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Chicago Water Bonds Seen Shielded From Pension Woes: Muni Credit.

Chicago, bearing the biggest pension burden among the nation's most-indebted localities, is selling water bonds for the first time since 2012. Investors say the deal's strengths outweigh the city's fiscal woes.

Tomorrow's planned sale of about $372 million of debt will pay for work on pumping stations and the replacement of water mains, some of which are more than a century old, according to bond documents and the city. Mayor Rahm Emanuel in 2011 set in motion an almost doubling of water and sewer rates over four years. The move has bolstered the system's finances, earning the debt a AA- grade, Standard & Poor's fourth-highest level.

While Emanuel pushed through higher rates, he has failed to contain the swelling pension costs that led Moody's Investors Service to cut Chicago's general-obligation rating to the lowest among the 90 most-populous U.S. cities, excluding Detroit. Paul Mansour of Conning and Patrick Morrissey of Great Lakes Advisors LLC are considering buying the water bonds, in part with the expectation that the association with Chicago will boost yields on an otherwise healthy issuer.

"The water enterprise bonds are among the best that Chicago can offer," said Richard Ciccarone, the Chicago-based chief executive officer of Merritt Research Services LLC, which analyzes municipal finance. "Even though Chicago has been in the news and has some fiscal challenges, the enterprise itself has been well-supported."

Chicago faced heightened scrutiny in the $3.7 trillion municipal market after Moody's in July 2013 lowered the city's grade three levels the same week that Detroit filed for bankruptcy. The New York-based company dropped Chicago again in March, to Baa1, three steps above junk.

The park district, board of education and transit authority also had their ratings cut by Moody's. The same goes for the water and sewer system: its A3 mark for second-lien bonds, the fourth-lowest investment grade, is down three levels from 14 months ago.

Moody's may be too punitive, said Morrissey, who helps oversee $3.8 billion of fixed income at Great Lakes Advisors in Chicago. S&P ranks the second-lien water and sewer bonds three levels higher than Moody's.

Payoff Time

S&P's rating shows that "Chicago's efforts are paying off with respect to increased service coverage and better financial oversight of our utilities," Emanuel, a 54-year-old Democrat who is up for re-election next year, said in a Sept. 2 statement. S&P also rates the city's general obligations three steps higher than Moody's.

The water system's finances have improved. Revenue is projected to double by 2016 from 2009 after the rate increases, while cash reserves are expected to hold at three months of operating expenses through fiscal 2016, bond documents show.

While Chicago’s rates rose 25 percent in 2012, with planned increases of 15 percent in each of the following three years, residents in New York, Los Angeles and San Francisco face higher charges, bond documents show. A family’s cost per 7,500 gallons of water in Chicago was below $30 in 2013, compared with more than $50 in San Francisco, according to the documents.

Chicago’s system, whose source is Lake Michigan, supplies and treats water for about 5.4 million people in Chicago and its environs. Suburban customers made up about 47 percent of net sales in 2013, bond documents show.

880 Miles

The 10-year project that Emanuel introduced in 2011 will improve pumping stations, replace 880 miles (1,416 kilometers) of water main and install 204,000 meters.

This is the first sale of water debt for the city since May 2012, according to data compiled by Bloomberg. The bonds are federally tax-exempt though subject to state levies.

Among the most-traded Chicago water and sewer bonds in the past week have been wastewater securities callable in January 2017, Bloomberg data show. A customer bought the debt Sept. 2 with a 1.57 percent yield, or about 1.2 percentage points above benchmark debt, the narrowest gap since July.

Chicago also plans to sell $301 million of second-lien wastewater bonds next week to fund sewer improvements, according to deal documents and Bloomberg data.

While the water system’s customer base and the city’s control over rates buoy the bonds, investors have to consider Chicago’s risk of fiscal distress, said Mansour, head of muni research in Hartford, Connecticut, at Conning, which oversees about $11 billion of local debt.

Association Eyed

“There has to be some premium associated with this credit because of the outside chance the city of Chicago’s ratings could fall again, and this credit could go along with it,” he said by telephone.

Chicago’s pension liabilities represented 678 percent of revenue in fiscal 2011, according to a Moody’s study released in September 2013. The city found a partial solution in June to address the $19.2 billion shortfall across its four retirement funds. Illinois lawmakers restructured two of the systems, which had a combined $9.4 billion in unfunded liabilities for about 60,000 municipal workers and retirees.

The water system pays into the pension fix, showing it’s not immune to the city’s financial pressures. The measures increase the system’s yearly pension contributions, which were $13 million in fiscal 2013, by an average of 25 percent a year until fiscal 2019, bond documents show. The additional revenue from rate boosts is projected to “more than offset increases in retirement costs,” the documents say.

“The water and wastewater credits are largely insulated from the city’s general finances,” Libby Langsdorf, a city spokeswoman, said in an e-mail.

Any yield premium on the water bonds may make the debt more attractive, said Ciccarone.

“The most important takeaway is they’re revenue-based,” Morrissey of Great Lakes Advisors said of the bonds. “There’s so much less risk of people not paying their water bills here, and the revenue increases have already been put in place.”

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