

2005 Financial Statements



CITY OF PHILADELPHIA WATER DEPARTMENT

2005 FINANCIAL STATEMENTS

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The City of Philadelphia Water Department Management Discussion and Analysis

The Philadelphia Water Department is a municipal utility serving the citizens of the Philadelphia region by providing integrated water, wastewater, and stormwater services. The utility's primary mission is to plan for, operate, and maintain both the infrastructure and the organization necessary to purvey high quality drinking water, to provide an adequate and reliable water supply for all household, commercial, and community needs, and to sustain and enhance the region's watersheds and quality of life by managing wastewater and storm water effectively.

The Water Department management has prepared this narrative overview and analysis of the financial statements of the City of Philadelphia, Pennsylvania Water Fund for the fiscal year. The information presented here should be read in conjunction with the financial statements immediately following the discussion and analysis.

Financial Highlights

The Water Department met its bond coverage ratios for the year with a revenue bond coverage ratio of 1.20, a total debt service coverage ratio of 1.08, and a net operating revenue bond coverage ratio of 1.20.

At the end of the current fiscal year, the Water Fund's *Net Assets totaled* \$616.3 million resulting from an excess of its assets over its liabilities; its *unrestricted net assets* showed a balance of \$188.7 million.

The Water Fund's net assets showed an increase of \$93.8 million during the current Fiscal Year This increase was primarily due to the following:

- A \$70.4 million increase due to the recording of the proprietary portion of the net pension obligation.
- An \$8.0 million increase to include the Water Capital in the water/sewer portion of the net pension obligation.
- A 12.8% water and sewer rate increase effective on February 1, 2005 which resulted in a \$36.2 million increase in revenue collections.
- A \$7.9 million increase in interest earnings on the Sinking Fund and other investments.

- A \$12.8 million increase in the collection of sewer charges due from other municipalities. This increase reflects a payment of \$9.0 million collected from Bucks County for the reservation of additional capacity and other related items and new rates for all other wholesale customers that were effective July 1, 2004.

These increases in the Water Fund's net assets were offset by the following:

- A \$2.3 million reduction in Grant revenues.
- A \$7.2 million increase in bond principal payments.
- A \$6.8 million increase in spending for purchased services.
- A \$14.6 million increase in employee benefits expense.
- A \$7.9 million increase in the net pension obligation
- A \$4.4 million transfer of year end excess balance of Water Sinking Fund Reserve to the General Fund

Net Assets

As noted earlier, net assets are useful indicators of a government's financial position. At the close of the current fiscal year, the Water Department's assets exceeded its liabilities by \$616.3 million

Capital assets, such as land, buildings, meters, water mains, and sewer lines, less any outstanding debt issued to acquire these assets comprise \$101.8 million of the Water Department's net assets. Although these capital assets assist in providing services to our customers, they are generally not available to fund the operations of future periods.

In addition, a portion of the Department's net assets, \$325.9 million is subject to external restrictions as to use. The remaining component of net assets is the unrestricted net assets, which ended the fiscal year with \$188.6 million.

Bond Issuance

During FY2005, the department issued its Water and Wastewater Revenue Bond Series 2005A in the aggregate principal amount of \$250,000,000. The proceeds of the Series 2005A Bonds will be applied to (i) fund capital improvements to the City's Water and Wastewater Systems (as hereinafter defined), (ii) fund a Debt Reserve Account of the Sinking Fund (as hereinafter defined) relating to the Series 2005A Bonds, and (iii) pay costs of issuance relating to the Series 2005A Bonds. The department also issued \$86,105,000 of Water and Wastewater Revenue Refunding Bonds, Variable Rate Series 2005B. The proceeds of the 2005B Bonds was used to refund a portion of the City's Water and Wastewater Revenue Bonds, Series 1995 and to pay costs of issuance relating to the Bonds.

Water and Wastewater Rates

In early 2005 the Water Department proposed a revised rate increase to cover its cost of operation from FY05 through FY08. The Department has determined that additional revenues of \$282 million would be required to cover the Department's costs for the FY05 through FY08 period. This additional revenue is required for a variety of reasons including the following: increased debt service (\$72.2 million); transfers to the Residual Fund for Capital purposes (\$67.6 million); additional regulatory requirements (\$30.6 million); wage increases and fringes (\$28.4 million); loss of state subsidy for wastewater operations (\$32.0 million); decrease in interest income (\$25.4 million); and additional security and related costs (\$8.9 million).

To raise this additional revenue, the Department proposed a rate increase to be phased in over a four-year period, FY05 through FY08. Rate increases averaging 8.73 percent per year would eventually add an additional \$16.53 to the average monthly residential charges for water, sewer, and storm water service. Accordingly, average residential charges would increase from the current \$41.77 per month to \$58.30 in 2008.

On Jan 21, 2005 the Water Commissioner approved a 12.8% across-the-board rate increase. The approved first phase rate increase was implemented on February 1, 2005. The average customer's bill increased from \$41.77 per month to \$47.08. On July 22, 2005, the Water Commissioner approved a rate increase of 1.9% for phase two to be implemented on August 1, 2005. Additional rate increases of 6.7% for FY2007 to be applied on July 1, 2006, and 4.2% for FY2007 to be applied on July 1, 2007 were also included in the July 22, 2005 decision.

Unlike many neighboring communities where sewer and/or storm water bills are separate from water bills or assessed through an annual charge, Philadelphians receive a bill that combines water, wastewater, and storm water charges. Unfortunately, this combined billing sometimes leads to the impression that water rates of the Philadelphia Water Department are the higher than other utilities in the region. The fact is the Philadelphia Water Department provides water and sewer services that are the least expensive rates in the region. PWD's water rates continue to be less than half those charged by most neighboring utilities. Even after full implementation of the Department's proposed rates in 2008, the Department expects to have water rates that are lower than comparable surrounding utilities. In fact, PWD's proposed water rates for FY08 will be less than the 2004 water rates for some neighboring water utilities.

2005 Area Residential* Water/Sewer Charges	Monthly Water Bill	Monthly Sewer Bill
Pennsylvania American Water+	\$47.23	N/A
Philadelphia Suburban Water+	\$45.75	N/A
New Jersey American Water+	\$35.15	N/A
North Wales Water Authority+	\$26.44	N/A
North Penn Water Authority+	\$25.61	N/A
Doylestown Township	\$25.40	\$36.67
CCMUA (Camden County)**	N/A	\$26.25
Trenton	\$18.12	\$27.37
Philadelphia Water Department	\$20.21	\$19.23

Rates in effect on November 16, 2005. Storm Water charges are excluded from sewer calculation because many jurisdictions fund such services from the general tax base or a separate utility assessment.

* Calculations based on 6,230 gallons/month (833.cu.ft.)

** Sewer-only utility.

+ Water-only utilities

Source: *Philadelphia Water Department*.

As of the close of the current fiscal year, Moody's, Standard and Poor's, and Fitch rate the City's bonds as follows:

City of Philadelphia's Bond Ratings
General Obligation and Revenue Bonds

	Moody's Investors Service	Standard & Poors Corporation	Fitch IBCA
General obligation bonds	Baa1	BBB	BBB+
Water & sewer revenue bonds	A3	A-	A-
Aviation revenue bonds	A3	A	A

The following excerpt accompanied the A3 rating of Moody's Investors service: "The management of this large combined water and wastewater system has produced a strong record of operational and financial achievements over the past decade. Operational achievements include improvements in environmental compliance, launch of a proactive water main replacement program that has significantly reduced the number of main breaks, and installation of automated meters for a significant proportion of residential customers. In addition to the resulting improvements in billing accuracy, the billing cycle was accelerated to a monthly basis. On the financial side, operating costs have been well controlled, with significant reductions in some areas such as contracted electricity costs and costs of operating the biosolids recycling center. ...management has been able

to maintain significant cash balances that support the system's working capital needs, help with rate stabilization, and provide for contingencies.

The following excerpt accompanied the A- rating of Fitch: "Fitch Ratings expects the system to maintain its historical practice of actual results outperforming projections..."

The Water Department has implemented numerous measures to improve service, reduce costs, and enhance revenues over the past decade. It has greatly reduced the cost of operations at its Biosolids and Wastewater facilities. The Department has greatly contributed to the noticeably improved quality of Philadelphia's rivers and streams. It has re-financed more than \$1.7 billion in revenue bonds for net present value savings of \$92 million in debt service expense.

Pilot Plant Research

The Water Department is conducting research at two pilot plants, one for the treatment of drinking water withdrawn from the Delaware River, the other for the Schuylkill. This research will provide the department with vital information that will provide a better understanding of how changes to our treatment process will impact the operations of our treatment facilities, as well as the overall quality of the treated water, before investing in major capital improvements at our water treatment plants,. This research will also provide the specific information required to sustain the Departments' ability to meet future regulatory mandates that protect public health, in a cost-effective way, and to do so well ahead of the federal deadlines.

On-line Drinking Water Quality Monitoring

In response to heightened security concerns, real-time water quality monitoring systems at our water treatment plants, reservoirs, pumping stations, wholesale customer connections, and at numerous points throughout our water distribution system will provide us accurate information in a timely manner. This technology is vital to the utmost safety of water quality and the health of our customers. Expected installation cost: \$500,000.

Early Warning System

To further protect our drinking water sources from chemical spills and other potential hazards, this system is our first line of defense. Funded in part by a \$725,000 grant from the Pennsylvania Department of Environmental Protection, it will provide us with essential information when making critical treatment and pumping decisions in response to spills and accidents that can have a detrimental impact on the rivers. Recent events including the major oil spill on the Delaware in the fall of 2004, a tanker car derailment of hazardous materials

along the banks of the Schuylkill, and a fire at a Bridgeport, Pennsylvania chemical plant have emphasized the need to improve coordination and planning for such events. This state-of-the-art system has already increased communication among water suppliers up and down the Delaware and Schuylkill Rivers.

New Pumping Station

The construction of a new water pumping station is necessary to enhance local water pressure and water service reliability for our customers in the Northwest section of the City. This new pumping station will house eight energy-efficient pumps, a control room and offices.

Assessing the City's Sewer Infrastructure

Maintaining the sewer system is equally important. Heavy rains experienced in the summer were highly unusual for Philadelphia, and they greatly impacted our sewers in several neighborhoods. That is why it is important for us to continue a sewer assessment program begun more than a year ago. With nearly 3,000 miles of sewers collecting nearly 500 million gallons of wastewater a day, assessing sewer conditions is a major part of our operations. We've already videotaped and evaluated nearly 230 miles of sewers, and are developing a database and ranking system to prioritize sewer improvements. We will continue to assess additional miles of sewers each year.

Long-term Control Plan for Combined Sewer Overflows

During heavy rainstorms, the release of some storm water and sewage over flows from combined sewers (sewers that carry storm water and sanitary waste in one pipe) to the City's rivers and streams, causes pollution to these waterways. Nearly eight years ago we began a short-term plan, using industry accepted best practices to operate our sewer system. These efforts successfully reduced overflow volume by three percent or six billion gallons a year. Our efforts included detecting and eliminating overflows during dry weather, getting the most storage possible in our sewer system, and stepping up inspections and monitoring at sites where overflows occur. Since then, we have begun a long-term control plan that includes \$48 million in capital improvements so we can capture even more flow in the sewer system. During the next three years, our plan features a "watershed-based" approach, which involves other regional stakeholders in planning efforts that are more comprehensive and reach far beyond city boundaries. We anticipate that these efforts will result in reducing overflow volume from combined sewers approximately 15 percent to 19 percent by late 2007 and early 2008.

Waterways Restoration Program

Philadelphia has a rich network of more than 100 miles of streams and tributaries. During wet weather, storm water and sanitary waste can overflow to these waterways. Some of the most visible and distressing effects of overflows are debris and floatable materials that remain in the waterways. This past year, we began a Waterways Restoration Program to clean up the waterways and we are undertaking restoration projects at both combined sewer overflows and storm water overflows. These projects will help eliminate potential health hazards by removing pools of water that remain where the overflows occur. The cost for the first year was \$515,000 and we have removed over 100 tons of debris, including cars, from Philadelphia's streams.

Advance Regional Source Water Protection Plans

A healthy water environment means a better quality of life for our customers. It will also support sustainable economic development. We've already completed source water assessments for the Schuylkill and Delaware River watersheds. Funded in part by a grant from Pennsylvania Department of Environmental Protection, other partners in the project included Aqua Pennsylvania and Pennsylvania American Water companies. We now have a better understanding of the major issues within the watersheds, such as agricultural run-off up river from Philadelphia that can impact the quality of our drinking water sources. During the next three years, we will develop source water protection plans for both rivers, using a grant of \$200,000 from the Department of Environmental Protection. These plans will help us prioritize source water protection programs to preserve Philadelphia's water sources.

Requests for Information

This financial report is designed to provide a general overview of the City of Philadelphia Water Department's finances for all interested parties. Questions concerning any of the information provided in this report, or requests for additional information, should be addressed to the Philadelphia Water Department, Finance Division, Aramark Tower, 5th Floor, 1101 Market Street, Philadelphia, Pa. 19107.

STATEMENT OF NET ASSETS, JUNE 30, 2005 AND 2004

(amounts in thousands)

	...2005...	...2004...
ASSETS		
Current Assets:		
Cash on Deposit and on Hand	\$30	\$30
Equity in Treasurer's Account	47,300	43,875
Due from Other Governments	109	73
Accounts Receivable	199,238	198,404
Allowance for Doubtful Accounts	(96,633)	(106,059)
Inventories	14,077	13,338
Total Current Assets	164,121	149,661
Noncurrent Assets:		
Restricted Assets:		
Equity in Treasurer's Account	397,406	225,369
Sinking Funds and Reserves	173,031	158,109
Grants for Capital Purposes	0	50
Receivables	1,728	2,792
Total Restricted Assets	572,165	386,320
Net Pension Asset	71,300	
Capital Assets:		
Land	5,919	5,919
Infrastructure	1,740,978	1,614,779
Construction in Progress	127,140	123,924
Buildings and Equipment	1,353,384	1,387,220
Accumulated Depreciation	(1,531,943)	(1,460,933)
Total Capital Assets	1,695,477	1,670,909
Total Noncurrent Assets	2,338,942	2,057,229
Total Assets	2,503,063	2,206,890
LIABILITIES		
<u>Current Liabilities:</u>		
Vouchers Payable	5,358	5,324
Accounts Payable	6,490	6,467
Salaries & Wages Payable	5,453	5,076
Construction Contracts Payable	5,995	7,969
Accrued Expenses	13,609	13,437
Deferred Revenue	6,740	6,109
Current Portion of Long Term Obligations	79,120	71,897
Total Current Liabilities	122,765	116,280
<u>Noncurrent Liabilities:</u>		
Long Term Obligations	1,842,773	1,666,507
Unamortized Discount and Loss	(98,394)	(114,474)
Other Noncurrent Liabilities	19,573	16,032
Total Noncurrent Liabilities	1,763,952	1,568,065
Total Liabilities	1,886,717	1,684,346
NET ASSETS		
Invested in Capital Assets, Net of Related Debt	101,807	134,076
Restricted For:		
Capital Projects	23,942	79,145
Debt Service	173,031	158,109
Rate Stabilization	128,903	128,300
Unrestricted	188,663	22,915
Total Net Assets	\$616,346	\$522,545

STATEMENT OF REVENUES, EXPENSES AND CHANGES IN NET ASSETS
FOR THE FISCAL YEAR ENDED JUNE 30, 2005 AND 2004

(amounts in thousands)

	...2005...	...2004...
Operating Revenues:		
Charges for Goods and Services	\$445,367	\$397,253
Miscellaneous Operating Revenues	5,245	4,318
Total Operating Revenues	<u>450,612</u>	<u>401,571</u>
Operating Expenses:		
Personal Services	106,418	107,334
Purchase of Services	70,230	63,405
Materials and Supplies	24,109	24,157
Employee Benefits	56,515	41,914
Indemnities and Taxes	2,607	1,711
Depreciation and Amortization	82,503	82,445
Total Operating Expenses	<u>342,382</u>	<u>320,966</u>
Operating Income (Loss)	<u>108,230</u>	<u>80,605</u>
Nonoperating Revenues (Expenses):		
Operating Grants	552	2,893
Interest Income	10,875	2,942
Net Pension Obligation	(7,189)	
Debt Service - Interest	(87,567)	(91,757)
Other Expenses	(5,188)	(4,146)
Total Nonoperating Revenues (Expenses)	<u>(88,517)</u>	<u>(90,068)</u>
Income (loss) before Transfers	19,713	(9,463)
Transfers Out	(4,401)	0
Change in Net Assets	<u>15,312</u>	<u>(9,463)</u>
Net Assets - Beginning of Period	522,545	510,368
Adjustment	78,489	21,640
Net Assets - End of Period	<u>\$616,346</u>	<u>\$522,545</u>

STATEMENT OF CASH FLOWS
JUNE 30, 2005

(amounts in thousands)

	...2005...	...2004...
Cash Flows from Operating Activities		
Receipts from Customers	\$443,058	\$409,760
Payments to Suppliers	(98,871)	(91,903)
Payments to Employees	(159,197)	(149,096)
Claims Paid	(2,408)	(2,821)
Other Receipts (Payments)	0	0
Net Cash Provided by Operating Activities	<u>182,582</u>	<u>165,940</u>
Cash Flows from Non-Capital Financing Activities		
Operating Grants Received	602	2,843
Operating Subsidies and Transfers to Other Funds	4,401	0
Net Cash Provided by Non-Capital Financing Activities	<u>5,003</u>	<u>2,843</u>
Cash Flows from Capital & Related Financing Activities		
Proceeds from Capital Debt	244,566	0
Capital Contributions Received	0	0
Acquisition and Construction of Capital Assets	(100,477)	(111,785)
Interest Paid on Capital Debt	(85,032)	(89,169)
Principal Paid on Capital Debt	(71,515)	(69,032)
Other Receipts (Payments)	0	0
Net Cash Provided (Used) by Non-Capital Financing Activities	<u>(12,458)</u>	<u>(269,986)</u>
Cash Flows from Investing Activities		
Interest and Dividends	335	2,811
Net Cash Provided by Investing Activities	<u>335</u>	<u>2,811</u>
Net Increase (Decrease) in Cash & Cash Equivalents	175,462	(98,392)
Balances - Beginning of the Year	269,274	367,666
Balances - End of the Year	<u>444,736</u>	<u>269,274</u>
Reconciliation of Operating Income (Loss) to Net Cash Provided (Used) by Operating Activities:		
Operating Income (Loss)	108,230	80,605
Adjustments to Reconcile Operating Income to Net Cash Provided (Used) by Operating Activities:		
Depreciation Expense	82,503	82,445
Change in Assets and Liabilities:		
Receivables, Net	(10,246)	2,407
Inventories	(738)	(408)
Accounts and Other Payables	2,661	1,662
Accrued Expenses	172	(771)
Net Cash Provided by operating activities	<u>\$182,582</u>	<u>\$165,940</u>

BUDGETARY COMPARISON SCHEDULE

Water Operating Fund

For the Fiscal Year Ended June 30, 2005

(amounts in thousands)

<u>Revenues</u>	<u>Budgeted Amounts</u>			Final Budget to Actual Positive (Negative)
	<u>Original</u>	<u>Final</u>	<u>Actual</u>	
Locally Generated Non-Tax Revenue	\$ 433,100	\$ 410,744	\$ 419,696	\$ 8,952
Revenue from Other Governments	2,200	1,108	501	(607)
Revenue from Other Funds	<u>73,571</u>	<u>52,424</u>	<u>31,272</u>	<u>(21,152)</u>
Total Revenues	508,871	464,276	451,469	(12,807)
<u>Expenditures and Encumbrances</u>				
Personal Services	107,656	107,571	98,791	8,780
Pension Contributions	22,000	25,308	25,308	0
Other Employee Benefits	<u>31,369</u>	<u>28,061</u>	<u>27,835</u>	<u>226</u>
Sub-Total Employee Compensation	161,025	160,940	151,934	9,006
Purchase of Services	92,494	92,494	78,143	14,351
Materials and Supplies	33,962	33,966	32,469	1,497
Equipment	5,931	5,927	4,632	1,295
Contributions, Indemnities and Taxes	6,525	6,609	2,413	4,196
Debt Service - Principal	76,203	76,203	68,980	7,223
Debt Service - Interest	100,401	100,401	87,567	12,834
Short-Term Interest	1,500	1,500	0	1,500
Payments to Other Funds	<u>42,830</u>	<u>42,830</u>	<u>37,951</u>	<u>4,879</u>
Total Expenditures and Encumbrances	<u>520,871</u>	<u>520,871</u>	<u>464,089</u>	<u>56,782</u>
Operating Surplus (Deficit) for the Year	<u>(12,000)</u>	<u>(56,595)</u>	<u>(12,620)</u>	<u>43,975</u>
Fund Balance Available, July 1, 2004	-	-	-	-
<u>Operations in Respect to Prior Fiscal Years</u>				
Commitments Cancelled - Net	12,000	12,000	12,619	619
Prior Period Adjustments	<u> </u>	<u> </u>	<u>1</u>	<u>1</u>
Adjusted Fund Balance, July 1, 2004	<u>12,000</u>	<u>12,000</u>	<u>12,620</u>	<u>620</u>
Fund Balance Available, June 30, 2005	<u>0</u>	<u>\$ (44,595)</u>	<u>0</u>	<u>\$ 44,595</u>

CITY OF PHILADELPHIA WATER DEPARTMENT

BONDED DEBT FOR THE FISCAL YEAR ENDED JUNE 30, 2005

(amounts in thousands)

Series	ORIGINAL AUTHORIZATION		Outstanding June 30,2005	Maturities	Interest Rates	FISCAL YEAR 2006		Outstanding June 30, 2006
	Date	Issued				Debt Service Interest	Principal	
Revenue Bonds:								
Fourteenth Series	5/15/89 *	\$158,265	\$60,400	10/2005 to 10/2008	N.A.	\$	6,600	\$53,800
Series 1993	8/1/93 *	1,010,025	300,230	6/2006 to 6/2011	5.50 to 7.00	18,755	36,100	264,130
Series 1995	04/15/95	221,630	88,100	8/2005 to 8/2018	5.30 to 6.25	5,164	8,810	79,290
Series 1997 (A)	10/15/97	250,000	210,020	8/2005 to 8/2027	5.00 to 5.25	10,527	5,235	204,785
Series 1997 (B)	11/25/97	100,000	88,300	8/2005 to 8/2027	Variable	1,957	2,300	86,000
Series 1998	12/25/98	135,185	135,185	12/2011 to 12/2014	5.25	7,097		135,185
Series 1999	07/07/99	33,040	33,020	12/2005 to 12/2006	5.00	1,248	16,135	16,885
Series 2001	11/15/01	285,920	285,920	11/2011 to 11/2024	3.800 to 5.500	14,566		285,920
Series 2003	04/01/03	381,275	374,310	6/2006 to 6/2023	Variable	16,919	995	373,315
Series 2005 (A)	05/04/05	250,000	250,000	7/2006 to 7/2035	3.250 to 5.250	8,106		250,000
Series 2005 (B)	05/04/05	86,105	86,105	8/2005 to 8/2018	Variable	2,862	1,385	84,720
Penn Vest	04/30/00	6,700	2,201	7/2005 to 4/2019	1.41 to 2.73	55	408	1,793
Total Revenue Bonds		\$2,918,145	\$1,913,791			87,256	77,968	1,835,823
General Obligation Bonds:								
Penn Vest	06/15/93	20,000	8,101	07/2005 to 04/2012	1.00	76	1,151	6,950
Total Bonded Debt			\$1,921,892			87,332	79,119	\$1,842,773

* Partially Refunded

ANNUAL BONDED DEBT SERVICE REQUIREMENT:

Fiscal Year	Interest	Principal	Total
2006	87,332	79,119	166,451
2007	88,710	84,002	172,712
2008	85,081	89,596	174,677
2009	81,550	93,169	174,719
2010	77,815	96,944	174,759

The First Series through the Thirteenth, Fifteenth, and the Sixteenth were refunded.

Capitalized Interest added to Construction in Progress in Fiscal 2005 was \$6,605,790
Interest Expense was reduced by the same amount.

**SUPPLEMENTAL SCHEDULE OF RATE COVENANT COMPLIANCE FOR FISCAL YEAR ENDED
 JUNE 30, 2005 (Legally Enacted Basis)**

(amounts in thousands)

LINE NO.2005.....
1. Total Revenue and Beginning Fund Balance	\$463,462
2. Net Operating Expense	(277,705)
3. Transfer (To) From Rate Stabilization Fund	628
4. Net Revenues	<u>186,385</u>
5. Revenue Bonds Outstanding	(155,320)
6. General Obligation Bonds Outstanding	0
7. Pennvest Loan	(1,227)
8. Total Debt Service	<u>(156,547)</u>
9. Net Revenue after Debt Service	29,838
10. Transfer to General Fund	(4,401)
11. Transfer to Capital Fund	(16,709)
12. Transfer to Residual Fund	(8,728)
13. Total Transfers	<u>(29,838)</u>
14. Net Operating Balance for Current Year	<u>(0)</u>

The rate covenant contained in the General Ordinance requires the City to establish rates and charges for the use of the Water and Wastewater Systems sufficient to yield Net Revenues, as defined therein, in each fiscal year at least equal to 120%(coverage A) of the Debt Service Requirements for such fiscal year (excluding debt service due on any Subordinated Bonds). In addition, Net Revenues, in each fiscal year, must equal at least 100%(coverage B) of : (i) the Debt Service Requirements (including Debt Service Requirements in respect of Subordinated Bonds) payable in such fiscal year; (ii) amounts required to be deposited of Subordinated Bonds payable in such fiscal year; (ii) amounts required to be deposited into the Debt Reserve Account during such fiscal year; (iii) debt service on all General Obligations Bonds issued for the Water and Wastewater Systems payable in such fiscal year; (iv) debt service payable on Interim Debt in such fiscal year; and (v) the Capital Account Deposit Amount for such fiscal year, less amounts transferred from the Residual Fund to the Capital Account during such fiscal year. To insure compliance with the rate covenant, the General Ordinance requires that the City review its rates, rents, fees, and charges at least annually.

Additional Rate Covenant. As long as the Insured Bonds are outstanding, the City covenants to establish rates and charges for the use of the System sufficient to yield Net Revenues (excluding amounts transferred from the Rate Stabilization Fund into the Revenue Fund during, or as of the end of, such fiscal year) at least equal to 90% (coverage C) of the Debt Service Requirements (excluding debt service on any Subordinated Bonds) in such fiscal year.

COVERAGE A:

Line 4	<u>\$186,385</u>
/ Line 5	<u>\$155,320</u>
= COVERAGE A:	<u>1.20</u>

COVERAGE B:

Line 4	<u>\$186,385</u>
/ Line 8 + Line 11	<u>\$173,256</u>
= COVERAGE B:	1.08

COVERAGE C:

Line 4 - Line 3	<u>\$185,757</u>
/ Line 5	<u>\$155,320</u>
= COVERAGE C:	<u>1.20</u>

1. THE GOVERNMENT OF PHILADELPHIA

The City of Philadelphia was founded in 1682 and was merged with the county in 1854. There are two principal governmental entities in Philadelphia: (1) the City of Philadelphia, which performs both the ordinary municipal functions and the traditional county functions; and (2) the School district of Philadelphia, which is part of the public education system of the Commonwealth of Pennsylvania. In addition to the School District of Philadelphia, there are a number of other governmental and quasi-governmental entities operating within the City. The financial statements as set forth herein present only the operations of the City of Philadelphia Water Fund.

The City is governed largely under the 1951 Philadelphia Home Rule Charter. In some matters, including the issuance of short and long-term debt, the City is governed by the laws of the Commonwealth of Pennsylvania.

Pursuant to the Philadelphia Home Rule Charter, the Water Department has the power and duty to operate, maintain, repair and improve the City's Water and Wastewater Systems. The Water Department is managed by a Commissioner who is appointed by the City's Managing Director with the approval of the Mayor. The Commissioner appoints his deputies with the approval of the City's Managing Director and substantially all other employees are appointed under the provisions of the City's Civil Service Regulations. The executive offices of the Water Department are located at ARAMark Tower, 1101 Market Street, Philadelphia, Pennsylvania 19107-2994.

The Department of Revenue of the City has performed for the Water Department all functions relating to meter reading, billing and collections. The Director of Finance performs general fiscal accounting and has overall responsibility for the fiscal administration of all City departments, including the Water Department. The audit function for the City, including the Water Department, is the responsibility of the Office of the City Controller. Legal matters affecting the Water Department are the responsibility of the Office of the City Solicitor.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements of the Philadelphia Water Department have been prepared in conformity with Generally Accepted Accounting Principles (GAAP) as applied to governmental units. The Governmental Accounting Standards Board (GASB) is the accepted standard setting body for establishing governmental accounting and financial reporting principles. The more significant of the City's accounting policies are described below.

A. Basis of Accounting

For purposes of rate setting, calculating rate covenant compliance, debt service coverage and budgeting, the Water Fund accounts are maintained on the modified accrual basis of accounting also referred to as the “Legally Enacted Basis.” Under this basis, revenues are recognized in the accounting period in which they are received. Investment earnings are recorded when earned, as they are measurable and available. Expenditures are recorded in the accounting period in which the fund liability is incurred, if measurable, except expenditures for debt service, prepaid expenditures, and other long-term obligations, which are recognized when paid. Expenditures for claims and judgments, compensated absences and other long-term obligations are accrued if expected to be liquidated with available resources.

At fiscal year-end the Water Fund accounts are adjusted to the full accrual basis of accounting required by GAAP. The Water Fund is accounted for on a flow of economic resources measurement focus. With this measurement focus, all assets and all liabilities associated with the operation are included on the Statement of Net Assets. Fund equity (i.e., net total assets) is segregated into contributed capital and retained earnings components. In accrual basis accounting, revenues are recognized in the accounting period in which they are earned and expenses are recognized at the time the liabilities are incurred. Under GASB Statement No. 20, Accounting and Financial Reporting for Proprietary Activities, the Water Fund will continue to follow Financial Accounting Standards Board (FASB) pronouncements issued on or before November 30, 1989 unless those pronouncements conflict with or contradict GASB pronouncements and will follow FASB standards issued after that date which do not conflict with GASB standards.

Water revenues, net of uncollected accounts, are recognized as billed on the basis of scheduled meter readings. Revenues are accrued for unpaid bills at June 30 and for services provided but not yet billed at June 30.

B. Legal Compliance

The City’s budgetary process accounts for certain transactions on a basis other than GAAP.

In accordance with the Philadelphia Home Rule Charter, the City has formally established budgetary accounting control for its operating and capital improvement funds.

The operating funds of the City-consisting of the General Fund, five Special Revenue Funds (County Liquid Fuels Tax, Special Gasoline Tax, Hotel Room Rental Tax, Grants Revenue and Community Development Funds) and two Enterprise Funds (Water and Aviation Funds) – are subject to annual operating budgets adopted by City Council. These budgets appropriate funds for all City departments, boards and commissions by major class of expenditure within each department. Major classes are defined as: personal services; purchase of services; materials and supplies; equipment; contributions; indemnities and taxes; debt service; payments to other funds; and miscellaneous. The appropriation amounts for each fund are supported by revenue estimates and take into

account the elimination of accumulated deficits and the re-appropriation of accumulated surpluses to the extent necessary. All transfers between major classes (except for materials and supplies and equipment, which are appropriated together) must have Council approval. Appropriations not expended or encumbered at year-end are lapsed. Departmental comparisons of budget to actual activity are located in the City's Supplemental Report of Revenues and Obligations.

The City Capital Improvement Fund budget is adopted annually by the City Council. The Capital Improvement budget is appropriated by project for each department. Due to the nature of the projects, it is not always possible to complete all bidding, contracts, etc. within a twelve-month period. All transfers between projects exceeding twenty percent for each project's original appropriation must be approved by City Council.

As part of the amendment process, budget estimates of City related revenues are adjusted and submitted to City Council for review. Changes in revenue estimates do not need City Council approval, but are submitted in support of testimony with regard to the appropriation adjustments.

The following schedule reconciles the differences between the Legally Enacted Basis and GAAP Basis:

Water Fund	
Fund Balance-Legal Basis 6/30/05	\$ 0
Assets omitted from the legal basis:	
(1) Receivables from Other Governments or Funds	41,602
(2) Fixed Assets-Net of Depreciation	1,695,477
(3) Restricted Assets	572,165
(4) Proprietary Portion of Net Pension Obligation	<u>71,244</u>
	\$ <u>2,380,488</u>
Liabilities omitted from the legal basis:	
(5) Construction Contracts Payable	(5,995)
(6) Other Current Liabilities	(100,444)
(7) Bonds Payable and Other Long-Term Debt	<u>(1,763,952)</u>
	<u>(1,870,391)</u>
Fund Balance accounts included in the legal basis:	
(8) Reserve for Collectible Receivables	64,296
(9) Reserve for Inventories	14,077
(10) Reserve for Purchase Commitments	<u>27,876</u>
	<u>106,249</u>
Equity accounts omitted from the legal basis:	
(11) Invested in Capital Assets, Net of Related Debt	(101,807)
(12) Restricted for Capital Projects	(23,942)
(13) Restricted for Debt Service	(173,031)
(14) Restricted for Rate Stabilization	<u>(128,903)</u>
	<u>(427,683)</u>
Unrestricted Net Assets – GAAP Basis – 6/30/2005	<u>(\$188,663)</u>

C. Water Account

The City has established a City of Philadelphia Water Account to be held exclusively for Water Department purposes, separate and apart from all other funds and accounts of the City, and not to be commingled with the City's Consolidated Cash Account or any other fund or account of the City not held exclusively for Water Department purposes.

The City has covenanted that it will not make temporary loans or advances of Bond proceeds or Project Revenues (even while temporarily held in the City's Consolidated Cash Account) from the Water Account, the Water Sinking Fund, the Water Sinking Fund Reserve or the Water Rate Stabilization Fund to any City account not held exclusively for Water Department purposes. The City has established subaccounts within the Water Account into which deposits and from which disbursements shall be made for operating and capital purposes.

D. Pledge of Revenues

Section 4.02 and 4.04 of The ordinance of 1989, amended 1993, which authorized the issuance of Water and Sewer Revenue Bonds, hereby pledges and assigns to the Fiscal Agent for the security and payment of all Bonds, a lien on and security interest in all Project Revenues and amounts on deposit in or standing to the credit of the: 1) Revenue Fund; 2) Sinking Fund et.al.; 3) Subordinated Bond Fund; 4) Rate Stabilization Fund; 5) Residual Fund; and 6) Construction Fund etal. The Fiscal Agent shall hold and apply the security interest granted in trust for the Holders of Bonds listed above without preference, priority, or distinction; provided however, that the pledge of this ordinance may also be for the benefit of a Credit Facility and Qualified Swap, or any other person who undertakes to provide moneys for the account of the City for the payment of principal or redemption price and interest on any Series of Bonds (other than Subordinated Bonds), on an equal and ratable basis with Bonds, to the extent provided by any Supplemental Ordinance or Determination.

E. Grants from Other Governments for Capital Purposes

Grants from Federal, State, and other governments are recognized as revenue when grant expenditures have been recorded. Grants are recorded as non-operating revenues.

F. Property, Plant and Equipment

Property, plant and equipment are stated at cost. Where cost could not be developed from the records available, estimated historical cost was used to record the value of the assets. Upon sale or retirement, the cost of the assets and the related accumulated depreciation are removed from the accounts. Maintenance and repair costs are charged to operations.

Capital assets are defined by the City as assets with an initial individual cost of more than \$5,000 and an estimated useful life in excess of three years.

G. Depreciation

Depreciation on fixed assets is provided on the straight-line method over their estimated useful lives as follows:

Computer equipment	3 years
Automotive	5 years
Leasehold Improvements	8 years
General and monitoring equipment	10-20 years
Buildings	40 years
Reconstructed transmission and distribution lines	40 years
New transmission and distribution lines	50 years

H. Construction in Progress

Cost of construction includes all direct contract costs plus overhead charges. Overhead costs include direct and indirect engineering costs and interest incurred during the construction period on projects financed with Revenue Bond proceeds. Interest is capitalized by applying the average financing rate during the year to construction costs incurred. Interest earnings on bond proceeds reduce the amount capitalized. Capitalization of interest during construction for Fiscal Year 2005 was \$6,605,790.

I. Amortization of Bond Discount

Bond discounts and issuance costs are deferred and amortized by the bonds outstanding method.

J. Inventories

The materials and supplies inventory is priced using the “moving average cost” method.

K. Revenues

All billings rendered to general customers through June 30, 2005 are included in accounts receivable. In addition an amount for services rendered through June 30, 2005, but not billed, has been accrued. Historically, billings and collections for general customers remain relatively constant except for periods when there has been a rate change.

L. Insurance

The City, except for the Gas Works, the Airport, and certain other properties, is self-insured for most fire and casualty losses to its structures and equipment and provides statutory worker’s compensation, unemployment benefits, and health and welfare to its employees through a self-insured plan. Construction contractors are required to carry protective general liability insurance indemnifying the City and the Contractor. A reserve for payment of reported worker’s compensation claims and incurred but unreported claims has been recorded in the accompanying financial statements as

Other Long-Term Obligations.

M. Investments

All highly liquid investments (except for Repurchase Agreements) with a maturity of three months or less when purchased are considered to be cash equivalents.

The investments of the City are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Securities traded on national or international exchanges are valued at the last reported sales price. The fair value of real estate investments is based on independent appraisals. Investments, which do not have an established market, are reported at estimated fair value.

N. Deferred Revenues

Deferred revenues represent funds received in advance of being earned. In the Water Fund, deferred revenues relate principally to overpaid Water and Sewer bills.

O. Interfund Charges

In accordance with an agreement between the Finance Director and the Water Department, the Finance Director may transfer to the General Fund up to a limit of \$4,994,000 in any fiscal year in “excess interest earnings” as defined by the Rate Covenants under the Ordinance. In fiscal 2005, excess interest earnings of \$4,401,141 were transferred to the General Fund of the City.

3. ACCOUNTS RECEIVABLE

Balances consisted of the Following:

FISCAL YEAR ENDED JUNE 30, 2005

Accounts Receivable:

Billed in the Last Twelve Months	\$ 90,759,952
Billed in 15-year Cycle Billing	61,383,699
Penalties on Receivables	31,373,383
Other Receivables	<u>15,720,576</u>

Total **\$199,237,610**

Bad Debts Written Off \$ 21,088,811

ALLOWANCE FOR DOUBTFUL ACCOUNTS:

Billed in the Last Twelve Months	\$ 0
Billed in 15-year Cycle Billing	62,946,828
Penalties on Receivables	22,273,182
Other Receivables	<u>11,413,017</u>

Total **\$96,633,027**

FISCAL YEAR ENDED JUNE 30, 2004

Accounts Receivable:

Billed in the Last Twelve Months	\$ 76,495,155
Billed in 15-year Cycle Billing	69,967,795
Penalties on Receivables	37,495,398
Other Receivables	<u>14,446,104</u>

Total **\$198,404,452**

Bad Debts Written Off \$ 9,910,280

ALLOWANCE FOR DOUBTFUL ACCOUNTS:

Billed in the Last Twelve Months	\$ 0
Billed in 15-year Cycle Billing	64,643,203
Penalties on Receivables	32,686,151
Other Receivables	<u>8,730,670</u>

TOTAL **\$106,059,421**

4. PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment at June 30, 2005 and 2004 consisted of the following:

Fiscal Years Ended	June 30, 2005	June 30, 2004
Land	\$ 5,919,160	\$ 5,919,160
Buildings and related improvements	1,301,630,732	1,257,398,575
Meters and other improvements	78,119,495	77,895,407
Equipment	51,752,814	51,925,618
Transmission and distribution lines	1,662,858,187	1,614,779,270
Construction in progress	<u>127,140,405</u>	<u>123,924,256</u>
Total	\$3,227,420,793	\$3,131,842,286
Less: Accumulated Depreciation	<u>(1,531,943,477)</u>	<u>(1,460,933,499)</u>
Total	<u>\$1,695,477,316</u>	<u>\$1,670,908,786</u>

5. VACATION

Employees are credited with vacation at rates which vary according to length of service. Vacation may be taken or accumulated up to certain limits until paid upon retirement or termination. Employees' vacation time accrued in Fiscal Year 2005 was \$9,463,251 and in 2004 was \$8,931,233. The expense for vacation pay is recognized in the year earned.

6. SICK LEAVE

Employees are credited with varying amounts of sick leave per year according to type of employee and/or length of service. Employees may accumulate unused sick leave to 200 days and union represented employees may convert up to 20 sick days per year to vacation days at a ratio of 2 for 1. Non-uniformed employees (upon retirement only) are paid 30% of unused sick time, not to exceed predetermined amounts. Employees, who separate for any reason other than indicated above, forfeit their entire sick leave. The City budgets for and charges the cost of sick leave as it is taken.

7. CAPITALIZED LEASES

Leases consist of \$2,167,249 in photocopier and computer equipment in Fiscal 2005. Capital leases are defined by the Financial Accounting Standard Board in Statement 13, Accounting for Leases.

8. RATE STABILIZATION FUND

The Rate Stabilization Fund was created with the sale of the Series 1993 Revenue Bonds on August 20, 1993. The purpose of the Fund is to maintain assets to be drawn down to offset future deficits (and corresponding rate increase requirements) in the Water Department Operating Fund.

During Fiscal 2005 the fund had the following activity:

Balance at July 1, 2004	\$128,300,313
Deposit from Operating Fund	0
Transfer to Operating Fund	(627,837)
Interest Earnings	<u>1,230,032</u>
Balance at June 30, 2005	<u>\$128,902,508</u>

9. DEFERRED COMPENSATION PLAN

The City offers its employees a deferred compensation plan in accordance with Internal Revenue Code section 457. As required by the Internal Revenue Code and Pennsylvania laws in effect at June 30, 2005, the assets of the plan are held in trust for the exclusive benefit of the participants and their beneficiaries. In accordance with GASB Statement No. 32, *Accounting and Financial Reporting for Internal Revenue Code Section 457 Deferred Compensation Plans*, the City does not include the assets or activity of the plan in its financial statements.

10. ARBITRAGE REBATE

The City has issued Water Revenue Bonds subject to federal arbitrage requirements. Federal tax legislation requires the accumulated net excess of interest income on the proceeds of these issues over interest expense paid on the bonds be paid to the federal government at the end of a five-year period. In Fiscal 2005, \$30,077 was paid. As of June 30, 2005 there was no arbitrage liability.

11. DEBT PAYABLE

Defeased Debt

In prior years, the Water Fund defeased certain bonds by placing the proceeds of new bonds in irrevocable trusts to provide for all future debt service payments on old bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the Water Fund's financial statements. At year end, \$103,700,000 of bonds outstanding are considered defeased.

In May 2005, the City issued \$86.1 million of Water and Wastewater Revenue refunding Series 2005B bonds. The proceeds of the bonds were used to refund a portion of the 1995 Series Water and Wastewater Revenue Bonds maturing from 2014 through 2019 in the amount of \$80.7 million. The cash flows required by the new bonds are \$18 million less than the cash flows required by the refunded bonds. This early extinguishing of debt resulted in an accounting loss of approximately \$3.9 million representing the difference between the reacquisition price of \$84.6 million and the amount of debt extinguished of \$80.7 million (less \$.076 million unamortized discount). The resulting loss will be amortized over the life of the refunded bonds at a rate of \$543,433 annually through February 2013.

Interest Rate Swaption

City of Philadelphia 1993 Water and Sewer Swaption/2003 Water and Sewer Swap

Objective of swaption: In December 2002, the City entered into a swaption that provided the City with an up-front payment of \$24,989,926. As a synthetic refunding of its 1993 Bonds, this payment represents the present value savings, as of December 2002 of a refunding on March 18, 2003, without issuing refunding bonds as of December 2002. The swaption gave Citigroup formerly Salomon Brothers Holding Company, Inc. the option to enter into an interest rate swap to receive fixed amounts and pay variable amounts. The option was exercised on March 18, 2003 and the City issued variable-rate refunding bonds and started making payments under the terms of the swap.

Terms: Citigroup exercised its option to enter into a swap on March 18, 2003 – the City's 1993 water and sewer bonds' first call date. The swap also commenced on the exercise date of March 18, 2003. Under the swap, the City pays a fixed payment of 4.52% and receives a variable payment computed as the actual bond rate through March 1, 2005 and thereafter computed as the lesser of the actual bond rate or 68.5% of the

London Interbank Offered Rate (LIBOR). The swap rate was set at a rate that, based on the swap notional amount and when added to an assumption for remarketing, liquidity costs and cost of issuance will approximate the debt service of the “refunded bonds.” The swap has a notional amount of \$374,310,000 and the associated variable-rate bond has a \$374,310,000 principal amount. The bonds’ variable-rate coupons are not based on an index but on market conditions. The bonds and the related swap agreement mature on June 15, 2023. As of June 30, 2005 rates were as follows:

	<u>Terms</u>	<u>Rates</u>
Interest Rate Swap		
Fixed payment to Citigroup	Fixed	4.52%
Variable payment from Citigroup	Actual Bond Rate	(2.28%)
Net Interest Rate Swap payments		2.24%
Variable Rate bond coupon payments	Market Driven	2.28%
Synthetic interest rate on bonds		4.52%

Fair Value: As of June 30, 2005, the swap had a negative fair value of \$48,758,601. Since the coupons on the City’s variable rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value increase. The fair value was estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. The payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement of the swap.

Risk: As of June 30, 2005 the City is not exposed to credit risk because the swap had neither negative fair value nor basis risk since Citigroup’s payments are currently based on the actual bond rate paid on the variable-rate bonds. The swap uses the International Swap Dealers Association Master Agreement, which includes standard termination events. The Schedule to the Master Agreement includes an “additional termination event.” That is, the swap may be terminated if Citigroup’s or its Credit Support Provider, or the City has one or more outstanding issues of rated unsecured, unenhanced senior debt and none of such issues has a rating of at least (i) Baa3 or higher as determined by Moody’s Investors Service, Inc., or (ii) BBB- or higher as determined by Standard & Poor’s Ratings Service, A Division of the McGraw-Hill Companies, Inc. Or (iii) an equivalent investment grade rating determined by a nationally- recognized rating service acceptable to both parties.

Swap payments and associated debt: As of June 30, 2005, debt service requirements of the variable-rate debt and net swap payments for their term, assuming current interest rates remain the same, were as follows. As rates vary, variable rate bond interest payments and net swap payments will vary.

Fiscal Year Ending <u>June 30</u>	Variable Rate Bonds		Interest Rate	<u>Total Interest</u>
	<u>Principal</u>	<u>Interest</u>	<u>Swaps Net</u>	
(Amounts in thousands)				
06/15/2006	\$995	\$8,534	\$8,385	\$16,919
06/15/2007	1,045	8,511	8,362	16,874
06/15/2008	1,095	8,511	8,339	16,850
06/15/2009	1,145	8,463	8,314	16,777
06/15/2010	1,205	8,436	8,289	16,725
06/15/2011	1,260	8,409	8,262	16,671
06/15/2012	41,195	8,403	8,233	16,636
06/15/2013	43,205	7,441	7,311	14,752
06/15/2014	45,305	6,456	6,343	12,799
06/15/2015	47,515	5,423	5,328	10,751
06/15/2016	98,280	4,352	4,264	8,616
06/15/2017	11,280	2,099	2,062	4,161
06/15/2018	11,830	1,842	1,810	3,652
06/15/2019	12,410	1,572	1,545	3,117
06/15/2020	13,140	1,292	1,267	2,559
06/15/2021	13,780	990	972	1,962
06/15/2022	14,460	675	664	1,339
06/15/2023	15,165	345	340	685

City of Philadelphia, 1995 Water & Sewer Swaption

Objective of Swaption: In December, 2002, the City entered into a swaption that provided the City with an up-front payment of \$4,000,000. As a synthetic refunding of its 1995 Bonds, this payment represents the present value savings, as of December 2002, of a refunding on May 4, 2005, without issuing refunding bonds as of December, 2002. The swaption gives Citigroup formerly of Salomon Brothers Holding Company, Inc., the option to enter into an interest rate swap to receive fixed amounts and pay variable amounts. If the option is exercised, the City would then expect to issue variable-rate refunding bonds.

Terms: Citigroup has the option to exercise the agreement on May 4, 2005 – the City’s 1995 water and sewer bonds’ first call date. If the swap is exercised, the swap will also commence on May 4, 2005. Under the swap, the City pays a fixed payment of 4.53% and receives a variable payment computed as the lesser of the actual bond rate or 68.5% of the London Interbank Offered Rate (LIBOR) which were set at rates that were based on the swap notional amount and when added to an assumption for remarketing, liquidity costs and cost of issuance will approximate the debt service of the “refunded bonds.” The swap has a notional amount of \$86,105,000 and the associated variable-rate bond has an \$86,105,000 principal amount. The bonds variable-rate coupons are not based on an

index but on market conditions. The bonds and the related swap agreement mature on May 4, 2025. As of June 30, 2005, the rates were as follows:

	<u>Terms</u>	<u>Rates</u>
Interest Rate Swap		
Fixed payment to Citigroup	Fixed	4.52%
Variable payment from Citigroup	Actual Bond Rate	(2.27%)
Net Interest Rate Swap payments		2.26%
Variable Rate bond coupon payments	Market Driven	2.27%
Synthetic interest rate on bonds		4.53%

Fair value: As of June 30, 2005, the swaption had a negative fair value of \$13,341,493. Its fair value was estimated using the BDT option pricing model. This model takes into consideration probabilities, volatilities, time and underlying prices.

Market access risk and interest rate risk: As of June 30, 2005 the City is not exposed to credit risk because the swap had neither negative fair value nor basis risk since Citigroup's payments are currently based on the actual bond rate paid on the variable-rate bonds. The swap uses the International Swap Dealers Association Master Agreement, which includes standard termination events. The Schedule to the Master Agreement includes an "additional termination event." That is, the swap may be terminated if Citigroup's or its Credit Support Provider, or the City has one or more outstanding issues of rated unsecured, unenhanced senior debt and none of such issues has a rating of at least (i) Baa3 or higher as determined by Moody's Investors Service, Inc., or (ii) BBB- or higher as determined by Standard & Poor's Ratings Service, A Division of the McGraw-Hill Companies, Inc. Or (iii) an equivalent investment grade rating determined by a nationally- recognized rating service acceptable to both parties.

Swap payments and associated debt: As of June 30, 2005, debt service requirements of the variable-rate debt and net swap payments for their term, assuming current interest rates remain the same, were as follows. As rates vary, variable rate bond interest payments and net swap payments will vary.

Fiscal Year Ending	Variable Rate Bonds		Interest Rate	
<u>June 30</u>	<u>Principal</u>	<u>Interest</u>	<u>Swaps Net</u>	<u>Total Interest</u>
(Amounts in thousands)				
08/01/2005	\$1,385	\$1,955	\$1,946	\$3,901
08/01/2006	335	1,923	1,915	3,838
08/01/2007	350	1,916	1,907	3,823
08/01/2008	370	1,913	1,899	3,812
08/01/2009	390	1,899	1,891	3,790
08/01/2010	405	1,890	1,882	3,772
08/01/2011	425	1,881	1,873	3,754
08/01/2012	450	1,877	1,863	3,740
08/01/2013	14,820	1,861	1,853	3,714
08/01/2014	15,535	1,525	1,518	3,043

08/01/2015	16,315	1,172	1,167	2,339
08/01/2016	17,145	804	798	1,602
08/01/2017	18,015	413	410	823
08/01/2018	165	4	4	8

12. PENSION PLAN

The City, via the Municipal Pension Plan, maintains the following employee retirement system:

(1) City Plan

(a) Plan Description

The Philadelphia Home Rule charter (the Charter) mandates that the City maintains an Actuarially sound pension and retirement system. To satisfy that mandate, the City's Board of Pensions and Retirement maintains the single-employer Municipal Pension Plan (the Plan). The Plan covers all officers and employees of the City and officers and employees of five other governmental and quasi-governmental organizations. By authority of two Ordinances and related amendments passed by City Council, the Plan provides retirement benefits as well as death and disability benefits. Benefits vary by the class of employee. The Plan has two major classes of members – those covered under the 1967 Plan and those covered under the 1987 Plan. Both of these two plans have multiple divisions.

Retirement Benefits

An employee who meets the age and service requirements of the particular division in which he participates is entitled to an annual benefit, payable monthly for life, equal to the employee's average final compensation multiplied by a percentage that is determined by the employee's years of credited service. The formula for determining the percentage is different for each division. If fund earnings exceed the actuarial assumed rate by a sufficient amount, an enhanced benefit distribution to retirees, their beneficiaries, and their survivors shall be considered. A deferred vested benefit is available to an employee who has 10 years of credited service, has not withdrawn contributions to the system and has attained the appropriate service retirement age. Members of both plans may opt for early retirement with a reduced benefit. The **Deferred Retirement Option Plan (DROP)** was initiated on October 1, 1999. Under this plan, employees that reach retirement age may accumulate their monthly service retirement benefit in an interest bearing account at the Board of Pensions for up to four (4) years and continue to be employed by the City of Philadelphia.

Death Benefits

If an employee dies from the performance of duties, his/her spouse, children or dependent parents may be eligible for an annual benefit ranging from 15% to 80% of the employees final average compensation. Depending on age and years of service, the beneficiary of an employee who dies other than from the performance of duties will be eligible for either a lump sum benefit only or a choice between a lump sum or an annual pension.

Disability Benefits

Employees disabled during the performance of duties are eligible for an immediate benefit equal to contributions plus a yearly benefit. If the employee subsequently becomes employed, the benefit is reduced by a percentage of the amount earned. Certain employees who are disabled other than during the performance of duties are eligible for an ordinary disability payment if they apply for the benefit within one year of termination. If the employee subsequently becomes employed, the benefit is reduced by a percentage of the amount earned.

Membership

Membership in the plan as of July 1, 2004 was as follows:

Employee Group	Number
Retirees and beneficiaries	
Currently receiving benefits	32,465
Terminated members entitled to	
Benefits but not yet receiving them	809
Active members	<u>31,487</u>
Total Members	<u>64,761</u>

The Municipal Pension fund issues a separate annual financial report. To obtain a copy, contact the Director of Finance of the City of Philadelphia.

(b) Funding Policy

Employee contributions are required by City Ordinance. For Plan 67 members, employees contribute 3.75% of their total compensation that is subject to Social Security Tax and 6% of compensation not subject to Social Security Tax. Plan 87 contribution rates are defined for the membership as a whole by Council ordinance. Rates for individuals are then determined annually by the actuary so that total individual contributions satisfy the overall rate set by Council.

The City is required to contribute the remaining amounts necessary to fund the Plan, using an acceptable actuarial basis as specified by the Home Rule Charter, City Ordinance and State Statute. Court decisions require that the City's annual employer contributions are sufficient to fund:

- The accrued actuarially determined normal costs;
- Amortization of the unfunded actuarial accrued liability determined as of July 1, 1985. The portion of that liability attributable to a class action lawsuit by pension fund beneficiaries (the Dombrowski suit) is amortized in level installments, including interest, over 40 years through June 30, 2009. The remainder of the liability is amortized over 34 years with increasing payments expected to be level as a percentage of each year's aggregate payroll;

- Amortization in level dollar payments of the changes to the July 1, 1985 liability due to the following causes over the stated period:
 - Non-active member's benefit modifications (10 years)
 - Experience gains and losses (15 years)
 - Changes in actuarial assumptions (20 years)
 - Active members' benefit modifications (20 years)

Under the City's current funding policy, the total required employer contribution for the current year amounted to \$358.1 million or 28.4 % of covered payroll of \$1,260.7 million.

Administrative costs of the Plan are paid out of the Plan's assets.

Annual Pension Cost and Net Pension Obligation

The City and other employers' annual pension cost and net pension obligation for the Municipal Pension Plan for the current year were as follows:

Annual Required Contribution (ARC)	358,141
Interest on Net Pension Obligation (NPO)	(90,448)
Adjustment to ARC	<u>124,687</u>
Annual Pension Cost	392,380
Contributions Made	<u>299,266</u>
Increase in NPO	93,114
NPO at beginning of year	(1,004,980)
NPO at end of year	(911,866)
Interest Rate	9.00 %
15 Year amortization Factor (EOY)	8.06 %

The actuarial valuation that was used to compute the current year's required contribution was performed as of July 1, 2003. Methods and assumptions used for that valuation include:

- The individual entry age actuarial cost method
- A five-year smoothed market value method for valuing investments
- A level percentage closed method for amortizing the unfunded liability
- An annual investment rate of return of 9%
- Projected annual salary increases of 5% (including inflation)
- Annual inflation of 3.5%

- No post-retirement benefit increases

Under the City’s funding policy, the recommended contribution for the City for the current year amounted to \$349.5 million. The City’s actual contribution was \$290.6 million. The City’s contribution did meet the Minimum Municipal Obligation (MMO) as required by the Commonwealth of Pennsylvania’s Acts 205 and 189. The Annual Pension Cost and related percentage contributed for the three most recent fiscal years are as follows:

Fiscal Year Ended June 30	Annual Pension Cost (In Millions)	Percentage Contributed	Net Pension Obligation (In Millions)
2003	\$234.6	76.61%	(\$1,093.2)
2004	291.1	69.68%	(1,005.0)
2005	392.3	76.27%	(911.9)

(c) Summary of Significant Accounting Policies

Financial statements of the Plan are prepared using the accrual basis of accounting. Contributions of employees and employers are recognized as revenues in the period in which employee services are performed. Benefits and refunds paid are recognized when due and payable in accordance with the terms of the plan. Investments are valued as described in Footnote M.

13. POST EMPLOYMENT BENEFITS

In addition to providing pension benefits, the City provides certain post employment health care and life insurance benefits for retired employees, dependents and/or beneficiaries through provisions of City ordinances, civil service regulations and agreements with its various employee bargaining units. The City provides these benefits from one to five years after retirement depending upon the classification of the employee at his or her retirement. Substantially all of the City’s employees may become eligible for those benefits if they reach normal retirement age while working for the City. These and similar benefits for active employees are provided through a combination of a self-insurance program and insurance companies whose premiums are based on the benefits paid during the year. The cost of providing these health benefits and life insurance for approximately 4,250 eligible retirees amounted to \$36.1 million and \$4.0 million respectively.

14. CLAIMS, LITIGATION AND CONTINGENCIES

Generally, claims against the City are payable out of the General Fund, except claims against the City Water Department, City Aviation Division, or Component Units which are paid out of their respective funds and only secondarily out of the General Fund which is then reimbursed for the expenditure. Unless specifically noted otherwise, all claims hereinafter discussed are payable out of the Water Fund. The Act of October 5, 1980,

P.L. 693, No. 142, known as the “Political Subdivision Tort Claims Act,” established a \$500,000 aggregate limitation on damages arising from the same cause of action or transaction or occurrence or series of causes of action, transactions or occurrences with respect to governmental units in the Commonwealth such as the City. The constitutionality of that aggregate limitation has been upheld by the United States Supreme Court. There is no such limitation under federal law.

Various claims have been asserted against the Water Department and in some cases lawsuits have been instituted. Many of these claims are reduced to judgment or otherwise settled in a manner requiring payment by the Water Department. At year-end, the aggregate estimate of loss deemed to be **probable** is \$1.5 million.

In addition to the above, there are other lawsuits against the Water Department in which some amount of loss is reasonably **possible**. The aggregate estimate of the loss, which could result if unfavorable legal determinations were rendered against the Water Department with respect to these lawsuits, is \$3.2 million.

15. ENHANCED SECURITY

In light of the events of September 11, 2002, when terrorists struck the United States, the Water Department has taken steps to improve the security of the City’s water supply and all other major Water Department facilities and assets. These steps have been taken in close coordination with the City’s Managing Director’s Office and all other appropriate city agencies and departments. On October 11, 2002, the City of Philadelphia reopened the Emergency Operations Center, designed to permit city emergency personnel to respond quickly to any major event through specialized computer and communications equipment. This center is staffed around the clock by officials from the Police, Fire, and Health Departments, as well as the Water Department and additional city agencies. The Center has a backup 911 system, in addition to computer terminals that are able to communicate with all City enforcement and emergency personnel. Details of the enhanced security measures already taken and those presently under consideration cannot be presently disclosed.

It should be noted that the Water Department had an extensive water quality protection and security plan in place prior to the events of September 11, 2002. All finished water basins are completely covered; all plants are fenced in and topped by barbed wire; gates are secured; and the Water Department continues to draw and conduct nearly one thousand tests on water samples from various locations each day.