Summary:
Lehigh County Authority, Pennsylvania; Water/Sewer

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Credit Profile

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Rationale

Standard & Poor's Ratings Services has assigned its 'A' rating to Lehigh County Authority (LCA), Pa.'s $291.5 million series 2013 water and sewer revenue bonds (City of Allentown Concession). The outlook is stable.

To remediate rising unfunded pension costs and liabilities, the City of Allentown decided to lease its water and sewer assets. The transaction involves Allentown leasing its water and sewer systems to LCA in exchange for an upfront concession and lease payment from the latter. At the same time, the LCA will continue operating its existing water and sewer system, which remains a separate entity secured under an accordingly separate indenture and legal structure and does not secure the 2013 bonds. Conversely, the concessioned system's revenues do not secure LCA's existing water and sewer revenue bonds.

In our opinion, the rating reflects the following credit strengths:

- The historical competency of LCA to operate, maintain, and financially manage a utility system;
- A relatively stable and predominately residential customer base;
- Ample capacity and resources to fulfill customer requirements;
- Affordable utility rates juxtaposed to area incomes, which provides for additional revenue raising flexibility; and
- Financial projections that illustrate adequate to strong debt service coverage margins and robust liquidity exceeding 440 days over the life of the bonds.

We believe tempering credit factors include:

- The potential challenges associated with the transition of the concessioned system to LCA;
- The absence of historical financial results under the concession and lease structure;
- Pressure on concession revenues to achieve projected financial margins;
- The local service area economy characterized by adequate, yet below-average, income indicators and high unemployment.

The issuance of water and sewer revenue bonds related to the Allentown Concession consists of $247.6 million series
A, $25.4 million series B capital appreciation bonds, and $18.6 million series C. The majority of 2013 bond proceeds ($212 million) will fund the up-front concession and lease payment to the city pursuant to the Allentown Water and Sewer Utility System Concession and Lease Agreement (the Concession Agreement) dated as of May 1, 2013, between the city and LCA. LCA will apply other proceeds to fund about $32 million in capital improvements through 2017 and make deposits to various reserves and funds as well as pay issuance and transaction costs.

The bonds are secured by a pledge of revenues under the concession agreement, defined as all revenues derived from the operation of the concessioned system. Such revenues include service charges from all users net of any payments from a municipal customer allocated to its share of administrative order bond debt service, which are not secured by a pledge of the trust estate under the 2013 indenture. In addition, the bonds will be secured by a $25 million debt service reserve fund to be funded on closing.

The city, as lessor, and LCA, as the concessionaire, are party to the concession agreement with a term of 50 years. We are aware that a private citizen is currently challenging the lease of the city's system. Based on available information, we do not believe it would have an adverse impact on the system at this time, and we will monitor the situation. Furthermore, special counsel to the city has delivered an opinion that the challenge has no merit. In general, the agreement provides for the lease of the city's water and sewer system, referred to as the concessioned system, to LCA. Furthermore, under the agreement the city grants LCA the right to operate the concessioned system, to impose rates, charges, and fees and to collect concession revenues and it will assign, transfer, and convey to LCA city system assets free of any encumbrances. In exchange, LCA will pay the city an up-front lease payment and will make annual payments to the city of $500,000 beginning in 2016, adjusted annually for inflation and LCA will establish a related reserve to secure the annual city payment. As part of the agreement, LCA will be responsible for the operation and maintenance of the concessioned system including repairs and replacements, billing, and collection of service charges and fees, provision of an adequate water supply, and maintenance of working capital reserves and setting of rates.

The city's water plant and distribution system and sewer utility system comprise the concessioned system. The water plant and distribution system supplies water to residential, commercial, governmental, and industrial customers within the city and to several surrounding municipalities and municipal authorities, including LCA's existing water system, pursuant to water municipal service agreements. Similarly, the city sewer utility serves customers within the city as well as numerous surrounding municipalities and municipal authorities, including LCA's existing sewer system, pursuant to sewer municipal service agreements. According to LCA, concessioned system capacity and resources are ample to meet customer requirements. LCA is well positioned to operate the concessioned system given its expertise in operating similar assets in the same geographic and demographic regions, the working knowledge of the municipal service agreements between the city and suburban municipalities for service, with LCA being party to two such agreements, coupled with an experienced management team.

Currently the city's average monthly residential bill totals $63.57 per 7,500 gallons usage, a level we view as affordable, representing 2.5% of the city's income. Presence of affordable rate provides flexibility for future revenue raising flexibility. LCA will collect all amounts due from the concessioned system's customer base including those revenues attributable to municipal services agreements with the city. The concession agreement outlines maximum permitted rate adjustments applicable to system accounts: no rate increase years 2013-2015, consumer price index (CPI) plus a
2.5% margin years 2016-2032, CPI plus 2% margin years 2033 until end of concession agreement term. In addition to
the adjustments outlined in the agreement, LCA may raise rates to cover costs for major capital expenditures greater
than $1 million, for new regulatory requirements, for costs related to any water supply shortfalls or for any occurrence
of force majeure. Furthermore, LCA can impose capital recovery fees for new users or for expansion of existing
non-residential customers.

The city system's well-established, stable customer base facilitates sound projected financial metrics, which, generated
$6.4 million and $4.7 million in net available revenues for debt service for water and sewer debt, yielding 2.2x and 2.7x
annual debt service coverage, based on the city's 2011 audited financial statement. LCA's forecasted financial model
projects annual debt service coverage to range between 1.2x and 1.3x through fiscal 2017, with debt service escalating
to about $12.5 million that year. The model considers historical city utility system data coupled with assumptions we
consider reasonable. Major revenue assumptions include modest population and general usage growth of less than 1%
along with required usage levels stipulated in the service agreements and maximum permitted rate adjustments
according to the concession agreement. Expense assumptions include various cost escalation factors dependent on the
nature of the expense but in general most expenses escalate 2% to 3.5%. The model also incorporates various required
deposits, payments, and capital projects stipulated in the concession agreement. LCA projects the concessioned
system will sustain liquidity at strong levels, exceeding 400 days over the life of the bonds. From 2013 through 2017,
LCA plans to fund capital improvements up front with $32 million in bond proceeds.

Allentown is located about 60 miles north of Philadelphia in Lehigh County. The population has grown 3.4% since
2009, reaching an estimated 118,743 in 2012, a rate similar to county population trends. City income, as represented
by median household effective buying income, is adequate, yet below average, in our view at 76% of the
commonwealth and 73% of the national levels. Leading area employers include Lehigh Valley Hospital, St. Luke's
Hospital, Air Products and Chemicals, Allentown School District, along with state and county government. City
unemployment of 10.1% in April 2013, trends above the state and national averages of 7.2% and 7.5%, respectively.
(For more information on Allentown's general obligation rating, see the report published June 20, 2013, on
RatingsDirect.)

Outlook

The stable outlook reflects our expectation that LCA will adequately manage the concessioned system during its
transition period given its existing expertise and skills related to operating a water and sewer system utility.
Furthermore we expect the concessioned system will have at least an adequate financial profile following the transition
given the presence of a stable, well-established customer base and sound system operations. Based on these
expectations, we do not expect to change the rating over the two-year outlook horizon.

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
Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.