MEMORANDUM

Date: February 28, 2011

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

From: C.H. Huckelberry
County Administrator

Re: **Bond Rating for Issuance of Sewer Debt Obligations**

I am enclosing a recent rating from Standard & Poors as well as one from Fitch Ratings. In both cases, the County's bond rating was upgraded. This credit upgrade is largely related to adopted sound fiscal policy of the County with respect to wastewater rates, as well as our anticipated on time, under budget development of major wastewater plant upgrades as will be required by new water quality standards now being included in our discharge permits.

The language in the rating documents is self-explanatory. Please contact me if you have any questions regarding these ratings and their resulting upgrades to our credit rating.

CHH/mjk

Attachments

c: Chairman and Members, Pima County Bond Advisory Committee
Tom Burke, Director, Finance and Risk Management

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.

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