Allentown carves out pension 'tumor' with water-sewer deal

Municipal market observers said **Allentown**’s USD 211m deal to monetize its water and sewer operations, which closed 7 August, deserves praise as an example of a concession done right.

“Trading an asset for a liability is always a plus,” said John Filan, a vice president with municipal restructuring firm DSI Civic. “The main reason you’re there is not to fund pensions, it’s to run the city. They had a liability, it was substantial and growing. They are really taking control of the liability.”

The deal was first contemplated as a way to address Allentown’s skyrocketing pension costs, as previously reported. The city had an unfunded actuarial accrued liability (UAAL) of USD 160m, with a USD 20m annual required contribution (ARC) of about 23% of its USD 88m general fund budget, according to Mayor Ed Pawlowski.

The UAAL was like a “tumor”, Pawlowski told *Debtwire Municipals.* “There was no way we could raise taxes to address this. This (deal) was the key to the future or the demise of the city.” As of 31 December 2012, the funded ratios of the city’s four pension plans were funded at 41%, 41%, 77%, and 95%.

Allentown has made its full ARC for at least the past three years, according to its FY12 comprehensive annual financial report.

Peter Schweyer, chair of the city council’s finance committee, said Pawlowski “did not undersell how critical” the deal was. “Almost 25% of the budget was going to pay people who did not work or even live in the city.”

There is a distinction between monetizing an asset in order to use the upfront payment for ongoing operations and paying down a liability, Filan said. Schweyer agreed: “You should never do these things to plug operational deficit. This was a long-term obligation that we had that frees up cash flow.”

“I think it was a wise choice for a very tough problem,” said Filan, who predicts there will be more such monetizations in the future.

The upfront payment by the winning bidder, the Lehigh County Authority (LCA), erased the UAAL, but also provided some ongoing budget relief by taking the ARC to USD 4m per year, from USD 20m. It also allowed the city to redeem half, or USD 15m, of its outstanding USD 30.2m of Series 2004 pension obligation bonds, thereby saving USD 2.5m per year in debt service.

Pawlowski and Schweyer both praised the advisory team, which was led by The PFM Group. The team did an “outstanding” job of protecting current city workers, Schweyer said. All current employees were offered unionized positions with the LCA.

Scott Shearer, a PFM managing director, said in an email that one unique aspect of the deal was that the proposed concession agreement was drafted in October, before the deal was bid out. “By structuring the procurement in this order instead, PFM was able to ensure that favorable provisions for our client, the City, were included.”

It was also important to the city that ratepayers be protected, Pawlowski said. Rate increases were locked in for the life of the contract at 4.5% after a grace period of zero, less than the 40-year historical average of 5.2%.

A source familiar with the deal said that while the city is likely pleased with the results, there is one hitch – it won’t have access to the water and sewer revenues for the term of the lease. But Pawlowski rejected that argument. The water and sewer system was making money but the general fund had no way to tap it, he said.

While a municipality's decision to monetize an asset as a response to distress is very different than entering a concession agreement to build a new asset, the source familiar said, he also acknowledged that many of the potential risks can be addressed in the contract process. "A politician would say if they screw up, we get the money back. That's not happy for the people who lent the money, though."

Moody's Investors Service called the deal a credit positive in a May report; it rates the city's general obligation debt A3 with a negative outlook. Standard & Poor's rates it BBB+ with a positive outlook following a June outlook change from stable.

Series 2011 general obligation bonds maturing in 2025 last traded on 10 June 2013 at 109.205, yielding 2.128%, according to Electronic Municipal Market Access. Bondholders could not be identified.

by Andrea Riquier