



New Issue: MOODY'S ASSIGNS A1 RATING AND STABLE OUTLOOK TO CITY OF PHILADELPHIA'S (PA) \$185 MILLION WATER AND WASTEWATER REVENUE BONDS

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A1 RATING APPLIES TO \$1.83 BILLION IN OUTSTANDING RATED DEBT, INCLUDING THE CURRENT ISSUE

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

Moody's Rating

ISSUE	RATING
Water and Wastewater Revenue Bonds, Series 2010C (Tax-Exempt)	A1
Sale Amount	\$185,000,000
Expected Sale Date	07/23/10
Rating Description	Revenue

Opinion

NEW YORK, Jul 19, 2010 -- Moody's Investors Service has assigned an A1 underlying rating and stable outlook to the City of Philadelphia's (PA) \$185 million Water and Wastewater Revenue Bonds, Series 2010C. The bonds are secured by a pledge of net revenues of the water and sewer system (the system). Concurrently, Moody's has affirmed the A1 rating and stable outlook on the system's \$1.64 billion in previously issued parity debt. Proceeds of the bonds will be used to finance the system's ongoing capital improvement plan, as well as to terminate a forward starting swap the Water Department had entered into with Wachovia Bank (Long-term Issuer Rating of Aa2/stable outlook).

The A1 underlying rating reflects the system's strong management, weakened debt service coverage managed through transfers from significant cash balances in the Rate Stabilization Fund, ongoing improvements addressing environmental concerns and an above average debt position. System management's conservative projections show that the 1.2 times coverage mandated by the rate covenant will be managed through draws on the Rate Stabilization Fund over the next several years, drawing down the reserves from their currently healthy levels. 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, although there are annual transfers to the city's General Fund, they are based on investment performance and capped at just below \$5 million. 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 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. Operating costs have been well-managed, with significant reductions in some areas such as contracted electricity costs and a projected \$197 million in savings over the life of a contract for the management outsourcing of 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 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 study incorporated fiscal years 2005 through 2008 and went through a required hearing process with little dispute. The current rate filing affected fiscal years 2009 through 2012 and was approved in October 2008 and became effective November 1, 2008. 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 the lowest in the region, approximately one-half of some regional providers.

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, U.S. Bank - Long-term Issuer Rating of Aa1/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 A1 with a negative 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. The department expects to transfer less than \$2 million in fiscal 2011. 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.

STABLE SERVICE AREA

The city's water department supplies water and provides wastewater treatment services to residents of Philadelphia and portions of Bucks, Montgomery (both G.O. rated Aaa) and Delaware Counties (G.O. rated Aa1), although over 90% of households served are residents of the city and approximately 9% are from Bucks County. Philadelphia has experienced a long trend of industry and population loss since 1950, with a particularly sharp economic retreat hitting in the late 1980's and early 1990's. The late 1990's saw a resumption of growth, with employment up 5.7% between 1998 and 2001. After a decline between 2001 and 2003, reflecting the last slowdown in the national economy, modest growth in employment resumed, with growth of about 1.1% in 2005, 0.9% in 2006, 0.7% in 2007 and 0.2% in 2008. In 2009, annual employment growth reversed sharply, with a 3.3% drop in employment levels for the year. Year-over-year employment losses continued through May, although the magnitude of job losses seem to be leveling off, and in May, Philadelphia had a preliminary 0.9% reduction in employment, the smallest loss in employment since December 2008. Unemployment rates have continued to grow (11.3% in March 2010 vs. 9.4% in March 2009), however. Manufacturing has continued to decline in importance, and as of 2005, diversified services account for 54% of total employment (or more than 60% including the finance/insurance/real estate sector). Population loss during the 1990's was just over 4%, although this was only about half the loss that had been estimated prior to the 2000 census count. With an estimated 1.54 million residents, the city is the nation's sixth 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. A relatively large portion of the city's job base is in low-paying sectors, with healthcare, social services, and state and local government accounting for about 30% of total jobs (a large share of which are likely held by city residents, as opposed to commuters). 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.

COVERAGE MANAGED BY SIGNIFICANT CASH BALANCES

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 peaked at the end of fiscal 2007 at approximately \$187 million. Draws on the Rate Stabilization Fund in fiscal 2008 and fiscal 2009 reduced total reserves to a still healthy \$148 million. Both funds are pledged as security for bondholders, and are in addition to a Debt Service Reserve Fund. Additionally, the system's unrestricted cash position was at \$56 million at the end of fiscal 2009. 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 2001 to 2007, transfers were made to the Rate Stabilization Fund from the Revenue Fund in all but two years, 2003 and 2005, due to positive operations driven by conservative annual budgeting and multi-year financial planning, as well as healthy economic conditions.

The fiscal 2008 and fiscal 2009 draws on the Rate Stabilization Fund were \$9.7 million and \$34.7 million, respectively, leaving the balance at the current \$148 million, well in excess of the system's policy of maintaining the fund at a minimum of \$45 million in this fund. System officials project to draw from the fund again in fiscal 2010, reducing it to \$120 million. Despite this, conservative projections continue to reflect the depletion of the Rate Stabilization Fund to about \$48 million at the end of the upcoming six-year period. In the future, department officials report that fund draws may become more frequent as management utilizes the fund to mitigate rate increases. 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.

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.

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.

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 debt ratio has improved to 72.8% in fiscal 2009 from 84.4% in 2005, but remained more than twice the national median for combined water and wastewater systems (as calculated by Moody's), although similar to some other large urban systems. Despite the debt load, in recent years, sizeable rate increases, significant increases in interest income revenue, and expenditure controls have resulted in senior lien debt service coverage levels from net recurring revenues that had improved from 1.04 times in 2004 to a peak of 1.41 times in fiscal 2007. Senior lien coverage fell again in fiscal 2008, however, 1.27 times and further in fiscal 2009, to a narrow 1.12 times. When including the transfer from the rate stabilization fund, fiscal 2009 senior lien coverage was a stronger 1.28 times.

Transfers from the Rate Stabilization Fund are used to mitigate customer rate increases. The system has planned rate increases of 5.7% in fiscal 2011 and 5.9% in fiscal 2012. In addition to the current issue, the system has approved a debt issuance planned for 2014 of \$135 million and two proposed \$200 million debt issuances in fiscal 2015 and 2016. In order to accommodate the additional debt, system management projects annual rate increases of at least 5.5% from 2013 to 2016. The additional debt will keep the debt ratio at elevated levels. The system's current CIP (2011-2016) is approximately \$1.24 billion and will focus on replacement of aging water and sewer mains, improvements to the wastewater treatment plants, and combined sewer overflow needs. 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.

The system has a manageable amount of variable rate debt, with \$162 million, or 9% of the system's outstanding debt in a variable rate mode. Providing some potential pressure are the terms of repayment of bank bonds on the Bank of America, N.A. (Long-term Issuer Rating of Aa3/stable outlook) irrevocable letters of credit for the Series 1997B Bonds (\$75.8 million) and for the 2005B Bonds (\$83 million). Repayment provisions for bank bonds in the Bank of America LOCs have repayment of draws made on the liquidity facility divided into semi-annual payments after a 60 day period, with final term out in three years. The 1997B facility is set to expire in September 2011 and the 2005B facility will expire in July 2012.

The city currently has one floating-to-fixed rate swap on its outstanding debt, related to the 2005 variable rate issue; Citigroup is 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 mark-to-market valuation of the swap as of June 30, 2010 was \$14.1 million in favor of the counterparty, although we believe the city's ability to bond out for termination payments adequately addresses this risk.

In February 2007, the city also entered into two forward starting swaps with Merrill Lynch and Wachovia Bank in anticipation of the current issue, which was initially contemplated as a variable rate offering. Given that the issue will be fixed rate, the Water Department has terminated the Merrill Lynch swap with cash and will terminate the Wachovia swap with proceeds of the current issue.

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 - 480,500

Wastewater - 479,000

Operating Ratio, FY 2009: 63.3%

Senior Lien Debt Service Coverage (w/o transfers), FY 2009: 1.12x

Senior Lien MADS Coverage (w/o transfers), FY 2009: 1.13x

Debt Ratio, FY 2009: 72.8%

Parity Bonds Outstanding: \$1.83 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%)

PRINCIPAL METHODOLOGY AND LAST RATING ACTION

The principal methodology used in rating the current issue was "Analytical Framework for Water and Sewer System Ratings," which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

The last rating action with respect to the City of Philadelphia Water and Sewer Enterprise was on March 22, 2010, when an A3 rating and stable outlook were assigned to the Water and Wastewater Revenue Refunding Bonds , Series 2010A. That rating was subsequently recalibrated to A1 on April 23, 2010.

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