Moody's Investors Service

Global Credit Research
Rating Update
8 AUG 2008

Rating Update: **Philadelphia (City of) PA**

MOODY'S AFFIRMS A3 UNDERLYING RATING ON APPROXIMATELY $1.6 BILLION OF THE CITY OF PHILADELPHIA'S (PA) WATER AND WASTEWATER BONDS OUTSTANDING IN CONJUNCTION WITH REMARKETING OF 1997B VARIABLE RATE BONDS WITH LOC SUPPORT

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

Opinion

NEW YORK, Aug 8, 2008 -- Moody's Investors Service has affirmed the A3 underlying rating and stable outlook on the City of Philadelphia's outstanding Water and Wastewater Revenue Bonds, affecting approximately $1.6 billion of bonds. The bonds are secured by net revenues of the water and sewer system (the "system"). The affirmation is in conjunction with the remarketing of the city's Water and Wastewater Revenue Bonds, Variable Rate Series 1997B to substitute an existing Ambac insurance policy with a Aaa-rated Bank of America, N.A. letter of credit and reimbursement agreement. Ambac's current financial strength rating is Aa3 with a negative outlook. Pursuant to an Endorsement and Release Agreement between Ambac, U.S. Bank N.A. (fiscal agent), Citigroup Global Markets (remarketing agent) and the city, the Ambac insurance policy on the Variable Rate Series 1997B bonds will be cancelled on the effective date (expected to be during first week of September 2008). The letter of credit agreement is being reviewed by Moody's Municipal Structured Products Group and a separate short-term rating report will be issued at or prior to closing.

The A3 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 the 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, and both have led to an increase in collection rates from 87.3% in fiscal 2000 to 91% consistently in the last three fiscal years ending with 2007. 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 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 will affect fiscal years 2009 through 2012 and is expected to be approved in October 2008 and be effective November 1, 2008. The proposed rate increases are expected to be 7.8% in fiscal 2009, 6.4% in 2010, 6.6% in 2011, and 6.5% in 2012. The city's rates remain very competitive and are approximately one-half of many 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, Wachovia Bank N.A.; senior unsecured rated Aa2) 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 with a 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.

STABLE SERVICE AREA

The city's water department supplies water and provides wastewater treatment services to residents of Philadelphia and portions of Bucks, Montgomery and Delaware Counties (G.O. rated Aa1, Aaa and Aa2, respectively), although over 90% of customers 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, and then down about 1.6% between 2001 and 2003, reflecting the slowdown in the national economy. The decline flattened in fiscal 2004 and then grew by about 1.0% in 2005, 0.9% in 2006, and 0.7% in 2007. Results for the first two months of 2008 demonstrate continued growth, with each month showing an increase over the same month of the prior year. Manufacturing has continued to decline in importance, and diversified services now 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 1.45 million residents, the city remains the nation's fifth most populous. 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 2007 was approximately $187.3 million, up from fiscal 2006 when the combined balance was approximately $155 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. Additionally, the system's unrestricted cash position has improved annually since fiscal 2003 from $37.7 million to $52.6 million in fiscal 2007.

The significant Rate Stabilization Fund (RSF) 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. Since fiscal 2001, transfers were made to the Rate Stabilization Fund from the Revenue Fund in all but one year (2003) due to positive operations, enabling the system to maintain a strong level of reserves in the RSF. The city notes that the last few years of strong operations have benefited from healthy economic conditions, which is not expected to be replicated in the medium-term, and sizeable rate increases. In fiscal 2007, another year of healthy operations due to a 4.2% rate increase and a $9.3 million increase in interest on investment income resulted in a $26 million transfer to the RSF, increasing it to $185.6 million and well above the water department's policy of maintaining at least $45 million in this fund. Unaudited fiscal 2008 results (ended June 30) are projecting a $20 million drawn on the RSF, although department officials believe the final amount may be less, and the Residual Fund will also be drawn down to about $100,000 with no significant plans to rebuild it.

Although better-than-projected financial results have historically kept the RSF at significantly higher levels, a trend we believe is likely to continue, conservative projections continue to reflect the depletion of the RSF to about $45 million at the end of six-year periods. In the future, department officials report that RSF draws may become more frequent as management utilizes RSF funds 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 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 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 and expected to increase to $22 million in 2010) 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 approximately $130 million, with a surety bond for $67 million, which netted $64 million that was placed in a new fund called the Special Water Infrastructure Account to be used for the cost of renewals, replacements and improvements. At this time, there are no additional 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 ratio of debt to net plant and working capital has improved slightly to 76% in fiscal 2007 (from 83% in 2006), 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 debt service coverage levels from net recurring revenues that have improved to approximately 1.4 times in fiscal years 2006 and 2007, from a recent low of 1.04 times in fiscal 2004.

Transfers from the RSF are used to mitigate customer rates increases. Despite an estimated $325 million in additional debt expected to be issued in fiscal 2009, the proposed rate increases in 2009 and 2010 (and through 2012) are expected to be similar to previous years at 7.8% and 6.4%. An additional planned debt issuance of $350 million in fiscal 2012 is projected to result in a more sizeable rate increase of 13.1% in fiscal 2013. The additional debt will also serve to keep the debt ratio at elevated levels. The system's current CIP (2009-2014) is approximately $986 million 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 RSF 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.

A portion of the city's outstanding water and sewer debt is variable rate (32% of outstanding principal). The city currently has two floating-to-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 (4.52% and 4.53%, respectively) 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 combined mark-to-market valuation of these two swaps as of June 30, 2008 was a significant $42.5 million in favor of the counterparties, although we believe the system's strong liquidity position and the city's ability to bond out for termination payments adequately addresses the risk in the unlikely event of a termination. The swaps are also insured by FSA and there is no termination event tied to FSA.

In February 2007, the city also entered into two forward starting swaps with A2-rated Merrill Lynch and Aa2-rated Wachovia Bank that are effective February 17, 2009 in anticipation of the fiscal 2009 bond issuance. The total notional amount is $180 million is split evenly between Merrill Lynch and Wachovia, hedging a portion of the $325 million bond authorization planned for fiscal 2009. Under the terms of the swaps, the city will make payments based on a fixed rate of 4.1184% and receive payments based on SIFMA. The swap may be terminated if rating falls below investment grade by any rating agency, applying to both the issuer and the counterparty. Should the city decide to issue fixed rate bonds instead, the swaps will be terminated; as of June 30, 2008, the swaps had a mark-to-market valuation of approximately $4.4 million in favor of the counterparties.

Outlook

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 RSF 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

- Significant increase to debt ratio

KEY STATISTICS:

Number of Accounts:

Water - 470,300

Wastewater - 468,000

Operating Ratio, FY 2007: 57%

Senior Lien Debt Service Coverage (w/o transfers), FY 2007: 1.39x

Peak Senior Lien Debt Service Coverage (w/o transfers, FY 2007 Revenues: 1.38x

Debt Ratio, FY 2007: 76%

Payout of Principal (10 years): 60.3%

Parity Bonds Outstanding: $1.66 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%)

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