STANDARD & POOR'S

RATINGSDIRECT®

August 15, 2008

Philadelphia, Pennsylvania; Water/Sewer

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Credit Profile		
Philadelphia wtr & swr		
Long Term Rating	A/Stable	Upgraded
Philadelphia wtr & swr		
Unenhanced Rating	A(SPUR)/Stable	Upgraded
Philadelphia wtr & wastewtr		
Unenhanced Rating	A(SPUR)/Stable	Upgraded
Many issues are enhanced by bond insurance.		

Rationale

Standard & Poor's Ratings Services raised its standard long-term rating and Standard & Poor's underlying rating (SPUR) on Philadelphia, Pa.'s water and sewer revenue debt one notch to 'A' from 'A-' based on the system's stable financial performance, resulting in the utility's persistently satisfactory coverage ratios on senior-lien debt of 1.2x; consistently strong management team; and sound overall system operations with ample capacity. The outlook is stable.

Other credit factors supporting the rating are:

- Despite the use of rate stabilization fund support at times, financial performance has been stable. With the rate stabilization funds, senior-lien debt service coverage is a satisfactory 1.20x with 1.08x coverage of revenue debt.
- Rates, which are currently low, should rise to only moderate levels due to proposed rate increases to take effect in fall 2008. The last rate increase of 4.2% went into effect on July 1, 2007; and additional rate increases are expected to range from 5%-10% in each of the next five years.
- Philadelphia's well-experienced utility management team continues to emphasize, and is achieving, improved system maintenance, stronger collections, and more-comprehensive fiscal monitoring systems.
- Although still below average, collections have continued to improve, resulting in a decline in significant receivables, bad debt write-offs, and service shutoffs for fiscal 2007.

Despite the positive credit factors, the rating remains restrained by the system's:

- Continued reliance on rate stabilization fund support -- projected to continue over forecast period 2009 through 2014 -- to meet covenanted coverage levels;
- Overall service area economy of the city, characterized by weak demographic trends, including long-term population decline, resulting in overcapacity within the water system; and
- Sizable $986 million capital improvement plan (CIP) for fiscals 2009-2014.

Philadelphia's water and wastewater systems provide service to roughly 1.7 million and 2.2 million people, respectively, in the city and suburbs. The systems serve predominantly retail residential customers. The number of retail accounts has been slowly declining over the past several years, in step with the city's population decline, reported at about 13% over the past decade. Both water and wastewater accounts total about 478,000. The department's customer base, in which the city is the leading user, remains stable and diverse: The 10 leading customers accounted for about 12% of total billings in 2007. Overall system operations are strong, complying with environmental regulations and ample system capacity.

As of the last-implemented increase for 2007, current rates remain competitive at $67 for a combined residential water and sewer bill for the typical 7,500-gallon usage customer. Although recently proposed rate increases, which are to take effect beginning in November 2008, (7.8% in 2008, 6.4% in 2009, 6.6% in 2010, and 6.5% in 2011) will increase bills, officials still expect rates to remain competitive with the rates of surrounding regional systems. These rate increases are necessary to support rising costs, especially chemical and fuel costs, and maintain coverage ratios and liquidity while the system lessens its reliance on the use of rate stabilization reserves. The water department made another deposit of nearly $26.0 million into the rate stabilization reserve in fiscal 2007 that brought the balance up to $185.6 million. Officials previously expected the depletion of these reserves by 2010; but due to strong operations for fiscal 2007, the city did not have to touch the balance, in which original projections included the need to draw on the reserve by at least $22 million. Despite the increase in this fund, the city still conservatively projects using a portion of these reserves to meet covenants by fiscal 2014; the expectation of no implemented rate increases and modest overall growth form the basis of these projections. The water department expects to draw on the reserve in fiscal 2008 by roughly $20 million.

Standard & Poor's has assigned Philadelphia a Debt Derivative Profile (DDP) overall score of '2' on a scale of '1'-'4', with '1' representing the lowest risk and '4' the highest risk. The overall score of '2' reflects our view that Philadelphia's water-and-sewer-enterprise-fund-related swap portfolio is currently a neutral credit risk.

Outlook

The stable outlook reflects Standard & Poor's expectation that the water department will adopt the currently proposed rate increases to continue to maintain current satisfactory coverage as rate stabilization reserves are drawn on, as forecast over the next several years.

Service Area Economy: Stabilizing After A Period Of Decline

Philadelphia's diversified economy has notable strength in health care services, pharmaceutical manufacturing, education, and tourism. While this diversity buffers the Philadelphia economy from a more-severe downturn, it has also limited the economy's expansion since many of the sectors forming the regional economic base are growing slowly.

The city experienced moderate declines in labor force (2.0%) and employment (2.2%) from 2001 through 2005 but posted modest gains in 2006 by adding back about 14,000, or half, of the lost jobs from the previous period. The city's 6.3% unemployment rate in 2006 edged away from peaks posted in 2002 and 2003. While in keeping with many urban centers, however, unemployment remains well above the commonwealth's and nation's rates. A long history of out-migration has fostered a large disparity in education and income levels between central city and suburban residents. Philadelphia's population declined by 4.3% over 1990-2000; recent data suggests this long-term trend continued between 2000 and 2006 with a 4.6% decline. The rate of decline, however, has eased over the past couple of years. Like many older urban cities, Philadelphia's income levels are below average. City median household effective buying income is just 75% of the national benchmark.

Education and health services represent a large 28% of Philadelphia's jobs. Growth prospects are good for the metropolitan area's core of knowledge-based industries, including health services, pharmaceuticals, education, and biotechnology due chiefly to a highly educated workforce drawn from suburban areas. With 45 hospitals and seven medical schools, the city is one of the world's leading health care centers and is home to more than 80 degree-granting higher education institutions.

Leading employers include several hospitals and health systems, numerous higher learning institutions, government, and Merck Pharmaceuticals. High-technology industries, however, provide a relatively small portion of total employment.

Redevelopment of the city's U.S. Navy shipyard continues to provide economic benefits, offsetting losses incurred with the closure of several defense facilities (employing 20,000) in the 1990s. The Navy still maintains 2,500 personnel at the shipyard, which is also home to 60 companies, employing 4,500, including shipbuilder Aker, formerly Kvaerner, which employs 1,300. Long-range plans for the shipyard are for mixed-use development with employment levels in the 15,000-20,000 range. Building on successes at the Navy yard, Philadelphia has launched redevelopment projects along the Delaware River waterfront. Covering 3,500 acres, the project seeks to convert dilapidated industrial properties into mixed-use properties, including the planned site of two recently approved casinos.

Limited new housing data is available, but management reports sale prices are down by about 1%. Residential values never experienced the large increase in value during the strong real estate market; therefore, any projected residential value declines should not be as severe. The commercial market, however, remains solid with low 9% vacancy rates despite the recent addition of the city's Cira and Comcast centers, netting nearly two million square feet of class A space. Tourism remains a key component of the city economy. The city assumes SugarHouse Casino and Foxwoods Casino Philadelphia will open in 2010. City officials expect the creation of more than 1,000 construction and 9,000 permanent jobs. From a revenue standpoint, officials are projecting $20 million in annual "host fee" revenues generated from a 4% tax on casinos gross revenues. A delay in the projects could compromise the city's five-year financial plan because it contains nearly $78 million of forecast casino-related revenues.

Several large-scale economic development projects have bolstered the city's tourism base over the past several years. The construction of new stadiums for the National Football League's Philadelphia Eagles franchise and Major League Baseball's Philadelphia Phillies franchise, for a combined $1 billion, serving as cornerstones of the city's sports district, are among these projects. Other recent large-scale projects include a performing arts center, enhancing the city's Avenue of the Arts; the completion of an attractions/museums building on the city's historic past; the addition of 4,000 hotel rooms; and the expansions at the Philadelphia Airport. Meanwhile, the city plans to expand its convention center to 685,000 square feet from 440,000 square feet, making it the nation's eighth-largest center. These projects should help enhance the city's efforts to expand tourism, which is already a key driver of Philadelphia's economy.

Finances/CIP

Finances are stable but reliant on rate reserve funds

Financial operations have been stable but reliant, at times, on transfers from a rate stabilization reserve created with the $69 million series 1993 bond issuance. The use of these reserves and interest earnings allows the system to meet its total obligations and satisfy its 1.2x rate covenant coverage level. The rate stabilization reserve's purpose is to maintain assets to be drawn down to offset operating shortfalls and corresponding rate increases in the operating fund. The rate stabilization fund had a $185.6 million balance at fiscal year-end 2007, up by nearly $26.0 million from fiscal 2006 and closer to the fund's $201.0 million peak balance in fiscal 1998. Despite this substantial deposit into the rate stabilization fund at fiscal year-end 2007, the water department, once again, expects a draw on the rate stabilization fund of $20 million for fiscal 2008. As such, debt service coverage before the transfer into the rate stabilization fund was 1.34x in fiscal 2007. The department had originally projected further drawdowns over the next four fiscal years, depleting the rate stabilization reserve by 2010; but better-than-projected operations in fiscal 2007 have diminished the need to use reserves and have, in essence, extended this fund's life.

The department has a past history of poor revenue collections, which management attributes, in part, to a quarterly billing cycle and a four-month moratorium on shut-offs during the winter months. Implementation of monthly billing in fiscal 1993 improved collections, which leveled off at about 85%-86% over the past several years, still posing a credit concern. This rate has since continued to improve, alleviating some, but not all, of the concern. Collections improved to 91.5% as of fiscal 2007 due to increased collections, including the use of collection agencies, and the shutting off and installing of meters with automatic reading devices to reduce billing disputes. There are roughly 16,000 water and wastewater accounts that are in nonservice status due to service shutoffs for nonpayment. Allowance for doubtful accounts was a still-high $75 million at fiscal 2007, down slightly compared with $78 million at fiscal year-end 2006. The department's liquidity is an adequate 67 days' unrestricted cash on hand; this ratio improves when the rate stabilization fund is included.

CIP

The CIP for fiscal 2009-20014, including the current capital budget, totals $986 million with the two largest projects being $295 million, or 30% of the total plan, for storm flood relief projects and $251 million, or 25%, for treatment plant improvements. Officials expect a $325 million issue to come with a forward-starting swap, as is a second issue of roughly $350 million, in 2012. The city expects most of the debt to be water and wastewater revenue bonds with a portion funded from commonwealth loans to the city through Pennvest.

Legal Provisions

A net pledge of water and wastewater system revenues secures the bonds. The indenture defines revenues as those generated from system rates and charges, transfers from the rate stabilization fund, and interest earnings from the trust accounts. Rates must be set to provide current revenues plus transfers from the rate stabilization fund of at least 1.2x annual debt service on revenue bonds and 1.0x coverage when including all subordinate debt and certain other transfers.

The city can issue additional debt as long as it is in compliance with the rate covenant at the time of issuance, and net revenues should be sufficient for the two fiscal years following debt issuance.

The requirement that net system revenues "exclusive of transfers from the rate stabilization fund" fund 90% of operating requirements provides additional bondholder protection. This provision also applies to the additional bonds test.

The flow of funds is closed, eliminating concerns about transfers of funds between the general fund and water department. The indenture, however, allows for an interdepartmental charge paid to the city for compensation for support services provided, as well as transfers to fund annual general obligation (GO) bond debt service payments.

The indenture requires a fully funded debt service reserve fund at aggregate maximum annual debt service. A rate review is required annually.

Debt Derivative Profile: '2' -- A Neutral Credit Risk

Standard & Poor's has assigned Philadelphia an overall DDP score of '2', reflecting our view that Philadelphia's water-and-sewer-enterprise-fund-related swap portfolio is currently a neutral credit risk due to:

- The system's limited counterparty risk, given significant trigger spreads;
- The swap's above-average economic viability;
- The system's good management practices with a formal swap management policy; and
- A remote termination risk.

Philadelphia has two water-and-sewer-enterprise-fund-related swaps. The city's floating to fixed swaps, in conjunction with the series 1993 and 1995 water and wastewater revenue bonds, are with Citigroup (AA). Counterparty risk was low due to the trigger spread between the counterparty's rating and a credit event. In addition, due to the low degree of termination risk because swap termination payments are insured by Financial Security Assurance and the swap's above-average economic viability, Standard & Poor's is not currently factoring in these values as contingent liabilities for the city.