

Credit Opinion

Moody's affirms the rating on Lancaster County Solid Waste Management Authority's Resource Recovery System Revenue Bonds

Global Credit Research – 23 February 2013

\$30.6 million outstanding revenue bonds affected

Opinion

Moody's Investors Service (Moody's) has affirmed the A3 rating to the Lancaster County Solid Waste Management Authority's (the Authority or LCSWMA) Series 2006 Resource Recovery System Revenue Bonds. The Authority has \$30.620 million of revenue bonds outstanding. The outlook is stable.

RATINGS RATIONALE

The rating affirmation is based on the track record of successful operations in a competitive environment that the Authority has established in recent years. Additional factors supporting the rating include the Authority's stable finances, high liquidity levels, and well-managed operations. The stable outlook is based on the well-designed contracts with haulers which extend beyond the maturity of outstanding debt, efficient facility operations with recognized operators, and supportive waste streams from municipalities that keep the plants running smoothly.

In June 2012, the Authority was selected the winner of a competitive bidding process to negotiate for the purchase of the Harrisburg Materials Energy Recycling Recovery Facility (HMERRF) by the Office of the Receiver for the City of Harrisburg, Pa. Our rating incorporates knowledge of this transaction. At this time however specific details are extremely limited. Given the history of this particular asset, the undertaking by the authority may be credit negative in our view. Depending on the structure of the transaction and the associated debt financing, it may have significant credit implications and could result in a multiple-notch rating change.

STRENGTHS

- *Tonnage protected by both legal flow controls and contracts with haulers
- *Current round of hauler contracts expire after the final maturity of outstanding debt
- *Strong maintained liquidity position with over 400 days cash on hand

CHALLENGES

- *Very limited rate-raising ability to increase rates under current hauler contracts
- *Declines in tonnage could result in use of liquidity given limited rate-raising ability
- *Potential heightened risk associated with integrating a new waste-to-energy facility with poor operating history

LEGAL SECURITY: Net Revenues of the Authority and a cash-funded debt service reserve fund.

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INTEREST RATE DERIVATIVES: None.

WHAT COULD CHANGE THE RATING—UP: Sustained growth in operations and widening of financial margins may result in upward pressure on the rating.

WHAT COULD CHANGE THE RATING--DOWN: Increased competitive pressures on the Authority's waste flow and/or reduction of cash reserves could result in a downward revision of the rating.

DETAILED CREDIT DISCUSSION

BACKGROUND:

The Authority owns, operates and manages an integrated solid waste disposal system that includes (i) a Waste-to-Energy (WTE) facility; (ii) a landfill, (iii) and a transfer station. The Authority serves Lancaster County (GO rated A1), and haulers within the County are required to bring the Municipal Solid Waste (MSW) to system facilities due to a local flow control ordinance. The Authority also processes Construction and Demolition (C&D) Waste and has developed a successful industrial (or "special") waste disposal/processing program, dealing with non-municipal solid waste, typically from industrial customers both within and outside the County.

The WTE facility is owned by the Authority and is located 20 miles west of the City of Lancaster, 16 miles from the landfill. The facility has a maximum capacity of 1200 tons per day (TPD) through 3x 400 TPD boilers, and was constructed and is operated by Covanta Energy. In 2012, facility processed 388k tons of waste and produced 225k MW of electricity.

The Landfill consists of a total of 153 acres, and was designed to serve as the disposal facility for all waste generated within the County that is not acceptable for processing at the WTE facility, and for all materials generated by facility. The total permitted capacity of the Landfill is 10.8m cubic yards, with a daily permitted operational capacity of 2,000 tons. At its projected rate of use, the Landfill's remaining capacity should serve the Authority's needs until 2019. The Authority has begun the design of a future landfill project on land it currently owns, which should be operational by 2019 and provide disposal capacity for the Authority for 20 to 25 years thereafter.

The Transfer Station is located just outside the Lancaster City limits, and charges a separate transfer fee of \$3.00/ton for MSW and \$9.00/ton for C&D Waste, in addition to the tipping fee. The Authority expanded the transfer station's permitted daily tonnage from 1600 TPD to 2200 TPD in a project completed in 2008 at a cost of \$33.5m. In 2012, the station received 315k tons of waste, utilizing approximately 50% of its daily capacity. The Authority expects the transfer station to serve its needs for the next 30 – 40 years.

PREDICATIBILITY OF CASH FLOWS:

The majority of the Authority's revenues are subject to flow control ordinances, which direct all MSW generated within Lancaster County to Authority facilities. Beyond legal flow control, the Authority has executed multi-year waste delivery contracts with commercial haulers operating in the County for delivery of MSW and C&D waste since 1994, further incentivizing haulers to bring waste to Authority facilities. These contracts obligate each hauler to deliver all MSW and C&D waste collected within the County to Authority disposal facilities. The Authority rebates a fixed amount per ton (\$10.20) back to the hauler on a quarterly basis if it delivers more than 100 tons/year. The haulers have the

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ability to terminate contracts if the Authority increases tipping (disposal) fees above a per-ton set cap. Of the waste disposed in 2012, 97% of MSW and 80% of C&D waste was under contract.

The last round of contracts became effective January 1, 2013, and will expire December 31, 2017, two years following maturity of the outstanding revenue bonds. With this new contract, the tip fees net of rebate remain the same for MSW and C&D waste, but the contractual max was lowered by \$5.00/ton for MSW and \$10.00/ton for C&D waste. By giving the haulers the comfort that rates would not rise for the next four years, the Authority has significantly reduced its flexibility to raise rates, leaving only a margin of \$0.20 for MSW and \$4.20 for C&D waste, a credit negative in our view. This reduced flexibility is partially mitigated by the Authority's \$42 million of unrestricted cash and the short maturity of the outstanding debt.

Beyond the MSW and C&D waste programs, the Authority has also developed its special waste program, where it negotiates separate tip fees for each waste stream, secured by 1 to 3 year contracts with customers. The Authority also receives a tipping fee premium for this service, with tipping fees often exceeding \$100/ton. Special Waste accounted for 25% of tip fee revenues in 2012.

The Authority has entered into an contract to sell the electricity generated by the Facility and not used in its operation to Metropolitan Edison Company until February 1, 2016. The Authority must pay penalties if minimum generation levels are not met, though it has never missed its minimum target generation levels. In 2012, the electricity was sold at an average price of \$.056/kWh, generating revenue of \$12.5m to the Authority.

SERVICE AREA AND COMPETITION:

There are no private landfill facilities in Lancaster County for MSW. The only non-Authority-owned landfill, the Milton Grove Landfill, is permitted to accept only C&D waste, and has entered into an agreement with that landfill restricting the landfill to a maximum of 500 tons/year from within the County. Outside the County lines, there are two private landfills with substantial capacity operating in the adjoining counties of Berks and York. These facilities have arrangements to receive waste from their host counties but they have daily capacity which far exceeds the daily waste generation of the host counties. Given the Authority's flow control ordinance and hauler contracts, Lancaster County MSW is at very low risk to go to these sites.

There are no real local alternatives to its special waste business, but it is subject to more regional competition from some other WTE facilities in other states.

OPERATING TRACK RECORD:

The service contract for the operation of the WTE facility with Covanta expires December 31, 2016. Covanta's performance obligations under the Service Agreement are unconditionally guaranteed, and Covanta has historically exceeded the minimums.

CAPITAL IMPROVEMENTS:

The Authority has approximately \$13.2 million of capital needs through 2015 and expects to fund these needs with balance sheet cash. The current debt expires in 2015, though the Authority is contemplating the purchase of the Harrisburg waste-to-energy facility. This purchase will likely be mainly debt financed.

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FINANCIAL METRICS:

Debt service coverage in 2013 is projected to drop from 1.15x to 1.01x due largely to the combination of a planned 3-week turbine outage and moderate increase in debt service. That said, the Authority has outperformed its budgeted DSCR going back to 2006, and its cash reserves can cover modest shortfalls if necessary. Given the amount of existing cash on hand and debt maturity in 2015, we feel the A3 rating is adequate. The Authority also benefits from a modest \$3 million cash-funded debt service reserve fund that could be released in the final year of maturity..

The Authority has maintained significant liquidity in recent history, built up as a result of the Authority's covenant to use best efforts to maintain reserve levels equal or greater to the prior year's expenditures. Over the past five fiscal years, unrestricted cash has ranged between a high of \$55 million in fiscal 2008 to \$42 million in 2012. The strong liquidity position has enabled the Authority to fund capital needs with cash on hand and was demonstrated with the ability to invest in alternative revenue generation projects in 2010 and 2012. Available cash is projected to decrease slightly as the Authority will spend approximately \$6 million for capital needs and real estate purchases, though this too is mitigated by the short maturity of the outstanding debt. In Moody's opinion, the Authority's practice of maintaining these ample reserves in the form of operating and other funds significant financial and operating flexibility and provides key support to the A3 rating.

KEY STATISTICS:

Type of System: County solid waste disposal system comprised of a landfill, a transfer station, and a resource recovery facility

FY 2011 tonnage handled: 643,300 tons

2012 waste under contract: 97%

CAGR municipal solid waste, 2006-2011: -1.51%

CAGR total waste deliveries, 2006-2011: 2.5%

Debt service coverage, FY 2011: 1.54x

Net Working Capital, FY 2011: \$45.8 million

Net Working Capital/O&M FY 2011: 111%

RATED DEBT:

Series 2006 Revenue Bonds: \$30.620 million

ISSUER CONTACTS

Mr. James Warner

Executive Director

+1 (717) 397-9968

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