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Philadelphia Water, Sewer and Stormwater Rate Board
c/o Ms. Marie McNeill
Philadelphia Water Department
1101 Market Street, Fifth Floor
Philadelphia, PA 19107

RE: Philadelphia Water Department's Response to the Hearing Officer's Reports

Dear Hearing Officer Brockway and Members of the Rate Board:

This correspondence is submitted by the Philadelphia Water Department ("Department" or "PWD") in response to the Hearing Officer's Reports captioned "IWRAP" and "Financial Stability and Impacts." The Department's comments are set forth in the Attachments to this letter designated below which are incorporated herein by reference.

Attachment A - IWRAP; and
Attachment B - Financial Stability and Impacts.

Thank you for your attention to this matter.

Respectfully submitted,

/s/ Andre C. Dasent

ANDRE C. DASENT, ESQUIRE
Attorney for Philadelphia Water Department

Attachment A

The following comments are submitted by the Department in response to the Hearing Officer's Report on IWRAP (the "Report").

SUMMARY – Affordability Targets

The Report misstates the Department's affordability targets. See, Report at 1. The Department proposes the following affordability targets:

- 2% of household income for 0-50% of the federal poverty level (FPL)
- 3% of household income for 50-100% of FPL
- 4% of household income for 100-150% of FPL
- 4% of household income for 150-250% of FPL

See PWD Brief at pages 26-27, Tr. at 6:16-20 and 38:3-17 (4/12/16) and PA Hearing Exhibit 5 at page 1 of 12, second column ("Affordability Threshold"). The Department and the Public Advocate agree as to the affordability threshold for 0-50% of FPL and 150-250% of FPL, and only disagree as to the affordability threshold for 50-150% FPL.

SUMMARY – WRAP Program

The statement that the WRAP Program will be phased out over the next year and into FY 2018 is not supported by the record and is contrary to the Department's testimony and Proposed Finding of Fact 335 (The Department expects some level of funding for existing low-income programs to continue after IWRAP is implemented). The Department submits that the statement in the summary regarding WRAP should be deleted and replaced with Proposed Finding of Fact 335.

SUMMARY – PIPP v. Rate Discount Program

The Department submits that the summary of the Department's position on the type of program omits the Department's post-hearing discussion of the AWWA Manual on this issue, as stated on page 26 of its brief and in its Proposed Finding of Fact 300 (The AWWA Manual refers to both discounts on the full bill and percentage of income programs as accepted water rate affordability programs). The Department requests that the summary prepared by the Hearing Officer include a statement that the AWWA Manual refers to both discounts on the full bill and percentage of income programs as accepted water rate affordability programs. See, AWWA Manual M-1, 6th Edition at 191-192.

Appended Pages Omit the Department's Brief on IWRAP

The summary appends the full brief of the Public Advocate on IWRAP, but includes only the Department's Proposed Findings of Fact and omits the Department's brief on IWRAP (Section IX of the Department's Brief). Therefore, the summary does not provide the Board with the Department's full argument and provides an unfair advantage to the Public Advocate, whose full argument is included in the summary. Since the Public Advocate's full brief on IWRAP is appended, the Department's full brief on IWRAP should be included in the appended material.

<u>Attachment B</u>

The following comments are submitted by the Department in response to the Hearing Officer's Report, captioned, Financial Stability and Impacts (the "Report").

Global

The statement in the Scope of the Report indicating that the Department seeks to increase rates "to improve its bond credit rating" creates the false impression of the purpose of the application for rate relief. Report at 1. As stated in the Department's Brief, the purpose of the rate increase request is maintain (preserve) our current credit rating. PWD Brief at 5-6. In point of fact, as discussed below, there are concerns that the Department's current credit rating may actually deteriorate, if rate relief is delayed, denied or significantly lowered from requested levels. See discussion, *infra*. PWD Statement 2, Exhibit ML-2.

The following narrative emphasizes the importance of the Financial Plan in this rate filing. The plan is critical given the Department's substantial borrowing needs. Critical elements of the plan have been discussed throughout the proceeding, including the need to target higher debt service coverage levels and "pay go" financing. The plan is important given our highly leveraged system (93% debt to net plant) and escalating capital requirements. Continuity is also a concern in light of disclosures to investors and the rating agencies that increased use of internally generated funds and pay go financing would underpin future capital spending.

Overview of FY 2016-2021 Financial Plan

The Department proffers the following discussion to supplement the summary of its position in the Report (page 4):

The Department's improved financial performance and its success in achieving and maintaining strong bond ratings is primarily the result of financial planning implemented consistent with the goals and objectives summarized below. In March 2015, Standard and Poor's Rating Services ("S&P"), Moody's Investors Service ("Moody's") and Fitch Ratings ("Fitch") reaffirmed their current "A," "A1" and "A+" ratings, respectively, on the Department's senior debt favorably viewing key elements the Department's financial plan (e.g., targeting higher debt service coverage levels; pay-go financing) as well as identifying prospective financial challenges. See discussion, *infra*. The Financial Plan serves as one of the Department's management tools to monitor progress in meeting financial goals and to proactively address financial and operational issues.

One practical goal of the financial plan is to balance (i) the near term objective of keeping rates as low as reasonably possible with (ii) the longer term objective of managing escalating costs associated with the Department's capital program and regulatory requirements on a sustainable basis. The above goal and objectives are the natural corollary to the following:

1. The Department operates under a regulatory and capital project driven environment that requires a longer term six-year planning horizon. In order to provide our customers with the best service possible while ensuring gradual and predictable rate increases, the Department must plan for all projects on a long-term and integrated basis, including both capital and operating requirements. A six-year capital budget is also prepared to address the major regulatory, operational and capital project issues that will impact service, operations and rates over this same planning horizon.

2. The Department is charged with the following (1) propose rates so that customer types are charged based upon cost of service principles; (2) increase and implement rates transparently and predictably; and (3) use financially prudent options to mitigate future rate impacts on customers. Since proposed future rate increases are primarily driven by growing operating and maintenance costs to maintain the system, a higher capital program addressing an aging system coupled with regulatory mandates and debt service on existing bonds and bond related covenants, the development of a six-year financial plan allows the Department to meet these key goals.

3. A six-year plan is required to bridge current operations and related capital and operating budgets with these long term goals.

Financial policies, strategic planning, priorities and guidance in several key financial areas drive the development of the FY 2016-2021 financial plan. Given the Department's substantial borrowing needs over the next six years, adherence to these financial policies is crucial in order to cost effectively access the capital markets and retain our credibility with customers and regulators. See, PWD Exhibit 2 at 5.

Rating Agency Concerns

As alluded to above, in affirming the Department's current "A" category rating, the rating agencies expressed their reasons for doing so as well as their concerns for PWD's financial future. The Rate Board should note that the rating agencies rely on the Department's financial planning assumptions (including targeting higher debt service coverage levels and "pay-go" financing) in evaluating PWD and assigning a "stable" or "positive" outlook, as discussed below.

<u>Moody's Concerns</u> - Moody's assigns an "A1" rating to the Department's senior debt with a stable outlook. In making this assignment, it notes that consistent annual rate relief is an essential requirement to maintaining this credit rating:

> The A1 rating incorporates the water department's large and diverse service area, stable operating profile, narrow but consistent debt service coverage, and manageable debt burden. <u>The rating also recognizes the utility's heavy capital needs including those associated with a Commonwealth DEP consent order and agreement, implying a likelihood of increasing debt and potential pressure on coverage levels unless the city continues its solid history of consistent annual rate increases</u>. [Emphasis added].

PWD Statement 2, Exhibit ML-2 (Moody's Report at 1). Moody's also acknowledges that maintaining adequate debt service coverage levels is essential to its current assigned "stable outlook." Moody's specifically states that:

> <u>The stable outlook reflects the city's willingness to continue investing in the system, increasing user rates annually, and maintaining ample operating liquidity</u>. <u>The city's ability to maintain adequate coverage levels will be a key factor in its rating going forward</u>. [Emphasis added].

Id. Moreover, Moody's indicates that achievement of debt service coverage levels more in-line with peer utilities is important to maintaining or preserving its credit rating. *Id*. It bears emphasis that the Department's financial planning assumptions are designed to directly address this concern, as long term planning is essential to implementing PWD's Capital Improvement Program ("CIP") on a sustainable basis. PWD Exhibit 2 at 6.

Fitch Concerns - Similarly, Fitch states that while financial performance is satisfactory for the assigned rating, debt levels are moderately high and sizeable additional borrowing is expected. As stated Fitch:

> SOUND MANAGEMENT GUIDES STABLE OPERATIONS: Financial performance of the PWD is satisfactory for the rating category. Operations generally generate narrow, but consistent debt service coverage levels that are somewhat mitigated by a sound level of liquidity and affordable rates.
>
> ELEVATED DEBT LEVELS TO INCREASE: Debt levels are moderately high and sizeable additional borrowing plans are expected over the medium term. Leverage concerns are heightened by the imposition of a new ratemaking board, which will determine PWD's future ability to fund capital needs from a healthy mix of equity and long term debt. [Emphasis added].

PWD Statement 2, Exhibit ML-2 (Fitch Report at 1). Fitch emphasizes that the Department has a leveraged system where debt to net plant is 93% and all-in debt service is 30% of gross revenues. *Id.* at 4. In this context, the rating agency observes the reasons for the Department's large capital program (driven by the Consent Order and Agreement with the Pennsylvania Department of Environmental Protection or "COA") and notes the potential negative impact of associated increased capital spending, assuming 100% debt financing of the CIP – clearly indicating the need for alternative funding such as IGF or "pay-go" financing.

> …. Compliance with the COA will require the city to spend approximately $2.4 billion over a 25 year period. The program also includes wastewater treatment facility enhancements and pipe renewal and replacement. Fitch views the program favorably considering that alternative strategies to mitigate CSOs [combined sewer overflows], including the construction of tunnels and storage tanks, would have cost substantially more.
>
> Projected capital financing through fiscal 2020 totals $1.78 billion. The current CIP represents a slight increase of about 1% over the prior six-year plan, but annual growth over the last several years has been more pronounced at closer to 8%. Management believes the capital program is at a peak level and that a gradual reduction in spending will begin within the next few years. Nevertheless, the cumulative projected capital spending has the potential to place downward pressure on the rating over the medium term, particularly if the system continues to pursue nearly 100% debt financing for the CIP. [Emphasis added].

Id. **The recurring theme in the rating agency reports is the need for prudent financial planning to protect the Department's current rating and associated costs. Significantly greater use of internally generated funding or pay-go financing for a portion of capital expenditures is wholly consistent with rating agency concerns about the sustainability of the Department's CIP**.

S&P Concerns - S&P assigned its "A" rating with a positive outlook noting that the improved outlook reflects its opinion that there is at least a one-in-three chance that the rating could improve from its current level within the next two years (with associated lower costs of future debt), if the following trends continue:

- The water department's financial performance meets or exceeds the current projections, both on a GAAP basis and on the essentially modified accrual basis that the city tracks its financial performance to meet rate and additional bonds covenants;

- There are no significant cost escalations or unanticipated projects that arise in conjunction with the city's large capital improvement plan (CIP); and
- Economic trends in the city and surrounding service base continue to steadily improve, as per the recent trends regarding population and unemployment rates.

PWD Statement 2, Exhibit ML-2 (S&P Report at 2). Notably, S&P observes that the Department is highly leveraged and recognizes that funding the CIP with nearly 100% debt financing is problematic for a sustainable financial future. In this context, it recognizes the importance of the Department's prudent financial planning (greater utilization of cash funding for capital projects):

> Philadelphia's combined water and sewer system is highly leveraged and the $1.78 billion 2016-2021 CIP is likely to require significant additional debt funding. However, now that the city entered into $1.2 billion (net present value; nominal value is over $2 billion), 25-year consent order with the Pennsylvania Department of Environmental Protection in 2011, a good portion of the CIP projects are now definable….we would expect that annual debt service costs would also steadily increase as additional debt is issued. <u>We expect that management will continue to raise rates, as it has in the past, to fund these additional costs as well as cash-funded capital costs for general operating expenses. Total debt has consistently represented about 90% of net property, plant and equipment, which we consider high.</u> Given the large CIP, we do not expect this to change materially over time. [Emphasis added].

Id. at 4. S&P indicates that its positive outlook is contingent upon current financial planning parameters and that if financial metrics deteriorate or a significant amount of capital spending is added to the city's CIP, it could lower the rating or revise the outlook.

Common Sense Rationale for Financial Planning and Ratemaking

In the final analysis, financial planning and ratemaking objectives are intertwined, as both have prospective application and appropriately look at a reasonable planning horizon (not just the immediate term). So in looking at Table C-1 (PWD Statement 9A, Exhibit BV-E1), the rate period is important, but so are succeeding years which are impacted by ratemaking and financial decisions today.

The Department believes that the objectives of ratemaking and financial planning appropriately balance near term objectives of mitigating rate increases with longer term objectives of managing escalating capital program costs on a sustainable basis. The proper balance can be achieved, if the Department can have sufficient authority to establish financial targets consistent with peer utilities.

Peer utilities are identified in the testimony of Katherine Clupper and the PWD Financial Plan. The peer group referenced in Ms. Clupper's testimony included large urban water/wastewater utilities such as those serving Baltimore, MD, Washington, DC and Cleveland, OH. These utilities generally enjoy higher ratings than the Department ("AA" category ratings) given the level of financial reserves maintained with attendant flexibility to meet expected (normal O&M and debt service) and unexpected operating requirements, as well as the option to cash fund capital expenditures using internally generated funds. See, PWD Statement 7 at 8. The Department believes in targeting higher debt service coverage levels and pursuing greater cash funding for capital programs comparable to its peer utilities, it can plan a sustainable course for implementing its CIP for the longer term, at least cost to ratepayers. A peer rating agency comparison of water/wastewater utilities serving Baltimore, MD, Washington, DC, New York, NY and Chicago, IL is set forth in the PWD Financial Plan. PWD Exhibit 2 at 34.

Participant's Detailed Arguments

The detailed arguments in the Report attributable to the Department should be expanded to include pages 2-6 of the Department's brief addressing financial issues as well as footnote 1 on page 1 (which describes the withdrawal of $58 million from the RSF to mitigate the impact of the rate increase). Parallel arguments presumably attributable to the Public Advocate should include page references to the Advocate's brief and exhibits to avoid the inference that these are the recommendations of the Hearing Officer. See, Report at 13.

Rate Stabilization Fund Table

The following table depicts deposits to and withdrawals from the Rate Stabilization Fund ("RSF") and is offered to replace the table in the Hearing Officer's Report (with corrected data inputs for the historic period covered).

Projected and Actual RSF Deposits/Withdrawals
(Thousands of Dollars)

Fiscal Year	Projected RSF Withdrawal or Deposit[1]	Actual RSF Withdrawal or Deposit[2]
2012	$ (14,435)	$ 8,526
2013	(43,615)	(4,666)
2014	(20,325)	22,925
2015	(3,675)	21,456
2016	(36,900)	N/A
2017	(19,300)	N/A
2018	(39,000)	N/A

[1] See, PWD Statement 2, Exhibit ML-6 for RSF deposits/withdrawals for FY 2012-2015. See, PWD Statement 9A, Exhibit BV-E1: Table C-2 for projections for FY 2016-2018.
[2] See, PWD Statement 2, Exhibit ML-3.