S&P Global
Ratings

RatingsDirect®

Summary:
Philadelphia; Water/Sewer

Primary Credit Analyst:
Theodore A Chapman, Farmers Branch + 1 (214) 871 1401; theodore.chapman@spglobal.com

Secondary Contact:
Jeffrey M Panger, New York + 1 (212) 438 2076; jeff.panger@spglobal.com

Table Of Contents

Summary:

Philadelphia; Water/Sewer

Credit Profile		
US$303.78 mil wtr and wastewtr rev rfdg bnds (Federally Taxable) ser 2021B due 06/01/2051		
Long Term Rating	A+/Stable	New

Rating Action

S&P Global Ratings assigned its 'A+' long-term rating to Philadelphia's $303.78 million series 2021B taxable water and wastewater revenue refunding bonds. At the same time, we affirmed our 'A+' long-term ratings and underlying ratings (SPURs) on the city's existing $2.3 billion of water and wastewater revenue bonds. The outlook on the ratings is stable.

The city will use the proceeds to advance refund eligible maturities of its series 2014A and 2015A and 2015B revenue bonds for savings purposes. Management is not extending the maturity schedule.

The bonds are secured by a first-lien pledge on the net revenue of the city's water and sewer fund. A reserve funded in the amount of maximum annual debt service provides additional liquidity. Pledged revenue is defined as -- net of operating expenses -- rates and charges of the system, transfers from the rate stabilization fund (RSF), and interest earnings and must be budgeted to generate at least 1.2x annual debt service on senior revenue bonds and 1.0x coverage when including all subordinate debt. There is no subordinate-lien debt currently outstanding. The city can issue additional debt as long as it is complying with the rate covenant at the time of issuance and net revenue projections are sufficient to provide for rate covenant compliance for the two fiscal years following the debt issuance. There is an additional test that requires that the city maintain net system revenue (excluding transfers from the RSF) totaling at least 90% of operating requirements, providing some limit on the deployment of the RSF. Transfers of surplus net revenue are limited to the lesser of a formula or $4.994 million; in recent history it has been the latter. Surplus net revenue is otherwise not allowed to be used for non-utility purposes, also serving to prohibit interfund borrowing.

Credit overview

Factors that we view as key credit drivers include:

- Liquidity that remains ample, even with continued planned use of the RSF to lessen rate shock. The combined unrestricted and RSF balances have typically represented 200-250 days' operations ($250 million to $300 million);
- A large, regulatory-driven capital improvement plan (CIP) that could lead to a doubling of debt by 2027; and
- The management and governance team's ongoing need to balance operational needs and revenue requirements with affordability concerns given Philadelphia's median household effective buying income is 76% that of the U.S., elevated poverty rate of approximately twice that of the U.S. level, and a still-elevated unemployment rate of over 9% as of April 2021. The utility's service territory, however, serves more than 1.58 million people, including wholesale relationships outside the city for both water and wastewater.

In addition to a number of cost containment measures to both the operating and capital budgets that Philadelphia Water Department (PWD) management implemented in the early days of the COVID-19 pandemic, it also withdrew a proposed 9% adjustment for fiscal 2021, instead re-filing in February 2021 with the city's rate board for a requested 7.74% increase, phased in over fiscal years 2022 and 2023. This was less than the original January 2021 request of 17.6%, partly due to savings PWD realized from a recalculation in its recurring obligation for PWD's allocable share of the substantially underfunded citywide pension liability. The rate request could be reduced even further in 2023 depending on how much federal American Rescue Plan and related assistance PWD may yet receive; the city has tentatively been allocated $1.4 billion over the next two years, though city leaders plan to use it to shore up the general fund. Management has similarly not yet been informed about the eligibility, timing, or amount of any of the $1.1 billion federal low-income water household assistance program funds it could potentially receive.

As of this analysis, PWD had not received the rate board's decision on the rate case, though we view the ability to increase revenue as crucial to rating stability. The rate board had previously agreed to long-term financial targets, including senior debt service coverage (DSC) of 1.3x (including RSF use), a combined RSF and residual fund balance of $150 million, and 20% pay-as-you-go spending for capital needs. As of fiscal 2021, even after RSF draws, the combined designated reserve balance was $160 million, by itself equivalent to about 90 days of operating expenses, with a beginning-of-year balance in the operating fund of another $132 million.

Our all-in DSC calculation of 1.2x-1.4x for the past four audited fiscal years does not include nonrecurring sources of revenue, such as transfers from the RSF. All-in DSC is S&P Global Ratings' adjusted DSC metric that incorporates all use of operating revenue regardless of lien or accounting treatment. Management is targeting traditionally calculated senior-lien DSC of between 1.2x-1.3x in each of fiscal years 2022 and 2023, assuming the proposed phased-in rate adjustment is approved, and 1.3x thereafter, though the outer years of its forecast are also heavily predicated on future planned high single-digit rate adjustments. Given the likelihood that PWD's total debt outstanding could easily double before decade's end, as about 23% of capital commitments are related to an environmental mandate, maintenance of similar financial capacity and liquidity is vital to the current rating, though in our view is attainable.

A 2011 consent decree related to the combined sewer system is driving the need for those rate increases. The corrective action plan to resolve the consent decree must be completed by 2036. The 25-year timeline is generally much longer than those of cities with similar unfunded mandates, providing the city the ability to stretch out the debt and rate impacts from what might otherwise be a more compressed timeline. Philadelphia recently received a seven-month extension, to 2022, to provide the state a comprehensive report on the first 10 years of progress on what could eventually be $3.5 billion in total capital investments and $1 billion in cumulative operating costs related to the consent decree. Management's forecast notes that just within the next five years, 23% of the capital budget will be allocated to required projects, even as PWD aims to invest an additional $2.5 billion in drinking water infrastructure rehabilitation, such as aging pipes, advance metering infrastructure, and continued lead service line replacements.

The system predominantly serves retail residential customers in the city, as well as in 11 surrounding townships and utility authorities on a wholesale basis. The number of retail accounts has remained relatively stable since 2001 and currently totals about 490,000 for the water system and 545,000 for the wastewater system, which includes about 60,000 stormwater-only accounts. The water department customer base, in which the city is the leading user, remains stable and diverse: The 10 leading retail customers accounted for less than 10% of total revenue in fiscal 2020, with no reported material disruptions to any of the key accounts.

Environmental, social and governance (ESG) factors

We note that because of the ongoing corrective action plan measures and the attention that must be paid to affordability metrics, both environmental and social factors carry outsize credit relevance. The moratorium on shutoffs and disconnects, implemented in March 2020, has been extended through at least April 2022. While long-term customer billings did dip in 2020 and again in 2021, the consulting engineer's 2021 forecast has assumed it will return to the historical level of at least 96%. Still, the city has an industry-recognized, multi-faceted customer bill-pay assistance program for qualifying customers, including payment programs, bill reductions, and a dedicated surcharge on usage to provide dedicated funding for a portion of the program. The average monthly residential water and sewer bill, assuming a favorable decision from the rate board, would be just under $70, or 2.7% of median household effective buying income, though higher for those at the lowest end of the income distribution curve.

Although the system is older and the capital plan will be driven by reinvestment needs, it still has ample and reliable raw water supply and treatment capacity. We note that in some aspects it even compares favorably versus peers, such as readiness for potential state rulemaking on currently unregulated contaminants, and that it converts 100% of its biosolids for Class A beneficial land application usage.

The CIP, although daunting, is supported by operational and financial management that is highly aligned, establishing prioritization among non-mandated projects and to the extent reasonably possible, inclusive of resilience measures toward climate change and overall risk management that we view as comparable with peer very large systems.

Stable Outlook

The stable outlook reflects our opinion that the water department should be able to continue meeting or exceeding its financial projections as long as it receives sufficient rate adjustments from the rate board and controls its overall costs in a fashion consistent with or better than what the projections indicate.

Downside scenario

Setting aside the short-term impacts from the pandemic, the rating or outlook could be pressured should we view financial capacity to be potentially outstripped -- even beyond our two-year outlook horizon -- by the rapidly escalating needs of the capital budget. We would also inform our forward-looking view by observing the ongoing relationship between PWD and the rate board as assessed by the timing and magnitude of future rate cases and the delta -- if any -- between that which is requested versus what is ultimately granted. Actual results that prove to be weaker than the forecast, as measured by both DSC and higher-than-planned use of designated reserves, could cause us to lower the rating.

Upside scenario

We view any upside potential as remote for the next two years, given the disruption to management's rate request, lower system revenue due to the pandemic and recession, and the large amount of capital and debt needs. In time, if the city's actual financial performance significantly and consistently exceeds current projections, we could raise the rating.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of June 14, 2021)		
Philadelphia wtr & swr		
Long Term Rating	A+/Stable	Affirmed
Philadelphia wtr & swr (AGM)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Philadelphia wtr & swr (BAM)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Philadelphia wtr & swr (BAM) (SECMKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Philadelphia wtr (BAM) (SECMKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.