

Rating Update: MOODY'S AFFIRMS A3 RATING AND ASSIGNS A NEGATIVE OUTLOOK TO COTTONWOOD MUNICIPAL PROPERTY CORPORATION WATER ENTERPRISE (AZ)

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A3 RATING AND NEGATIVE OUTLOOK AFFECT \$35.5 MILLION OF RATED DEBT OUTSTANDING

Water/Sewer
AZ

Opinion

NEW YORK, Oct 28, 2010 -- Moody's Investors Service has affirmed the A3 rating and assigned a Negative outlook to the Cottonwood Municipal Property Corporation Water Enterprise (AZ) senior lien debt obligations affecting \$35.5 million in outstanding debt. The bonds are secured by the lease purchase payments made by the City from net water utility system revenues.

RATINGS RATIONALE

The A3 rating is primarily based on the enterprise's relatively small size and rural service area and strong liquidity position. The negative outlook reflects the highly leveraged nature of the system and narrow debt service coverage (DSC), which has experienced significant declines in recent years.

DIVERSIFIED, MATURE SERVICE AREA WITH ADEQUATE CAPACITY TO MEET FUTURE DEMAND

The City of Cottonwood (GO rated A1) is located 50 miles south of Flagstaff (GO rated Aa2) and about 20 miles southwest of the City of Sedona. Recreational tourism and services for retirees are important economic drivers for the region. The system's service area includes the city limits and surrounding areas just adjacent to the city limits. The system's customer base has grown 7.3% since FY 2009, but has moderated in recent years with an approximate 1% gain in FY 2009 to 9,136 accounts. The system's capacity includes all above ground storage facilities including 21 reservoirs with a capacity of 3.4 million gallons, which remains sufficient to meet future demand. The system remains diversified with the top ten customers making up a small 4.19% of the system's total revenues.

SUBSTANTIAL LIQUIDITY POSITION OFFSETS WEAK COVERAGE LEVELS

Moody's believes the system's debt service coverage levels will remain suppressed in FY 2010 due to expenditure pressures stemming from increasing repair and replacement costs. The System's FY 2009 DSC of 0.86 times and expected FY 2010 DSC of 0.85 times remains low and fails to meet the system's rate covenant. The System drew down \$400,000 to pay debt service in FY 2009 and expects to draw down an additional \$500,000 in FY 2010. The system's expenditures increased 13.5% in FY 2008 and 22.5% in FY 2009 as a result of needed repairs to existing water lines and costs related to water quality. Management has indicated that arsenic levels have been reduced and is in compliance with water regulation standards. For FY 2011, management expects DSC to improve to 1.26 times primarily supported by \$500,000 in expenditure cuts and a 8% rate increase, which was approved by city council in FY 2010. Rate increases became effective October of 2010 and will be reflected in the FY 2011 financials. The System's weakened coverage levels are offset by a strong liquidity position represented by 989 Days Cash on Hand and NWC as % of O&M of 425.9%. Moody's notes that the system maintains a fully cash funded debt service reserve account. Moody's notes that further decreases in debt service coverage levels could result in negative action on the system's rating. In addition, Moody's believes the on-going maintenance of the system's strong liquidity position remains a significant credit factor.

WHAT COULD MAKE THE RATING GO UP (REMOVAL OF NEGATIVE OUTLOOK)

- * Maintenance of an above average liquidity position
- * Demonstrated progress toward restoring debt service coverage levels to historical averages

WHAT COULD MAKE THE RATING GO DOWN

- * Further deterioration of the system's coverage levels and cash position

KEY STATISTICS:

Security: Secured by the lease purchase payments made by the City from net water utility system revenues

Legal Provisions: Slightly stronger than standard with a rate covenant and additional bonds test of 1.35x of annual debt service coverage.

Total Accounts (2009): 9,127

FY2009 DSC Including Connection Fees: 0.86 times

FY2009 DSC Excluding Connection Fees: 0.81 times

Net Working Capital as % of O&M: 425.9%

FY 2009 Days Cash on Hand: 989

Debt Ratio: 111.4%

10 Yr Payout: 31%

The principal methodology used in rating Cottonwood Municipal Property Corporation Water Enterprise (AZ) was Analytical Framework For Water And Sewer System Ratings, rating methodology published in August 1999. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found on Moody's website.

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