# MEMORANDUM

Date: April 29, 2011

To: The Honorable Chairman and Members
Pima County Board of Supervisors

From: C.H. Huckelberry
County Administrator

Re: **Regional Wastewater Reclamation Department 2011 Financial Plan**

I am enclosing a copy of the 2011 Financial Plan reviewed by the Pima County Regional Wastewater Reclamation Department Advisory Committee. No Board action is required on this plan. The Board previously approved a series of rate increases but required submission of an annual report to the Board regarding the need for those rate increases. The enclosed financial plan and this memorandum serve as the annual report.

Implementation of the Regional Optimization Master Plan (ROMP) and major capital renovation of our two largest regional wastewater treatment facilities are on schedule. In fact, capital improvements implemented to date have been substantially less than estimated in the original ROMP and financial plan. Cost savings to date total more than $60 million and are expected to increase as the program is implemented over the next 36 months.

The financial plan continues to be cautiously optimistic regarding the need for future rate increases beyond the forecast period; none are expected. In fact, as the end of the ROMP construction program approaches, the County should have a substantial accumulated cash balance in the Wastewater Reclamation Revenue Fund to allow the Board to consider a rate reduction or rebate in 2015. At that time, a substantial portion, if not all, of the ROMP program will have been completed; and the need for future capital construction appears to be very modest when compared to the program now being undertaken. This modest need results in stabilization and perhaps declines in sewer user charges.

I am also attaching the most recent debt ratings by Fitch and Standard & Poors, which reaffirm the positive ratings we have obtained in the past and reflect a stable outlook. The Board's proactive rate establishment to meet federal and state regulatory mandates is the single largest contributor to the positive and stable debt ratings issued by Fitch and Standard & Poors.

CHH/mjk
Attachments

c: John Bernal, Deputy County Administrator for Public Works
Tom Burke, Director, Finance and Risk Management
Jackson Jenkins, Director, Regional Wastewater Reclamation

# PIMA COUNTY

## Regional Wastewater Reclamation Department
## 2011 Financial Plan

*April 2011*

***Pima County Department of Finance and Risk Management***
*130 West Congress, 10th Floor*
*(520) 740-3030*

# 2011 Financial Plan

## Pima County Regional Wastewater Reclamation Enterprise Fund

**Summary and Recommendations:**

On an annual basis, Pima County reviews the rate structure for the sanitary sewer services provided through the Regional Wastewater Reclamation Department. On March 9, 2010, the Board of Supervisors adopted automatic increases in fees effective annually through July 1, 2013. At the time the Board adopted this fee structure, the Board directed Finance and Risk Management to prepare an annual report and analysis in conjunction with the annual County budget process. To prepare this analysis, Finance and Risk Management reviewed the projected revenues and expenses for the remainder of the current fiscal year and for the next four fiscal years through Fiscal Year 2014-15 as well as the projected capital improvement program for the same period. The focus of the review is to ensure that the County has sufficient cash when needed to meet all operating and maintenance expenses, to meet all debt service payments and reserves required by the County's debt covenants, and to provide a sufficient unrestricted reserve to enable the County to continue to issue debt for the sewer improvements included in the Capital Improvement Program. Based on this review, the Pima County Finance and Risk Management Department is recommending:

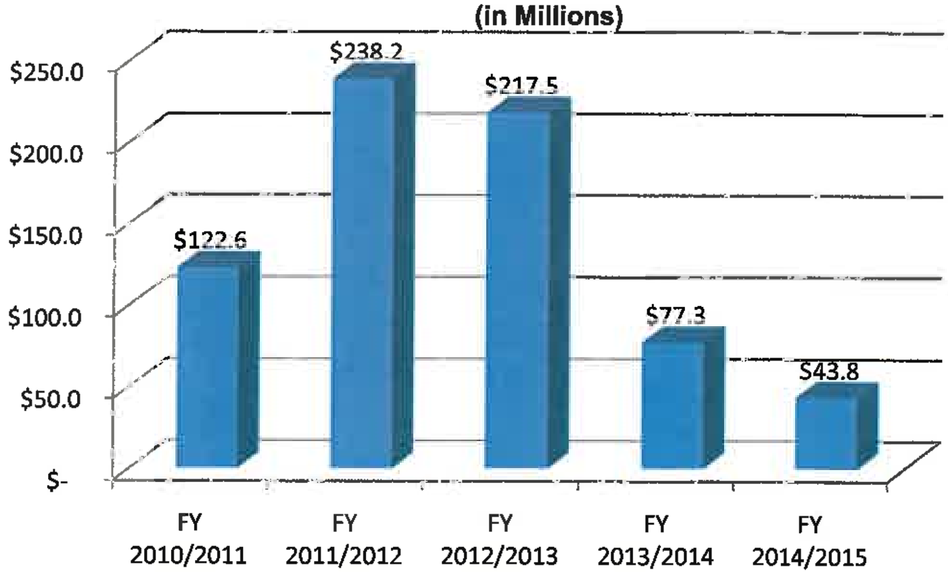
1. The continuation of the existing fee structure with the scheduled annual increases through July 1, 2013.
2. The delay, until early Fiscal Year 2011-12, of the issuance of new debt originally planned to be issued during the current fiscal year.
3. An increase in the amount of the next debt issue to $230 million to coincide with the timing of the cash needs of the capital improvement program.

**Analysis of Cash Needs of the Regional Wastewater Reclamation Department**

**Capital Improvement Program:** Pima County has began the design and construction of a major capital improvements program, generally referred to as the Regional Optimization Master Plan (ROMP), necessary to meet the County's permitting requirements for environmental compliance. The ROMP program is described in detail at http://www.pima.gov/wwm/programs/ROMP/. The County's current capital needs include the ROMP program as well as improvements needed to perform ongoing maintenance of the conveyance system and treatment system. For the five fiscal years included in this review, through Fiscal Year 2014-15, the County estimates it will need to expend $699.4 million for these capital improvements. An additional $54.3 million of capital improvements are currently anticipated to be needed thereafter. The capital project costs anticipated annually for Fiscal Year 2010-11 through Fiscal Year 2015-16 is shown in **Figure 1**.

**Figure 1: $699.4 Million Capital Project Costs by Fiscal Year**

(in Millions)



These capital costs are lower than projected in the 2010 Financial Plan. The County experienced significant cost savings in several construction contracts that were awarded during the past year which reduced the overall cost of the ROMP and other capital projects by more than $60 million.

To meet the $699.4 million of capital needs, Pima County must generate sufficient revenues from the operations of the Regional Wastewater Reclamation Department (1) to cover the sewer system's operating and maintenance expenses, (2) to meet the debt service payments for the existing and anticipated debt needed for the ROMP and other capital programs and (3) to have an adequate level of net operating revenue to provide for sufficient cash reserves to meet minimum debt service ratios.

**Projected Revenues:** Revenues from the wastewater system are generated basically from two major sources: sewer user fees and sewer connection fees. Projected Revenues in this Financial Plan are at approximately 98 per cent of the amounts projected in the prior year's Financial Plan. Although sewer user fees are higher, connection fees are approximately $3 million lower each year than the amounts projected in last year's Financial Plan. With the current contraction in the real estate industry and the increase in sewer volumetric user fees, the County's reliance upon sewer connection fees has declined substantially in recent years. Sewer connection fees are expected to be near 10 per cent of revenues for future years. Sewer user fees are now expected to be 89 per cent of total revenues from the system.

Revenues from the sewer system for the current fiscal year are expected to be $147.5 million, with $129.5 million of those revenues derived from sewer user fees and $16.5 million derived from connection fees. Revenues for the next four fiscal years are expected to steadily increase with sewer user fees increasing by approximately 10.7% for each of the next three years. The Financial Plan assumes very low growth in the customer base.

**Projected Operating and Maintenance Expenses:** The operating and maintenance (O&M) expenses for the Regional Wastewater Reclamation Department are significantly lower than projected in the 2010 Financial Plan. The Department is expecting to complete the current fiscal year with O&M costs of $72.3 million, more than $10 million less than the $82.9 million projected in last year's Financial Plan. The O&M portion of the budget requested by the Department for Fiscal Year 2011-12 is for $73 million, a one per cent increase over the O&M expenses for this year. This is more than $12 million less than anticipated in the 2010 Financial Plan. The most significant portion of O&M costs are related to employee compensation, which, at $36 million next fiscal year, represents 49.4 per cent of total O&M costs.

The Board of Supervisors implemented controls over the portion of the Department's budget relating to operating and maintenance expenses. In prior years, the Regional Wastewater Reclamation Department's O&M expenses were increasing by more than 12 per cent annually, from $39.2 million in Fiscal Year 2001-02 to more than $75.8 million in Fiscal Year 2007-08. In March 2010, the Board adopted budgetary guidelines beginning with Fiscal Year 2010-11 by restricting increases in the Department's O&M expenses to a maximum of 3.4 per cent annual increase over the prior year's actual expenses. The County Administrator has further directed the Regional Wastewater Reclamation Department to limit the increase in O&M expenses for Fiscal Year 2011-12 to one per cent, permitting an increase from $72.3 million to $73 million as part of a County-wide cost reduction plan. Other County departments were directed to decrease their operating budgets by 1.5 per cent.

For planning purposes for subsequent years, this Financial Plan assumes that O&M expenses will increase by the 3.4 per cent maximum amount set by the Board of Supervisors on March 9, 2010.

Even at that rate of increase, the O&M increases are expected to be more than $60 million lower during the five year period covered by this Financial Plan than had been anticipated in the 2010 Financial Plan. The use of a 3.4 per cent annual increase in future years is a conservative approach to planning for O&M expenses which may, in fact, increase at a slower rate or potentially decrease due to innovations in technology, the privatization arising from the Design-Build-Operate contract with CH2M Hill for the Wastewater Reclamation Campus at Roger Road, and the implementation of the multi-skilled training program by the Department.

**Net Operating Revenues:** The net operating revenues (derived from the system revenues less the O&M expenses) must be sufficient to meet the required debt service payments, reserves established by the Board of Supervisors and the debt covenants, and the necessary reserves to enable the County to obtain acceptable ratings from the key rating agencies for debt issues. The County has structured the debt issues to provide cash for the Regional Wastewater Reclamation Department's capital improvement program. The Net Operating Revenues from the sanitary sewer system are expected to increase from $75.2 million this fiscal year to $118.8 million in Fiscal Year 2014-15. As discussed in more detail below, the County needs to finance capital programs through debt issues rather than use available cash. The cash resulting from the Net Operating Revenues can, however, be used to significantly decrease the debt service requirements for debt. Appendix A provides additional detail of the revenues, major expenses and net operating revenues of the system.

**Sewer Revenue Debt Issues:**

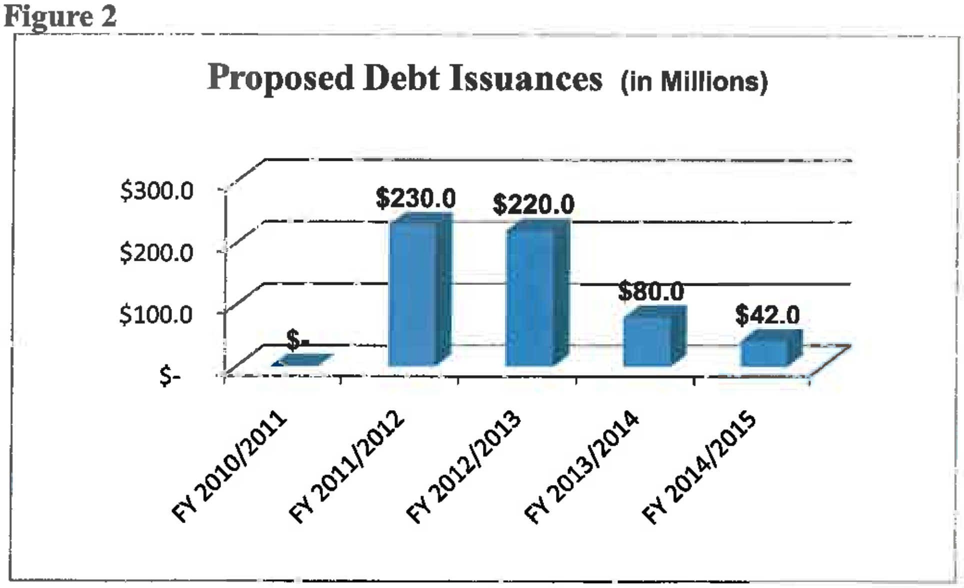
At June 30, 2010, Pima County had $398 million of outstanding sewer revenue debt. This includes the $165 million issued in June 2010, which had an interest rate of 3.9227%, and sold for

$178.2 million, thus yielding a premium of $13.2 million. In addition to the debt issued last fiscal year, the County recently competed a refunding of $43.6 million of existing sewer revenue bonds and WIFA loans in March 2011. This reduced the interest rate to 2.48562%, producing interest savings of $1.87 million, with a present value of $1.745 million.

The 2010 Financial Plan indicated that the County would have another debt issue for an additional $165 million during Fiscal Year 2010-11. Due to the cost savings experienced with some capital projects and the timing of several major projects, the County has not expended all of the funds from the June 2010 debt issue and does not anticipate spending down all of those funds until the first quarter of Fiscal Year 2011-12. Because the proceeds from the June 2010 debt issue will meet the cash needs of the capital program for the remainder of this year, Finance and Risk Management determined that there was no need for a debt issue until next fiscal year. Based on the current schedule of capital project expenses, a debt issue of $230 million will be needed in the first quarter of Fiscal Year 2011-12; an additional $220 million in Fiscal Year 2012-13; an additional $80 million in Fiscal Year 2013-14; and a debt issue of $42 million in Fiscal Year 2014-15.

The anticipated debt issues for through Fiscal Year 2014-15 are show in Figure 2, below.

**Figure 2**

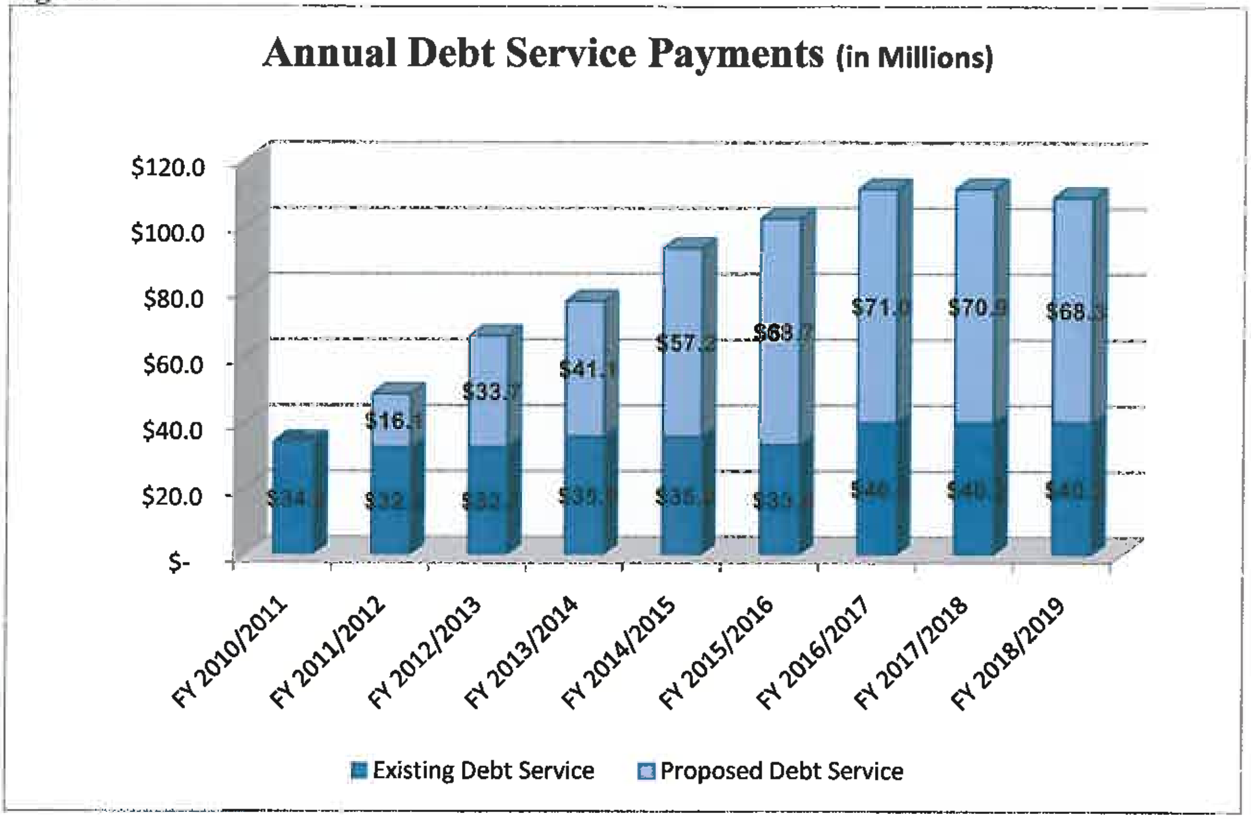


**Debt Service:**

Because the County must issue significant debt to fund the ROMP and other capital projects of the sewer system, the debt service payments are expected to increase significantly in the upcoming years. Debt service for the current fiscal year will be $34.3 million. As additional debt is issued to pay for the ongoing capital projects, debt service payments will increase to $48.8 million for next fiscal year. Depending on the ultimate cost to complete the ROMP projects and other capital projects, debt service payments may increase to more than $110 million by Fiscal Year 2016-17. For this Financial Plan review, Finance and Risk Management has made the assumption that future debt will have an interest rate of five per cent next year and six per cent each debt issue thereafter. Although Pima County has experienced more favorable interest rates in the most recent debt issues, the vagaries of the municipal debt markets make future interest rates unpredictable. The projections of debt service for future debt also include an assumption that Pima County will use available cash to accelerate the payment of principal on new debt (after meeting the requirements for cash reserves and debt service ratios). Accelerating the payment of principal on new debt will provide additional interest savings.

The current rate structure is anticipated to generate a sufficient revenue stream to meet the debt service payments for each of the upcoming years included within the period covered by this Financial Plan. Projected annual debt service payments through Fiscal Year 2018-19 are show in Figure 3.

Figure 3




**Cash Reserves, Cash Balances and the Expenditure Limitation:** Pima County has several types of restricted cash accounts created to meet the debt covenants contained in the existing debt issues as well as to establish an emergency fund to enable the County to handle unexpected events. The restricted cash accounts include:

1. **Emergency Reserve Fund** – $20 million has been set aside into an Emergency Reserve Fund originally established by the Board of Supervisors at $10 million and increased over a period of years to $20 million. This fund has been designated by the Board to be used for unexpected events that affect the ongoing operations of the sewer system. This fund is not formally restricted either by covenant with third parties or by statute and is therefore available for any use relating to the sewer system that the Board deems appropriate.

2. **Operating Reserve Fund** – The County maintains 90 days of anticipated operating expenses in this restricted fund. This fund currently has $16.5 million in reserve and could increase to $18 million depending upon actual expenses by the end of the fiscal year.

3. **Debt Service Reserve Fund** – This restricted fund is used to set aside cash for debt service payments. On a monthly basis, the County transfers one-twelfth of budgeted annual debt service into this reserve account to ensure cash is available for the annual debt service payments. Additionally, the County has $11.2 million being held as a debt service reserve by the trustee bank servicing the $165 million debt issued in June 2010.

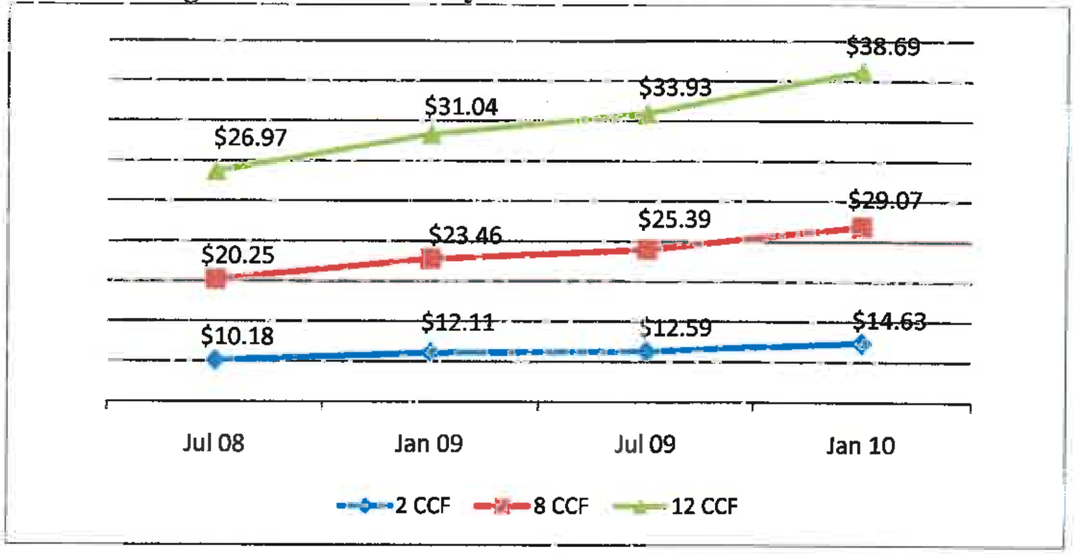
4. **Unrestricted Cash Balances** – At its March 9, 2010, the Board of Supervisors adopted a series of future rate increases and, simultaneously, restricted any unrestricted cash balances in the County's Regional Wastewater Reclamation Enterprise Fund to be used for reduction of debt or for rebate of sewer fees. In order to meet this directive, Finance and Risk Management monitors the cash available within the fund for such purposes. In addition to these uses, the County needs to maintain sufficient unrestricted cash to satisfy the debt service ratios at levels mandated by debt covenants as well as at levels necessary to obtain favorable debt ratings from the national rating agencies which evaluate County debt.

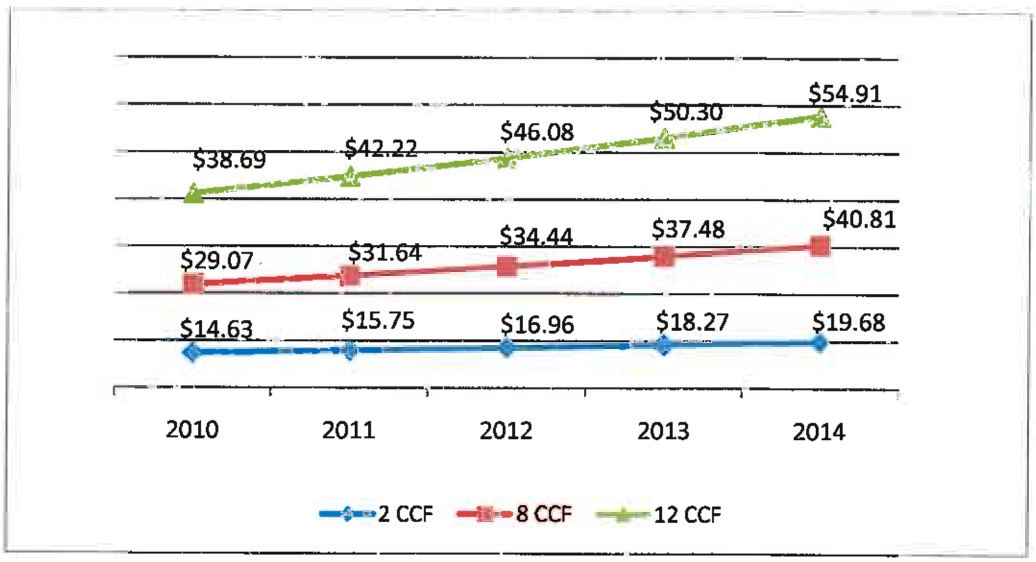
Due to the constitutional expenditure limitations restrictions in Article 9, Section 20, of the Arizona Constitution, the County is not able to use available cash on hand to fund capital improvements. The expenditure limitation restricts the use of "local revenues." Local revenues consist of primary property taxes, impact and connection fees for both the RWRD and the Department of Transportation, and all fees charged for County services, which would include all fees charged for sewer services. The expenditures limit, established by the State's Economic Estimates Commission, is currently $516 million for Pima County. The County may not exceed the expenditure limit even if the County has cash available to spend. County expenditures, especially expenses related to the wastewater system, have increased at a rate greater than the rate of increases in the expenditure limitation, and the County's expenditures are now essentially at the Constitutional limit. The County can use the available cash to pay for debt service but not to fund projects. In order to comply with the expenditure limitation, the County must fund capital projects with borrowed funds, and the available unrestricted cash will instead be used to pay down the principal of debt issues.

**Rating Agencies:** Pima County currently receives ratings from Fitch Ratings and from Standard & Poor's for all of its debt instruments, including Pima County sewer revenue debt. Both these agencies recently issued ratings for Pima County sewer debt. The most recent rating reports are shown on Appendix B.

**Rates:** The Board of Supervisors set sewer fees through July 1, 2013. The rates and effective dates for the volumetric sewer fee for a residential customer is currently $2.647 per ccf, and will increase to $2.912 on July 1, 2011, to $3.203 on July 1, 2012, and to $3.523 on July 1, 2013. The standard monthly service fee is currently $10.46 and will increase to $11.14 on July 1, 2011, to $11.86 on July 1, 2012, and to $12.63 on July 1, 2013. Typical monthly bills for residential users based on various volume levels are depicted in Figure 4.

**Figure 4** **Average Customer Monthly Bills**




**Recommendations:**

The Pima County Finance and Risk Management Department is recommending:

1. The continuation of the existing fee structure with the scheduled annual increases through July 1, 2013.
2. The delay, until early Fiscal Year 2011-12, of the issuance of new debt originally planned to be issued during the current fiscal year.
3. An increase in the amount of the next debt issue to $230 million to coincide with the timing of the cash needs of the capital improvement program.

# List of Appendices

# APPENDIX A

## Five Year Financial Projections

**FISCAL YEAR 2010-11**
**FINANCIAL PLAN**

| | Fiscal Year Ended June 30 | | | | |
|---|---|---|---|---|---|
| | 2010-2011 | 2011-2012 | 2012-2013 | 2013-2014 | 2014-2015 |
| **System Revenues:** | | | | | |
| Sewer Utility Service | $ 129,450,000 | $ 143,412,943 | $ 158,781,906 | $ 175,844,962 | $ 178,361,992 |
| Sewer Connection Revenue | 16,500,000 | 16,791,540 | 17,882,990 | 19,045,384 | 19,045,384 |
| Engineering Review & Inspection Fees | 40,872 | 45,000 | 45,000 | 45,000 | 45,000 |
| Other Income | 1,487,945 | 524,070 | 1,573,928 | 1,781,488 | 2,035,169 |
| **Total Revenues** | 147,478,817 | 160,773,553 | 178,283,824 | 196,716,834 | 199,487,545 |
| **Operations and Maintenance Costs:** | | | | | |
| Employees Compensation | 34,883,264 | 36,030,705 | 37,255,749 | 38,522,444 | 39,832,208 |
| Other Operation and Maintenance Costs | 34,062,864 | 35,255,100 | 36,453,773 | 37,693,202 | 38,974,770 |
| Capital Expenses | 3,334,797 | 1,709,997 | 1,768,137 | 1,828,254 | 1,890,414 |
| **Operations and Maintenance Costs:** | 72,280,925 | 72,995,802 | 75,477,659 | 78,043,900 | 80,697,392 |
| **Net Revenues** | 75,197,892 | 87,777,751 | 102,806,165 | 118,672,934 | 118,790,153 |
| Plus Cash Balances Remaining After Reserves | 11,259,876 | 36,795,452 | 68,371,164 | 86,403,450 | 109,191,653 |
| **Net Revenues Including Remaining Cash Balances** | 86,457,768 | 124,573,203 | 171,177,329 | 205,076,384 | 227,981,806 |
| **Debt Service Payments:** | | | | | |
| Principal | 16,774,556 | 16,201,296 | 16,918,880 | 20,795,592 | 21,585,758 |
| Interest | 17,479,269 | 16,500,521 | 15,840,699 | 15,144,003 | 14,284,721 |
| **Total Existing Debt Service Payments** | 34,253,825 | 32,701,817 | 32,759,579 | 35,939,595 | 35,870,479 |
| Proposed Debt (Principal & Interest) | - | 16,100,000 | 33,662,000 | 41,054,000 | 57,239,333 |
| **Total Debt Service Payments** | 34,253,825 | 48,801,817 | 66,421,579 | 76,993,595 | 93,109,812 |
| **Debt Service Coverage for Revenue Obligations** | 2.52 | 2.55 | 2.58 | 2.66 | 2.45 |

# APPENDIX B

## Recent Reports From Fitch Ratings and Standard and Poor's

FitchRatings

# FITCH RATES PIMA COUNTY, AZ'S $46MM SEWER SYSTEM RFDG REVS 'AA-'; OUTLOOK STABLE

Fitch Ratings-Austin-22 February 2011: Fitch Ratings assigns an 'AA-' rating to the following Pima County, AZ (the county) subordinate lien revenue bonds:

--$46.1 million sewer system revenue refunding bonds, series 2011A.

The bonds are expected to sell via negotiation the week of March 15. Proceeds will be used to refinance outstanding sewer revenue bonds, prepay certain loans, and pay costs of issuance.

In addition, Fitch affirms the following ratings:

--$165 million in outstanding subordinate lien sewer system revenue obligations at 'AA-';
--$167.1 million in outstanding senior lien sewer revenue bonds at 'AA'.

The Rating Outlook is Stable.

RATING RATIONALE:
--Financial performance is expected to remain sound through the forecast period.
--The county prudently adopted a series of automatic annual rate increases to counter the anticipated rise in fixed costs over the next few years; user charges remain affordable, though are expected to increase rapidly, possibly eroding future rate flexibility.
--Capital needs are large and relate primarily to meeting regulatory requirements.
--Debt levels are projected to more than double over the next five years; however, capital costs are expected to drop considerably beyond the five-year horizon, and debt is retired rapidly.
--The service area is anchored by the presence of the military and defense industry which provides some stability; county unemployment rates are below state and national levels.

KEY RATING DRIVERS:
--Maintenance of sound financial results despite rising fixed costs will be important to maintaining the rating level.
--Successful management of construction and implementation of the county's Regional Optimization Master Plan (ROMP) projects will be important to keep costs from escalating.

SECURITY:
The series 2011A bonds are payable and secured by pledged revenues of the system, with such pledge being subordinate to the outstanding senior lien debt; the senior lien is closed.

CREDIT SUMMARY:
Financial operations are sound, with all-in annual debt service (ADS) coverage at 2.2 times (x) in fiscal year 2010. Including planned issuances totaling $632 million over the next five years, all-in coverage is forecast to drop to a low of 1.3x in fiscal 2015. However, given the county's history of enacting rate increases, in some cases even up to three rate hikes within one fiscal year, Fitch believes management will take the necessary steps to maintain the system's good financial performance. Furthermore, the aforementioned projections do not include unrestricted cash balances, which are legally part of pledged revenues and can only be used to pay debt service or provide rate relief. When projected unrestricted cash balances are included, all-in coverage estimates are over 2.0x in all years throughout the forecast period.

Liquidity has been healthy and was solid at 226 days cash on hand and 1,091 days working capital in fiscal 2010. The county recently increased both its emergency and operating reserves, and constitutional expenditure limitations restrict the amount of cash from revenues or fees that can be used for operating and capital expenditures (no restrictions exist for paying debt service). The increase in the reserve amounts combined with the spending limitations should lead to even stronger liquidity levels going forward. The county plans eventually to use some of its cash reserves to retire some of its debt.

The county completed a regional master plan in November 2007 that identified capital needs at an estimated $974 million over a 10-year period. The extensive capital improvement plan (CIP) focuses on addressing regulatory wastewater de-nitrification requirements at two of its facilities. The 50-year old Roger Road facility will be replaced by a new water reclamation campus and improvements will be made at the Ina Road plant. The new plant is scheduled to be in operation by January 2015, and rehabilitation and capacity needs at the Ina Road plant are scheduled to be completed by January 2014. Thus far, the projects are scheduled to be completed on time and costs have come in 30% below budget.

Given the constitutional limitations on cash spending, the county plans to predominantly debt-fund its CIP over the next five years. Debt levels currently are average but will more than double with the $630 million of planned added debt over the next five years.

Amortization of debt including the current issuance, however, is rapid with principal payout at 59% and 100% in 10 and 20 years, respectively. To cover the anticipated rise in fixed costs, the county enacted automatic annual rate hikes over the fiscal 2011 to 2014 periods. Volumetric user fees and standard service fees will increase annually by 10% and 6.5%, respectively. Rates are currently affordable at 0.7% of median household income (MHI). However, rapidly increasing user charges could erode future rate flexibility.

The county provides wastewater service to the Tucson metropolitan statistical area (MSA) as well as separate outlying areas in eastern Pima County. The system serves a population of approximately 1 million through 263,000 sewer connections. Together the wastewater facilities have a combined capacity of 99.8 million gallons per day (MGD) with sewer flows averaging 69.3 MGD.

Pima County is home to Tucson, Arizona, southern Arizona's largest city and county seat. Fitch rates the county's general obligation bonds 'AA'. The area's economy is diverse, featuring military and defense, higher education, healthcare, government, and manufacturing as primary anchors. County unemployment levels at 8.3% as of December 2010 are below state (9.1%) and national (9.1%) averages. County wealth levels are slightly below state and national levels.

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Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's U.S. Municipal Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:
--'Revenue-Supported Rating Criteria', dated Oct. 8, 2010;
--'Water and Sewer Revenue Bond Rating Guidelines', dated Aug. 6, 2008.
--'2011 Water and Wastewater Medians', dated Jan. 18, 2011.
--'2011 Outlook: Water and Wastewater Sector', dated Jan. 18, 2011.

For information on Build America Bonds, visit 'www.fitchratings.com/BABs'.

Applicable Criteria and Related Research:
Revenue-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=564565
Water and Sewer Revenue Bond Rating Guidelines
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=395918
2011 Water and Wastewater Medians
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=593285
2011 Outlook: Water and Wastewater Sector
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=593286

STANDARD & POOR'S

# Global Credit Portal
RatingsDirect®

February 24, 2011

# Pima County, Arizona; Water/Sewer

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# Pima County, Arizona; Water/Sewer

| Credit Profile | | |
|---|---|---|
| US$46.095 mil swr sys rev rfdg bnds ser 2011A due 07/01/2016 | | |
| *Long Term Rating* | A+/Stable | New |
| Pima Cnty swr (AGM) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Upgraded |
| **Pima Cnty swr** | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Upgraded |

## Rationale

Standard & Poor's Ratings Services has raised its rating on Pima County, Ariz.'s county's series 2010 sewer system revenue obligations to 'A+' from 'A'. At the same time, Standard & Poor's upgraded the county's sewer improvement and refunding revenue bonds to 'AA-' from 'A+'. Standard & Poor's also assigned its 'A+' long-term rating to the county's sewer system refunding revenue bonds, series 2011A, which is on par with the 2010 obligations. The outlook is stable.

The upgrade on the 2010 obligations reflects our expectation of decreased reliance on connection fees and nonrecurring revenue sources; and that the utility will build up a sizable cash balance after reserves from automatic annual rate increases through fiscal 2014. The upgrade further reflects our expectation that management will adjust rates as needed to ensure annual debt service coverage (DSC) is no less than about 1.3x (excluding unrestricted cash balance).

The upgrade on the sewer improvement bonds reflects our view of a closed lien structure and our expectation of very strong DSC levels, which in our opinion are more consistent with the higher rating. These bonds have a senior claim on net system revenues. Pima has covenanted not to issue any additional prior-lien obligations that would have a claim on net revenues senior to that of the 2011A bonds and 2010 obligations.

The ratings reflect our opinion of the county's sewer system's:

- Service area that encompasses the large and diverse Pima County (general obligation rating: AA-/Stable) regional economy, which includes the city of Tucson;
- Approved automatic rate increases through fiscal 2014 that system officials forecast will increase year-end cash balances while yielding very strong senior DSC ratios and good subordinate DSC ratios (excluding unrestricted cash balance) and reducing reliance on connection fees; and
- Consistently strong system liquidity since fiscal 2005 at no less than 153 days of operations, backed by a formal policy to target three months' operations and an emergency fund with $20 million balance.

Factors that partially offset these strengths, in our view, include the utility's:

- Historically high-but-decreasing reliance on connection fees in recent years when DSC without such fees was close to zero;
- Substantial five-year $742 million capital plan to comply with regulatory permit requirements by fiscal 2014 that

the county projects to require approximately $630 million in additional debt through fiscal 2014; and

- Reliance on higher rates to meet escalating debt service obligations.

A subordinate lien on sewer system net revenues and unrestricted cash balances secure the proposed bonds. Bond proceeds will refund portions of various prior-lien obligations. After the proposed refunding, the county will have approximately $180 million of prior-lien obligations and approximately $211 million of total obligations outstanding (that includes the series 2010 and the proposed 2011A bonds), the latter having a junior claim on net system revenues.

The 2011A bond provisions include a rate covenant to maintain rates, fees, and charges sufficient to cover 1.2x annual debt service on prior and parity obligations. The additional bonds test (ABT) requires 1.2x maximum annual debt service (MADS) coverage on previous and parity obligations. The ABT and rate covenant are somewhat weak, in our view, since revenues include the system's nonrecurring unrestricted cash balances, which totaled approximately $11.1 million in fiscal 2010.

Furthermore, if the system chooses to issue variable-rate debt, the indenture calculates debt service based on what we believe is a somewhat permissive assumed interest rate, which is the lesser of a maximum rate or the previous 30-day interest rates published by the bond buyer or another published index. The ABT and rate covenant also allows the inclusion of the direct subsidy for Build America Bonds (BABs), which also weakens the tests. Currently there are no BABs or variable-rate debt outstanding. Although the previous bonds require a debt service reserve (DSR) funded at average annual debt service, bond provisions for the 2011A bonds lack a DSR. The bond provisions for the 2010 obligations, however, include a DSR funded at one-half of MADS.

Pima projects cash balance remaining after reserves will gradually increase to about $115.3 million in fiscal 2015 from about $11.2 million in fiscal 2011. We view the proposed bonds' credit quality the same as the 2010 obligations, despite the lack of a DSR. The revenue growth the county expects from the approved automatic rate increases through fiscal 2014, growing year-end unrestricted cash balances, and projected system net revenues provide good DSC of no less than 1.3x (excluding unrestricted cash balances) of all of the system's existing and future debt service obligations through fiscal 2015 offset the lack of a DSR for the proposed bonds.

The county also secures its prior lien obligations with DSRs that are currently being satisfied with DSR surety policies from Assured Guaranty Municipal Corp. (AA+/Stable/--); National Public Finance Guarantee Corp. (BBB/Developing/--); and Ambac Assurance Corp. (not rated). The DSR funding requirements for the prior lien bonds is approximately $19.8 million, equal to average annual debt service. Assured provides $8.3 million of coverage, National $10.2 million, and Ambac $1.4 million. Pima is not planning to replace any of its surety policies. We are not concerned about the system's exposure to DSR surety policies for the prior-lien obligations because of strong expected coverage levels from rating increases, as well as the gradual paydown of these obligations and the bulk of the DSR requirements being covered by investment grade surety providers.

The Pima County Regional Wastewater Reclamation Department provides wastewater collection and treatment services to 263,596 customers in the Tucson metropolitan statistical and outlying service areas. The wastewater system's customer base increased at a 2.8% average annual rate from fiscals 2000-2007 before slowing to 0.7% and 0.6% in fiscals 2009 and 2010, respectively. New construction activity, particularly in the residential sector, had been very strong until a few years ago. New housing starts fell 82% to 2,179 in 2009 from a peak of 23,272 in 2005. This affected connection fees, which fell by 57% to $17.7 million in fiscal 2010 from a peak of $42.2 million in fiscal 2006, and are estimated at $15.7 million in fiscal 2011. System officials project connection fees of $16.8 million-$19.0 million annually from fiscals 2012-2015. The system is very diverse in our view, with the 10 leading customers in fiscal 2010 generating only 3.8% of gross system revenues.

As growth and connection fees have dropped off, county officials have implemented multiple rate increases in the past few years to meet operational and debt service needs. Despite this, the monthly residential sewer bill as of Jan. 1, 2010, is still affordable in our view, at $36.96, based on 7,500 gallons. The board has already approved additional annual rate increases through fiscal 2014 that will bring the monthly residential bill to $47.83 per 7,500 gallons by July 1, 2013. Annualized, this represents about 1.4% of the county's median household effective buying income (EBI). Rate increases will fund the utility's large capital plan in fiscals 2011-2015 to improve its existing metropolitan wastewater treatment facilities to meet regulatory requirements related to reducing ammonia and nitrogen in effluent discharged into the Santa Cruz River by Jan. 1, 2015. The utility is the last in Arizona to comply with the requirements. The county will finance the majority of the capital plan with debt.

We believe the utility has had historically good overall DSC and liquidity, despite it becoming increasingly reliant on diminishing connection fee revenues in the past few years as a weakening housing market slowed construction. From fiscals 2006-2009, DSC ranged from a high of about 3.1x in fiscal 2006 to a low of about 1.4x in fiscal 2009. For fiscal 2010, DSC is strong, in our view, at about 2.2x. The connection fee revenue was 40% of total system revenues in fiscal 2006; it declined to about 14% in fiscal 2010. At the same time, user fee revenue was 86% of total revenues in fiscal 2010 compared with 58% in fiscal 2006.

Officials forecast DSC ranging from 2.5x-2.7.x (including all debt and loans by the state's Water Infrastructure and Finance Authority) from fiscals 2011 through 2015 by all pledged revenues including unrestricted cash balances, and ranging from about 1.3x-2.2x without unrestricted cash balances. Excluding unrestricted cash balances and connection fees, projected DSC ranges from about 1.10x-1.75x in the same period. Projected senior DSC is very strong, in our opinion, at no lower than 3.7x. Forecasts include debt service after projected issuance of debt and approved rate and fee increases. The county assumes total operating expenses to rise no more than 3.4% annually based on a plan its board enacted in February 2010.

Liquidity is strong in our view, with $11.2 million in unrestricted cash at fiscal year-end 2010, equal to 60 days' operations. The board's plan formally changed the system's cash policies to include a 90-day operating reserve target and increase the funding level of its emergency reserve fund to $20 million from $10 million. As of Jan. 31, 2011, the emergency reserve fund balance totaled $20 million and the operating reserve balance was about $16.5 million, providing a combined 185 days' cash on hand based on projected fiscal 2011 operations. The plan also included a board-adopted policy of maintaining a 1.75x annual DSC on a combined senior and subordinate basis, including unrestricted cash balances. Because the system is limited on how much it can spend annually on expenditures by statute, excess cash above cash balance targets--the 90 day operating reserve and $20 million emergency reserve fund--will pay down principal or reduce user rates.

## Outlook

The stable outlook reflects our expectation that management will closely monitor the pace of development and adjust rates as necessary to maintain financial margins and liquidity consistent with the ratings. The outlook also reflects our expectation that the system will maintain good operating cash and cash reserves in line with its policies. Automatic rate increases offset by significant additional debt needs will likely not affect the ratings in the next two years. However, we could lower the ratings if the utility's financial performance deviates materially from forecast.

## Economy

Pima County encompasses 9,184 square miles in southern Arizona and had a 2010 population of approximately 1 million, 54% of which reside in Tucson. The county's population has risen steadily in recent years, with average annual increases of 2.3% from 2000-2010. We believe a stable-yet-growing local economy, coupled with favorable weather, good educational opportunities, and affordable housing, continues to draw new residents. However, similar to national trends, this growth has slowed in the past two years: In 2008, building permits hit record lows, and residential housing permits totaled what we consider a very low 2,179 compared with 12,272 in 2005. According to the county, the value of total building permits decreased to $564 million in 2009 from as high as $2.6 billion in 2005.

Services, government, and the military remain the primary employment sectors. Raytheon Missile Systems Co. (12,140 employees) became the leading employer in 2008. Following it was the University of Arizona (10,363), the state government (8,708), Davis-Monthan Air Force Base (7,755), and Tucson Unified School District (7,012). Tourism, particularly around Tucson, is another major economic driver, and visitors are attracted to the area's climate, nature areas, conventions, baseball spring training, and golf. Total tourist expenditures decreased to $1.79 billion in 2009 from $1.89 billion in 2008. The county's unemployment rate increased to 8.7% in 2010, on average, from 8.3% in 2009, but remains below the state's 9.1% average in 2010. Income indicators are good, in our view, with median household and per capita EBI measuring 92% and 96% of the national level, respectively.

## Related Criteria And Research

USPF Criteria: Key Water And Sewer Utility Credit Ratio Ranges, Sept.15, 2008

| Ratings Detail (As Of February 24, 2011) | | |
|---|---|---|
| Pima Cnty swr subord (AGM) | | |
| *Unenhanced Rating* | A+(SPUR)/Stable | Upgraded |
| Pima Cnty swr (ASSURED GTY) | | |
| *Unenhanced Rating* | AA-(SPUR)/Stable | Upgraded |

Many issues are enhanced by bond insurance.