

Rating Update: MOODY'S DOWNGRADES COTTONWOOD MUNICIPAL PROPERTY CORPORATION WATER ENTERPRISE (AZ) RATING TO Baa1 FROM A3

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NEGATIVE OUTLOOK REMOVED; Baa1 RATING AFFECTS \$34.6 MILLION OF RATED DEBT OUTSTANDING

Cottonwood Munic. Prop. Corp., AZ Wtr. Ent.
Water/Sewer
AZ

Opinion

NEW YORK, May 20, 2011 -- Moody's Investors Service has downgraded Cottonwood Municipal Property Corporation Water Enterprise (AZ) senior lien debt obligations to Baa1 from A3 affecting \$34.6 million in outstanding debt. The bonds are secured by the lease purchase payments made by the City from net water utility system revenues.

SUMMARY RATING RATIONALE

The Baa1 rating and downgrade reflects the city's weakened financial position, which has contributed to violation of the rate covenant for two consecutive years and a decline in the City's cash margins. The Baa1 rating also reflects the essentiality of the service, stable customer base, weak debt ratio and reluctance to raise rates to generate adequate net revenues for the payment of debt service. The removal of the negative outlook reflects management's commitment to increase coverage levels to comply with the rate covenant through expenditure cuts and rate increases over the next couple years.

STRENGTHS

- Ample liquidity position
- Adequate system capacity to meet future demand

CHALLENGES

- Multiple year rate increases to restore coverage levels to 1.35x rate covenant
- Above average debt ratio

DETAILED CREDIT DISCUSSION

SYSTEM EXHIBITS TREND OF DECLINING COVERAGE AND LIQUIDITY LEVELS

The System's debt service coverage levels have declined in recent years as a result of declining operating revenue and expenditure pressures stemming from increased repair and replacement costs. In fiscal 2009 and fiscal 2010 debt service coverage fell to 1.10x and 1.11x respectively, which fell below the rate covenant of 1.35x coverage on a net revenue basis. Despite an 8% rate increase, which was approved by City Council in fiscal 2010, management projects fiscal 2011 coverage to be 1.08x. Management acknowledges the need to increase coverage levels to satisfy the rate covenant and plans to do so through a collection of expenditure cuts and rate increases.

AMPLE LIQUIDITY DESPITE RECENT DRAWDOWNS

The System's liquidity position has declined in recent years as a result of increased capital expenditures related to needed repairs to existing water lines and costs related to water quality. Management has indicated that arsenic levels have been reduced and is compliance with water regulation standards. Days Cash on Hand declined from 927 days in fiscal 2009 to 504 days in fiscal 2010. Management has indicated that there is no expectation to utilize cash reserves outside of standard repair and maintenance charges. Moody's believes the on-going maintenance of the system's ample liquidity position remains a significant credit factor. In addition, the City has indicated that the system maintains a fully cash funded debt service reserve account.

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

The City of Cottonwood (UTGO, rated A1) is located 50 miles south of Flagstaff (UTGO 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 adjacent to the city limits. 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 4.19% of the systems total revenues.

WHAT COULD MAKE THE RATING GO UP

- * Demonstrated trend of increasing net revenues and debt service coverage above the rate covenant

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

Fiscal 2010 operating ratio: 67%

Fiscal 2010 Debt Service Coverage: 1.11 times

Fiscal 2010 Days Cash on Hand: 504

Debt Ratio: 116.6%

Projected Payout (10 years): 32%

The principal methodology used in this rating was Analytical Framework For Water And Sewer System Ratings published in August 1999.

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