Moody's Investors Service

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New Issue: Philadelphia (City of) PA

MOODY'S ASSIGNS A3 RATING TO CITY OF PHILADELPHIA'S $247.54 MILLION WATER AND WASTEWATER REVENUE REFUNDING BONDS; OUTLOOK REMAINS STABLE

AFFIRMATION OF RATING APPLIES TO APPROXIMATELY $1.82 BILLION IN PARITY DEBT, INCLUDING THIS ISSUE

Philadelphia (City of) PA Wtr. & Sew. Ent.
Water/Sewer
PA

Moody's Rating

ISSUE		RATING
Water and Wastewater Revenue Refunding Bonds, Series 2007A		A3
Sale Amount	$188,635,000	
Expected Sale Date	03/09/07	
Rating Description	Revenue	
Water and Wastewater Revenue Refudning Bonds, Series 2007B		A3
Sale Amount	$58,625,000	
Expected Sale Date	03/09/07	
Rating Description	Revenue	

Moody's Outlook Stable

Opinion

NEW YORK, Mar 5, 2007 -- Moody's Investors Service has assigned an A3 underlying rating and stable outlook to the City of Philadelphia's $188.64 million Water and Wastewater Revenue Refunding Bonds, Series 2007A and $58.6 Series 2007B. At this time, Moody's has affirmed the A3 and stable outlook to the City's approximately $1.82 billion in outstanding water and wastewater revenue debt, including this issue. The medium-grade rating reflects the system's strong management, improved financial operations, significant cash balances in the Rate Stabilization Fund, ongoing improvements in environmental compliance, and an above-average amount of debt. Although conservative projections show that management may draw on the Rate Stabilization Fund over the next several years to meet the 1.2 coverage mandated by the rate covenant, recent improvement to financial operations, as well as anticipated ongoing rate increases, will likely mitigate the dependence on this fund. The closed-loop system is effectively segregated financially from the City's general funds and accounts, with a daily sweep of customer revenues to a third-party fiscal agent. In addition, a moderate portion of revenues is related to wholesale services provided under contract to various suburban communities outside of the City.

STRONG OPERATING AND FINANCIAL MANAGEMENT

The management team of this large combined water and wastewater system has produced a strong record of operational and financial achievements over the past decade. Operational achievements include continued improvements in environmental compliance, launch of a proactive water main replacement program that has significantly reduced the number of main breaks, and installation of automatic meters for a significant proportion of residential customers. In addition to the resulting improvements in billing accuracy, the billing cycle was accelerated to a monthly basis. On the financial side, operating costs have been well controlled, with significant reductions in some areas such as contracted electricity costs and costs of operating the biosolids recycling center. As discussed in detail below, management has been able to maintain significant cash balances that support the system's working capital needs, help with rate stabilization, and provide for contingencies.

Rate-setting authority resides with the Water Commissioner, although there is some input from the City Council regarding standards and due process. A four-stage increase in water and sewer rates went through a required hearing process several years ago with little dispute. Rates were increased by 12.8% in fiscal 2005, 1.9% in 2006, and 6.7% in 2007; an additional increase of 4.2% has been approved for fiscal 2008. In anticipation of additional debt to be issued in fiscal 2008, the City is currently undertaking an Engineering and Rate Study to determine what further increases will be needed to maintain coverage. Even with the increases, rates are expected to remain well below average regional rates.

SYSTEM IS FINANCIALLY SEGREGATED FROM CITY'S GENERAL FUNDS

By covenant in the bond ordinance, the City is required to deposit all water and wastewater funds with an independent fiscal agent (currently, Wachovia Bank N.A.; senior unsecured rated Aa1) and to keep such funds separate and apart from general City funds and accounts. Although the Water Revenue Bureau within the City's Revenue Department performs billing and collection for customers located in the City, there is a daily sweep of collected funds to the fiscal agent. Per the bond ordinance, the City may not borrow any water or wastewater funds for other City purposes, including temporary or seasonal cash flow needs. These provisions were put in place to protect water and wastewater bondholders during the early 1990's, when the City's General Fund was experiencing significant financial stress. The City's general obligation bonds are currently rated Baa1/stable outlook.

The ordinance does permit an annual transfer to the City of up to $4,994,000, but not to exceed the actual amount of interest earnings on the system's debt service reserve fund. Apart from this, the water and wastewater system is a financial closed-loop, with all revenues and cash balances available for system purposes only, including capital purposes.

Over the next several years, Moody's expects the economic and demographic base of the service area, including that of the City of Philadelphia, to remain fairly stable. Although the city's population declined moderately during the 1990's, the 2000 census revealed that the loss was significantly less than previously estimated. The city economy produced fairly good growth in employment in the late 1990s through 2000, but some decline from 2000 to 2003. The decline flattened in fiscal 2004, and then grew by about 1.1% in 2005. Results for 2006 demonstrate continued growth, with each month showing an increase over the same month of the prior year. The suburban portions of the service area are wealthier and somewhat faster-growing than the city, but are much less significant to the system as they account for less than 10% of total customer revenues.

IMPROVED FINANCIAL OPERATIONS IN RECENT YEARS; SIGNIFICANT CASH BALANCES MAINTAINED

The system has built and maintained a strong level of cash balances over recent years in the Rate Stabilization Fund and the Residual Fund. The combined balance in these funds at the end of fiscal 2006 was approximately $155 million, up from fiscal 2005 when the combined balance was approximately $138 million. Both funds are pledged as security for bondholders, and are in addition to a Debt Service Reserve Fund equal to maximum annual debt service.

The significant Rate Stabilization Fund and Residual Fund were built up through conservative annual budgeting and multi-year financial planning. While the rate covenant in the bond ordinance requires 1.2x debt service coverage, transfers from the Rate Stabilization Fund may be used to "manage to" the required level. From fiscal 2002 to 2006, transfers were made between Rate Stabilization Fund and the Revenue Fund, allowing the system's officials to manage debt service coverage to meet the 1.2x rate covenant in years of insufficient net revenues. Although fiscal 2004 coverage was met with a significant $28.8 million transfer from the Rate Stabilization Fund to the Revenue Fund, only a $628,000 transfer was needed in fiscal 2005, the effect of the 12.8% rate increase. In fiscal 2006, despite the expectation of an additional transfer, officials were able to transfer $21.6 million back into the Rate Stabilization Fund due to conservative budgeting, revenue growth, and control of expenditures. Although an additional transfer out of the Rate Stabilization Fund of $36.2 million was originally projected for fiscal 2007, mid-year projections indicate a significantly reduced transfer by the end of the year. Conservative projections in past years have showed the depletion of the Rate Stabilization Fund by 2008 or 2010, but improved financial results may lead to the maintenance of sufficient cash in that fund beyond 2010. Projected, although unapproved, annual rate increases are expected to be sufficient to allow the system to meet its rate covenant without additional transfers over time. When available, however, Moody's expects management to continue to utilize Rate Stabilization Fund transfers to mitigate rate increases. Maintenance of the current rating is predicated on the system's ability to either maintain strong cash balances available for debt service or to maintain adequate debt service coverage through growth in net operating revenues while still maintaining adequate reserve levels.

In addition, approximately $20 million per year has been expended from internal funds for capital maintenance and improvements, a trend that is expected to continue and that reduces the need for additional debt finance. These transfers are in addition to a requirement of the bond ordinance to transfer a minimum annual amount to the capital account (approximately $16 million in recent years) to support plant renewal and replacement.

The Water Department also expects to replace a portion of its Debt Service Reserve Fund, currently sized at approximately $130 million, with a surety bond sometime after July 1, 2007. This freed-up cash will be placed in a new fund called the Special Water Infrastructure Account and be used for the cost of renewals, replacements and improvements. System management has yet to determine the amount of the reserve requirement that will be covered by the surety.

ABOVE-AVERAGE DEBT LOAD; IMPROVED COVERAGE FROM RECURRING REVENUES

The system's above-average debt load mainly reflects major investments in the early 1990's to improve environmental compliance, plus a significant ongoing program to replace aging water and sewer mains throughout the city. The ratio of debt to net plant and working capital has remained close to 80%, more than twice the national median for combined water and wastewater systems (as calculated by Moody's) but at the same time similar to some other large urban systems. The debt load, together with relatively low customer rates and charges, has resulted in low measures of debt service coverage from net recurring revenues in some years. Excluding transfers from the Rate Stabilization Fund, coverage hit a recent low of 1.04 times in fiscal 2004. The large rate increase for fiscal 2005 strengthened net revenue coverage to 1.26 times and the trend continued in fiscal 2006 with a satisfactory net revenue coverage of 1.37 times.

The practice of using transfers from the Rate Stabilization Fund to meet coverage has helped to keep customer rates relatively low, although an additional debt issue expected in 2008 will necessitate additional rate increases through 2013. The additional debt will also serve to keep the debt ratio, which was 78.7% in fiscal 2006, at elevated levels. As mentioned above, transfers from the Rate Stabilization Fund in excess of actual debt service flow to the Residual Fund, which is also a pledged fund, but not utilized in the calculation of debt service coverage.

With a good current level of environmental compliance, and some excess wastewater treatment capacity that allows for less costly solutions to stormwater overflow management, the system's capital improvement program over the next five years (2008-2012) is expected to be moderate. The $700 million program will focus on replacement of aging water and sewer mains and improvements to the wastewater treatment plants. A new money bond sale in the amount of $325 million is planned for fiscal 2008. An additional $325 to $375 million issue is expected to be issued in fiscal 2011.

A portion of the City's water and sewer debt is variable rate (28% of outstanding principal), some of which is unhedged (4.5% of outstanding principal). The City currently has two synthetic fixed rate swaps on water and sewer debt outstanding, one related to the 2003 variable rate issue and the other related to the 2005 variable rate issue. Both swaps have Citigroup Financial Products (senior secured rated Aaa) as the counterparty. For each swap, the City makes payments based on a fixed rate and receives payments based on either the Actual Bond Rate or a percentage of LIBOR. The current termination values of the swaps are significant, although the City does have the ability to bond out for termination payments if need be. The swaps are also insured by FSA.

The City has also entered into forward swaps with Merrill Lynch (senior unsecured rated Aa3) and Wachovia Bank in anticipation of the fiscal 2008 bond issuance. The notional amount is on $180 million of the $325 total issuance. The City will make payments based on a fixed rate and receive payments based on BMA.

Outlook

The credit outlook for the City's Water and Wastewater Revenue Bonds remains stable. The outlook reflects our anticipation of continued good operating and financial management, including maintenance of healthy (though possibly reduced) balances in the Rate Stabilization and Residual Funds and/or satisfactory coverage. The system's debt load is expected to remain high and net revenue coverage, exclusive of Rate Stabilization Fund transfers, may return to narrow levels. The economic and demographic base of the service area, including that of the City of Philadelphia, is also expected to remain fairly stable over this period.

What could make the rating go UP:

- Maintenance of strong cash reserves and increased debt service coverage by operating net revenues

- Reduction in debt ratio

What could make the rating go DOWN:

- Reduction in cash reserves without improvements in coverage

- Violation of rate covenant

KEY STATISTICS:

Number of Accounts:

Water - 475,300

Wastewater - 470,100

Operating Ratio, FY 2006: 55.5%

Senior Lien Debt Service Coverage (w/o transfers), FY 2006: 1.37x

Peak Senior Lien Debt Service Coverage (w/o transfers, FY 2006 Revenues: 1.31x

Debt Ratio, FY 2006: 78.7%

Payout of Principal (10 years): 59.1%

Post Sale Parity Bonds Outstanding: $1.82 billion

City 1999 Per Capita Income as % State: 79.1%

City 1999 Median Family Income as % State: 75.3%

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