FitchRatings

RATING ACTION COMMENTARY

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

Fri 11 Oct, 2024 - 4:28 PM ET

Fitch Ratings - New York - 11 Oct 2024: Fitch Ratings has assigned an 'A+' rating to the following Philadelphia, PA (the city) revenue bonds:

--Approximately $558.4 million water and wastewater revenue bonds, series 2024C.

The bonds are anticipated to be sold via negotiation the week of October 28th. Proceeds will be used to fund a portion of the capital improvement program, fund a deposit to the debt reserve account, refund via an invitation to tender a portion of outstanding water and wastewater revenue bonds, and pay issuance costs.

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

--Approximately $2.9 billion (pre-refunding) 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

VIEW ADDITIONAL RATING DETAILS

The 'A+' revenue bond rating and 'a+' SCP reflect the system's 'Strong' financial profile in the context of its 'Strong' revenue defensibility assessed at 'a' and a 'Very Strong' operating risk profile assessed at 'aa'. The system's leverage, measured as net adjusted debt to adjusted funds available for debt service (FADS), was moderate at 8.3x in fiscal 2023 (FYE June 30) but is projected to approach10.0x over the five-year horizon in Fitch's Analytical Stress Test (FAST) rating case, which remains consistent with the current rating.

Significant rate increases, approved by an independent rate-setting board, are needed over the forecast period to maintain and improve system assets and comply with a state consent order and agreement (COA). The operating risk profile reflects capital investment needs, expected to remain elevated due to long-term asset rehabilitation and efforts to address combined sewer overflows (CSOs) and master plan execution. Leverage may slightly increase over the next few fiscal years but should still support the 'a' financial profile assessment. However, the rating could come under pressure if recommended rate increases are delayed or capital needs continue to grow.

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

KEY RATING DRIVERS

Revenue Defensibility - 'a'

Midrange Service Area, Affordable Rates for a Significant Majority of the Population

Fitch considers the monthly residential water and sewer bill affordable for about 76% of the service area population based on standard monthly usage of 7,500 gallons for water and 6,000 gallons for sewer. The midrange service area is characterized by average income levels, moderate unemployment rate relative to the nation and midrange customer growth.

Customer growth registered a five-year compound annual growth rate of 0.3% as of fiscal 2023. Income levels are about 23% lower than the national median as of 2022. The unemployment rate has decreased to 4.0% since 2020. However, it was 17% more than the national average in 2023.

Rate Oversight and Structure: Since the establishment of the Philadelphia Water, Sewer, and Storm Water Rate Board (the rate board) in 2014, the city council no longer has direct approval and sole control over PWD's rates. The mayor appoints the rate board's five members, and the city council must approve them. Various parties can appeal the rate board's decisions. Although the process is time-consuming and typically results in lower-than-requested rate increases, the department indicates the process is collegial. The fiscal 2024 and 2025 rate determinations of 7.85% and 8.14%, respectively, are the largest approved increases to date.

Operating Risk - 'aa'

Very Low Operating Cost Burden, Elevated Investment Needs, Supported by Adequate Capital Investment

In fiscal 2023, the system's operating cost burden was considered very low at $2,805 per million gallons (mg), consistent with the operating risk assessment. The life cycle ratio is elevated at 48% in fiscal 2023. Capex to depreciation has been robust averaging 205% over the last five fiscal years from 2019 to 2023. Planned capital spending for the next five years should generally outpace historical depreciation, resulting in a stable to improving life cycle ratio.

The city prepares a six-year capital improvement plan (CIP), with fiscal 2025 through 2030 budgeted spending of $4.8 billion. System reinvestment remains the focus. Water Revitalization Plan (WRP) projects total about $801 million, with another $1.2 billion for water treatment and supply facilities. COA spending is about $1.3 billion or approximately 28% of the total plan. Funding is about 89% debt financed with the remainder pay-go. 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.

Financial Profile - 'a'

Leverage to Increase: The system had moderate leverage of 8.3x as of fiscal 2023, slightly below the 8.7x average of the prior four fiscal years. The liquidity profile is neutral to the overall assessment with current days cash on hand of 133 and coverage of full obligations (COFO) of 1.6x. Fitch-calculated total debt service coverage was 1.9x in fiscal 2023.

The FAST considers the potential trend of key ratios in a base case and stress scenario over a five-year period. The stress scenario is designed to impose capital costs 10% above expected base case levels and evaluate potential variability in projected key ratios. The FAST reflects Fitch's view of a reasonable scenario, which is generally informed by publicly available and/or management provided information with respect to capital expenditures, user charges and rate of revenue and expenditure growth.

In the base case scenario, the leverage ratio is expected to increase to 9.0x through fiscal 2028. In the stress scenario, which is considered the rating case, the leverage ratio is projected to increase to 9.7x over the next five years. The liquidity profile is expected to remain neutral to the assessment over the five-year horizon.

The leverage trend depends on substantial rate increases that increase FADS. If necessary approvals for projected rate increases are not obtained, Fitch expects PWD to adjust operating 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 complying with regulatory mandates would pressure the rating.

Asymmetric Additional Risk Considerations

No asymmetric additive risk considerations affected this rating determination.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Leverage sustained above 10.0x in Fitch's rating case scenario, 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.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Leverage sustained below 8.0x in Fitch's rating case scenario, provided maintenance of current revenue defensibility and operating risk assessments;

--Improvement in the revenue defensibility assessment driven by an improved assessment of service area characteristics.

PROFILE

PWD provides potable water to all of the approximately 1.6 million residents of the city and 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, and 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). Ample water supply is provided by the Delaware and Schuylkill rivers with average daily water demand comfortably below permitted levels. Water consumption typically equals about one-half of the city's capacity and nearly one-third the combined withdrawal (680 mgd) permitted from both water supply sources.

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. PWD anticipates increasing peak capacity by 50 mgd at its Southwest water pollution control plant, currently planned for 2031.

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 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 related entity, the issue rating could become constrained by a material decline in the general credit quality of the city.

Updated U. S. Environmental Protection Agency (EPA) Regulations

The city is addressing new regulations set forth by the EPA. The EPA's enhanced focus on lead and copper lines and per-and-polyfluoroalkyl (PFAS) contaminants has led to the finalized Lead and Copper Rule Improvements (LCRI) along with specific testing requirements for PFAS.

Regarding the LCRI revisions, a complete inventory should be filed by the October 2024 deadline. No utility lead service lines have been identified, but the city continues to replace any residential lines uncovered during water main replacements. Based on PFAS sampling results, certain compounds have registered above the regulated maximum contaminant levels at two of the three water treatment plants. Pilot testing of powdered activated carbon is underway.

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 by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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APPLICABLE CRITERIA

U.S. Public Sector, Revenue-Supported Entities Rating Criteria (pub. 12 Jan 2024) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub. 29 Feb 2024) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

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