

Rating Update: MOODY'S DOWNGRADES THE HARRISBURG AUTHORITY'S (PA) WATER REVENUE BONDS TO Ba1 FROM A1; NEGATIVE OUTLOOK ASSIGNED

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Water/Sewer
PA

Opinion

NEW YORK, Jan 18, 2011 -- Moody's Investors Service has downgraded to Ba1 from A1 The Harrisburg Authority's (PA) \$69.42 million in outstanding Water Revenue Refunding Bonds, Series of 2008. The rating has been removed from Watchlist and a negative outlook has been assigned. The bonds are secured by net revenues of the authority's water system. We do not maintain a rating on the City of Harrisburg's general obligation debt.

RATING RATIONALE

The downgrade to Ba1 from A1 reflects the system's exposure to the City of Harrisburg's financial distress given the city's relationship as operator of the water system and the authority's governance structure. The results of this relationship include a lack of timely financial disclosure, weakened debt service coverage and late adoption of a 2010 budget. The downgrade also considers the risk to the system's liquidity and potential disruption to financial operations if the city pursues a bankruptcy filing under Chapter 9, an action that the city could take having recently filed for distressed city status under Act 47. The negative outlook incorporates the potential for additional deterioration given the city's ongoing financial crisis, although we believe bondholders have some protection given that the authority is prohibited from conveying assets to the city without impairing bondholder security (as per the Municipal Authorities Act and Trust Indenture). Additionally, given the system's function as an essential service, we believe the city is unlikely to take actions that would considerably disrupt the water system's operations for an extended period of time.

ONGOING EXPOSURE TO THE CITY OF HARRISBURG'S FINANCIAL DISTRESS NEGATIVELY AFFECTS FINANCIAL HEALTH OF WATER SYSTEM

The Harrisburg Authority owns the water system and is responsible for setting water rates and charges. Pursuant to a Management Agreement (originally dated March 1, 1990), the City of Harrisburg operates and manages the system, including billing and collections, as well as employee payroll. This relationship exposes the water system to the city's financial distress, which could result in a disruption in financial operations should the city file for bankruptcy under Chapter 9. In addition, with the Authority's consent the water system's liquidity may be drawn into the financial plan developed by the Act 47 coordinator, which is expected to be formulated over the next few months. The City of Harrisburg's distressed financial position stems from guaranteed resource recovery facility debt, which is first secured by revenues from Harrisburg Authority's Resource Recovery Facility. Although the facility is managed and administered by Harrisburg Authority, the water system, which is also administered by the authority, remains a distinct and separate system with separate financial operations. Insufficient revenues of the resource recovery facility caused the city to pay on guaranteed debt beginning in 2007 and deplete its own liquidity; starting on June 1, 2009 date the city stopped making its guarantee payments. Facing \$282 million of unsupported city-guaranteed resource recovery debt, the city filed distressed city status under Act 47 on December 15, 2010. Act 47 has provision for filing for bankruptcy under Chapter 9, if necessary to financial recovery.

The water system pays an annual General Administration Fee (GAF) to the city, which represents the indirect costs associated with the operation and maintenance of the system. In fiscal 2008, the \$5.2 million GAF payment represented a notable 10.3% of the city's General Fund revenues. The GAF payment is subordinate to direct O&M and debt service. The relationship between the city and the authority has historically limited the system's ability to maintain a stable and healthy liquidity position given the city's reliance on the GAF transfers from the water system. In fiscal years 2005 and 2006, unrestricted cash was 31.2% and 33.7% of direct O&M. However, 2007 and 2008 results reflect a material increase in the system's cash position to a healthier 77.8% and 60.8% respectively. The authority utilized portions of these available funds to maintain transfers to the city in 2009 (unaudited) and 2010 (projected) and plans to draw reserves moving forward for capital expenditures. Since 2004, the annual GAF transfer to the city has ranged from \$3.5 million to a more typical \$5.2 million. Although revenues have declined in recent years and expenses have increased, reducing debt service coverage to 1.34 times annual debt service in fiscal 2009 (unaudited) from a healthier 2.22 times in 2007, the annual GAF payment has remained high at \$4.3 million and \$4.9 million in 2008 and 2009, respectively. Favorably, the adopted fiscal 2011 budget reduces the payment to just \$1.4 million.

The city's distressed financial operations and strained political environment have created a challenging environment for the authority to adequately manage the water system's annual financial disclosure and budgeting. As a result of the city's role as operator of the water system, the authority has yet to release its fiscal 2009 audit, over 12 months after the close of the year. The city also controls the water system's initial budget, although the authority maintains final approval. A delay in the city's budgetary process has prohibited the authority from adopting a budget and from timely rate increases. In fiscal 2010, when the mayor and city council failed to appoint enough authority board members for a quorum until mid-year, a budget was not approved until November. Board members are appointed by the mayor and approved by city council and maintain sole control over raising rates. The delay in appointing board members in 2010 resulted in a delay in the authority's review of the system's rate study and any rate increase deemed necessary. The rate study initially recommended a rate increase in 2011, although, management has maintained rates level and plans the use of cash reserves instead.

CITY'S DISTRESS COULD AFFECT SYSTEMS LIQUIDITY

The city's ongoing financial distress could affect the water system's liquidity. The authority reportedly maintains approximately \$12 million of excess authority and trustee held funds, beyond debt service reserve and operational reserve requirements, which could provide financial relief for the city. As system operator, the city maintains a Water System Operating Account on behalf of the authority, which could be at least temporarily disrupted by a Chapter 9 filing. The authority has the ability to take over the water system operations currently under city control and maintain them itself. It is uncertain, however, how long it would take for the authority to establish billing and payroll processes that may require

requests for proposals or other obstacles to a swift takeover.

Although state statute allows an authority to transfer assets back to a municipality, we believe bondholders remain relatively well-protected. The Municipal Authorities Act allows for a municipality to compel an authority to convey authority property back to the municipality. There is precedent in Pennsylvania (County of Mifflin v. Mifflin County Airport Authority), where the Commonwealth Court ruled that conveyance of authority property is prohibited if prohibited under the indenture. The original and supplemental water system indentures prohibit the conveyance of property to the city without a Consulting Engineer's Certificate stating that the disposition of properties will not impair bondholder security.

WATER SYSTEM OVERVIEW; MODERATELY SIZED CUSTOMER BASE IN SOUTH CENTRAL PENNSYLVANIA

The Harrisburg Authority's Water Enterprise supplies, treats and distributes water for the City of Harrisburg as well as a few surrounding municipalities in Dauphin County, including part of Borough of Penbrook (G.O. rated A3) and the Townships of Susquehanna (G.O. rated Aa2), Swatara and Lower Paxton (G. O. Aa2). The service area's population is approximately 66,250, of which roughly 82% are in the City of Harrisburg. As of 2010, the water enterprise had 20,770 customers, of which approximately 90% are residential. While all residents within Harrisburg are served by the authority, many of the surrounding municipalities are served by a private water provider, thereby limiting the authority's ability to expand its service area and customer accounts. Socioeconomic indices within the city are below average, with per capita and median family incomes that have steadily declined in each of the last four decades and are currently 75.6% and 60.1% of the state, respectively. As of October 2010, unemployment rates in the city were still elevated at 11.9%, above state and national levels of 8.4% and 9%, respectively.

The water enterprise's primary water source is DeHart Dam, located about 21 miles north of the city and from which water flows by gravity via transmission line to the water treatment plant. A secondary (primarily emergency) source of water is via a pump station at the Susquehanna River. The water treatment plant has a maximum capacity of 20 million gallons per day (MGD) and although permitted capacity is lower at 15 MGD, it has ample capacity to address an average daily demand of 8 MGD and peak demand of 10 MGD. The authority has four storage tanks with a total capacity of approximately 31 million gallons, or almost four days of water. At this time, the treatment plant is not under any mandates or consent decrees. The system's water loss rate is estimated to be between 15% and 20%, which is slightly above national levels, but not uncommon relative to regional systems.

The original and supplemental indentures provide a debt service reserve fund (DSRF), replacement and renewal fund, rate covenant and additional bonds test. The DSRF requirement is cash funded for each series of bonds at the lesser of (i) 10% of the bonds; (ii) maximum annual debt service (MADS); or (iii) 125% of average annual debt service. The system is required to maintain a replacement and renewal fund at a minimal level of \$500,000. The rate covenant is relatively weak at 1.1 times annual debt service and accumulated surplus may be included in the coverage calculation. Additional bonds may be issued if net revenues for any 12 consecutive months out of the 18 months immediately preceding the month of the delivery of the bonds are not less than the Debt Service Requirements on the bonds outstanding during that period and provide 1.1 coverage of MADS on the bonds then to be issued.

ABOVE AVERAGE DEBT POSITION

We believe the water enterprise will remain highly leveraged as amortization of principal is below average with 32.6% repaid in 10 years. Since 2004, the enterprise's debt ratio has averaged 146.6% (154.3% in 2008), which may limit the authority's ability to finance any unexpected capital needs through borrowing. The authority's capital improvement plan calls for \$9.2 million of expenditures over next three years, of which \$3 million is expected to be financed with a loan from Pennvest. Of the \$156.6 million of outstanding debt, 19.6% is variable rate (Series 2002 B and C) and is insured by Assured Guaranty.

WHAT COULD MOVE THE RATING (UP):

- Improved financial operations at city-level
- Implementation of financial recovery solution for city and resource recovery facility that doesn't negatively impact water system operations

WHAT COULD MOVE THE RATING (DOWN):

- Actions related to the city's financial distress or recovery that could negatively affect the water system's operations
- Narrowing of water system's financial debt service coverage or liquidity

KEY FACTS:

Security: Net revenues of the water enterprise

Type of System: Water supply, treatment and distribution

Service Area/Population: City of Harrisburg and portions of Dauphin County

Number of Water System Accounts, FY 2010: 20,770

Operating Ratio (2008/2009 unaudited): 23.9%/27.7%

2008 Debt Ratio: 154.3%

Senior Lien Debt Service Coverage Ratio (2008): 1.77x

Senior Lien Debt Service Coverage Ratio (2009, unaudited): 1.34x

Post-Sale Debt Outstanding: \$156.6 million

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published August 1999.

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