater system revenue bonds, series 2010C, rated 'A+'.
--$173.8 million water and wastewater system revenue bonds (Federally Taxable - Build America Bonds - Issuer Subsidy), series 2010D, rated 'A+'.

Fitch also affirms the 'A+' rating on Philadelphia's approximately $1.6 billion in outstanding parity water and wastewater system revenue bonds.

The Rating Outlook is Stable.

The series 2010C and 2010D bonds are scheduled for negotiated sale on July 26, 2010. Proceeds from the series 2010C bonds, together with a cash withdrawal from the system's rate stabilization fund (RSF), will fund the cost to terminate a 2007 forward swap agreement. Proceeds from the series 2010D bonds will finance capital improvement projects of the city's combined water and wastewater system (the system). The city may issue all of the bonds as tax-exempt if it is determined a more cost effective option at the time of pricing the bonds.

RATING RATIONALE:

--The system benefits from sole rate-setting authority independent of outside approval.
--The system maintains an ample water supply and treatment capacity for the foreseeable future.
--Although the system's multiyear capital improvement plan (CIP) is moderately sized relative to the overall size of the system and its large customer base, the size and scope of the plan is expected to grow as regulatory projects develop. Given the system's growing debt levels and rate structure, Fitch believes the affordability of mandated projects will become increasingly challenging for the system and its rate payers.
--The system's credit characteristics include historically weak collection rates, narrow debt service coverage levels, weak legal provisions, and a high amount of water loss.

KEY RATING DRIVERS:

--Maintenance of the system's currently healthy RSF and overall liquidity will be critical to ensuring an adequate operating cushion, given the weak collection rates, typically slim debt service coverage levels, and the expected rise in capital demands.
--Fitch expects the system to manage rates sufficient enough to fund costly mandates and maintain current operating margins.

SECURITY:

The bonds are secured by net operating revenues of the system.

CREDIT SUMMARY:

The system serves approximately 480,000 retail accounts throughout the city and in neighboring suburban areas pursuant to long-term wholesale agreements for water and sewer service. The system's stable customer base consistently shows little growth. Average daily water demand is comfortably below permitted water supply and treatment capacity at all facilities, and daily wastewater flows are well within treatment plant permit limits. No concentration exists among retail and wholesale customers, and user charges are moderately affordable despite the city's income levels, which rank well below regional, state and national figures. Annual rate hikes ranged between 4%-6.5% between fiscal years 2006 and 2010, and a 5% yearly increase for fiscals 2011 and 2012 has already been adopted. Legal provisions are below average, essentially requiring 1.2 times (x) coverage from net operating revenues (with the inclusion of cash in the RSF) of senior-lien debt

service and sum sufficiency of subordinate debt obligations and all required deposits. The additional bonds test is based on projected compliance with the rate covenant. Notwithstanding a prescribed annual transfer to the city, the system operates with a financial closed loop with all revenues and resources available to the system only.

Although offset by a high fixed cost burden related primarily to debt service, the system generates good operating margins despite historically weak collection rates of about 90%. Financial operations are adequate as management consistently budgets to meet the rate covenant. As such, the system's financial forecast through fiscal 2016 shows annual debt service coverage remaining at 1.2x. The narrow debt service coverage is balanced by the system's strong cash position driven primarily by the RSF.

Despite a draw of approximately $34.7 million in fiscal 2009, $147.6 million remained in the RSF by year-end, leaving the system with about 230 days of cash available for operations. The system's financial forecast through fiscal 2016 shows a substantial drawdown in the RSF to almost $48 million to support the maintenance of 1.2x coverage of debt service through the projection period. However, Fitch believes the system is likely to outperform its financial forecast given its demonstrated history of maintaining relatively strong cash reserves and generating solid operating margins. Mid-year results for fiscal 2010 showed a projected decline in the RSF of about $34.2 million, significantly less than the $51 million draw included in the system's adopted 2010 budget. More recent projections for fiscal year-end show a substantially smaller withdrawal from the RSF of about $8 million, due in large part to reduced interest costs on debt, lower than anticipated supply expenses, and savings from the city's pension deferral.

The system's proposed CIP for fiscal 2011-2016 totals slightly more than $1.24 billion, up almost $200 million over the prior year's CIP. Growth in the plan stems primarily from additional projects designed to reduce combined sewer overflows (CSOs) caused by wet weather events that are common among older systems. The regulatory projects are mandated by the state department of environmental protection (DEP) and are expected to grow in size and cost as the system's long-term control plan is reviewed by the DEP. Currently, slightly more than one-third of the CIP will address ongoing CSO projects. The balance of the plan addresses routine renewal and replacement needs, including replacement of aging water and sewer mains throughout the city. Almost 70% of capital financing for the CIP will be derived from revenue bonds, including a $135 million issuance authorized for fiscal 2014 and a $200 million borrowing planned for 2015. The balance of funding is expected to come from state loans and excess operating revenues and reserves.

Philadelphia, with an estimated population of about 1.5 million residents, benefits from its role as a regional economic center and a stable employment base weighted in the education and health care sectors and led by the University of Pennsylvania and Jefferson Health System as the largest private employers. Despite a slowing economy, commercial and retail development projects have continued, including the transitioning of the city's naval yard into a large private sector business park. However, despite the size and stability of its employment anchors, the city's unemployment rate, mirroring national trends, has experienced a notable increase over the past year, growing to 11% in April 2010 from a more moderate 8.8% one year prior. Income levels are also weak; almost one-fourth of the city's residents live at or below the poverty rate according to the U.S. Census Bureau.

These rating actions reflect the application of Fitch's current criteria which are available at 'www.fitchratings.com' and specifically include the following reports:

--'Revenue-Supported Rating Criteria' (Dec. 29, 2009);
--'Water and Sewer Revenue Bond Rating Guidelines' (Aug. 6, 2008).

Considerations for Taxable/Build America Bonds Investors

The following sector credit profile is provided as background for investors new to the municipal market.

Water and Sewer Utility Revenue Bonds:

Municipal water and sewer utilities in the U.S. are enduring natural monopolies that typically have autonomous rate setting ability and provide highly essential services. The bonds are secured by a pledge of net revenues generated by the water and/or sewer system; and typically include structural legal protections such as rate covenants, debt service reserve requirements, and anti-dilution tests. As such, the sector exhibits extremely strong credit characteristics with minimal defaults. Reflective of this strong performance, the average water and sewer revenue bond rating is 'A+' with 53% at or above 'AA-' and approximately 6% rated 'BBB+' or below. Those with low investment-grade or below-investment-grade ratings generally have substantial capital programs, a high degree of leverage or weak financial flexibility as reflected in low cash levels, narrow debt service coverage and/or limited rate-raising flexibility.

Contact: Christopher Hessenthaler +1-212-908-0773 or Ann Flynn +1-212-908-9152, New York.

Media Relations: Brian Bertsch, New York, Tel: +1 212-908-0549, Email: brian.bertsch@fitchratings.com.

Additional information is available at www.fitchratings.com.

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