STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

RatingsDirect®

Summary:

Philadelphia; Joint Criteria; Water/Sewer

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Summary:

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Credit Profile		
US$93.255 mil wtr & wastewtr rev rfdg bnds ser 2014A dtd 01/23/2014 due 06/30/2028		
Long Term Rating	A/Stable	New
Philadelphia wtr & swr		
Long Term Rating	A/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services has assigned its 'A' long-term rating to Philadelphia's series 2014A water and wastewater revenue refunding bonds and affirmed the following ratings:

- The 'A' long-term rating and underlying rating (SPUR) on the city's existing water and wastewater revenue debt; and
- The 'AAA/A-1+' rating on the city's series 1997B bonds, which are jointly secured by the city and the letter of credit (LOC) provider TD Bank N.A.

The outlook on the ratings is stable, except for when joint criteria has been applied to the issue's long-term rating, in which case the outlook is not meaningful.

The city will use the series 2014A bond proceeds to refund a portion of its outstanding bonds.

The 'A' long-term rating and SPUR are based on the following characteristics:

- A broad service area that covers the city of Philadelphia and several suburbs, but with an overall weak economic profile when comparing income and unemployment with commonwealth and national averages;
- Rates that we consider competitive, even with the weaker economic profile, along with management's historical willingness to raise rates annually;
- Stable financial performance, albeit with reliance on its rate stabilization fund to support operations; and
- A sizable capital improvement plan (CIP) combined with an already-high system ratio of debt to capital, in our opinion.

Securing debt service are net revenues of the water and sewer fund, which includes (net of operating expenses) rates and charges of the system, transfers from the rate stabilization fund, and interest earnings. Rates must be set to provide rates and charges plus transfers from the rate stabilization fund that represent at least 1.2x annual debt service on the 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 complying with the rate covenant at the time of issuance and net revenue projections are sufficient to provide for rate covenant compliance for the two fiscal years following the debt issuance. As long as Assured Guaranty Municipal Corp. (AGM; formerly FSA) insures any of the city's 2005A, 2005B, and a portion of the 2010A bonds, AGM requires that the city maintain net system revenues, excluding transfers from the rate stabilization fund, totaling at least 90% of operating requirements (90% test). This provides additional bondholder protection, in our

view, since this effectively limits how much the system can rely on draws from the rate stabilization fund. This provision also applies to the additional bonds test.

Philadelphia's water and wastewater systems provide service to roughly 1.7 million and 2.3 million customers, respectively, in the city and suburbs. The systems predominantly serve retail residential customers, but also serve 12 surrounding townships and utility authorities on a wholesale basis. The number of retail accounts has remained relatively stable since 2001; water and wastewater accounts each total about 480,000. The water department customer base, in which the city is the leading user, remains stable and diverse: The 10 leading retail customers accounted for approximately 12% of total billings in fiscal 2012. Water and wastewater treatment capacities are 683 million gallons per day (mgd) and 522 mgd, respectively. We consider water capacity adequate, given average use of less than half that; sewer average use is about 90% of capacity, and about 50% of the city's water and sewer capital budget is dedicated to combined sewer overflow mitigation and flood relief.

The service base's weak demographic profile reflects below-average incomes, as well as an unemployment rate consistently above commonwealth and national averages. In our opinion, income indicators are just adequate, with median household effective buying income at about 75% of both state and national levels; meanwhile, we consider combined metropolitan area median household incomes strong at 130% of the national average. In 2012, city unemployment averaged 10.8% and has mostly remained in double digits since July 2009. By comparison, the 2012 commonwealth and national unemployment rates were 7.9% and 8.1%, respectively.

We consider rates affordable, even with the city of Philadelphia's weaker demographic profile. The city increased rates by about 6% in each year since fiscal 2009 as part of a four-year program that started in 2008. In addition, approved rate increases will increase operating revenues by about 4.5% through the 2015 fiscal year. Management estimates that the average monthly combined bill currently totals $64.24 (including stormwater charges, and 600 cubic feet of use). Even when considering that for 1,000 cubic feet of usage (what Standard & Poor's uses as its benchmark consumption rate for peer comparison purposes) monthly bills would be $84.89; we still consider this affordable.

Despite generally stable financial performance, the city does rely on periodic draws on its rate stabilization fund to support operations. After making deposits into the fund in fiscal years 2006 and 2007, the water department drew $9.8 million in fiscal 2008, $34.7 million in 2009, and $1.9 million in 2010. For 2011 and 2012, however, deposits were made, bringing the balance to $165.9 million at June 30, 2012. For 2013, a $4.7 million use of the rate stabilization fund is planned; management's latest available financial projections show the water department continuing to rely periodically on rate stabilization fund draws to meet its minimum coverage requirements, but the projections do not indicate the balance dropping below $153.5 million.

As reported on an unaudited basis, the system has been able to meet its targeted coverage of debt service by 1.2x since at least 2001. Management can reach this target by making a transfer into or out of its rate stabilization fund. Throughout this period, revenues from operations have continued to meet the 90% test, as indicated above. On an audited basis, debt service coverage (DSC) has fluctuated more, but remains at least adequate, in our view. In 2009, when the system did experience a larger-than-average transfer in from the rate stabilization fund, audited net revenues available for debt service represented 1.0x annual debt service. For 2012, DSC was 1.6x and it was 1.2x in 2013 (unaudited); both these figures represent coverage from net revenues excluding transfers.

Unrestricted cash levels at the end of each fiscal year also demonstrate stable financial performance, in our view. They have typically represented 60-90 days' operations (about $50 million to $80 million), which we characterize as adequate to good. This excludes the rate stabilization fund (see balance information above), capital fund ($253.0 million at the end of fiscal 2012), and residual fund ($59.3 million at the end of 2012). According to management, the capital and residual funds are primarily used for capital to offset bonding needs. The city's general revenue bond ordinance dictates that each year a cash deposit equal to 1% of net property, plant, and equipment (PP&E) is to be transferred to the capital fund. The bond ordinance also stipulates that amounts on deposit in all three of these restricted funds can be loaned to the revenue fund to pay operating expenses or even debt service (because the revenue fund is included as pledged security for the revenue bonds).

Continually improved revenue collection rates also support the department's financial operations. The allowance for uncollectible revenue in 2012 totaled $121 million, equivalent to 47% of total accounts receivable or 19% of operating revenue. The water department has employed various methods to improve collections, including the use of collection agencies, shutting off delinquent accounts after they miss two billing cycles, and installing meters with automatic reading devices to reduce billing disputes.

Philadelphia's combined water and sewer system is highly leveraged and the $2 billion 2014-2020 CIP is likely to require significant additional debt funding. However, now that the city has entered into a $1.2 billion (net present value; nominal value is over $2 billion), 25-year consent decree (a consent order with the Pennsylvania Department of Environmental Protection in 2011), a good portion of the CIP projects are now definable. As debt is layered in from Pennvest loans and proposed revenue debt, annual debt service costs should also steadily increase. We expect that management will continue to raise rates, as it has in the past, to fund these additional costs as well as cash-funded capital costs for general operating expenses. Total debt has consistently represented about 90% of net PP&E, which we consider high. Given the large CIP, we do not expect this to change materially over time.

Only about 8% of the city's water and sewer revenue debt is variable rate, and just 4% remains unhedged after taking into account a floating-to-fixed interest rate swap related to the city's 2005B bonds (notional amount of $67.2 million as of November 2013); these bonds have been purchased by Bank of America pursuant to a variable-rate securities agreement that expires at bond maturity in 2018 and payable at 68.5% of LIBOR. The swap counterparty is Citigroup Inc. Under the swap, the city receives the 2005B bond rate or 68.5% of LIBOR and pays a fixed rate of 4.53%. The additional termination event for the counterparty and city are the same: The ratings fall below 'A-'. As long as AGM insures the city's swap payments, no termination event based on the city's water and wastewater rating can occur as long as we rate AGM at least 'A'. Counterparty risk is somewhat elevated since we rate Citigroup 'A-/Negative'. The city, however, maintains the option of terminating the swap if Citigroup's ratings fall below the rating trigger; according to management, there are no current plans to change counterparties or terminate the swap.

Outlook

The stable outlook on the various long-term ratings and SPURs assigned on the basis of the pledged of net water and wastewater revenues reflects Standard & Poor's expectation that the water department will continue to raise rates to support financial operations in a historically consistent fashion.

With projections that indicate some use of the rate stabilization fund to subsidize operations, we also expect that if the draws do occur as projected, management will continue to manage its rate structure to keep DSC and unrestricted cash consistent with historical trends. If financial metrics are not maintained in this fashion, we could lower the rating or revise the outlook.

Given the large CIP and the weak demographics of the service base, we do not see the rating improving within our two-year outlook horizon. However, over a longer period of time we could foresee the rating improving as the need for additional debt subsides.

Related Criteria And Research

Related Criteria

- USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept. 15, 2008
- USPF Criteria: Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds, Sept. 15, 2008

Ratings Detail (As Of December 31, 2013)		
Philadelphia wtr & swr		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia wtr & wastewtr		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia wtr & wastewtr VRDB - 1997B		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Long Term Rating	AAA/A-1+	Affirmed

Many issues are enhanced by bond insurance.

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