S&P Global
Ratings

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Summary:
Philadelphia; Water/Sewer

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Summary:

Philadelphia; Water/Sewer

Credit Profile		
US$485.14 mil wtr and wastewtr rev bnds ser 2023B due 09/01/2053		
Long Term Rating	A+/Stable	New
US$96.265 mil wtr and wastewtr rev rfdg bnds ser 2023C due 09/01/2053		
Long Term Rating	A+/Stable	New
Philadelphia WS		
Long Term Rating	A+/Stable	Affirmed
Philadelphia W/S (BAM)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed

Credit Highlights

- S&P Global Ratings assigned its 'A+' long-term rating to Philadelphia's series 2023B water and wastewater revenue bonds and series 2023C 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 $2.5 billion of water and wastewater revenue bonds.
- The outlook is stable.

Security

Securing debt service is pledged collateral, which, in our view, is equivalent to a net revenue pledge of the water and sewer fund. This net revenue pledge includes revenues (net of operating expenses) rates and charges of the system, transfers from the rate stabilization fund (RSF), and interest earnings.

Rates must be set to generate revenues and charges plus transfers from the RSF that represent at least 1.2x annual debt service on senior revenue bonds and 1.0x coverage when including all subordinate debt (if outstanding, which currently they are not) and certain other transfers. 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 provision for both the rate covenant and additional bonds test that requires that the city maintain net system revenues (excluding transfers from the RSF) totaling at least 90% of operating requirements (90% test). While this sets a limit on how much the system can rely on draws from the RSF, we generally view reliance on accumulated cash to meet covenants as permissive. Philadelphia Water Board (PWD) has historically met its 1.2x and 1.0x coverage tests without reliance on the 90% test, but if it needed to rely on it to maintain covenant compliance, then we would likely lower our rating.

All revenue bonds secured by pledged collateral are further secured by a debt service reserve account funded at maximum annual debt service (MADS).

Credit overview

Our 'A+' rating reflects our view that the service territory benefits from its location in a large metropolitan center that serves as an anchor for employment throughout the region, despite facing ongoing headwinds due to challenges keeping its utility rates affordable for all its ratepayers. While the city's rate board has historically supported rate increases to maintain ample capacity for PWD's operations and capital needs, we foresee ongoing challenges that could place downward pressure on PWD's financial position, most notably funding of a large capital improvement program (CIP) while concentrating on rate affordability. However, we believe that the city has flexibility in dealing with future revenue pressures, and because of this, the rating outlook is stable.

Examples of this flexibility include the following:

- The city's ability to reprioritize its CIP, as it demonstrated in 2020 and 2021 during the COVID-19 pandemic, which it could continue doing due to inflationary and supply-chain pressures. Only about 20% of the six-year CIP (2024-2029) is related to regulatory mandates of its consent order and agreement (COA) with the Pennsylvania Department of Environmental Protection (PADEP). In addition, we have observed a good degree of cooperation between state and local officials regarding COA implementation, which we expect will continue.
- Significant legally unrestricted balances that generally hover around or exceed $300 million, including an RSF, which should help support PWD's liquidity needs. According to the last publicly available forecast from bonds the city issued in 2023, Philadelphia plans to use about $155 million of cash generated from net operating revenues over the 2024-2028 period to support its $4.6 billion CIP, but the funding will come from the residual generated by the 1.2x in annual debt service coverage (DSC) that PWD's projections indicate will be at or higher through the 2027 forecast period.
- Demonstrated strengths at mitigating environmental, social, and governmental (ESG) risks through assistance programs, commitment to a significant amount of green infrastructure, and consistent communications of financial trends with the rate board.

Balanced with this flexibility are several ongoing factors that continue to be integral to management's decision-making process regarding rate affordability, adequate funding of capital maintenance, and future debt needs:

- To meet the 1.2x DSC covenant, PWD relies on approval of future rate increases that generate a range of about 8%-14% of additional revenues annually, not accounting for any positive variances that could occur to offset this revenue requirement. Given inflationary and wage pressures, we believe the revenue needs could be higher. Setting rates to the legal minimum leaves very little cushion for future revenue deviations, which could threaten compliance in any given year without additional unplanned use of the RSF.
- We also note that while PWD has a certain degree of flexibility in how much funding it dedicates toward capital projects in any one year, the CIP is large. A component of the plan is the 25-year $4.5 billion COA project cost, involving about $3.5 billion of capital expenditures and $1.0 billion in operating and maintenance costs. Deferral of capital could result in infrastructure underinvestment, creating additional risks.

Environmental, social, and governance

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 outsized risk. PWD's effectiveness to date in addressing these risks is a key component of its operating profile.

Social risks are being addressed with an industry-recognized, multifaceted 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, which we view as credit supportive. The average monthly residential water and sewer bill is about $75, which we view as affordable.

Environmental risks are significant and include maintaining compliance with its COA, maintaining a watershed for a large service area population, and lead service line replacement. Mitigating these risks is a key aspect of management's overall planning, community outreach, and compliance goals, but balancing these proactive efforts with capital and operating costs will remain a critical component of our rating analysis. We note that the CIP, while large, is supported by operational and financial management that is highly aligned, establishing prioritization among nonmandated projects and, to the extent reasonably possible, includes resilience measures toward climate change and overall risk management that we view as comparable with peer very large systems.

Governance risks are currently a neutral factor in the rating, but could become elevated if future rate increases start to generate lower revenue than management's current projections indicate. Combined water and sewer rates are about 2.0% of local incomes (including the stormwater fee), but we believe requests for increases may be pressured given current recessionary conditions and social risks stemming from the elevated county poverty rate. Rate board approval is required for all rate increases.

Outlook

The stable outlook is predicated on the city being able to generate margins that are generally in line with current financial projections, which show steadily improving DSC after consideration of both operating expenses and transfers for capital projects. While the outlook also incorporates some planned spenddown in the RSF as indicated in PWD's current projections, we would also expect that along with the improving DSC, the RSF reductions will be no greater than what current projections show. Our assessment that the financial projections are attainable is based on PWD's historical willingness to adjust rates to meet its financial targets while maintaining compliance with all required covenants.

Downside scenario

If PWD's appetite for rate adjustments wanes and current projections for DSC and liquidity are not met, we could lower our rating. We could also do so if there is a willingness to permanently reduce liquidity because of unforeseen capital costs or in lieu of rate increases.

Upside scenario

Because of the inflationary headwinds and ongoing, significant capital needs, we do not foresee an upgrade in at least the next several years. Over the longer term, if the city's financial performance significantly and consistently exceeds current projections, we could raise our rating.

Related Research

- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

Ratings Detail (As Of September 7, 2023)		
Philadelphia WS		
Long Term Rating	A+/Stable	Affirmed
Philadelphia WS		
Long Term Rating	A+/Stable	Affirmed
Philadelphia WS (AGM)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Philadelphia WS (BAM) (SECMKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
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Many issues are enhanced by bond insurance.