



MEMORANDUM

Date: April 17, 2012

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

From: C.H. Huckelberry
County Administrator

A handwritten signature in black ink, appearing to be "C.H. Huckelberry", is written over the printed name and title.

Re: **Wastewater 2012 Financial Plan**

I am enclosing a copy of the 2012 Financial Plan prepared for the Regional Wastewater Reclamation Enterprise Fund. This plan has been forwarded to and will be discussed by the Regional Wastewater Reclamation Advisory Committee within the next two weeks. The plan will ultimately be submitted to the Board of Supervisors for your consideration and adoption. The plan is a continuation of an aggressive construction program to implement the Regional Optimization Management Plan (ROMP) and bring our two largest regional wastewater reclamation facilities into environmental compliance with new requirements by Fiscal Year (FY) 2014/15.

The ROMP program is well underway and is more than 45 percent complete. To date, as I have previously informed the Board, the cost of implementing ROMP is now less than was forecasted when first adopted. Further, implementation of ROMP will slow the rate of overall operating and maintenance annual cost increases as indicated in the plan and will produce effluent at the regional facilities meeting advanced water quality standards.

The plan contains the following key components:

- No adjustments to the wastewater reclamation rate increases adopted by the Board in 2010 except as noted below pertaining to connection fee rates.
- Proposes to implement an early debt retirement plan whereby, within the next two years, short term, or existing, debt of \$74.3 million will be retired. It is anticipated this aggressive debt retirement program can continue as the final construction phases of ROMP are completed, allowing unrestricted cash reserves now satisfying debt overlap requirements to be used for additional debt reduction.
- Facility construction for both the Ina Road and Roger Road wastewater reclamation facilities are significantly underway with no significant cost increases or changes in the adopted ROMP program.

The Honorable Chairman and Members, Pima County Board of Supervisors
Re: **Wastewater 2012 Financial Plan**
April 17, 2012
Page 2

- Due to new facilities coming online in the next two years, the annual operating and maintenance cost increases which have been held to no more than 3.4 percent per year are expected to moderate and drop to approximately 1.7 percent per year.
- The present capital construction program is beginning to diminish and will do so significantly over the next two years with the \$210 million in debt issuance to support capital construction planned for FY 2012/13 decreasing to \$55 million in two years.
- All fees are assumed to remain under the existing 2010 Board adopted rate schedule. Total revenues forecasted also anticipate Board adoption of the connection fee reduction in May 2012. Due to the general lack of building activity, this reduction is not expected to have any significant impact on overall revenues and will not require any adjustment to other rates such as user fees.

The implementation of the ROMP program and its financing requires continuous monitoring; hence, the annual adoption of the Wastewater Reclamation Financial Plan.

CHH/mjk

Attachment

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



2012 Financial Plan

Pima County Regional Wastewater Reclamation Enterprise Fund

Prepared by
Pima County Finance and Risk Management Department
April 12, 2012

2012 Financial Plan

Pima County Regional Wastewater Reclamation Enterprise Fund

April 12, 2012

Summary and Recommendations.....	1
Analysis of Cash Needs of the Regional Wastewater Reclamation Department.....	2
Capital Improvement Program.....	2
Projected Revenues.....	2
User Fees.....	2
Connection Fees.....	3
Projected Operating and Maintenance Expenses.....	3
Net Operating Revenues.....	4
Sewer Revenue Debt Issues.....	5
Debt Service Payments.....	6
Cash Reserves, Cash Balances and the Expenditure Limitation.....	7
1. Emergency Reserve Fund.....	7
2. Operating Reserve Fund.....	8
3. Debt Service Reserve Fund.....	8
4. Unrestricted Cash Balances.....	8
Rating Agencies.....	9
Rates.....	9
Recommendations.....	10
List of Appendices.....	11

Appendix A – Financial Projections Fiscal Year 2012 through 2017

Appendix B – November 2011 Reports from Fitch Ratings and Standard & Poor's

2012 Financial Plan

Pima County Regional Wastewater Reclamation Enterprise Fund

April 12, 2012

Summary and Recommendations:

On an annual basis, Pima County reviews the rate structure for the sanitary sewer services provided by 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 of the fees in conjunction with the County's overall annual budget process.

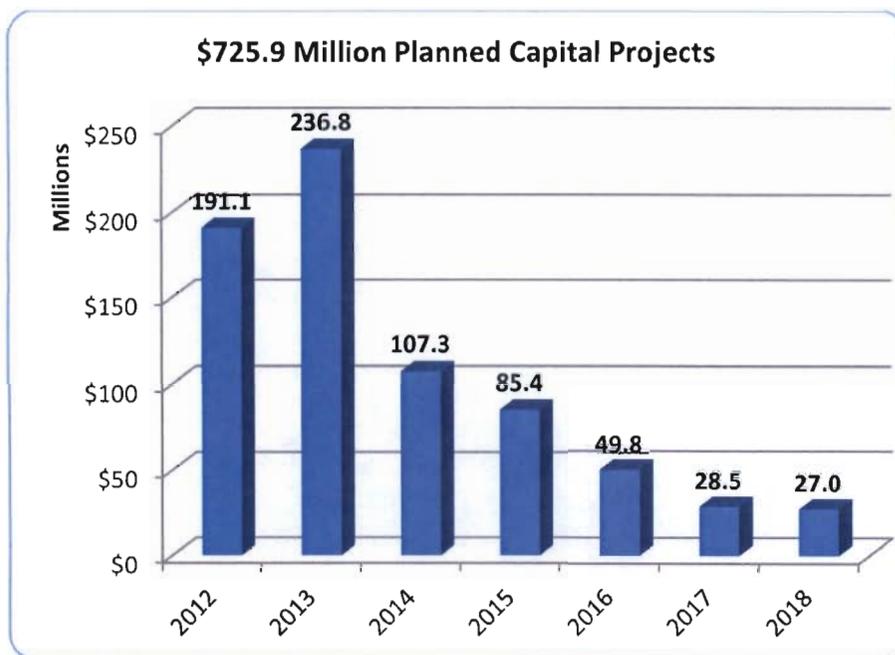
To prepare this analysis, Finance and Risk Management reviewed the projected revenues and expenses for the current fiscal year and for fiscal years through Fiscal Year 2016-17 and the projected capital improvement program for the same period. The focus of the review is to ensure that the County has sufficient revenues to meet all operating and maintenance expenses, to meet all debt service payments and to provide for the reserves required by the County's debt agreements. This will enable the County to continue to issue future debt for the improvements included in the Capital Improvement Program. Based on this review, the Finance and Risk Management Department is recommending:

1. The continuation of the existing fee structure adopted by the Board of Supervisors in 2010 with the scheduled annual increases through July 1, 2013.
2. In Fiscal Year 2012-13, the issuance of \$210 million of new debt with \$180 million in the form of sewer revenue obligations and \$30 million in the form of shorter term Certificates of Participation.
3. In Fiscal Year 2013-14, the early repayment of \$16.5 million of the Series 2004 Sewer Revenue Bonds and the 2004 WIFA Loan when that debt becomes callable.
4. In Fiscal Year 2014-15, a careful evaluation of rates increase in order to maintain adequate debt service ratios in future years and to maintain low interest rates.
5. In Fiscal Year 2016-17, the early repayment of \$27.8 million of the Series 2007 Sewer Revenue Bonds when those bonds become callable.

Analysis of Cash Needs of the Regional Wastewater Reclamation Department

Capital Improvement Program: Pima County has commenced significant construction of the Regional Optimization Master Plan (ROMP) capital improvements as well as improvements needed to perform ongoing maintenance of the conveyance system and treatment system. For the period through Fiscal Year 2016-17, including the current fiscal year, the County estimates it will need to expend \$725.9 million for these capital improvements. An additional \$25 million to \$30 million of capital improvements are anticipated to be needed annually thereafter. The capital project costs projected through Fiscal Year 2016-17 is shown in Figure 1.

Figure 1



To meet these capital needs, Pima County must generate sufficient revenues from the operations of the sewer system to (1) cover the system's ongoing operating and maintenance expenses, (2) meet the debt service payments for the existing and anticipated debt needed for the capital programs and (3) have an adequate level of net operating revenue to meet minimum debt service requirements.

Projected Revenues: Revenues from the wastewater system are generated from two major sources: sewer user fees and sewer connection fees.

User Fees: The sewer user fees consist of standard service fees and volume rates. In 2010, the Board of Supervisors approved automatic rate increases for user fees through July 1, 2013, with 6.5% annual increases to the standard service fee and 10% increases to the volume rate fee effective on July 1 of each year through 2013. The two rate increases remaining take effect on

July 1, 2012 and on July 1, 2013. The County anticipates the growth rate of new users to continue to be relatively flat, at 0.5% for the next two years, and increasing gradually to 2% by Fiscal Year 2015-16. Based on the automatic rate increases and growth rates, revenues from user fees are expected to increase from \$143 million projected for Fiscal Year 2011-12 to \$170.6 million by Fiscal Year 2013-14. After that, revenues are expected to remain level, with any increase dependent upon future growth in the number of new users and in the real estate industry.

Connection Fees: On May 15, 2012, the Pima County Board of Supervisors will be considering a change in the County's method of charging connection fees. Connection fees have historically been calculated based on the number of fixture units equivalent installed as part of new construction or as part of rehabilitation of existing structures. The proposed change would base connection fees on the size of the water meter servicing the property. The impact of this change in the first year of implementation is estimated to be a reduction in connection fee revenues of \$292,000, a decrease of 1.7 per cent of connection fees, or 0.17 per cent of total revenues of \$173.8 million for next year. This report assumes the proposed change to the methodology for connection fees is adopted by the Board of Supervisors.

The principal factor affecting revenues from connection fees will be the level of new construction within Pima County. With the continued contraction in the real estate industry, revenues from connection fees have remained relatively flat. For purposes of this analysis, connection fees are projected to increase at the same growth rate as projected for new users.

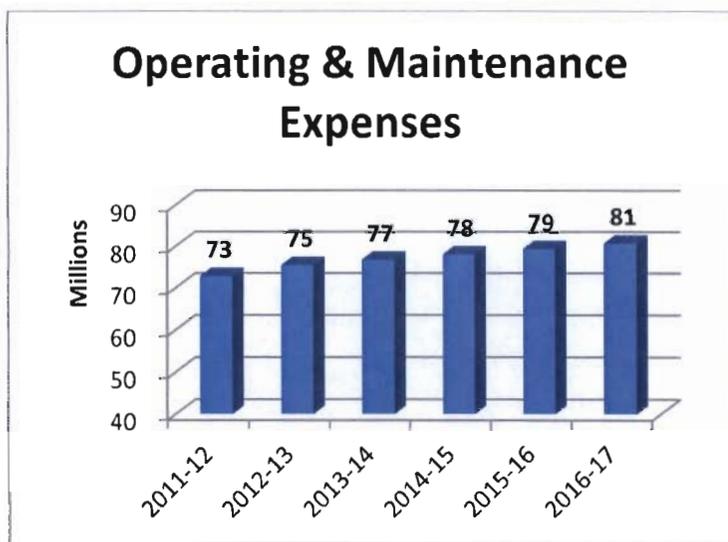
Total revenues from the sewer system for the current fiscal year are expected to be \$161 million, with \$143 million of those revenues derived from sewer user fees, \$16.8 million derived from connection fees, and \$1 million from other sources. Revenues for the next five fiscal years are expected to increase steadily with sewer user fees increasing by approximately 10.7% in the first two years due to the automatic rate increases. Thereafter, increases in revenues is based on projected growth in Pima County, which is projected to be no more than two percent per annum.

Projected Operating and Maintenance Expenses: The operating and maintenance (O&M) expenses for the Regional Wastewater Reclamation Department are essentially at the level projected in the 2010 Financial Plan. The Department is expecting to complete the current fiscal year with O&M costs of \$73 million, basically as projected in last year's Financial Plan. The O&M portion of the budget requested by the Department for Fiscal Year 2012-13 is for \$75.5 million, a 3.4 per cent increase over the O&M expenses projected for this year. The most significant portion of O&M costs are related to employee compensation, which, at \$35.2 million next fiscal year, represents 46.7 per cent of total O&M costs.

In March 2010, the Board of Supervisors implemented controls over the portion of the Department's budget relating to operating and maintenance expenses. 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 Department has stayed within this guideline since its adoption.

For planning purposes for subsequent years, this analysis assumes that the O&M expenses will increase by 3.4 per cent in Fiscal Year 2012-13 and by 1.7 per cent each year thereafter. At that rate of increase, the O&M increases are expected to increase by approximately \$2.6 million annually during the five year period covered by this Financial Plan. The use of a 1.7 per cent annual increase in future years is a reasonable approach to planning for O&M expenses which may, in fact, increase at a slower rate than the maximum rate authorized by the Board or potentially decrease due to innovations in technology and the privatization arising from the Design-Build-Operate contract for the Water Reclamation Campus at Roger Road. Figure 2 shows the projected increase in Operation and Maintenance Costs over the Financial Plan period.

Figure 2

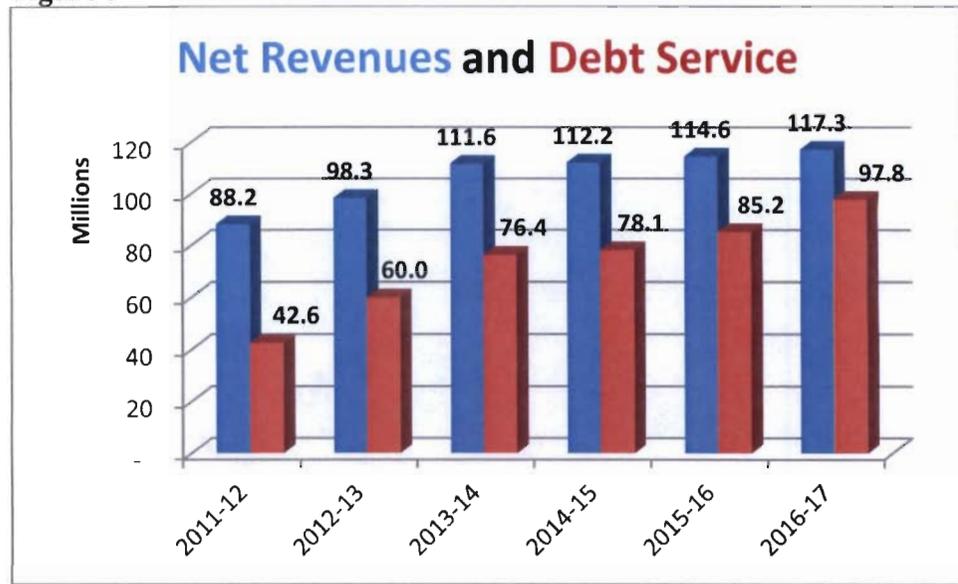


Net Operating Revenues: The net operating revenues (derived from total system revenues less the Operation and Maintenance expenses) must be sufficient to meet (1) the required debt service payments, (2) the reserves required by the debt covenants and established by the Board of Supervisors, and (3) the reserves necessary to enable the County to obtain acceptable ratings from key rating agencies for debt issues.

The County has planned the timing of the future debt issues to provide cash to meet the needs of the capital improvement program. The net operating revenues from the system are expected to increase from \$88.2 million this fiscal year to \$117.3 million in Fiscal Year 2016-17.

As discussed in more detail below, the County needs to finance capital programs through debt issues rather than through the use of 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 more detail of the revenues, major expenses and net operating revenues of the system. Figure 3 shows projected net revenues and debt service through Fiscal Year 2016-17.

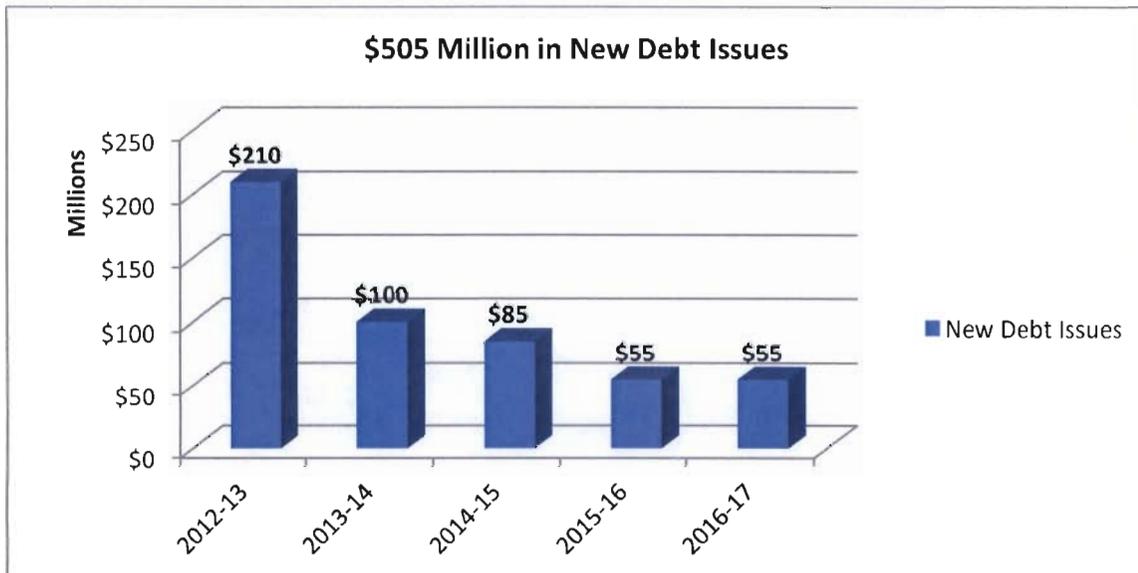
Figure 3



Sewer Revenue Debt Issues: As of June 30, 2011, Pima County had \$389 million of outstanding sewer revenue debt. In December, 2011, the County issued an additional \$189 million of debt to fund capital projects for Fiscal Year 2011-12 for a total of \$578 million of debt.

Based on the current schedule of capital projects shown in Figure 1 above, Pima County will need to issue an additional \$505 million in sewer debt by Fiscal Year 2016-17. These debt issues are currently scheduled at \$210 in the first quarter of Fiscal Year 2012-13; \$100 million in Fiscal Year 2013-14; \$85 million in Fiscal Year 2014-15; and issues of \$55 million in both Fiscal Year 2015-16 and Fiscal Year 2016-17. The anticipated debt issues for through Fiscal Year 2016-17 are show in Figure 4, below.

Figure 4



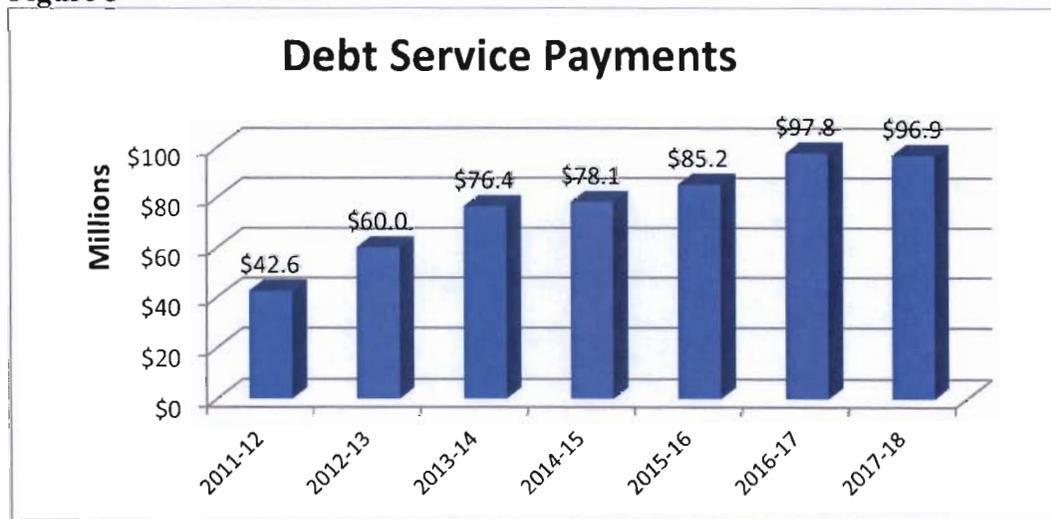
Debt Service Payments: Because the County must issue significant debt to fund the ROMP and other capital projects of the sewer system, the debt service payments are expected to continue to increase in the upcoming years. Debt service for the current fiscal year will be \$42.6 million, up from \$34.2 million last year.

As additional debt is issued to pay for the ongoing capital projects, the debt service payments will increase by \$17.4 million next year to be \$60 million for Fiscal Year 2012-13. Based on the projected cost to complete the planned capital projects, debt service payments are expected to increase to \$97.8 million by Fiscal Year 2016-17, an increase of more than \$55 million above the current year's debt service.

These estimates are based on an assumption that future debt will have an interest rate of 4.5 per cent in Fiscal Year 2012-13, an interest rate of 5.0 per cent for Fiscal Years 2013-14 through 2015-16, and an interest rate of 5.5 percent in Fiscal Year 2016-17. This reflects the favorable interest rates Pima County has received in recent sewer revenue debt issues, but anticipates a slight rise in future interest rates. Future interest rates in the municipal debt markets are highly unpredictable and any major change will require reevaluation of this financial plan.

The projections of debt service for future debt also include an assumption that Pima County will use available cash (after meeting the requirements for cash reserves) to accelerate the payment of principal on any new debt. This financial plan incorporates spending approximately \$104 million of cash to refund \$44.4 million of existing debt and to accelerate payments by using shorter term debt instruments (Certificates of Participation) to provide additional interest savings. Projected annual debt service payments through Fiscal Year 2018-19 are show in Figure 5.

Figure 5

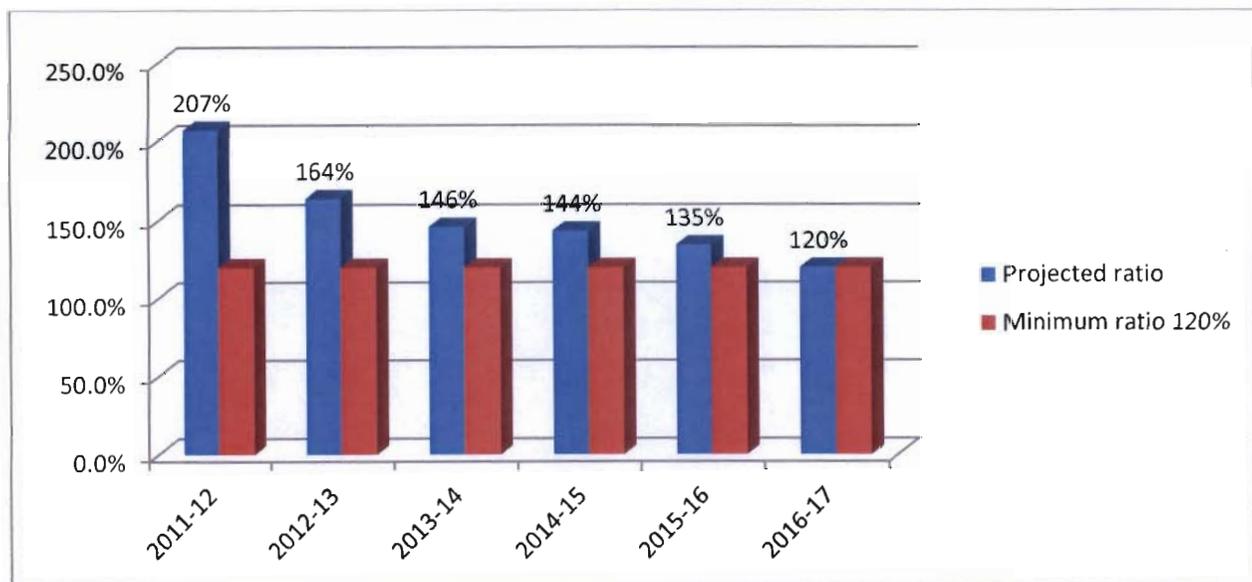


The current rate structure is expected to generate a sufficient revenue stream to meet the anticipated debt service payments for each of the upcoming years, which will be approximately \$97 million annually in Fiscal Year 2016-17 and Fiscal Year 2017-18. Although the revenues are sufficient to cover debt service, projected revenues may not be sufficient to provide adequate debt service ratios to continue borrowing with low interest rates in later years.

The debt service ratio is the ratio net operating revenues are to debt service for each year. In the current fiscal year, the net operating revenues are projected to be \$88.2 million and debt service is projected to be \$42.6 million, yielding a debt service ratio of 207 per cent. But by Fiscal Year 2016-17, the debt service ratio will drop to 120 per cent, which is the minimum level required under the debt covenants for all existing debt.

Unless the number of users and the number of connections increase more than projected in this financial plan, or the debt is issued at lower interest rates, the County will either need to increase the fee structure or decrease operating expenses to meet the minimum debt service requirement. To maintain low interest rates, however, the debt service ratio must be higher than the minimum 120 per cent. Figure 6 shows the projected debt service coverage ratios as compared to the 120 per cent. Given the anticipated increase in debt service payments and decreases in the debt service coverage ratios, it will be necessary for the County to carefully evaluate rates after the Fiscal Year 2014-15 debt issue, when essentially all the debt associated with the ROMP program will have been issued and actual future debt service will be known.

Figure 6 Debt Service Coverage Ratio



Cash Reserves, Cash Balances and the Expenditure Limitation: Pima County has several types of restricted cash accounts to meet the various debt covenants 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. The fund is for unexpected events affecting the ongoing operations of the system. The fund is not formally restricted by debt covenants or by statute and is available for any use relating to the sewer system that the County deems appropriate.

2. **Operating Reserve Fund** – The County maintains 90 days of anticipated operating expenses in this restricted fund. This fund currently has approximately \$18.2 million in reserve. By the end of next fiscal year, these debt reserves are projected to increase to \$18.9 million.
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 \$25.4 million for debt service reserve held either by WIFA or by the trustee bank servicing the sewer revenue obligations. These funds will be applied to the final debt service payments for the respective debt. By the end of next fiscal year, these debt reserves are projected to increase to \$33.1 million.
4. **Unrestricted Cash Balances** – At the March 9, 2010 Board of Supervisors meeting, the Board adopted a series of future rate increases and, simultaneously, restricted any unrestricted cash balances in the Enterprise Fund to be used for reduction of debt or for rebate of sewer fees. The County plans to call and retire debt as soon as the debt instruments are callable. During Fiscal Year 2013-14, the County will call and prepay \$16.5 million of the 2004 Sewer Revenue Bonds and of the 2004 WIFA Loan; and in Fiscal Year 2016-17 an additional \$27.8 million of the 2007 Sewer Revenue Bonds will be called. To further reduce future debt payments, \$30 million of the \$210 million debt that will be issued in Fiscal Year 2012-13 is planned to be issued with much shorter terms, of approximately three years, in the form of Certificates of Participation.

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 on a “pay as you go” basis. The constitutional expenditure limitation restricts the use of "local revenues." Local revenues consist of primary property taxes, impact and connection fees, and any other fees charged for County services, which would include all fees charged for sewer services. The County may not exceed the expenditure limit even if there is 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. The expenditures limit for Pima County, established by the State's Economic Estimates Commission, decreased from \$516 million last year to \$501.2 million in the current year and is preliminarily projected to be \$516.2 million next year.

In recent years, County's overall expenditures have essentially been near the Constitutional limit and are expected to remain near the limit for the foreseeable future. The County can use available cash to pay debt service without impacting the expenditure limit but cannot use the cash to fund projects on a “pay-as-you-go” basis. In order to comply with the expenditure limitation, the County must fund all capital projects with borrowed funds, and use available unrestricted cash to pay down the principal of debt issues.

Rating Agencies: Pima County currently receives ratings from Fitch Ratings and from Standard & Poor's for debt issued by the County, including sewer revenue debt. The most recent rating reports from these agencies, issued in November 2011 are shown on Appendix B.

Rates: In 2010, 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 \$2.912 and will increase to \$3.203 on July 1, 2012, and to \$3.523 on July 1, 2013. The standard monthly service fee is currently \$11.14 and will increase to \$11.86 on July 1, 2012, and to \$12.63 on July 1, 2013. Typical monthly residential users' bills based on various volume levels are depicted in Figure 7. These rates are the same rates shown in the 2011 Financial Plan.

Figure 7 Average Customer Monthly Bills



Recommendations:

The Pima County Finance and Risk Management Department is recommending:

1. The continuation of the existing fee structure adopted by the Board of Supervisors in 2010 with the scheduled annual increases through July 1, 2013.
2. In Fiscal Year 2012-13, the issuance of \$210 million of new debt with \$180 million in the form of sewer revenue obligations and \$30 million in the form of shorter term Certificates of Participation.
3. In Fiscal Year 2013-14, the early repayment of \$16.5 million of the Series 2004 Sewer Revenue Bonds and the 2004 WIFA Loan when that debt becomes callable.
4. In Fiscal Year 2014-15, a careful evaluation of rates increase in order to maintain adequate debt service ratios in future years and to maintain low interest rates.
5. In Fiscal Year 2016-17, the early repayment of \$27.8 million of the Series 2007 Sewer Revenue Bonds when those bonds become callable.

List of Appendices

Appendix A – Five Year Financial Projections

Appendix B – Rating Agency reviews of Pima County’s sewer debt

APPENDIX A

Regional Wastewater Reclamation Enterprise Fund Financial Projections Fiscal Year 2012 through 2017

	Fiscal Year:					
	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17
System Revenues:						
Sewer Utility Service	\$ 143,062,943	\$ 155,652,917	\$ 170,684,115	\$ 172,276,007	\$ 175,714,527	\$ 179,221,817
Sewer Connection Revenue	16,791,540	16,499,180	16,581,676	16,747,493	17,082,443	17,424,091
Engineering Review/Inspection Fees	72,018	45,000	45,000	45,000	45,000	45,000
Other Income	1,085,863	1,573,928	1,060,862	1,148,862	1,116,862	1,292,862
Total Revenues	\$ 161,012,364	\$ 173,771,025	\$ 188,371,653	\$ 190,217,362	\$ 193,958,832	\$ 197,983,770
Operations and Maintenance Costs:						
Employees Compensation	36,026,964	35,249,535	35,848,777	36,458,206	37,077,996	37,708,322
Consultants and Outside Services	5,228,831	7,205,422	7,327,914	7,452,489	7,579,181	7,708,027
Treatment Supplies and Chemicals	10,096,211	10,457,484	10,635,261	10,816,061	10,999,934	11,186,933
Repairs & Maintenance	4,926,342	4,948,064	5,032,181	5,117,728	5,204,730	5,293,210
General and Administrative	14,837,278	15,292,144	15,552,110	15,816,496	16,085,377	16,358,828
Capital Expenses	1,709,997	2,307,743	2,346,975	2,386,873	2,427,450	2,468,717
Operations and Maintenance Costs	\$ (72,825,623)	\$ (75,460,392)	\$ (76,743,219)	\$ (78,047,853)	\$ (79,374,667)	\$ (80,724,036)
Net Revenues	\$ 88,186,741	\$ 98,310,633	\$ 111,628,434	\$ 112,169,508	\$ 114,584,165	\$ 117,259,734
Existing Debt Service Payments	42,553,150	50,954,330	54,140,767	48,398,319	50,098,133	57,146,982
Proposed New Debt Service	-	9,021,981	22,226,018	29,725,965	35,078,300	40,638,383
Debt Service Payments	\$ 42,553,150	\$ 59,976,311	\$ 76,366,785	\$ 78,124,284	\$ 85,176,433	\$ 97,785,365
Debt Service Coverage Ratio	207.2%	163.9%	146.2%	143.6%	134.5%	119.9%

APPENDIX B

Fitch Ratings Analysis, November 7, 2011

Standard & Poor's Analysis, November 7, 2011

Standard & Poor's Outlook Revision, November 7, 2011

FITCH RATES PIMA COUNTY, AZ'S \$197MM SEWER SYSTEM REVS 'AA-'; OUTLOOK STABLE

Fitch Ratings-Austin-07 November 2011: Fitch Ratings assigns an 'AA-' rating to the following Pima County, Arizona (the county) revenue obligations:

--\$197.2 million sewer system revenue obligations, series 2011B.

The bonds are expected to sell via negotiation the week of Nov. 28. Proceeds will be used to finance improvements and extensions to the county sewer system (the system), fund a debt service reserve and pay costs of issuance.

In addition, Fitch affirms the following ratings:

--\$203.6 million in outstanding subordinate lien sewer system revenue obligations at 'AA-';

--\$167.5 million in outstanding senior lien sewer revenue bonds at 'AA'.

The Rating Outlook is Stable.

KEY RATING DRIVERS:

Sound Financial Profile: Financial performance is sound and is expected to remain good through the forecast period.

Automatic Rate Increases: 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 will increase rapidly, possibly eroding future rate flexibility.

Increasing Debt Burden: Capital needs are large and relate primarily to meeting regulatory requirements. Debt levels are projected to more than double (when including the current debt issuance) over the next five years to fund the sizeable capital plan. Nevertheless, capital costs are expected to drop considerably beyond the five-year horizon and debt is retired rapidly.

Stable Economy: 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.

SECURITY:

The series 2011B obligations are payable from installment payments made by the county to the trustee. The county's obligation to pay the installment payments is secured by pledged revenues (net revenues, including unrestricted cash balances) of the county's sewer system (the system); such lien on, pledge of, and security interest in the pledged revenues is subordinate to the prior pledge and lien on 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 \$545 million (including the current debt issuance) over the next four years, all-in coverage is forecast to drop to a low of 1.4x by 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 beyond the four-year horizon. Furthermore, it should be noted that the aforementioned projections do not include unrestricted cash balances which 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 2.5x 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 capital expenditures. The increase in the reserve amounts combined with the spending limitations should lead to improved liquidity levels going forward. The county plans eventually to use some of its cash reserves to retire some of its debt (amounts received from the issuance of bonds are excluded from the expenditure limitation).

The county's 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 2014 and rehabilitation and capacity needs at the Ina Road plant are scheduled to be completed by January 2015. Thus far, the projects are scheduled to be completed on time and costs have come in at a very favorable 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 \$545 million of planned added debt. Amortization of debt including the current issuance, however, is rapid with principal payout at 56% and 100% in 10 and 20 years, respectively.

To cover the anticipated rise in debt service costs, the county enacted automatic annual rate hikes over the fiscal 2011 to 2014 periods. Volumetric user fees and standard service fees are being increased annually by 10% and 6.5%, respectively. The county will provide an annual review of the adequacy of its rates as part of the annual recommended budget. 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 94.3 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 8.9% as of July 2011 are below state (9.7%) and national (9.3%) averages. Similarly, county wealth levels are slightly below state and national levels.

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Managing Director

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Additional information is available at 'www.fitchratings.com'. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

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

Applicable Criteria and Related Research:

- 'Revenue-Supported Rating Criteria' (June 20, 2011);
- 'U.S. Water and Sewer Revenue Bond Rating Criteria' (Aug. 10, 2011);
- '2010 Water and Sewer Medians' (Jan. 18, 2011);
- '2010 Water and Sewer Sector Outlook' (Jan. 18, 2011).

Applicable Criteria and Related Research:

Revenue-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=637130

U.S. Water and Sewer Revenue Bond Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=647331

2010 Water and Sewer Medians

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=509146

2010 Water and Sewer Sector Outlook

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=499482

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November 7, 2011

Summary:

Pima County, Arizona; Water/Sewer

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Table Of Contents

Rationale

Outlook

Related Criteria And Research

Summary:

Pima County, Arizona; Water/Sewer

Credit Profile

US\$197.18 mil Swr Sys Rev Obligations ser 2011B due 07/01/2026

<i>Long Term Rating</i>	A+/Positive	New
Pima Cnty swr (AGM)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Positive	Outlook Revised
Pima Cnty swr (ASSURED GTY)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Positive	Outlook Revised

Rationale

Standard & Poor's Ratings Services has revised its outlook on Pima County, Ariz.'s sewer system revenue bonds to positive from stable. At the same time, Standard & Poor's assigned its 'A+' rating to the county's sewer system revenue bonds, series 2011B. Standard & Poor's also affirmed its 'AA-' rating on the county's (prior lien) sewer improvement and refunding revenue bonds.

The outlook revision reflects the possibility that we could raise the ratings in the next two years if rate increases proceed as planned and debt service coverage (DSC; Standard & Poor's-calculated, excluding cash balances, but including connection fees) and liquidity levels stay in line with what we consider a reasonable forecast

The ratings 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. We also expect management to adjust rates as needed to ensure annual DSC is no less than about 1.3x (excluding unrestricted cash balance).

The 'AA-' on the county's sewer improvement bonds reflects our view of a closed lien structure and our expectation of very strong DSC levels. 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 2011B and 2011A bonds, and 2010 obligations.

The ratings reflect our opinion of the 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
- Generally strong system liquidity, 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, \$604 million capital plan to comply with regulatory permit requirements by fiscal 2014 that the county projects will require approximately \$345 million in debt; 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 fund construction, expansion and improvement of sewer treatment facilities and conveyance systems for the system.

After the proposed bond issue, the county will have approximately \$167.5 million of prior-lien obligations and approximately \$400.8 million of total parity obligations outstanding (that includes the 2010, 2011A bonds, and 2011B bonds), the latter having a junior claim on net system revenues.

The 2011B 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 \$32.8 million for fiscal year ending, June 30, 2011. The ABT and rate covenant also allows the inclusion of the direct subsidy for Build America Bonds (BABs), which also weakens the tests. 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 proposed 2011B bonds, however, include DSR funded at one-half of MADS, similar to the 2010 obligations.

Pima projects cash balance remaining after reserves will gradually increase to about \$118.2 million by the end of fiscal 2014 from about \$32.8 million at the end of fiscal 2011. The revenue growth the county expects from the approved automatic rate increases through fiscal 2014 will increase year-end unrestricted cash balances, with projected system net revenues providing no less than about 1.3x (excluding unrestricted cash balances) of all of the system's existing and future debt service obligations through fiscal 2015, which we consider good.

Pima also secures its prior lien obligations with DSRs that are currently being satisfied with DSR surety policies from Assured Guaranty Municipal Corp. (AA+/Watch Neg/--); 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 pay-down 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 264,882 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%, 0.6%, and 0.5% in fiscals 2009, 2010, and 2011 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 57% to \$17.7 million in fiscal 2010 from a peak of \$42.2 million in fiscal 2006, and are estimated at \$19.6 million in fiscal 2011. System officials project connection

fees of \$16.7 million-\$19.0 million annually from fiscal years 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 opinion, 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. Rate increases will fund the utility's large capital plan in fiscal years 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 relying increasingly on diminishing connection fee revenues in the past few years as a weakening housing market slowed construction. From fiscal years 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 of 2.5x-2.7x (including all debt and loans by the state's Water Infrastructure and Finance Authority) from fiscal years 2011-2015 by all pledged revenues (including unrestricted cash balances), and ranging from about 1.3x-2.2x without the balances. Excluding unrestricted cash balances and connection fees, projected DSC ranges from 1.06x to 1.64x in the same period. Projected senior DSC is very strong, in our opinion, at no lower than about 3.2x. Forecasts include debt service after projected issuance of debt and approved rate and fee increases. The forecast assumes total operating expenses rising no more than 3.6% annually.

We believe system liquidity has been generally strong historically. Fiscal year-end unrestricted cash balances have provided no less than 153 days of operations from fiscals 2005 through 2011, with the exception of fiscal 2010, when the system's fiscal year-end cash balance of \$11.2 million provided an adequate 58 days of operations. However, the system had \$32.8 million in unrestricted cash at fiscal year-end 2011, which provided 160 days' operations. In addition, 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 Sept. 30, 2011, the emergency reserve fund balance totaled \$20 million and the operating reserve balance was \$17 million, providing a combined 185 days' cash on hand based on projected fiscal 2012 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 positive outlook reflects our opinion that there is at least a one-in-three chance that we could raise the rating within our two-year outlook horizon if rate increases are made as planned and DSC (Standard & Poor's-calculated, excluding cash balances) and liquidity levels are in line with forecast. We could revise the outlook to stable if the

utility's financial performance deviates materially from forecast.

Related Criteria And Research

- 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 November 7, 2011)

Pima Cnty swr subord (AGM)

Unenhanced Rating

A+(SPUR)/Positive

Outlook Revised

Pima Cnty swr sys rev rfdg bnds

Long Term Rating

A+/Positive

Outlook Revised

Many issues are enhanced by bond insurance.

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Outlook Revised To Positive On Pima County, AZ's Sewer System Revenue Bonds

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NEW YORK (Standard & Poor's) Nov. 7, 2011--Standard & Poor's Ratings Services has revised its outlook to positive from stable on Pima County, Ariz.'s existing sewer system revenue bonds. At the same time, Standard & Poor's assigned its 'A+' long-term rating to the county's series 2011B sewer system revenue bonds, which is on par with the 2011A bonds and 2010 obligations. Standard & Poor's also affirmed its 'AA-' rating on the county's (prior lien) sewer improvement and refunding revenue bonds.

"The positive outlook reflects our view that we could raise the ratings during the next two years if rate increases proceed as planned and debt service coverage excluding cash balances and liquidity levels are in line with what we consider a reasonable forecast," said Standard & Poor's credit analyst Joseph Pezzimenti. "Further supporting the outlook and ratings is our expectation that the utility's finances will be less reliant on connection fees and nonrecurring revenue sources and rate increases will allow it to build a sizable cash balance after reserves," Mr. Pezzimenti added.

A subordinate lien on sewer system net revenues and unrestricted cash balances secure the proposed bonds. Bond proceeds will fund construction, expansion and improvement of sewer treatment facilities and conveyance systems for the system

The Pima County Regional Wastewater Reclamation Department provides wastewater collection and treatment services to 264,882 customers in the Tucson metropolitan statistical and outlying service areas.

If the utility's financial performance deviates materially from its forecast,

Outlook Revised To Positive On Pima County, AZ's Sewer System Revenue Bonds

we would revise the outlook to stable.

RELATED CRITERIA AND RESEARCH

- 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

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