S&P Global Ratings

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Summary:

Philadelphia; Water/Sewer

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Table Of Contents

Summary:

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Credit Profile		
US$647.61 mil wtr and wastewtr rev bnds ser 2024C due 09/01/2054		
Long Term Rating	A+/Stable	New
Philadelphia WS		
Long Term Rating	A+/Stable	Affirmed

Credit Highlights

- S&P Global Ratings assigned its 'A+' long-term rating to Philadelphia's anticipated $647.61 million series 2024C water and wastewater revenue bonds.
- At the same time, we affirmed our 'A+' long-term rating and underlying rating (SPUR) on the city's $3.2 billion in outstanding water and wastewater revenue bonds.
- The outlook is stable.

Security

Management indicates the series 2024C bond proceeds will be used for approximately $308 million of capital improvements as well as a market-dependent tender of taxable and tax-exempt bonds.

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, of which currently there is none) and certain other transfers. The city can issue additional debt if it complies with the rate covenant at the time of issuance and net revenue projections are sufficient to provide for rate covenant compliance for two fiscal years following the debt issuance. There is an additional provision for both the rate covenant and additional bonds test that requires the city to 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 Department (PWD) has historically met its 1.2x and 1.0x debt service coverage tests without reliance on the 90% test. If PWD needed to rely on the 90% test to maintain covenant compliance, 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 is underpinned by the tenured management team that has been successful in navigating the city's complex operating and capital environment. The service territory also benefits from its location in a large metropolitan center that serves as an anchor for employment throughout the region, despite facing continued affordability challenges associated with the city's above-average poverty rate. The city has comprehensive and supportive affordability programs and the city's rate board has historically supported rate increases to maintain ample capacity for PWD's operations and capital needs, which we expect will continue. Financial performance is characterized by sound liquidity and relatively narrow, albeit stable, coverage metrics (when accounting for all the utility's obligations).

Future challenges may emerge because of the large capital improvement program (CIP) and rising operating expenses, which are expected to continue given compliance requirements, inflation, and supply chain factors. Consistent with the sector, we expect labor will continue to present challenges to construction progress, operations, and overall expenditures. Management has been proactive in taking steps to retain and attract qualified professionals as well as leveraging consultants where appropriate, which we view favorably. Management has also demonstrated acumen in adjusting its procurement and inventory practices to respond to the changing operating environment.

Credit fundamentals include:

- Service area that benefits from the size and diversity of the growing employment base but faces challenges related to population declines and below-average incomes--although incomes are growing at a faster rate than the nation).
- Comprehensive operational management, which includes water and wastewater master planning (revitalization) documents as well as risk modeling, the application of new technologies to identify deficiencies, and forward-looking planning (such as the Biosolids master planning, which will be undertaken in the fall of this year). We view this as essential given the aged infrastructure and regulatory challenges faced by the system.
- Strong financial policies, which include financial forecasting (five-year plan tied to master planning documents) and prudent budgetary practices as well as policies related to debt, reserves, and investments.
- The city's ability to reprioritize its CIP as needed, with only 20% of the six-year CIP 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 unrestricted balances that generally exceed 200 days of operations and exceed $325 million, including a RSF, which should help support PWD's liquidity needs but has been somewhat depleted.
- 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:

- Rate increases for 2024 and 2025 were 9% and 8%, respectively, which was approximately 90% of the amount requested. This is projected to provide 1.25x coverage (with the use of a small portion of the RSF). The relatively narrow margin provides minimal cushion for future revenue or expense deviation, which could result in a greater need for additional unplanned use of the RSF or weakened excess revenues. The city expects to return to its 1.3x coverage target by 2026. The next rate proceeding will begin in the first quarter of 2025.

- Affordability is an ongoing challenge, given that the poverty rate is more than 20%. The city has several payment assistance options available which we view favorably. Customer support is primarily provided by the tiered assistance program (TAP), which caps the bill relative to the ratepayer's income. Participation in the program rose to 56,000 in 2024 from 16,000 in 2023, a reflection of successful efforts to identify those in need and likely a reflection of shrinking disposable income due to inflation and other factors. The city has a surcharge that provides cost recovery for this program, which is trued-up annually (versus base rates, which are filed every two years). The surcharge reconciliation is a credit positive as it allows the city to meet the needs of the most vulnerable rate payers while holding financial performance stable.
- The capital plan is sizable ($4.7 billion) and relatively complex and critical with respect to execution. Addressing aging assets, climate needs, and regulatory considerations is a substantial undertaking. There are several regulatory considerations related to achieving compliance under the separate system permits as well as meeting existing requirements with respect to effluent exceedances and biosolids land application. Deferral of capital spending could result in infrastructure underinvestment, creating additional risks of asset deficiency, climate vulnerability or regulatory fines.

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. Combined water and sewer rates are about 2.0% of local incomes (including the stormwater fee). The average monthly residential water and sewer bill is about $84, which we consider 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 highly rated 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. 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, while meeting required capital spending. While the outlook also incorporates some planned spend down 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 and that the RSF will be replenished. 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 rate increases are insufficient to meet current projections for DSC, 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 or if failure to invest in infrastructure results in a rise in asset failure or greater exposure to operating vulnerabilities.

Upside scenario

Because of the significant capital needs and sector-wide regulatory, labor and climate challenges, we do not foresee raising the rating during the outlook period. In the longer term, if the city's financial performance returns to targeted levels and management successfully executes its projects--including any required changes to treatment or land application related to PFAS--we could raise the 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 October 8, 2024)		
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 (AGM)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Philadelphia WS (BAM) (SECMKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Philadelphia WS (BAM) (SECMKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Philadelphia WS (BAM) (SECMKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed

Ratings Detail (As Of October 8, 2024) (cont.)		
Philadelphia WS (BAM) (SECMKT)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed
Philadelphia W/S (BAM)		
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.spglobal.com/ratings for further information. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.