



RATING ACTION COMMENTARY

Fitch Rates Philadelphia (PA) Water and Wastewater Revs 'A+'; Outlook Stable

Fri 08 Sep, 2023 - 3:13 PM ET

Fitch Ratings - New York - 08 Sep 2023: Fitch Ratings has assigned an 'A+' rating to the following Philadelphia, PA (the city) revenue bonds:

--Approximately \$581.4 million water and wastewater revenue bonds, series 2023B.

The bonds are anticipated to be sold via negotiation the week of Sept. 18. Proceeds will be used to fund a portion of the capital improvement program, fund a deposit to the Debt Reserve Account, refund a portion of outstanding water and wastewater revenue bonds, and pay issuance costs.

Additionally, Fitch has affirmed the 'A+' rating on the following:

--Approximately \$2.5 billion outstanding water and wastewater revenue bonds.

Fitch has also assessed the standalone credit profile (SCP) of the Philadelphia Water Department (PWD or the system) at 'a+'. The SCP represents the credit profile of the system on a standalone basis irrespective of its relationship with and credit quality of, the city (Issuer Default Rating [IDR] A/Stable).

The Rating Outlook is Stable.

RATING ACTIONS

ENTITY / DEBT ◆

RATING ◆

PRIOR ◆

Philadelphia (PA) [Water,
Sewer]

Philadelphia (PA) /Water & Sewer Revenues/1 LT	LT	A+ Rating Outlook Stable	Affirmed	A+ Rating Outlook Stable
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ANALYTICAL CONCLUSION

Fitch's 'A+' rating and 'a+' SCP reflect PWD's leverage profile within the context of its strong revenue defensibility and very strong operating risk assessments, assessed at 'a' and 'aa', respectively. The Stable Outlook incorporates Fitch's expectations that PWD will secure rate adjustments sufficient to maintain leverage consistent with the current financial profile assessment and rating, while continuing to implement its substantial capital improvement plan (CIP).

Revenue defensibility reflects the system's role as an essential service provider within a well-defined service territory, historically stable demand characteristics, yet a rate setting process that constrains rate flexibility. Significant rate increases are needed over the forecast period in order to maintain and improve system assets, while also complying with a state consent order agreement (COA), which requires approval by an independent rate setting board. The operating risk profile incorporates capital investment needs that are expected to remain elevated for the foreseeable future as the system faces long-term asset rehabilitation needs and continues progress toward addressing combined sewer overflows (CSOs) and master plan execution.

The system's financial profile reflects low, albeit increasing leverage, measured by net adjusted debt to adjusted funds available for debt service, reaching 9.7x in fiscal 2022 (FYE June 30). While leverage could be slightly elevated the next few fiscal years, it should continue to support the 'a' financial profile assessment. However, the rating could become pressured if approval of recommended rate increases is delayed or capital needs continue to grow.

CREDIT PROFILE

PWD provides potable water to all of the approximately 1.6 million residents of the city as well as accounts in neighboring Montgomery and Delaware Counties per a wholesale agreement. PWD also provides wastewater collection and treatment to a service area that

includes the city, as well as portions of the surrounding counties through wholesale contracts, serving a larger population estimated at nearly 2.3 million.

Water treatment is provided by three water treatment plants. Combined capacity is 546 million gallons per day (mgd). Average daily water demand is comfortably below permitted water supply and water supply from the Delaware and Schuylkill rivers are sufficient for the foreseeable future. Three water pollution control plants provide wastewater collection and treatment, including biosolids treatment and disposal with combined capacity of 522 mgd or about 85% of demand.

The city continues to operate under a COA signed in 2011 with the Pennsylvania Department of Environmental Protection. The COA requires PWD to address CSOs over a 25-year period ending in 2036. Recent total cost estimates of the program, which began in 2012, are approximately \$4.5 billion (\$3.5 billion capital-related, \$1.0 billion O&M). The city reports it is on track to meet the next milestones, which have a deadline of June 2026.

Fitch considers the system to be a related entity to the city for rating purposes given the city's oversight of the system, including its management of operations and approving appointment of rate board members. The credit quality of the city does not currently constrain the bond rating. However, as a result of being a related entity, the issue rating could become constrained by a material decline in the general credit quality of the city.

KEY RATING DRIVERS

Revenue Defensibility 'a'

Monopolistic Service Provider, Limited Rate Flexibility

PWD provides essential utility services to a stable service area that serves as the economic hub for the region. The customer base is diverse, and demographic indicators are midrange when considering those areas outside the city limits. The rate approval process is extensive and rate affordability and cost recovery remain a concern, currently limiting the revenue defensibility assessment at its current level.

Operating Risks 'aa'

Very Low Operating Cost Burden, Elevated Capital Needs

The operating cost burden remains very low. Rising annual capex trends and sizable long-term capital reinvestment plans should continue to lower the system's currently elevated life cycle ratio.

Financial Profile 'a'

Strong Financial Profile, Leverage to Rise

The financial profile reflects the system's strong leverage, with a liquidity profile that is neutral to the assessment. Over time, leverage is expected to rise but financial metrics are anticipated to remain consistent with the current assessment and rating, should revenue expectations hold.

Asymmetric Additive Risk Considerations

No asymmetric additive risk considerations affect this rating.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

- Leverage sustained below 8.0x through Fitch's base and stress cases, provided maintenance of current revenue defensibility and operating risk assessments;
- Improvement in the revenue defensibility assessment driven by improved assessments of both service area characteristics and rate flexibility.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

- Leverage sustained above 10.0x through Fitch's base and stress cases provided maintenance of current revenue defensibility and operating risk assessments;
- Failure to secure rate increases in a timely manner to sufficiently support capital plan needs;
- Deterioration in the revenue defensibility assessment, raising the hurdle for leverage at the current rating.

SECURITY

The bonds are secured by a senior lien on combined net revenues of the PWD's water and sewer system and a debt reserve account funded in the amount of maximum annual debt service.

Revenue Defensibility

Revenue defensibility, assessed at 'a', is strong and reflects all of the system's revenue derived from monopolistic, primarily residential water delivery and wastewater services.

PWD's service territory is generally stable but with weaker median household income (MHI) and unemployment relative to national levels. Fitch uses the city's demographic statistics as a key input to its assessment of the service territory as the vast majority of customers are located within the city limits, but also recognizes that PWD provides service to areas with more favorable demographics outside of the city limits.

The city unemployment rate remains significantly above that of the nation, approximating 150% of national levels in 2022. More recent data show an improving trend, at 129% in May 2023. MHI has also improved, approximating 76% of the nation, compared to 73% in recent years.

Rate Oversight and Structure

With the establishment of the Philadelphia Water, Sewer, and Storm Water Rate Board (the rate board) in 2014, the city council no longer had direct approval and sole control over PWD's rates. The rate board's five members are appointed by the mayor and must be approved by the city council. The rate board's decisions may be appealed. Although the process is time consuming and typically results in rate increases lower than requested, the department indicates the process is collegial. The fiscal 2024 and 2025 rate determinations of 7.85% and 8.14%, respectively, are the largest increases to date.

Rates are deemed affordable for a significant majority of the population (around 75%) and the combined monthly residential customer bill totaled approximately \$103.00 for 7,500 gallons of water consumed and 6,000 gallons of sewer flows in fiscal 2022. PWD has implemented various bill reduction programs for a few thousand lower-income residents, which further offsets affordability concerns. The city's Tiered Assistance Program (TAP), which establishes charges as a percentage of household income, reduces the impact ongoing rate adjustments have on the most vulnerable population. Approved rates include a surcharge to recover a portion of the revenue lost due to TAP.

Operating Risks

Fitch assesses PWD's operating risk profile as very strong at 'aa', reflecting a very low operating cost burden, strong historical capital re-investment trends, and continued compliance with the COA. The operating cost burden has been relatively stable, registering about \$2,600 per million gallons in fiscal 2022, and economies of scale are anticipated to keep it consistent with the current assessment. Elevated investment needs are adequately addressed with sizable historical and projected capital spending. Annual capex to depreciation has been over 200% the past four fiscal years with a five-year average of 210% as of fiscal 2022.

Typical of most large, mature, urban combined utilities facing CSO mitigation and long-term renewal and replacement issues, PWD's capital improvement program is anticipated to remain substantial. The city prepares a six-year CIP, with fiscal 2024 through 2029 budgeted spending of \$4.57 billion. System reinvestment remains the focus. Water Revitalization Plan projects, including upgrades at all three water treatment facilities, total \$1 billion. COA projects also are about \$1 billion. Additional costs are assumed for wastewater facility upgrades including the pretreatment facility at the Northeast plant. A new 25-year wastewater master plan update is underway. About 88% of the CIP is expected to be debt funded with revenue bonds, state and/or federal loans.

Financial Profile

PWD's financial profile is assessed at 'a'. As expected, leverage rose in fiscal 2022 to 9.7x, a continuation of annual increases observed since fiscal 2018, when leverage registered 6.3x. The rise has previously been attributable to additional debt issuances in conjunction with lower sales revenue amid pandemic related challenges, exacerbated by the absence of a rate increase in fiscal 2021.

The liquidity profile is considered neutral to the assessment. Current days cash on hand measured 136 days in fiscal 2022. Additionally, the system's rate stabilization fund's (RSF) balance was about \$139 million as of fiscal 2022 and provides additional liquidity. Coverage of full obligations (COFO) measured 1.4x and Fitch calculated all-in debt service coverage (DSC) exceeded 1.7x, as this does not account for the system's net transfers.

Fitch Analytical Stress Test (FAST)

Fitch's FAST considers the potential trend of key ratios in a base case and a stress case. The stress case is designed to impose capital costs 10% above expected levels and evaluate potential variability in projected key ratios. Fitch's base case generally reflects PWD's

financial forecast, with adjustments made to smooth the increase from audited fiscal 2022 to fiscal 2023. Projected revenues reflect approval of the most recent rate package for fiscal 2023, with additional revenue increases between about 8.0% and 13% annually through fiscal 2027, largely driven by planned rate adjustments. The FAST also includes PWD's capital spending forecast and planned debt-funding sources.

In the FAST base case, leverage rises to 10.2x in fiscal 2024 and gradually declines, falling to 9.0x by fiscal 2027. In the stress case, leverage peaks at 10.5x in fiscal 2024 and then follows the same pattern of decline to 9.6x. The system also maintains a healthy construction fund balance. When considering funds reserved for construction (averaging over \$600 million), leverage remains below 9.0x.

The system's liquidity profile is expected to remain neutral to the assessment with COFO over 1.25x and solid days cash annually. Management's current projections reflect senior lien DSC of 1.25x, including anticipated transfers from the RSF. Current estimates include the system making annual deposits to the RSF beginning in fiscal 2026.

The declining leverage trend in the out years is dependent on substantial rate increases that increase funds available for debt service by almost 80% from the fiscal 2022 level, as capex continues increasing annually. Should projected rate increases fail to receive necessary approvals, Fitch anticipates PWD would adjust operating and/or capital spending, and related debt plans to meet internal financial targets and maintain leverage consistent with the current assessment. Failure to make necessary adjustments, while remaining compliant with regulatory mandates would pressure the rating.

Sources of Information

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed

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APPLICABLE CRITERIA

[U.S. Water and Sewer Rating Criteria \(pub. 03 Mar 2023\) \(including rating assumption sensitivity\)](#)

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 27 Apr 2023\) \(including rating assumption sensitivity\)](#)

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