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RESEARCH

Philadelphia, Pennsylvania; Water/Sewer

Publication date: 15-Apr-2009
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Credit Profile

US$144.92 mil wtr & wastewater rev bnds ser 2009 due 01/01/2040		
Long Term Rating	A/Stable	New
Philadelphia wtr & swr		
Long Term Rating	A/Stable	Affirmed
Philadelphia wtr & swr		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia wtr & wastewtr		
Unenhanced Rating	A(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services assigned its 'A' long-term rating, and stable outlook, to Philadelphia, Pa.'s series 2009 water and wastewater revenue bonds and affirmed its 'A' long-term rating and underlying rating (SPUR), with a stable outlook, on the city's existing water and wastewater revenue debt.

In our opinion, positive credit factors include:

- Despite the reliance on rate stabilization support, financial performance has been stable. With the rate stabilization funds, coverage of senior-lien debt service is adequate at 1.20x with 1.08x coverage of revenue debt and transfers into the general, capital, and residual funds.
- Rates, which are currently low, should rise to only moderate levels due to proposed rate increases that took effect in fall 2008. The last rate increase of 3.8% was effective July 1, 2007; and rate increases are expected to range between 5.0% and 10.0% over each of the next five years. Such increases are necessary to allow the maintenance of coverage as rate stabilization funds should continue to be drawn on.
- The well-experienced 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 the significant level of receivables, bad debt write-offs, and service shutoffs for fiscal 2007.

In our opinion, despite these positive credit factors, the rating remains restrained by:

- The city's continued reliance on rate stabilization fund support -- projected to continue to be drawn on over forecast period 2009 through 2014 -- to meet covenanted coverage, though fiscal 2007 closed out reporting an increase of this fund by nearly $26 million;
- The overall service area economy of the city characterized by weak demographic trends, which include a long-term population decline, resulting in overcapacity within the water system;
- A sizable capital program for the system, totaling $986 million for fiscals 2009 through 2014; and
- A highly leveraged system with a debt-to-plant ratio of 88%, which we consider high -- This, however, represents a

decline from 109% in 2005.

Water and wastewater system revenues secure the bonds. Officials will use series 2009 bond proceeds to finance a portion of the system's substantial 2010-2015 capital plan totaling $1.03 billion.

Philadelphia's water and wastewater systems provide service to roughly 1.7 million and 2.2 million, 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 approximately 12% of total billings as of 2008. Overall system operations are strong, complying with environmental regulations and ample capacity within the system.

Rates, which remain competitive, are currently $66.23 for a combined residential water and sewer bill for the typical 7,500-gallon use customer as of the last implemented increase for 2008, which was the first phase of a four-phase increase of 7.1%. Proposed rate increases to take effect for the first of three additional phases, however, reflect another 6.4% in 2009, 5.7% in 2010, and 5.9% in 2011. Although these are moderate increases, management still expects rates will remain competitive with the surrounding region. These rate increases are necessary to support increasing costs, especially in terms of chemical and fuel costs, as well as to maintain coverage ratios and liquidity as the system continues to wean itself from reliance on rate stabilization reserves. The water department made another deposit into the rate stabilization reserve of nearly $26.0 million in fiscal 2007 that brought the balance up to $185.6 million. Although the water department projected to draw on the rate stabilization fund for about $20.0 million in fiscal 2008, it actually drew down slightly more than $2.0 million, which left an ending balance of $183.1 million. As seen in the past, the water department continues to outperform projections without tapping into the stabilization fund to the substantial amounts projected. Management previously expected these reserves to be depleted 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 slight decrease in this fund, the city maintains its general usage trend for these reserves to meet covenanted coverage with a total balance of approximately $46 million by fiscal 2015; but these projections also assume modest overall growth. The water department expects to draw on the reserve for $49 million in fiscal 2009.

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

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 continue to adopt proposed rate increases to maintain current sound coverage as it expects to continue to draw on rate stabilization reserves, as forecast through 2015.

Service Area Economy

The Philadelphia economy is diversified with 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 because many of the sectors that form the region's economic base are growing slowly.

The city experienced moderate drops in its labor force (2.0%) and employment (2.2%) from 2001 through 2005; but it posted modest gains in 2006 by adding back approximately 14,000 (one half) of the jobs lost during the previous period. The city's 6.3% unemployment (2006) has edged away from peaks posted in 2002 and 2003; while in keeping with many urban centers, however, unemployment remains well above commonwealth 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 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. Median household effective buying incomes within the city account for just 75% of the national benchmark.

Education and health services account for a large 28% of Philadelphia's jobs. Growth prospects are good for the metropolitan area's core of knowledge-based industries -- which include 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 home to more than 80 degree-granting higher education institutions. Leading employers include several hospitals and health systems, numerous higher learning institutions, the government sector, 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 from the closure of several defense facilities (employing 20,000) in the 1990s. The Navy still maintains 800 personnel at the shipyard, which is also home to 80 companies that employ 7,000, including the 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 to mixed-use properties; the city expects these properties to be the site of one of its two newly approved casinos with the other expected to be located elsewhere in the city.

Limited new housing data is available, but management reports sale prices are down by about 1%. The city's residential values never experienced the strong increase in values during the strong real estate market; therefore, any expected declines in residential values 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 the SugarHouse Casino and Foxwoods Casino Philadelphia will open in 2010. The city is projecting these casinos to generate $23.6 million of annual "host fee" revenues from a 4% tax on casino gross revenues beginning in 2012. Should the projects be materially delayed, the city's five-year financial plan could be compromised because it contains approximately $78 million of projected casino-related revenues.

Several large-scale economic development projects have bolstered the city's tourism base over the past several years; these projects include the construction of new stadiums for the National Football League's Philadelphia Eagles and Major League Baseball's Philadelphia Phillies, for a combined $1 billion, as cornerstones of the city's sports district. Other recent large-scale projects include:

- A performing arts center to enhance 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 convention center. These projects should help enhance the city's efforts to expand tourism, which is already a key driver of Philadelphia's economy.

Finances And The Capital Improvement Plan

Finances

Philadelphia's financial operations have been stable, but they are reliant 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. 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 $185.6 million at fiscal year-end 2007, up by nearly $26.0 million from fiscal 2006 and closer to the fund's peak balance of $201.0 million in fiscal 1998. Of this balance at fiscal 2007, management transferred $12 million into the residual fund. Despite this substantial deposit into the rate stabilization fund at fiscal year-end 2007, the water department, once again, expected a draw on the rate stabilization fund of $20 million for fiscal 2008; but actual audited results report a draw of slightly more than $2.0 million, which left an ending balance of slightly more than $183.1 million. 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-expected fiscal 2007 operations have diminished the need to use reserves and, in essence, extended the fund's life. Although the department has drawn down the rate stabilization fund slightly in fiscal 2008, coverage is still maintained at a sound 1.2x, which is what the department operates to meet and maintain.

The department has a past history of poor revenue collections, attributable, in part, to a quarterly billing cycle and a four-month moratorium on shutoffs during the winter months. The implementation of monthly billing in fiscal 1993 improved collections, which leveled off at about 85%-86% over the past several years; this still poses a credit concern. This rate has since continued to improve, alleviating some, but not all, of the concern; collections improved to about 91% as of fiscals 2007 and 2008. The water department has employed other 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. There are roughly 16,000 water and wastewater accounts that are in nonservice status due to service shutoffs for nonpayment. The allowance for doubtful accounts was more than $75 million in fiscal 2007, down slightly compared with the $78 million at fiscal year-end 2006; but this allowance remains high. The department's liquidity was an adequate 59 days' unrestricted cash on hand for fiscal 2008; this ratio improves when the rate stabilization fund is included.

The capital plan

The capital improvement plan for fiscal 2010-2015, including the current capital budget, totals $1.03 billion with the two largest projects being $325 million, or 32% of the total plan, for storm flood relief projects and $288 million, or 28%, for treatment plant improvements. The system plans to issue $180 million with a forward starting swap in fiscal 2010 and approximately $350 million in 2013. 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.

Legal Provisions

A net pledge of the water and wastewater system secures the bonds. 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.

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, under the legal provisions, for the two fiscal years following the debt issuance. The requirement that net system revenues, excluding 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 over 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

The overall DDP score of '2' reflects our view that Philadelphia's water-and-sewer-enterprise-fund-related swap portfolio is currently a neutral credit risk due to:

- The limited counterparty risk due to 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-rate 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, because of the low degree of termination risk due to the swap termination payments being insured by Financial Security Assurance and the swap's above-average economic viability, we are not currently factoring in these values as contingent liabilities for the city.

Related Research

"Standard & Poor’s Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds," Sept. 15, 2008