FitchRatings

Fitch Rates Philadelphia, PA's $105.5MM Water & Sewer Revs 'A+'; Outlook Stable

Ratings Endorsement Policy
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Fitch Ratings-New York-31 December 2013: Fitch Ratings has assigned an 'A+' rating to the following Philadelphia, PA (the city) revenue bonds:

--Approximately $105.5 million water and wastewater revenue refunding bonds, series 2014A.

The city expects to sell the bonds in a negotiated sale the week of Jan. 14. Proceeds of the series 2014A bonds will refund a portion of the city's water and wastewater system (the system) outstanding parity debt for level interest savings.

In addition, Fitch affirms the following rating:

--$1.6 billion in outstanding water and wastewater revenue bonds at 'A+'.

The Rating Outlook is Stable.

SECURITY
The bonds and outstanding parity bonds are secured by a senior lien on combined net revenues of the city's water and sewer system. The 2014A bonds will have a cash funded debt service reserve funded at the maximum annual debt service amount.

KEY RATING DRIVERS

SOUND MANAGEMENT AND STABLE OPERATIONS: Financial performance is modest but satisfactory for the rating category. Operations typically generate narrow, but consistent debt service coverage levels that are somewhat mitigated by a sound level of liquidity and affordable rates.

ELEVATED DEBT LEVELS: Debt levels are moderately high and substantial additional borrowing plans are expected over the long-term. Leverage concerns are heightened by further increases in borrowings from recent projections provided by management.

LARGE CAPITAL PLAN: The capital program remains sizeable and will continue to be elevated for some time as a result of required consent order projects.

BELOW-AVERAGE ECONOMIC CHARACTERISTICS: The service area exhibits weak income levels and high unemployment, which contribute to chronically below-average collection rates.

AMPLE CAPACITY: Water supply and overall system treatment capacity are sufficient for the foreseeable future.

ESSENTIAL SERVICE: The city's combined water and wastewater system provides an essential service to a large and diverse service area.

RATING SENSITIVITIES

ACCELERATING CAPITAL AND DEBT PLANS: Continued escalation of debt levels to meet rising capital costs beyond what is currently included in the current six-year capital improvement plan (CIP) could pressure the rating.

POLICIZATION OF RATE RELIEF: Difficulty in implementing annual rate increases that keep pace with capital spending and provide a sufficient amount of pay-go revenues could lead to negative rating action. No immediate pressures are likely given an adopted rate package through fiscal 2015. Fitch expects the new rate-making board that will be formed in 2014 to take up the next rate case for implementation in fiscal 2016, which will provide an indication of future rate setting and capital funding strategies.

CREDIT PROFILE

LARGE, DIVERSE CUSTOMER BASE
The water system serves a diverse customer base consisting of all of the 1.5 million residents of the city as well as an additional 156,000 people in neighboring Bucks, Montgomery and Delaware Counties (Fitch rates Montgomery County's general obligation [GO] bonds 'AAA' with a Stable Outlook). Of the nearly 472,000 retail water customer accounts, the vast majority are residential and the 10 largest users account for just 12% of total billings.

The wastewater system serves a more expansive area that includes an estimated population of nearly 2.3 million people. In addition to retail service, the city maintains 11 wholesale agreements for wastewater service and two wholesale contracts for water service with customers outside of the city. In total, wholesale revenues accounted for less than 10% of total system revenues in fiscal 2012.

SUFFICIENT CAPACITY
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. Available water supplies from the Delaware and Schuylkill rivers are sufficient for the foreseeable future, although significant water loss through the city's delivery system persists. Unauthorized consumption was reduced by a notable 40% during the 1990s, but progress has since stalled as non-revenue water has averaged about 33% annually over the last five years.

Below-average collection rates continue to be a key credit concern. On a current basis annual collections typically average around 85%. However, delinquent collections are recovered through an enforcement process and property tax lien sales, increasing total collections to a more reasonable 98%. Management conservatively budgets for an 85% collection rate of current year revenues and a nominal percentage of delinquent charges.

SOUND FINANCIAL MANAGEMENT LEAD TO CONSISTENT OPERATING RESULTS
Financial operations are well managed, despite generally historically tight debt service coverage (DSC) levels. Management continues to budget to meet its bond required rate covenant of 1.2 times (x) senior annual debt service (ADS), although actual results typically outperform budgeted expectations, primarily as a result of the low collections assumptions. Net revenues covered all-in ADS by 1.5x in fiscal 2012 and available liquidity, which includes a rate stabilization fund (RSF), improved to nearly 300 days cash on hand. Both metrics are in-line with the rating. Unaudited results for fiscal 2013 indicate a slight but acceptable decline in DSC to 1.2x.

Affordable user charges provide the system with sufficient flexibility. Yearly rate increases have averaged a moderate 5% since 2002, leaving the average combined water and sewer bill currently equal to a moderate 1.6% of median household income (MHI). Including the city's stormwater fee levied according to the amount of impervious area a rate-payer owns, monthly charges rise to what Fitch considers above average at 2% of MHI. Nonetheless, the system's charges remain low in comparison to regional water and sewer systems.

Management's projected financial results through fiscal 2019 appear achievable in Fitch's view. Based on annual rate hikes of 4.5%, debt service coverage shows incremental improvement, driven in part by management's revised targeted minimum coverage level of 1.3x senior lien ADS. Financial projections include limited wage increases and moderate increases in operating expenditures. Sizeable operating surpluses included in the outer years of the forecast are projected, which could increase the RSF to a strong balance of $220.4 million compared to an estimated $161.4 million at the close of fiscal 2013. Fitch notes that future rate increases beyond fiscal 2015 will depend on the approval of the city's new ratemaking body.

NEW RATE SETTING BODY
Voters approved a November 2012 ballot measure that allows the city council to establish an independent rate making body responsible for setting water, sewer and stormwater charges. Rates were established historically by the city's water department, independent of any regulatory or political oversight.

As a result of the measure, an initial ordinance was introduced by the city council in April 2013 that would have established a five-member board and required certain prudent practices and standards in the establishment of rates. Specifically, the original ordinance would have required recurring revenues to be set to cover all flow of fund requirements without the application of any RSF monies, provide at least 20% of annual capital expenditures, with this amount increasing to 25% in fiscal 2019 and maintain a minimum of 120 days of working capital.

However, recent amendments made by the city council to the ordinance eliminated the provisions for pay-go for capital projects and working capital. The ordinance is now believed to be in its final form and is expected to become law in January 2014. Fitch expects the new ratemaking body will be selected and implemented in 2014, which would allow the regulatory body to be in place to consider rate increases included in the current forecast beyond fiscal 2015.

The recent amendments made to the ordinance raise some concern for Fitch given the system's escalating capital program and growing debt levels. It remains uncertain as to what extent the new regulatory body will be committed to reducing its reliance on debt issuance to fund capital needs and instead support a higher level of capital investment from rates.

ENVIRONMENTAL REGULATIONS DRIVE LARGE CAPITAL PROGRAM
After several years of negotiations, the Pennsylvania Department of Environmental Protection (PA DEP) and the city signed a consent order and agreement (the COA) in June 2011 requiring the city to substantially eliminate combined sewer overflows (CSOs) over the next 25 years. To comply with the COA, the city is employing its Green City, Clean Waters Program (the program), which will utilize largely green technologies to capture rainwater runoff that would otherwise infiltrate and overwhelm the system's sewer system. The system also offers a credit to customers willing to reduce the amount of impervious area on their property in favor of more green space.

Compliance with the COA will require the city to spend approximately $2.4 billion over the next 25 years. The program also includes wastewater treatment facility enhancements and pipe renewal and replacement. Fitch views the program favorably considering alternative strategies to mitigate CSOs, including the construction of tunnels and storage tanks, would have cost substantially more.

Reflecting the COA now in place, projected capital spending through fiscal 2020 totals $1.76 billion, with almost half of projected capital costs related to the COA and related needs. The current CIP is nearly 7% greater than the prior six-year plan, and has grown by an annual average of about 10% over the prior four years. Management's longer-term forecast of capital needs indicates additional, albeit modest growth in the 2016-2021 timeframe before a gradual reduction in capital costs begins. The cumulative projected capital spending has the potential to place downward pressure on the rating over the medium term, particularly if the system continues to pursue nearly 100% debt financing for the CIP.

LEVERAGED SYSTEM
Debt levels are elevated compared to similarly rated systems. Debt as a percent net plant (94%), debt to equity (10:1) and all-in debt service as a percentage of gross revenues (33%) has remained consistent with prior years, but is expected to increase going forward given almost 100% debt funding of the CIP.

Somewhat offsetting this concern is the slightly above average pay-out of existing debt relative to similarly rated systems as well as a steep drop-off in ADS currently scheduled from 2017 to 2020 that will allow future bond issuances to be structured around existing obligations. Nevertheless, Fitch expects, based on the current CIP and adjusting for principal amortization, a roughly 30% increase in the amount of debt outstanding by 2019.

ECONOMIC IMPORTANCE OFFSETS WEAK SOCIOECONOMIC INDICATORS
Philadelphia, as both a city and county and with an estimated population of over 1.5 million residents, benefits from its role as a regional economic center with a stable employment base weighted in the higher education and healthcare sectors. The city's October 2013 unemployment rate of 10.1% is notably higher in comparison to the broader metropolitan area (7.6%) and the state (6.8%). The city's poverty rate remains high at over 25%, and income levels on both a per capita and median household level are approximately 30% below the state and national averages. Socioeconomic indicators for the surrounding counties are notably stronger.

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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 and Black & Veach (Rate Consultants).

Applicable Criteria and Related Research:
--'Revenue-Supported Rating Criteria', June 3, 2013;
--'U.S. Water and Sewer Revenue Bond Rating Criteria', Aug. 3, 2013;
--'2014 Water and Sewer Medians', dated Dec. 12, 2013;
--'2014 Outlook: Water and Sewer Sector', dated Dec. 12, 2013.

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2014 Outlook: Water and Sewer Sector
Revenue-Supported Rating Criteria
U.S. Water and Sewer Revenue Bond Rating Criteria
2014 Water and Sewer Medians

Additional Disclosure
Solicitation Status