STANDARD & POOR'S RatingsDirect

RESEARCH

Philadelphia, Pennsylvania; Water/Sewer

Publication date: 01-Mar-2007
Primary Credit Analyst: Jeffrey Panger, New York (1) 212-438-2076; jeff_panger@standardandpoors.com
Secondary Credit Analyst: Karl Jacob, New York (1) 212-438-2111; karl_jacob@standardandpoors.com

Credit Profile

US$227.54 mil wtr & swr rev bnds ser 2007 due 08/01/2027		
Long Term Rating	A-/Stable	New
Philadelphia wtr & swr		
Long Term Rating	A-/Stable	Affirmed

Rationale

The 'A-' rating on Philadelphia, Pa.'s water and sewer revenue bonds reflects:

- A continued reliance on rate stabilization fund support (projected to be depleted by 2010) to meet covenanted coverage levels;
- Weak demographic trends, including long-term population decline, that result in overcapacity within the water system;
- Weak, but stable, collections resulting in a significant level of receivables, bad debt write-offs, and service shutoffs; and
- A sizable capital improvement program (CIP).

Positive credit factors include the following:

- With the rate stabilization funds, coverage of senior-lien debt service is adequate at 1.20x. Coverage of revenue debt and transfers to the general fund, capital fund, and residual fund is 1.08x.
- Rates, which are currently low, are expected to rise to moderate levels as a result of anticipated rate increases. A 3.8% rate increase effective July 1, 2007, has been adopted, and increases ranging from 5% to 10% over each of the next five years are under consideration. Such increases are necessary to enable the maintenance of coverage levels as rate stabilization funds are depleted.
- The seasoned management team emphasizes, and is achieving, improved system maintenance, stronger collections, and more comprehensive fiscal monitoring systems.

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

Philadelphia's water and wastewater systems provide service to roughly 1.7 million and 2.2 million residents in the city and suburbs, respectively. 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, which was reported at roughly 13% over the past decade. Both water and wastewater accounts total about 478,000. Rates are currently moderate at $51 for a combined residential water and sewer bill (for the typical customer averaging 9.6 million cubic feet of usage). A recently adopted 3.8% rate increase and anticipated rate increases over the next several years, however, will likely boost the bill. These rate increases are necessary as the system weans itself from reliance on rate stabilization reserves. Although the department made a deposit to the rate stabilization reserve in 2006, there has a been a general trend of usage of these reserves to meet covenanted coverage. These reserves were expected to be depleted by 2010. However, strong operations for fiscal 2007 are expected to reduce the need to draw on the reserve by at least $22 million, thereby prolonging availability of the reserve. The rate stabilization reserve balance totaled $115 million as of fiscal year-end 2006.

The water department is headed by an experienced and long-standing management team that has implemented a number of operational improvements in recent years. The water department is in full regulatory compliance with safe water regulations. In addition, the system's plants are now regularly cited for the high quality of their operation.

Outlook

The stable outlook reflects the expectation that the water department will adopt sufficient rate increases to maintain coverage levels as rate stabilization reserves are depleted, which is forecasted over the next several years.

Service Area And Economy

The water system serves a population of more than 1.67 million, which includes retail service in Philadelphia and wholesale service to Bucks County, Pa., and parts of Delaware and Montgomery counties. The department maintains 475,300 retail water accounts and 470,100 retail wastewater accounts. The number of retail accounts has been slowly declining since 1991 as the service area has lost population.

The combined system is predominantly retail; wholesale customers accounted for a small percent of revenues. The retail service is to predominantly residential customers. The customer base is diverse, with the 10 leading customers accounting for about 12% of revenue, led by the city of Philadelphia, which accounts for 5.8% of revenue.

The Philadelphia regional economy is highly diversified, with an emphasis on health care services, pharmaceutical manufacturing, aerospace manufacturing, education services, and transportation services. While buffering the Philadelphia economy from a more severe downturn, this diversity has also limited its expansion as many of the sectors that form the region's economic base are growing slowly. The region's other weaknesses include out-migration from the center city, relatively high business costs, a large number of poorly educated workers that live in Philadelphia, and high tax rates.

Despite the recent downturn, the city's housing market has performed well, in part as a result of low interest rates and in part influenced by gains made under the city's Neighborhood Transformation Initiative. This, in turn, has translated into property value growth and building activity, which, in turn, increased property tax and real estate transfer tax revenue.

The recent downturn in the Philadelphia economy has been mild relative to past recessions. After posting modest employment gains from 1998-2000 (the first gains in a decade), net job losses have been registered over the past three years, though at levels generally in keeping with national trends. The city's 5.8% unemployment rate as of December 2006 has edged off of peaks posted in 2002 and 2003; as with many urban centers, however, it remains well above the state and national 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 4.3% over the 1990-2000 period; recent data suggest that this long-term trend is continuing. However, the rate of decline has eased, due in part to economic development efforts amid the center city. Median household effective buying incomes within the city represent just 74% of the U.S. benchmark.

Education and health services comprise a large 18% of metropolitan area jobs. Growth prospects are good for the metropolitan area's core of knowledge-based industries, which include health services, pharmaceuticals, education, and biotechnology, chiefly due to a highly educated workforce drawn from suburban areas. With 45 hospitals and seven medical schools, the area is one of the largest health care centers in the world and is home to more than 80 degree-granting institutions of higher education. However, high-tech industries provide a relatively small portion of total employment.

Redevelopment of the city's Navy shipyard continues to provide economic benefit, offsetting losses incurred upon the closure of several defense facilities (employing 20,000) in the 1990s. Long-range plans for the shipyard are for mixed-use development and employment levels in the 15,000-20,000 range.

Finances/Capital Improvement Program

Finances

Financial operations have been stable, but also reliant on transfers from a rate stabilization reserve created with the series 1993 bond issuance of $69 million. This use of these reserves and interest earnings enables 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 future operating shortfalls and corresponding rate increases in the operating fund. The rate stabilization fund had a balance of $115 million at fiscal year-end 2006, down from its $201 million fiscal 1998 peak. In fiscal 2006, the department made a deposit to the rate stabilization reserve, extending its projected "life" to 2010. As such, coverage of debt service prior to the transfer was 1.32x in fiscal 2006. The department had projected further drawdowns over the next four years, virtually depleting the reserve by 2010. However, better-than-anticipated operations year-to-date in fiscal 2007 have diminished the need to utilize the reserves.

The department has a history of poor revenue collections, which was partially attributable 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 the collection rate, which has now leveled off at around 85%-86%, still posing a credit concern. The water department has employed other methods to improve collections, including the use of collection agencies, shutting off delinquents after they miss two billing cycles, and installation of meters with automatic reading devices to reduce billing disputes. There are roughly 16,000 water/wastewater accounts that are in nonservice status due to service shutoffs for nonpayment. Allowance for doubtful accounts is more than $78 million at fiscal year-end 2006, down somewhat from prior years.

Capital improvement program

The CIP for fiscal 2008-2013, including the current capital budget, totals $947 million. Major items include treatment plant improvements and new and reconstructed conveyance and collector systems. About 70% of the costs of the CIP are expected to be funded with the proceeds of debt. The city expects most of the debt will be water and wastewater revenue bonds with a portion funded from loans from the commonwealth to the city through Pennvest. Following this current debt issue, the city expects to next issue $375 million bonds in 2011.

Legal Provisions

The bonds are secured by a net pledge of the water and wastewater system. Under the indenture, revenues are defined as those generated from rates and charges of the system, 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 the revenue bonds and 1.0x coverage when including all subordinate debt and certain other transfers.

Additional debt can be issued as long as the city is in compliance with the rate covenant at the time of issuance and net revenues are projected to be sufficient for the two fiscal years following the debt issuance by a consulting engineer.

Additional bondholder protection is provided by the requirement that net revenues of the system "exclusive of transfers from the rate-stabilization fund" fund 90% of operating requirements. 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. However, the indenture allows for an interdepartmental charge paid to the city for compensation for support services provided, as well as transfers to fund annual 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

Philadelphia has been assigned a Standard & Poor's DDP overall score of '2' on a scale of '1' to '4', with '1' representing the lowest risk and '4' the highest. The overall score of '2' reflects Standard & Poor's view that Philadelphia's water and wastewater enterprise fund-related swap portfolio reflects a neutral credit risk at this time due to the following factors:

- Limited counterparty risk given significant trigger spreads,
- Above-average economic viability of the swap,

- Good management practices with a formal swap management policy, and
- Remote termination risk.

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

Ratings Detail (As Of 01-Mar-2007)

Philadelphia wtr & swr (FGIC)		
Unenhanced Rating	A-(SPUR)/Stable	Affirmed
Philadelphia wtr & swr (FSA)		
Unenhanced Rating	A-(SPUR)/Stable	Affirmed
Philadelphia wtr & wastewtr VRDB ser 2003 (FSA)		
Long Term Rating	AAA/A-1+/Stable	Affirmed
Unenhanced Rating	A-(SPUR)/Stable	Affirmed
Philadelphia wtr & wastewtr VRDB ser 2005B (FSA)		
Long Term Rating	AAA/A-1+/Stable	Affirmed
Unenhanced Rating	A-(SPUR)/Stable	Affirmed
Philadelphia wtr & wastewtr (AMBAC)		
Unenhanced Rating	A-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.