

Survey of Municipalities Confirms Resilience of Water Infrastructure Budgets.

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INVESTMENT CONCLUSION:

Recently, we surveyed large municipal water utilities across the United States, focusing on near-term capital spending levels and priorities. The survey results confirm our somewhat contrarian view that the sky not falling in terms of municipal water infrastructure spending, and in fact the near-term outlook remains favorable for this specific pocket of municipal spending despite the well documented fiscal headwinds facing state and local governments. Roughly 50% of the municipalities we spoke with will increase water-related capital spending in 2011, while 40% will hold spending flat with 2010 levels and just 10% will spend less. Although priorities predictably vary, distribution (pipes, mains) and metering (particularly AMR) remain consistent priorities, with large-scale capital projects (water treatment facilities, desalination, etc.) in some cases being deferred to the extent possible. While perplexing at first blush, the resilience of municipal water spending makes sense given that, (1) many municipal water utilities are organized as financially distinct Enterprise Accounts and are NOT vulnerable to general budget cuts, (2) municipalities themselves are quietly benefiting from improving tax receipts, and (3) water-related spending is largely non-discretionary even for those cities that are looking to cut spending wherever possible. Overall, we believe that municipal spending on water-related infrastructure will continue to surprise to the upside in 2011, and we remain positive on the stocks entering 2011.

KEY POINTS:

- **Survey of municipal water utilities confirms resilience of water infrastructure spending.** Recently, we surveyed municipal water utilities across the United States, with our survey inquiries focused on the directional trend of water-related capital spending in 2011 and specific infrastructure priorities within 2011 capital budgets. Overall, the survey results confirm our view that water infrastructure spending by municipalities will remain surprisingly resilient, with nearly 90% of the municipalities we spoke with set to spend at or above 2010 levels in 2011. Overall, the generally positive survey results confirm our favorable view of sector fundamentals entering 2011. For detailed survey results, including color from individual respondents, please see table on page 2 of this report.
- **Key Drivers: Enterprise Accounts, non-discretionary spending, rebounding tax receipts.** Given the consistent drumbeat of negativity in the press and in financial circles on the financial position of state and local governments, some may be surprised at the benign survey results. While our sample size was not exhaustive, the consistency of the responses was we believe that the results confirm three key realities of the municipal water infrastructure market: (1) Most water authorities are structured as so-called Enterprise Accounts and therefore are largely immune to the fiscal pressures facing their "parent" municipalities, (2) local governments themselves are benefiting from a quiet recovery in revenue, with tax receipts accelerating nicely throughout 2010 and likely to continue this trend in 2011, and (3) even in cases of true financial distress, water is a backbone service viewed as non-discretionary by most cities.
- **Distribution system rehabilitation, AMR priorities for many systems entering 2011.** Discussing the key priorities in their near-term spending plans, our survey respondents repeatedly cited distribution infrastructure improvements, with one major Midwestern city summing it up nicely by saying that "distribution system spending is core to meeting reliability standards." This is good news for companies specializing in basic water infrastructure products, such as BUY-rated Mueller Water. Metering is another area of focus, with many respondents saying they continue to move toward advanced Automated Meter Reading (AMR) solutions. This bodes well for BUY-rated Badger Meter, which ranks among the leaders in AMR and is currently upgrading several major cities.

MUNICIPAL WATER UTILITIES - FY2011 BUDGET SURVEY: DETAIL/COMMENTARY FOR SELECTED RESPONDENTS

City, State	Population	Dist. System Spending	Notes & Commentary
Akron, OH	205,375	↓	Water main spending in FY2011 is down dramatically from FY2010 levels. McWane and U.S. Pipe are both active in the market though historically, McWane has capitalized on opportunities as a result of its manufacturing plant's proximity to the city. Continuing AMR changeout with Itron transmitters.
Alexandria/Fairfax, VA	147,786	↑	FY2011 budget calls for 50% increase in distribution system spending to \$9 million. FY2011 includes 120% increase in emergency main replacement to \$1 million. Hydrants are a top priority for fire safety but spending flat. Manual-read meter replacement continues; city is evaluating feasibility of AMR.
Billings, MT	107,973	↔	Main rehabilitation is expected to be flat in FY2011 around 10,000 feet. Hydrants are replaced as needed, and new installations will depend on how much new main is installed by private developers. The budget calls for an approximate 5% increase in spending on meters to \$310,000 in FY2011.
Clearwater, FL	104,782	↔	Capital improvement projects are largely flat in FY2011 relative to last year. A meter replacement program begun in FY2010 budgets \$350,000 per year through FY2015 to upgrade to AMR meters.
Des Moines, IA	200,202	↑	FY2011 budget calls for 10% increase in both valve spending and main replacement. Overall water capex is down 50% as larger scale capital projects are deferred, but distribution system spending is core to meeting reliability standards. Meter and hydrant spending will be flat in FY2011 vs. FY2010.
Downey, CA	107,986	↔	Planned pipe spending flat in FY2011, ~630 feet. No additional hydrant installation planned. 300 manual & automated meters (Sensus) planned in FY2011, down from 500 in FY2010.
Elgin, IL	111,179	↑	FY2011 budget is focused on smaller scale projects and calls for almost 3 times more water main replacement than FY2010. Hydrant installation will increase at a similar pace. Badger meters are being deployed in an ongoing changeout project at a faster pace in FY2011 than in FY2010.
Evansville, IN	115,666	↓	FY2011 capital improvement budget calls for only 20% of FY2010 water main volumes (feet installed) and includes stable Mueller hydrant changeout vs. FY2010. Plans for 3,000 - 5,000 manual-read Neptune meter changeouts versus less than 3,000 installations last year with little AMR adoption.
Fort Collins, CO	141,921	↑	FY2011 & FY2012 spending package includes \$3.5 million for maintenance/repair of mains, valves, hydrants, meters after negligible spending last year. The city has consistently deferred a \$1 million automated meter changeout project since FY2009 (which is now on the books for FY2012).
Gainesville, FL	116,277	↔	About 70% of capital in the budget is going towards plant rehab, with the remaining 30% allocated to distribution and meters (flat in dollars vs. FY2010). Distribution system rehab includes 26,400 feet of pipe (\$2 million). City is using manual read Sensus meters and plans to spend \$0.5 million in FY2011.
Glendale, CA	199,608	↑	The adopted FY2011 budget calls for a 35% increase in spending on pipes, hydrants, and meters. Distribution system capex is expected to reach \$15.5 million in FY2011, up from \$11.6 million in FY2010 spending as the city replaces smaller diameter cast iron pipe with larger diameter ductile iron.
Hollywood, FL	142,105	↔	Budget is flat across the board in FY2011 vs. FY2010, for spending on pipes, hydrants and meters.
Joliet, IL	153,577	↑	FY2011 budget calls for a 200% increase in water main rehab spending compared to FY2010 levels, though absolute dollar spending will only reach \$0.25 million. The budget for meter replacement and reading is down from FY2010 as the city completed a significant changeout phase last year.
Midland, TX	111,357	↔	FY2011 CIP budget flat vs. FY2010 for distribution system maintenance including hydrants and mains. Changeout of meters also expected to be flat (20% of installed base) for FY2011.
Norfolk, VA	234,477	↑	FY2011 budget calls for a 145% increase to replace water pipelines (\$18 mil), compared to ~\$7 mil spent in FY2010 when 58,000 feet of pipe were replaced. Meter replacement flat ~3,000 units.
Oxnard, CA	189,413	↓	FY2011 capital spending on mains and hydrants is down 75%, with plans for ~2,500 feet of water main replacement compared to 10,000 feet installed in FY2010. All meters were switched to automated reading systems over the last seven years, so there is no plan for further changeout.
Richardson, TX	105,398	↔	Spending on mains and meters will be flat in FY2011. Hydrants will get a slight increase, though remain a small part of the overall budget with \$50,000 allocated in FY2011 vs. \$45,000 in FY2010.
Rockford, IL	155,109	↑	FY2011 budget calls for 5% spending increase vs. FY2010 to \$3 million. Hydrant replacement will be flat in FY2011 around \$1 million in capex. Meter spending will be down slightly to \$1.3 million.
Saint Paul, MN	281,501	↑	FY2011 budget for main replacement was expanded 30% to over 42,000 feet. Hydrant (ACIPCO) outlook stable ~170 new installations. The city is beginning a \$20 million meter replacement project in FY2011 - spending \$7 million per year for the next 3 years to adopt Neptune AMR system.
Scottsdale, AZ	241,464	↑	Spending on main replacement is expected to increase nearly 250% over FY2010 with 47,000 feet of pipe rehab. Hydrant replacement is also budgeted to increase, over 60% from FY2010. Meter replacement is expected to be nearly flat, with 5,000 units to be installed in FY2011.
Simi Valley, CA	121,990	↔	Due to a main replacement program starting FY2012, little main spending is in FY2011 budget. Hydrant spending in FY2011 is flat. \$500,000 is budgeted per year for meters, which is one of the department's biggest accounts. Most meters are automated, and manual reads are switched out.
St. Petersburg, FL	243,829	↑	5 year CIP calls for \$4.5 million in distribution capex in FY2011. FY2011 includes an increase in meter replacement, main replacement (60,000 feet), and hydrant/valve replacement (8,900 units).
Yonkers, NY	206,441	↔	FY2011 budget includes only emergency reserves for pipe changeout based on main breaks. In FY2010, 16,000 feet of new pipe also included the installation of Mueller hydrants. A \$5 million meter upgrade plan has been deferred for the past few years and meters are repaired as needed.

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