New Issue: **MOODY'S ASSIGNS A1 RATING AND STABLE OUTLOOK TO THE CITY OF PHILADELPHIA'S (PA) $200 MILLION WATER AND WASTEWATER REVENUE BONDS**

Global Credit Research - 20 Oct 2011

AFFIRMATION OF RATING AFFECTS $1.77 BILLION IN PARITY DEBT OUTSTANDING

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

Moody's Rating

ISSUE		RATING
Water and Wastewater Revenue Bonds, Series 2011A		A1
Sale Amount	$135,000,000	
Expected Sale Date	11/01/11	
Rating Description	Revenue	
Water and Wastewater Revenue Refunding Bonds, Series 2011B		A1
Sale Amount	$33,565,000	
Expected Sale Date	11/01/11	
Rating Description	Revenue	
Water and Wastewater Revenue Refunding Bonds, Series 2011C		A1
Sale Amount	$12,420,000	
Expected Sale Date	11/01/11	
Rating Description	Revenue	
Water and Wastewater Revenue Refunding Bonds, Series 2011D		A1
Sale Amount	$18,985,000	
Expected Sale Date	11/01/11	
Rating Description	Revenue	

Opinion

NEW YORK, Oct 20, 2011 -- Moody's Investors Service has assigned an A1 rating and stable outlook to the City of Philadelphia's (PA) $135 million Water and Wastewater Revenue Bonds, Series 2011A, $33.57 million Water and Wastewater Refunding Revenue Bonds, Series 2011B, $12.42 million Water and Wastewater Refunding Revenue Bonds, Series 2011C, and $18.99 million Water and Wastewater Refunding Revenue Bonds, Series 2011D. Concurrently, Moody's has affirmed the A1 rating and stable outlook on the system's $1.77 billion in previously issued parity debt. Proceeds of the Series 2011A bonds will be used to finance the system's ongoing capital improvement plan; proceeds of the Series 2011B bonds will refund the system's Series 2001A bonds for a net present value savings of $2.45 million; proceeds of the Series 2011C bonds will refinance a portion of the system's Series 1997B variable rate bonds into fixed rate debt for a net present value loss of $560,000; proceeds from the Series 2011D bonds will restructure a portion of the system's Series 2007D bonds for a net present value loss of $1.6 million.

SUMMARY RATINGS RATIONALE

The bonds are secured by a pledge of net revenues of the water and sewer system (the system). The A1 rating reflects: the system's significant, diverse and stable customer base; moderately weak legal structure that allows for use of reserves to meet its rate covenant; strong management with legal rate-setting authority and a record of regular, multi-year rate increases; fluctuating annual debt service coverage; a recent Consent Order and Agreement with the state Department of Environmental Protection to address the city's combined sewer overflow issues; and an above average debt position with modest and declining exposure to variable rate debt.

STRENGTHS

oLarge system a serving a stable, diverse population of 1.7 million

oLegal authority to raise rates without city or council approval

oStrong reserve position

CHALLENGES

oModerately weak legal structure that allows for use of reserves to meet coverage

oTypically below average coverage ratios

oAbove average debt profile with significant additional debt planned

DETAILED CREDIT DISCUSSION

MODERATELY WEAK LEGAL STRUCTURE MITIGATED BY RATE-SETTING AUTHORITY AND FINANCIAL SEGREGATION FROM CITY GENERAL FUNDS

We believe the legal protections for bondholders is moderately weak, given that it allows for the use of transfers from the Rate Stabilization Fund to meet its rate covenant of 1.2 times debt service for senior lien debt and sum sufficient coverage for all debt and Capital Account Deposits. The additional bonds test, which requires 1.2 times also may include transfers from the Rate Stabilization Fund in the coverage calculation. The Debt Service Reserve is required to be funded at maximum annual debt service (MADS), but may include the use of a surety policy. In fiscal 2008, the water department replaced a portion of its Debt Service Reserve Fund, which was sized at MADS at approximately $175 million, with a surety bond for $67 million, netting $64.3 which was placed in a new fund called the Special Water Infrastructure Account to be used for the cost of renewals, replacements and improvements. The surety bond is provided by Assured Guaranty (Insurance Financial Strength rating of Aa3/negative outlook). At this time, there are no plans to obtain any additional surety bonds.

Rate setting authority resides solely with the water department, with no authorization required from city council, although the water department is required to provide at least 30 days advance notice to city council of any proposed rate changes. Water and sewer rate increases are generally approved for four years at one time; the last rate increase approval, received in October, 2008, and effective in November 1, 2008, incorporated fiscal years 2009 through 2012. The approved rate increases were 7.8% for fiscal 2009, 6.4% for fiscal 2010, 5.7% for 2011, and 5.9% for 2012. The city's rates remain among the lowest in the region, approximately one-half of some regional providers.

By covenant in the bond ordinance, the city is required to deposit all water and wastewater funds with an independent fiscal agent (currently, U.S. Bank - Long-term Issuer Rating of Aa2/negative outlook) 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 A2 with a stable outlook.

The ordinance permits an annual transfer to the city of up to $4.94 million, but not to exceed the actual amount of interest earnings on the system's debt service reserve fund. The department expects to transfer less than $1 million in fiscal 2011. Apart from this, the system is a closed loop, with all revenues and cash balances available for system purposes only, including capital purposes.

STABLE SERVICE AREA; LARGE, DIVERSE CUSTOMER BASE

The city's water department supplies water and provides wastewater treatment services to residents of Philadelphia and portions of Bucks (G.O. rated Aaa/negative outlook), Montgomery (G.O. rated Aaa/negative outlook) and Delaware Counties (G.O. rated Aa1), serving an area with 1.7 million residents. The total billable accounts was estimated at over 480,000, with more than 91% of households served living within the city. The customer base has been stable, with modest account growth averaging 1.4% since 2006, although consumption (as measured by metered water usage) has fallen an average of 6.2% over the past five years.

The city experienced steady population loss from 1950 to 2000, although figures from the 2010 census indicate slight growth from 2000 of 8,456, taking the city population to 1.53 million residents, making it the nation's fifth most populous. Resident wealth indicators are low, with per capita and median family incomes only about 77% and 74% of the national median, respectively, and 23% of residents below the poverty level. The suburban portions of the service area are wealthier and have historically been 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.

The system also has two wholesale water customers and ten wholesale wastewater contracts. Most of these contracts do not expire until at least 2017, although the system's largest contract, with the Delaware County Regional Water Quality Control Authority (DELCORA - revenue rating of A1) for wastewater treatment, expired in July of this year after 30 years. Both parties agreed to a new two-year contract while a longer-term contract is being negotiated. Revenues from DELCORA represent a modest 1.6% of total system revenues; total revenues from all 12 wholesale customers represents 7.85 of system revenues.

FLUCTUATION IN COVERAGE MANAGED BY USE OF CASH BALANCES

The system's management team has produced strong operational and financial performance over the past decade. Operational achievements include continued improvements in environmental compliance, the launch of a proactive water main replacement program that has significantly reduced the number of main breaks, and the installation of automatic meters for a significant proportion of residential customers. In addition to the improved accuracy of billing, the billing cycle was accelerated to a monthly basis, and both of these improvements have led to an increase in 120 day payment patterns.

Management 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 peaked at the end of fiscal 2007 at approximately $187 million. While the Residual Fund balance grew in fiscal 2008 through 2010, draws on the Rate Stabilization Fund in those years reduced total combined reserves to $166 million, still providing satisfactory additional financial flexibility. The largest draw on the Rate Stabilization Fund was $34.7 million in fiscal 2009, followed by a much smaller draw in fiscal 2010 of $2.7 million. Both funds are pledged as security for bondholders in addition to a Debt Service Reserve Fund. Additionally, the system's unrestricted cash position was at $70 million at the end of fiscal 2010. The city is projecting a deposit to the Rate Stabilization Fund for fiscal 2011 of approximately $10.8 million, increasing it to $159 million, well in excess of management's policy to maintain the fund at a minimum of $45 million. Combined projected balance for the funds is $174 million at the end of the year. Current projections indicate gradual draws on the Rate Stabilization Fund will reduce the combined balances System to approximately $100 million, although system management has a history of conservative projections of use of these funds. Maintenance of the current rating is predicated on the system's ability to maintain adequate debt service coverage through growth in net operating revenues while still maintaining satisfactory reserve levels.

Senior lien debt service coverage from net revenues, without giving credit to reserve transfers, has fluctuated over the past several years, going as low as 1.12 times in fiscal 2009, although it averaged an adequate 1.31 times from fiscal 2006 to fiscal 2010. Senior lien debt service coverage was a somewhat stronger 1.40 times in fiscal 2010. Given the limited amount of subordinate debt, in the form of a GO-guaranteed loan from PennVest (which will be fully repaid in fiscal 2012), total debt service coverage is only slightly lower at 1.39 times. Projected fiscal 2011 results show coverage falling to 1.27 times.

Approximately $20 million has been expended annually from internal funds for capital maintenance and improvements, a trend that is expected to continue and that reduces the need for additional debt issuance. These transfers are in addition to a requirement of the bond ordinance to transfer a minimum annual amount to the capital account (approximately $17 million in recent years) to support plant renewal and replacement.

ABOVE AVERAGE DEBT LOAD WITH MODEST VARIABLE RATE EXPOSURE; RECENT CONSENT ORDER AND AGREEMENT ADD TO SIGNIFICANT CAPITAL PLAN

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 debt ratio has improved to 67.5% in fiscal 2010 from 84.4% in 2005, but remained more than twice the national median for Moody's rated combined water and wastewater systems, although similar to some other large urban systems. Pro forma debt ratio inclusive of the new money portion of the current issue is approximately 72%. The system has $450 million in authorized debt expected to be issued in 2014 and 2015.

The city's current six-year Capital Improvement Plan is sized at $1.3 billion, with $188 million expected to be expended in fiscal 2012. The plan includes the implementation of a Consent Order and Agreement (COA) with the Pennsylvania Department of Environmental Protection (PADeP) to reduce combined sewer overflows through a Long Term Control Plan Update, which the city has dubbed "Green City, Clean Waters." The goal of the plan is to eliminate or remove at last the amount of pollutants that would be removed with the capture of 85% of the sewage collected during rainfall events. The program includes the implementation of "green" stormwater infrastructure to reduce the need for treatment and storage expansion. The program is estimated to cost about $2.4 billion over 25 years.

Management continues to reduce its variable rate debt exposure with the Series 2011C bonds, which will leave the system with $146 million in variable rate debt, or 7% of total outstanding debt, significantly less than three years ago when the exposure was close to one-third. Management recently replaced the Bank of America (rated A2/negative outlook) letter of credit with an LOC from TD Bank (rated Aa2/negative outlook) for the Series 1997B bonds ($62.3 million post-refunding). The TD Bank LOC's provisions for draws on the facility include a five-year repayment schedule that begins ninety days after the draw. The LOC expires in September of 2015. The Series 2005B bonds ($83.3 million) has liquidity support from a Bank of America LOC which expires in July of 2012, although management expects to extend it. Repayment provisions for draws on the LOC include a three-year term out that begins after a 60 day period, although without an extension, the term out would extend past the facility's July 2012 expiration, so an unremarketed tender now could expose the authority to a very short term out period; that is offset by its good available liquidity.

The city currently has one floating-to-fixed rate swap on its outstanding debt, related to the 2005B bonds with Citigroup as the counterparty. Per the terms of the swap, the city makes payments based on a fixed rate of 4.53% and receives payments based on the lesser of the Actual Bond Rate or a percentage of one-month LIBOR. The swaps may be terminated if the rating on the city's water and wastewater revenue bonds falls below investment grade by any rating agency. The latest mark-to-market valuation of the swap is approximately $12.9 million in favor of the counterparty, although we believe the city's ability to bond out for termination payments adequately addresses this risk.

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 transfers, may return to narrow levels.

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

- Significant increase to debt ratio

KEY STATISTICS:

Number of Accounts:

Water - 480,997

Wastewater - 478,900

Operating Ratio, FY 2010: 51.9%

Senior Lien Debt Service Coverage (w/o RSF transfers), FY 2010: 1.4x

Senior Lien MADS Coverage (w/o RSF transfers), FY 2009: 1.36x

Debt Ratio, FY 2010: 67.5%

Pro Forma Debt Ratio (inclusive of current issue): 72%

Parity Bonds Outstanding: $1.97 billion

City 1999 Per Capita Income (as % PA and US): $16,509 (79.1% and 76.5%)

City 1999 Median Family Income (as % of PA and US): $37,036 (75.3% and 74.0%

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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