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Summary:
Aqua Pennsylvania Inc.

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Summary:

Aqua Pennsylvania Inc.

Credit Rating: A+/Stable/--

Rationale

Standard & Poor's Ratings Services' ratings on water utility Aqua Pennsylvania Inc. reflect the consolidated credit quality of its parent company, Aqua America Inc. (unrated). Aqua Pennsylvania accounts for more than one-half of consolidated Aqua America's revenues and cash flow.

Aqua Pennsylvania's business risk profile is excellent, in our assessment, reflecting a low-risk monopoly water distribution business; a supportive regulatory environment with favorable cost-recovery mechanisms that enhance cash flow predictability; a large, stable residential and commercial customer base that provides a stable revenue base; and solid operations in which purchased water accounts for only about 10% of water sales. The company's elevated capital spending requirements for infrastructure replacement, increasing costs of compliance with water quality standards, and a highly acquisitive growth strategy somewhat temper the company's strengths. We view the financial risk profile as intermediate, reflecting stable but weak cash flow metrics, high debt leverage, and solid access to the capital markets.

The Pennsylvania Public Utility Commission (PPUC) provides Aqua Pennsylvania with favorable cost-recovery mechanisms, including the addition of capital spending to rates outside the traditional rate proceedings, inclusion of certain expected expenditures in determining rates, and a consolidated rate structure. During 2010, 24 rate cases worth about $50 million were processed across several of Aqua America's subsidiaries. In 2011 the company received about $26 million worth of rate increases. A number of rate cases continue to be in progress. For 2012, we expect rate cases worth about $50 million to be processed.

Timely rate relief and balanced financing of its growth strategy support Aqua Pennsylvania's intermediate financial profile, which we view as appropriate for the rating, but consolidated financial metrics are modestly weaker than other 'A+' rated water companies. As of Dec. 31, 2011, Aqua America had total debt, including tax-effected pension and other postemployment benefits and operating leases, of about $1.7 billion, with total debt to capital of about 58%. Aqua America's adjusted funds from operations (FFO) are about $330 million and FFO to debt is about 20%. As of Sept. 30, 2011, Aqua Pennsylvania had total adjusted debt of $1.03 billion and adjusted FFO to total debt of about 24%. Over the intermediate term, we expect financial performance to approximate current levels for both Aqua America and Aqua Pennsylvania, supported by additional rate increases and existing recovery mechanisms.

Aqua America recently entered into a joint venture with Penn Virginia Resource Partners L.P. (PVR; rated BB-/Stable/--) to construct a 12-inch pipeline to provide fresh water to PVR's gas-gathering systems in Lycoming County, Pa. We believe that this project efficiently fulfills a requirement to provide water in the Marcellus Shale region and could provide Aqua with an opportunity to increase its nonregulated cash flows, which are currently less than 1% of total EBITDA.

Liquidity

We consider Aqua America's consolidated liquidity to be adequate under Standard & Poor's corporate liquidity methodology. Projected sources of liquidity (cash, FFO, and credit facility availability) exceed projected uses (maintenance and significant discretionary capital spending, dividends, and manageable debt maturities) by about 1.5x over the next 12 months. We base this calculation on a scenario where the company has no access to the capital markets, and excludes any uncommitted facilities. As per our criteria, we also excluded the available portion of the $95 million committed facility since it expires in May 2012. We expect this facility to be renewed shortly. Over the next 12 months, we expect Aqua America's cash from operations to be in the $340 million to $370 million range, in line with recent growth. Other sources of funds include minimal cash from expected rate cases in 2011 and some borrowing ability on the revolving credit facility. Uses of cash include capital spending that we expect to be in the $300 million to $350 million range, although we consider only about one-third of it is mandatory expenditure. Debt maturities of about $40 million, and expected dividends of about $83 million, in line with increases over the past few years, are other significant uses of capital.

Aqua Pennsylvania issued about $143 million of debt in October 2010, a portion of which it will likely use to refinance existing debt. The company will deposit proceeds from the incremental debt in a restricted account and use it to fund capital spending over the next few years. These funds, in addition to infrastructure replacement surcharges, support spending on discretionary projects and can also be used for any other near-term liquidity requirements.

There is significant covenant headroom under its debt agreements. The company is required to maintain total debt to capital (as defined) below 62%, and interest coverage (as defined) of 3.6x. We expect it to remain comfortably in compliance with these covenants over the next 12 months.

Recovery analysis

We rate Aqua Pennsylvania's first mortgage bonds (FMB) 'AA-', one notch higher than the corporate credit rating, based on a recovery rating of '1+' under our recovery methodology for regulated utilities. We assign recovery ratings to FMBs issued by U.S. utilities, and this can result in issue ratings being notched above the corporate credit rating on a utility, depending on the corporate credit rating category and the extent of the collateral coverage. We base the investment-grade FMB recovery methodology on the ample historical record of nearly 100% recovery for secured-bond holders in utility bankruptcies and our view that the factors that supported those recoveries (the small size of the creditor class, and the durable value of utility rate-based assets during and after a reorganization, given the essential service provided and the high replacement cost) will persist. Under our notching criteria, when assigning issue ratings to utility FMBs, we consider the limitations of FMB issuance under the utility's indenture relative to the value of the collateral pledged to bondholders, management's stated intentions on future FMB issuance, and the regulatory limitations on bond issuance. FMB ratings can exceed a corporate credit rating on a utility by as much as one notch in the 'A' category, two notches in the 'BBB' category, and three notches in speculative-grade categories. Aqua Pennsylvania's collateral coverage of greater than 1.5x supports a recovery rating of '1+' and an issue rating of 'AA-', one notch higher than the corporate credit rating.

Outlook

The stable outlook reflects Standard & Poor's expectation of adequate and timely rate relief, management of the company's growth strategy, and maintenance of an appropriate financial risk profile. We could lower the rating if the regulatory environment in Pennsylvania takes an unfavorable shift or the company increases debt to finance acquisitions or capital spending, resulting in consolidated FFO to debt consistently below the 17% to 18% range and leverage above 60%. Although less likely, we could raise the rating if regulators provide significant rate increases and above-average returns on equity that result in Aqua America's generating cash flow that is materially stronger than we expect, with FFO to debt of at least 25% and leverage below 55%.

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Sept. 28, 2011
- Key Credit Factors: Business And Financial Risks In the Investor-Owned Utilities Industry, Nov. 26, 2008
- Changes To Collateral Coverage Requirements For '1+' Recovery Ratings On U.S. Utility First Mortgage Bond, Sept. 6, 2007