PHILADELPHIA WATER DEPARTMENT
REBUTTAL STATEMENT NO. 1

BEFORE THE
PHILADELPHIA WATER, SEWER AND STORM WATER RATE BOARD

In the Matter of the Philadelphia Water Department's 2022 Special Rate Proceeding	Fiscal Year 2023

Rebuttal Testimony

of

**Melissa La Buda, Katherine Clupper,
and Peter Nissen**

on behalf of

the Philadelphia Water Department

Dated: April 19, 2022

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I. INTRODUCTION AND PURPOSE OF TESTIMONY

Q1. PLEASE STATE YOUR NAMES AND POSITIONS.

A1. My name is Melissa La Buda. My position with the Philadelphia Water Department, also referred to in this rebuttal testimony as "PWD" or the "Department," is Deputy Commissioner of Finance.

Testifying with me are Katherine Clupper, who is a Managing Director of Public Financial Advisors, LLC ("PFM"); Peter Nissen, who is a Managing Director of Acacia Financial Group, Inc. ("Acacia"). Together we are the financial panel for this proceeding.

Q2. HAVE ANY WITNESSES ON THIS PANEL PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING?

A2. Yes. I provided testimony and schedules in PWD Statement 1. Katherine Clupper and Peter Nissen provided testimony and schedules in PWD Statement 2. Please note that the resumes of all witnesses were included with their direct testimony.

Q3. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A3. In this rebuttal, we provide the Department's response to recommendations and criticisms of Mr. Lafayette Morgan in his direct testimony (PA Statement 1) submitted on behalf of the Public Advocate ("Advocate" or "Public Advocate").

As the Rate Board is aware, this Special Rate Proceeding is convened as the result of the Settlement of the 2021 general rate case ("Settlement") which was approved by the Board in its 2021 Rate Determination. This proceeding is narrowly focused on two potential adjustments to the FY 2023 Base Incremental Increase. The two potential adjustments include: (i) the Federal Stimulus Adjustment and (ii) the FY 2021 Financial Performance Adjustment[1]. Mr. Morgan concurs with the Department that no Federal Stimulus Adjustment is warranted in this proceeding. He disagrees with the Department with regard to the FY 2021 Financial Performance Adjustment.

This rebuttal specifically addresses areas of disagreement concerning Mr. Morgan's proposed FY 2021 Financial Performance Adjustment including:

- Overall Recommendation
- Fiscal Year 2021 Performance
- Minimum Threshold
- Sharing of the Available Reserves
- Peer Comparisons
- Impact of the Public Advocate's Proposed Adjustment

The other areas raised in Mr. Morgan's testimony are being addressed in PWD Rebuttal Statement 2.

[1] Please recall that the two potential adjustments in this proceeding were identified by PWD and the Public Advocate as a part of the Settlement to make sure there would not be an over-recovery in the 2021 general rate case (given the prospect of receipt of federal stimulus funding and/or FY 2021 financial over-performance). This proceeding was convened as a "fail safe" to insure against the above risks.

As it turns out, the Department did not directly receive any federal stimulus funding. Moreover, as explained below, given its sub-par financial performance in FY 2021, it has no excess reserves to share with customers (as there was no over recovery in that year). As a result there should be a "zero" adjustment to FY 2023 Base Incremental Revenues.

II. OVERALL RECOMMENDATION

Q4. MR. MORGAN RECOMMENDS A $6.6 MILLION REDUCTION IN THE FY 2023 BASE RATE INCREMENTAL INCREASE BASED ON HIS CALCULATION OF THE FY 2021 FINANCIAL PERFORMANCE ADJUSTMENT. PWD STATEMENT 1 AT 18-19. DO YOU AGREE WITH HIS RECOMMENDATION?

A4. No. Mr. Morgan's adjustment assumes PWD has the financial wherewithal to reduce the approved FY 2023 Base Rate Incremental Increase ($34.110 million) by $6.6 million. Mr. Morgan is mistaken.

As stated in PWD Statement 1, the Department is in a financial hole and can barely sustain its operations with the additional revenues previously approved in the 2021 Rate Determination. In light of the foregoing, PWD has proposed a "zero" adjustment to the FY 2023 Base Rate Incremental Increase in its direct testimony. If Mr. Morgan's adjustment is accepted, PWD will be on a trajectory for a credit rating downgrade.[2] We urge the Rate Board to reject Mr. Morgan's recommendation and approve the Department's proposal to avoid a negative rating action.

As a part of this proceeding, the Rate Board is to decide the merits of two potential adjustments to FY 2023 approved revenues (identified above).[3] There is only one adjustment in controversy based on the record presented (i.e., the FY 2021 Financial

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[2] Mr. Morgan also proposes, in the alternative, a $5.35 million downward adjustment to FY 2023 Base Incremental Revenues. PA Statement 1 at 19, 20. This proposal will also place PWD below the $120 million metric identified by S&P as a minimum level for the RSF. *See*, PWD Statement 1 (Schedule ML-3).

[3] As stated above, the Advocate and PWD agree that no Federal Stimulus Adjustment is warranted based on the record in this proceeding. The only remaining disagreements relate the FY 2021 Financial Performance Adjustment.

Performance Adjustment).

Per the Settlement, the Department agreed to "sharing" potential excess reserves, if it out-performed projections made in the 2021 general rate case — using the FY 2021 Rate Stabilization Fund ("RSF") actual ending balance compared to a "minimum threshold" (to be defined in this proceeding) as the barometer of financial performance.

PWD maintains that out-performance is reasonably measured using its targeted threshold for the RSF ($135 million). This metric was accepted by the Rate Board in the 2018 Rate Determination, as one of several metrics. For purposes of this proceeding, because the actual ending RSF balance is below the above minimum threshold, the Department submits that no sharing is warranted. The Department also maintains, in the alternative, that because it only marginally meets the S&P RSF metric ($120 million), no adjustment is warranted using this metric as well.[4]

Please note that, at present, the Department finds itself at the precipice of a negative rating action with limited financial reserves. As explained below, PWD can ill afford a rate reduction at this time in the amount of $6.6 million or any other amount (which perforce translates to an even lower RSF balance). PWD financial reserves are already substantially depleted.

[4] The Rate Board accepted the $135 million metric for the RSF in the 2018 Rate Determination. S&P identified the $120 million minimum threshold for the RSF in its September, 2021 rating report. *See*, PWD Statement 1 at 16-18, Schedule ML-3.

III. FISCAL YEAR 2021 PERFORMANCE

Q5. MR. MORGAN DESCRIBES PWD'S FY 2021 FINANCIAL PERFORMANCE AS "GOOD." PA STATEMENT 1 AT 8. DOES THE PANEL AGREE?

A5. No. Mr. Morgan makes this statement as a part of explaining his adjustment related to FY 2021 Financial Performance. He assumes financial over-performance[5] is demonstrated in FY 2021 and that this equates with "good" financial performance. Mr. Morgan appears to base this statement entirely on his conclusion that the ending balance in the RSF for FY 2021 was $10.674 million higher than the projected ending balance for the RSF in FY 2021. *See,* PA Statement 1 at 8.

To be sure, the Settlement indicates that the RSF is to be used as a proxy for determining "out-performance" in FY 2021, due to uncertainties created by the pandemic.[6] Financial performance, however, is more complicated than comparing actual and projected data points for a given year. There is a larger context. That is, financial performance is generally assessed over a longer period (several years during which trends can be observed) and involves the comparison of peer entities over the same period, as well as other financial metrics such as debt service coverage and level of self-funded pay-go. This rebuttal testimony addresses financial performance in this larger context. Mr. Morgan's testimony fails to offer a reasoned analysis of financial performance.

[5] The terms "over-performance" and "out-performance" are used interchangeably in this testimony.

[6] As explained later, the two potential adjustments in this proceeding were identified by PWD and the Public Advocate as a part of the Settlement given the prospect of direct receipt by PWD federal stimulus funding and/or FY 2021 financial over-performance). Neither of the two aforesaid scenarios came to pass. *See* discussion, *infra*.

Q6. BASED ON YOUR PRIOR RESPONSE, HAS PWD DEMONSTRATED FINANCIAL OVER-PERFORMANCE OR EVEN POSITIVE PERFORMANCE IN FY 2021 AS INDICATED BY MR. MORGAN?

A6. No. Mr. Morgan's analysis of financial performance is wrong. A simple variance between the actual and projected balances for the RSF does not necessarily show "out-performance" or financial strength, as the Department remains in financial difficulty. This proceeding is to determine whether there are excess reserves for sharing. In the absence of such excess reserves (as is the case here), there should be no sharing.

Mr. Morgan implies that a "positive" financial performance is demonstrated, if the actual RSF balance in FY 2021 exceeds the projected RSF balance for that year. PWD maintains that any judgment as to positive performance has to take into account its deteriorating financial condition. That is, the Department has been in financial difficulty in recent years and remains in financial difficulty at present given current cost and financial pressures it faces at a time when its financial reserves are (i) well below Rate Board targeted levels ($135 million); and (ii) barely meet the $120 million S&P metric. It bears emphasis that PWD will be subject to negative credit rating agency action, if it falls short of the latter metric.

In his assessment of "good" or "positive" financial performance, Mr. Morgan ignores both regulatory and financial circumstances presented. That is, he overlooks PWD's recent regulatory history (nominal rate increase of $24.5 million for FY 2019-2020; withdrawn rate increase for FY 2021; and $10.411 million in rate relief in FY 2022).[7]

[7] PWD acknowledges that $34.110 million in additional revenues was approved in the 2021 Rate Determination, as a part of the Settlement. PWD needs all of these additional revenues to sustain its operations and to avoid negative credit rating action.

That translates to increases in annual revenues of roughly 1.33%, 1.2% and 1.85% for FY 2019, FY 2020 and FY 2022, respectively. Such incremental increases were plainly insufficient. Consequently, the Department had no choice but to rely upon available financial reserves to sustain its operations during the above period. PWD now finds itself in a financial morass and unable to fund current operations with current revenues. These circumstances cannot be ignored (as in Mr. Morgan's testimony).

Our message to the Rate Board is that a "zero" adjustment in this proceeding avoids making a bad situation worse. In short, we need the full amount of additional revenues ($34.110 million) approved for FY 2023. PWD cannot continue to deplete its financial reserves.

Q7. HOW IS FINANCIAL STRENGTH OR POSITIVE FINANCIAL PERFORMANCE ASSESSED BY THE CREDIT RATING AGENCIES?

A7. The credit rating agencies assess financial strength in determining rating profiles. In this context, a wide range of criteria is considered — liquidity being one of the key financial metrics. Robust liquidity mitigates unforeseen system challenges and therefore it is an important driver in assessing financial strength.

The strength of liquidity metrics are not solely measured by comparing balances from projections to actual balances in a single year. A fuller assessment of liquidity is done by viewing trends over a period of years (during such period one can observe whether financial reserves have been repeatedly relied upon to maintain the system) and in comparison, with other similar systems. The cause of liquidity concerns would also be a factor in determining the rating profile for a given utility. In the instant context, please note that the Department's ability to obtain rate relief when needed is the stated concern of all three rating agencies.

Q8. DO THE CREDIT RATING AGENCIES HAVE ESTABLISHED METHODOLOGIES TO ASSESS THE FINANCIAL STRENGTH OF VARIOUS CREDITS?

A8. Yes. Credit rating agencies have established methodologies for analyzing the strength of issuers of debt in various sectors. These rating methodologies are a part of the rating process. All three rating agencies generally review similar criteria and compare against other similar systems and issuers. For example, the above agencies make an assessment for both enterprise and financial risk, which includes reviewing the economic fundamentals of the service area, industry risks, market position and an operational management assessment. The determination of financial risk would include assessing debt service coverage, strength of liquidity and reserves, debt and over liabilities and a financial management assessment. Please note that the analysis of financial performance is both quantitative and qualitative, based on comparative industry wide data and ongoing interactions between the utility and rating analysts. Such analysis perforce requires an accurate assessment of current financial conditions and significant factors impacting financial performance.

Q9. HOW HAVE THE RATING AGENCIES ASSESSED THE DEPARTMENT'S FINANCIAL PERFORMANCE IN THE RECENT PAST?

A9. PWD is barely holding on to its "A" rating based on the most recent rating reports of S&P, Fitch and Moody's. As the Rate Board is aware, credit ratings are based on forward-looking expectations, using historical trends as guidance. Given the forward-looking nature of these assessments, actions taken by the Rate Board, will impact the credit profile. This has been articulated both in the recent rating reports (Schedule ML-3) as well as in PWD Statement 2. In fact, as the financial advisors noted in PWD Statement 2, diminishing the targeted RSF balance from the $135 million level indicates a downward trajectory which itself could result in a negative rating action.

Hurricane Ida

Q10. MR. MORGAN SUGGESTS THAT $10.0 MILLION IN COSTS RELATED TO HURRICANE IDA COULD BE "ADDED BACK" TO THE ENDING BALANCE OF THE RSF FOR FY 2021. PA STATEMENT 1 AT 13-14. PLEASE RESPOND.

A10. Hurricane Ida provides no basis for adjusting the actual audited financial results of the Water Department for FY 2021, which were presented in Schedule ML-4.

Hurricane Ida occurred in FY 2022, not FY 2021. Fiscal year 2021 started on July 1, 2020 and ended on June 30, 2021. Schedule ML-4. Fiscal year 2022 started on July 1, 2021 and will end on June 30, 2022. The remnants of Hurricane Ida passed through the City and surrounding areas on September 1, 2021. *See,* PWD Exhibit 3 (Documents Incorporated by Reference), Official Statement – Series 2021C (September 29, 2021) at 27 (regarding Impact of Hurricane Ida). Impacts of Hurricane Ida are, therefore, part of FY 2022.

We fail to understand how Hurricane Ida can show any out-performance in FY 2021, since it did not occur in FY 2021 and could not have impacted the balance of the RSF in FY 2021.

Q11. PLEASE RESPOND TO MR. MORGAN'S STATEMENT THAT: "WHEN RATES ARE BEING DETERMINED, AN ADDITIONAL AMOUNT IS NOT ADDED TO ACCOUNT FOR THE COST OF A POSSIBLE HURRICANE." PA STATEMENT 1 AT 13.

A11. The Rate Ordinance provides, in part, that the Department's rates and charges shall include "a reasonable sum to cover unforeseeable or unusual expenses." Philadelphia Code, Section 13-100(4)(b).

When faced with an unforeseeable or unusual expense, the Department needs to rely upon (draw down) the RSF. The RSF is meant to provide, *inter alia*, cash to handle unexpected and extraordinary events. This means that the balance of the RSF should be maintained, if possible, so that the Department can pay for an unforeseeable or unusual expense and maintain the Department's financial stability.

We view financial stability as being able to both (a) comply with the rate covenant and sinking fund reserve requirements, and (b) avoid a downgrade or negative action by the rating agencies.

The Department's updated Financial Plan, Schedule ML-2, is designed to maintain the Department's current credit rating. Credit ratings are a critical component in determining the cost of debt as the ratings signal the Department's ability and willingness to meet financial obligations, notably including the repayment of its debt in full and on time. A downgrade of the credit ratings would result in an increase in the Department's borrowing costs and trigger higher rates over time. In addition, limiting the ability to pay for capital needs with internally generated funds and forcing increased leverage or debt financings, will only result in continually increasing rates in order to comply with the Bond Resolution coverage requirements.

<u>Construction Fund</u>

Q12. DO YOU AGREE WITH MR. MORGAN THAT THE TRANSFER OF $13.217 MILLION TO THE CONSTRUCTION FUND "DEMONSTRATES OUT-PERFORMANCE THAT IS NOT APPARENT BY LOOKING AT PWD'S RESERVES"? PA STATEMENT 1 AT 19-20.

A12. No. The Department is pursuing federal and state loans and grants in order to support critical infrastructure upgrades. Schedule ML-2. For many projects (if not all of) federal/state support will be in the form of low interest loans, for which the disbursement of proceeds will be done on a matching or reimbursement basis. This means that the Department needs to use its cash on hand to pay for construction before loan proceeds can be reimbursed to the Department.

The Department's revolving commercial paper program ($200 million currently authorized) supports such loans. The commercial paper program is, however, fully committed to loans/projects at this time. This means that the Department needs additional cash in the Construction Fund so as not to impede reimbursements for low-cost loans/projects that are beyond the financial limits of the commercial loan program.

The transfer of $13.217 million in FY 2021 was necessary to support the capital improvement program (CIP) and preserve utilization of low-interest financing programs to ensure long term rate affordability objectives are met.

Q13. MR. MORGAN SUGGESTS THAT THE "EXTRA AMOUNT," $13.217 MILLION, TRANSFERRED TO THE CONSTRUCTION FUND SHOULD BE "ADDED" TO THE ENDING BALANCE OF THE RSF FOR FY 2021. HE ALSO STATES THAT THIS TRANSFER WOULD NOT HAVE BEEN MADE, IF PWD DID NOT HAVE THE AVAILABLE FUNDS COLLECTED THROUGH RATES. PA STATEMENT 1 AT 13-14. DOES THE PANEL AGREE?

A13. No. The transfer was made to support the CIP while concentrating on rate affordability, as we discussed. The Department needs cash to manage expenses related to low-cost loans. Low-cost funding takes a significant amount of time to secure from application to award. It also takes a significant amount of time to receive reimbursement after the construction work is done. When the reimbursement is received by the Department, that reimbursement goes to the Construction Fund to support managing other expenses in the CIP.

We disagree that the 2021 transfer shows any out-performance in FY 2021, since the 2021 transfer worked to reduce the debt burden on ratepayers, as compared to other higher rate long-term capital debt. Without the transfer, the Department would need to incur additional borrowing and additional costs to support the CIP. The 2021 transfer does not demonstrate either out-performance in receiving revenues from customers or the availability of "extra" funds collected through rates.

Q14. MR. MORGAN STATES THAT THE AMOUNTS TRANSFERRED TO THE CONSTRUCTION FUND "HAVE BEEN SPENT." PA STATEMENT 1 AT 19-20. PLEASE RESPOND.

A14. Those funds are not available to the Department in FY 2023. This means that any reduction in rates based on the transfer made in FY 2021 will force the Department to draw down its limited financial reserves.

IV. MINIMUM THRESHOLD

Q15. DOES THE PANEL AGREE WITH MR. MORGAN'S RECOMMENDATION THAT THE "MINIMUM THRESHOLD" IN THIS PROCEEDING BE SET AT $113.988 MILLION, SINCE THAT WAS THE PROJECTED RATE STABILIZATION FUND BALANCE AT THE TIME THE SETTLEMENT WAS ENTERED? PA STATEMENT 1 AT 15.

A15. No. PWD believes that use of Mr. Morgan's proposed threshold ($113.988 million) is overly simplistic and ignores the Department's financial condition.

As alluded to above, the Department proposes a minimum threshold for the RSF of $135 million for reconciliation purposes. That amount is the same amount as the target level for the Rate Stabilization Fund in the Rate Board's 2018 Determination.[8] That amount is also consistent with the Department's goal to maintain liquidity by managing to a $135 million balance in the Rate Stabilization Fund (over time) and $15 million in the Residual Fund. PWD Schedule ML-2 at Table C-1 at Lines 37 and 40; PWD Statement 2.

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[8] *See,* 2018 Determination at 37-38. https://www.phila.gov/media/20180713144736/2018-RATE-DETERMINATION-TIMESTAMPED.pdf.

Consistent with PWD Statement 2, the Department maintains that using a minimum threshold amount lower than the current balance of $124.661 million in the Rate Stabilization Fund would not be reasonable given PWD's financial needs and the requirements of Fitch, Moody's and S&P.

The rating agencies expect the Department to move toward the target/goal of $135 million in the Rate Stabilization Fund. *See,* Schedule ML-3 (Rating Agency Reports); PWD Statement 2 at p. 5-7. PWD should minimize utilization of the RSF in FY 2023. In fact, S&P indicated in June 2021, that higher-than-planned use of liquidity could cause S&P to lower the rating for the Department.[9]

Please note that the rating agencies view the Department's key financial metrics as minimums because they are in fact on the low side in comparison to the rating category of other "A" credits as well as other peer systems. This issue is addressed in more detail in PWD Statements 1 and 2.

Q16. MR. MORGAN STATES THAT THE "MINIMUM THRESHOLD" IN THIS PROCEEDING WILL NOT DETERMINE THE ENDING BALANCE IN PWD'S RATE STABILIZATION FUND IN FY 2022 OR FY 2023. PA STATEMENT 1 AT 14-15. PLEASE RESPOND.

A16. Mr. Morgan is correct that the minimum threshold used in this proceeding will not impact the RSF balance in FY 2022, since this proceeding is not intended to address any of the revenues or the expenses for FY 2022.

[9] Schedule ML-3 (Rating Agency Reports), S&P Report (September 17, 2021) at 3.

Mr. Morgan is wrong about FY 2023. The minimum threshold used in this proceeding will impact the RSF balance in FY 2023. The minimum threshold, in and of itself, does nothing. Under the Settlement, the minimum threshold is used as part of the calculation that determines the "available balance." *See,* Schedule BV-1 at 5-7 (Examples). That balance may or may not be shared. The amount of sharing will force the Department, all else being equal, to rely upon (draw down) financial reserves to pay expenses that would have paid from the non-reduced portion of the FY 2023 Base Rate Incremental Increase.

The Department continues to utilize its RSF reserves to mitigate the effects of insufficient rate relief. Schedule ML-2. The availability of RSF reserves has helped the Department address unforeseen circumstances in the past 2 years (COVID-19 and Hurricane Ida). Schedule ML-2. If the Department's RSF reserves are further diminished, the Department will be that much more hampered in its ability to adequately address future challenges. Schedule ML-2.

Q17. WILL A DECISION IN THIS PROCEEDING IMPACT PWD'S FINANCIAL RESERVES?

A17. Yes. Any approved reduction in rates for FY 2023 will have the effect of drawing down PWD financial reserves. As alluded to above, the amount of sharing will force the Department, all else being equal, to rely upon (draw down) financial reserves to pay expenses that would have paid from the non-reduced portion of the FY 2023 Base Rate Incremental Increase.

We believe that the PWD cannot further significantly draw down its financial reserves in FY 2023. Instead, the Department should make efforts to minimize reliance on financial reserves in FY 2023. In FY 2024 and beyond, the Department should work to improve financial reserves as well as its financial position over the long term.

Q18. WILL A DECISION IN THE TAP-R PROCEEDING ALSO POTENTIALLY IMPACT PWD FINANCIAL RESERVES?

A18. Yes. The Rate Board's determination in the related TAP proceeding could also place pressure upon the Department's financial reserves to cover about $3 million in lost revenues, if the Advocate's conservative projection of new TAP participants is accepted.[10]

Q19. MR. MORGAN SAYS THAT THE "MINIMUM THRESHOLD" IN THIS PROCEEDING WILL NOT IMPACT THE DEPARTMENT'S CREDIT RATINGS. PA STATEMENT 1 AT 14-15. PLEASE RESPOND.

A19. Mr. Morgan makes a very focused statement (as referenced above) that misses the bigger financial picture.

S&P indicated in September 2021, that higher-than-planned use of liquidity could cause S&P to lower the rating for the Department. Schedule ML-3 (Rating Agency Reports), S&P Report (September 17, 2021) at 3. In doing so, S&P has clearly stated that depleting the RSF reserves below $120 million will likely result in a downgrade for the Department.

The other rating agencies have also indicated their concerns that PWD financial reserves are dwindling. *See,* Schedule ML-2 at 27 (PWD Credit Rating Overview); Schedule ML-

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[10] 2022 PWD TAP Rebuttal Statement 1 at 8-9.

3 (Rating Agency Reports). Moody's has expressed concerns over the use of financial reserves (or RSF) beyond current expectations. Fitch has expressed concerns over cost recovery and the continued use of Rate Stabilization Fund (RSF) to maintain financial metrics.

More specifically as to Moody's: Moody's recent rating report (Credit Report September 17, 2021) specifically notes: "Of concern, however, is the department's continued projections for fairly narrow 'legally enacted' debt service coverage. Also of material concern is the rate board's continued limitations on the departments revenue [raising] rating ability, which serves to materially curtail managements operating flexibility." (September 16, 2021) Moody's expressed concerns about PWD's rate pressures (i.e. uncertainty of obtaining sufficient rate relief) and specifically noted this as a factor that could lead to a downgrade: "the inability to increase rates commensurate with coverage requirements and in line with the Department's internal standards". (Credit Report September 17, 2021).

More specifically as to Fitch: Fitch noted that the rating and outlook assumes that PWD will continue to obtain rate adjustments to maintain its current level of liquidity and leverage. *See,* Schedule ML-3 (Rating Agency Reports). Specifically mentioned as leading to a negative rating action is having leverage ratios increase to over 10 times (from current 8x) and a failure to secure rate increases sufficient to maintain "current financial profile". Leverage ratios will increase if funds available for debt service do not increase with future debt burden needed to address ongoing and growing capital needs.

Clearly all three rating agencies are concerned about any Rate Board actions that would further weaken the Department's financial condition by reducing approved incremental revenues for FY 2023 and drive financial metrics such as the RSF still lower.

V. SHARING OF THE AVAILABLE RESERVES

Q20. MR. MORGAN OPINES THAT THE <u>MINIMUM</u> REDUCTION THAT CAN BE REASONABLY CONSIDERED IS A $5.35 MILLION DOWNWARD ADJUSTMENT. PA STATEMENT 1 AT 19-20. DOES THE PANEL AGREE?

A20. We disagree. The minimum adjustment to FY 2023 approved incremental revenues that can be reasonably considered is "zero," as recommended by the Department. This recommendation is based on establishing a reasonable minimum threshold for the Rate Stabilization Fund.

We disagree with Mr. Morgan's opinion, as it implies that there is only one number to be used as the minimum threshold. That is not the case. Neither the 2021 Rate Determination nor the Settlement defined the minimum threshold as the projected ending balance in the RSF for FY 2021. The number to be used as the minimum threshold is to be established in this proceeding.

Mr. Morgan's proposed number of $113.988 million, may be used for the minimum threshold. But, to be clear, the Department identified two other reasonable numbers for the minimum threshold based upon (i) the targeted RSF balance determined "reasonable" and "adequate…while not imposing an undue burden on customers" by the Rate Board ($135 million); and (ii) the S&P designated minimum reserve amount ($120 million) to avoid a rating downgrade.

With regard to the first threshold identified by PWD, the $135 million metric is the Department's target balance for the RSF which was accepted by the Rate Board in the 2018 general rate case. The fact that the RSF balance is well below $135 million confirms that the Department is in financial difficulty. If the Rate Board directs action that would increase the size of deficit between Rate Stabilization Fund balance and the targeted balance of $135 million, it would be knowingly placing the Department in greater financial difficulty and risk. Also, as noted in PWD direct testimony, ratepayers will be called upon to address this issue in FY 2024 and beyond.

With regard to the second threshold alluded to above, the $120 million RSF metric was identified by S&P as the lowest level that can maintained without risking a rating downgrade. As a practical matter, S&P has drawn a financial "red line" that PWD should not cross. No reduction in FY 2023 Base Incremental Revenues should be approved for this reason alone. Please note that Mr. Morgan rejects both of the above metrics in his testimony.

We further disagree with Mr. Morgan's opinion, since he implies that any available balance must be split evenly. The "sharing" of available reserves in the RSF as of the end of FY 2021 (if any) was not defined in the 2021 Rate Determination nor agreed upon in the Settlement. The actual split or shared percentage needs to be established in this proceeding. Here, as explained in PWD Statement 1, the Department is concerned that the remaining balance of $124.66 million in the RSF is too close to the $120 million threshold to justify sharing at any level.

Residual Fund

Q21. MR. MORGAN RECOMMENDS THAT HIS PROPOSED $5.35 MILLION DOWNWARD ADJUSTMENT BE INCREASED BY $1.24 MILLION, FOR AN OVERALL REDUCTION OF $6.6 MILLION (ROUNDED). PA STATEMENT 1 AT 20. HE NOTES THAT THIS AMOUNT IS BASED ON THE FY 2021 YEAR-END BALANCE IN THE RESIDUAL FUND, WHICH WAS $1.24 MILLION HIGHER THAN THE PROJECTION IN THE 2021 GENERAL RATE CASE. PA STATEMENT 1 AT 19-20. PLEASE RESPOND.

A21. We have a number of responses:

First, the scope of this limited proceeding is defined by the Joint Settlement Petition,[11] as approved by the 2021 Rate Determination[12] issued by the Rate Board on June 16, 2021. The mechanics of the potential adjustments was explained in those documents and in PWD Statement 1, PWD Statement 2 and Schedule BV-1. Given the Advocate's concurrence that there no Federal Stimulus Adjustment is warranted, the aforesaid mechanics are limited to the FY 2021 ending balance for the RSF. Those mechanics do not provide for any adjustment based on the balance of the Residual Fund ("RF") at the end of FY 2021.

Second, the RF does not represent a "pool" of money available for rate reductions. It is an emergency fund that cannot be used to satisfy other" legal" requirements, i.e., the rate covenant and sinking fund reserve requirements set forth in Rate Ordinance and the 1989 General Ordinance. This means that perforce that directions to "draw down" this fund

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[11] https://www.phila.gov/media/20210505154832/Joint-Petetion-for-Partial-Settlement.pdf.
[12] https://www.phila.gov/media/20210618105014/2021-General-Rate-Determination-as-filed-with-Records-Dept-20210616.pdf.

will - all else being equal - force the Department to deplete its financial reserves.

Third, Mr. Morgan proposes that the $1.24 million amount above the projected Residual Fund balance be used for the benefit of a rate reduction (without a percentage sharing). He offers no justification why he has proposed sharing at different levels between the RSF (50%) and the RF (100%). This runs counter to the Settlement terms and conditions that contemplate that a percentage sharing would be determined in this proceeding.

Additional Cost Pressures In FY 2023

Q22. PLEASE RESPOND TO MR. MORGAN STATEMENTS THAT DISCUSSION OF THE COST PRESSURES IN FY 2023 ARE BEYOND THE SCOPE OF THE PROCEEDING. PA STATEMENT 1 AT 17. HE OPINES THAT THE COST INCREASES PRESENTED BY PWD CANNOT BE CONSIDERED IN A VACUUM AND SHOULD BE DEEMED IRRELEVANT TO THIS PROCEEDING. PA STATEMENT 1 AT 19.

A22. The Department believes that additional cost pressures are relevant for the sharing component of this proceeding, since - all else being equal - the additional cost pressures will force the Department to rely upon (draw down) financial reserves to pay the expenses that would have paid from the FY 2023 Base Rate Incremental Increase.

The Department is concerned that a reduction in FY 2023 approved rates will reduce the Department's financial flexibility, which is already facing constraints in FY 2023. Notably, the full amount of the so-called "available balance" may not be enough to cover cost pressures and other challenges in FY 2023 arising from escalating regulatory requirements and dramatically increasing costs. The Department's (non-comprehensive) list of costs pressures and challenges shows an impact of $19.20 million in FY 2022 and or $23.21 million in FY 2023. In addition, the Rate Board's determination in the related TAP proceeding could place pressure upon the Department's financial reserves to cover about $3 million in lost revenues related to addition of new TAP participants.[13] That being said, it should also be noted that the full amount of the "available balance" may not be enough to cover unforeseeable or unusual expense (e.g., future storm event or emergency). In light of the above PWD believes that a "zero" adjustment is the most prudent outcome for this proceeding.

Q23. IN LIGHT OF CURRENT FINANCIAL CONDITIONS, ARE ANY FUNDS AVAILABLE FOR "SHARING" IN THIS PROCEEDING.

A23. No. The Department is concerned that the available balance in the RSF of $124.66 million is too close to the $120 million to justify sharing at any level. By mandating the reduction of the Rate Stabilization Fund to, or near, the above-described downgrade trigger of $120 million, would further constrain the Department's financial flexibility (as compared to utilizing the targeted balance of $135 million in the Rate Stabilization Fund).

[13] 2022 PWD TAP Rebuttal Statement 1 at 8-9.

VI. PEER COMPARISONS

Q24. MR. MORGAN RECOMMENDS THAT THE RATE BOARD NOT ESTABLISH RATES BASED UPON WHAT IS PRESENTED IN PEER COMPARISONS IN THIS PROCEEDING. PA STATEMENT 1 AT 17-18. HE STATES THAT THE CRITERIA FOR THE SELECTION OF THE PEERS ARE NOT CLEAR, AND THAT "RATEMAKING SHOULD BE CONDUCTED ON A CASE-BY-CASE BASIS THAT FOCUSES ON THE FACTS OF EACH PROCEEDING, NOT WHAT OTHER UTILITIES ARE DOING." PA STATEMENT 1 AT 17-18. PLEASE RESPOND.

A24. The Department provided peer comparisons as part of Schedule ML-2 because the Rate Ordinance requires the Department to compare itself to "to similar agencies in peer cities in the United States." Philadelphia Code, Section 13-101(2). Comparisons using these same cities were made in the 2018 General Rate Proceeding[14] and 2021 General Rate Proceeding.[15]

The peer comparisons only establish that with a "zero" adjustment in this proceeding, PWD rates compare favorably with similarly situated water/sewer utilities. Schedule ML-2 at 24 (Affordability). The mechanics of the potential adjustments do not include raising revenues for FY 2023 above the approved FY 2023 Base Rate Incremental Increase. Nothing in the aforesaid mechanics suggests that the Board should be increasing rates and charges FY 2023, as part of this proceeding, based upon peer comparisons.

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[14] 2018 Schedule ML-2: https://www.phila.gov/media/20180314143216/PWDStatementNo2_DirectTestimonyandSchedulesofMelissaLaBuda.pdf.

[15] 2021 Schedule ML-2: https://www.phila.gov/media/20210216165014/PWD-Statement-2-%E2%80%93-Direct-Testimony-And-Schedules-Of-Melissa-La.-Buda-Supplemented-As-Of-Formal-Filing.pdf

The Department has modest reserves compared to peer utilities. Schedule ML-2 at 23 (PWD Reserve Levels). Here, the Department is only seeking to avoid a downward adjustment to approved rates for FY 2023 that would have the effect of further drawing down PWD financial reserves compared to peer utilities.

VII. IMPACT OF PUBLIC ADVOCATE'S PROPOSED ADJUSTMENT

Q25. AT PAGE 15 OF PA STATEMENT 1, MR. MORGAN INDICATES THAT WHETHER PWD'S RATE STABILIZATION FUND BALANCE IS $120 MILLION OR $135 MILLION OR SOME OTHER AMOUNT IN FUTURE YEARS IS NOT BEFORE THE RATE BOARD. DOES THE PANEL AGREE?

A25. No. The Rate Board must determine if the changed rates and charges will enable the Department to (a) comply with the rate covenant and sinking fund reserve requirements, and (b) avoid a downgrade or negative action by the rating agencies. The Board initially did that evaluation for FY 2023 approved rates and charges (in the 2021 General Rate Proceeding). Any downward adjustment accepted in this proceeding (changing FY 2023 approved rates and charges) must be subject to this same evaluation.

Using an amount lower than $135 million as the "minimum threshold" for reconciliation purposes would also, predictively, lead to a spike in rates, since a rate increase would be required beginning in future years (FY 2024 and beyond) to raise additional revenues to bring the amount in the RSF back to the target/goal of $135 million. For example, using the lower amount of $113 million in the RSF as the "minimum threshold" for reconciliation purposes means that ratepayers would then need to pay $22 million in additional billings due to increased rates in FY 2024 and beyond to raise the Rate Stabilization Fund back to $135 million.

Q26. DID MR. MORGAN PROVIDE ANY ANALYSIS OF IMPACT ON THE DEPARTMENT FROM THE PUBLIC ADVOCATE'S PROPOSED ADJUSTMENT?

A26. Yes. Mr. Morgan provided Schedule LKM-1, which was provided for illustrative purposes. PA Statement 1 at 20. Schedule LKM-1 provides a summary of the results of operation for FY 2023 after reflecting the reduction of $6.6 million to PWD revenues. PA Statement 1 at 20.

Q27. MR. MORGAN STATES THAT HE IS "CONFIDENT PWD WILL BE ABLE TO MEET ITS OBLIGATIONS AND MAINTAIN ADEQUATE RESERVES" IN FY 2023. PA STATEMENT 1 AT 17. PLEASE RESPOND.

A27. We believe that "adequate" reserves means that RSF reserves will be sufficient to (a) comply with the rate covenant and sinking fund reserve requirements, and (b) avoid a downgrade or negative action by the rating agencies.

We, therefore, disagree with Mr. Morgan's definition of "adequate" reserves. Mr. Morgan's use of "adequate" implies that the Department only need to comply with the "legal" requirements, i.e., the rate covenant and sinking fund reserve requirements set forth in Rate Ordinance and the 1989 General Ordinance. That is not enough to maintain the Department's financial stability, since satisfaction of those requirements in FY 2023 will not avoid a downgrade or negative action by the rating agencies. Those "legal" requirements do not set a level of RSF reserves for the Department (that is a separate RSF metric), and PWD is likely to be downgraded if it is forced to follow a downward trajectory in RSF balances and/or draw down the RSF reserves below $120 million (S&P metric).

Mr. Morgan acknowledged that S&P drew a "line" for the RSF reserves, since he stated that S&P indicated that an RSF balance below $120 million could lead to a downgrade. PA Statement 1 at 14. He also stated that the "balance of concern is $120 million." PA Statement 1 at 14-15. However, Mr. Morgan does not temper or adjust his proposed adjustments to keep the Department above that "line."

We do not believe that the Department (or the Rate Board) can put blinders on and act as if the statements by the rating agencies will not have consequences in FY 2023. The Settlement was approved in June 2021. S&P issued its opinion in September 2021 providing, in Mr. Morgan's words, a "balance of concern." The ratepayers will draw little, if any, comfort if the Department complies with the "legal" requirements, but is downgraded because the Department depletes the RSF reserves (in accordance with the Rate Board's direction). This will expose ratepayers to a higher cost of borrowing over future years to support the Department's capital improvement program.

Q28. DOES MR. MORGAN'S ANALYSIS SHOW THAT THE DEPARTMENT IS AT RISK OF A DOWNGRADE OR OTHER NEGATIVE CREDIT ACTION BY S&P (AND/OR OTHER RATING AGENCIES)?

A28. Yes. Line 41a on Schedule LKM-1 shows that Mr. Morgan projects an RSF balance of $96.376 million at the end of FY 2023. That is a $23.624 million gap between Mr. Morgan's projection ($96.376 million) and $120 million, and a $38.624 million gap between Mr. Morgan's projection and the target of $135 million. On its face, Mr. Morgan's projected balance of $96.376 million would place the Department below the RSF balance that is likely to trigger a downgrade or negative action by one or more of the rating agencies.

PWD will access the capital markets in the coming months and the concerns raised in PWD Statement 2 and herein will be paramount as the new revenue bonds (in the aggregate amount of some $300 million) are rated and debt service obligations therefrom determine what ratepayers will be burdened with for the next 30 years. It is important to weigh this consideration together with all other PWD testimony/schedules as corroboration that a "zero" adjustment to FY 2023 approved rates is appropriate here.

VIII. CONCLUSION

Q29. DOES THIS CONCLUDE THIS REBUTTAL TESTIMONY?

A29. Yes, it does.