RESPONSE TO

PUBLIC ADVOCATE’S INTERROGATORIES

AND

REQUESTS FOR PRODUCTION OF DOCUMENTS

QUESTIONS 1-8

Dated: April 2025

PA-XII-1. REFER TO PAGE 3, LINE 13 OF PWD STATEMENT 2B. THE PANEL STATES THAT: “THE CURRENT CREDIT RATINGS ARE TIED TO PWD EITHER ACHIEVING OR MAKING INCREMENTAL PROGRESS TOWARD ACHIEVING REASONABLE FINANCIAL GOALS OR TARGETS.” PLEASE IDENTIFY THE SPECIFIC FINANCIAL GOALS OR TARGETS PWD ACHIEVED THAT MAY HAVE CONTRIBUTED TO ITS CURRENT CREDIT RATINGS.

RESPONSE:

The recent rating reports contained in PWD Statement 2A: Direct Testimony and Schedules of the Financial Panel provide specific references to financial targets relevant to the resulting ratings.

As stated in the Moody’s ratings report of October 11, 2024 appended to PWD Statement 2A: Direct Testimony and Schedules of the Financial Panel, “The department’s consistently solid financial performance will continue because of the department’s commitment to hitting its coverage target while maintaining a decent amount of cash in its rate stabilization fund”; “Coverage is likely to remain in this [current] range because the department's rate covenant requires it to generate sufficient net revenue to cover O&M, debt service, and a capital account deposit of at least 1% of net property, plant and equipment. That capital account deposit requirement, which requires at least some surplus funds be generated each year, combined with conservative budgeting will assure coverage of well more than 1x, though coverage is unlikely to rise much above current levels because of the department's rate-setting process”; “The Philadelphia Water Department holds good liquidity, although many rated municipal utilities hold significantly more.”

As stated in the S&P Global Ratings report of October 8, 2024 as contained in PWD Statement 2A: Direct Testimony and Schedules of the Financial Panel, “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.

As stated in the Fitch Ratings report of October 11, 2024 as contained in PWD Statement 2A: Direct Testimony and Schedules of the Financial Panel, "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 approach 10.0x over the five-year horizon in Fitch's Analytical Stress Test (FAST) rating case, which remains consistent with the current rating."

RESPONSE PROVIDED BY: Acacia Financial Group, Inc. and PFM Financial Advisors LLC

PA-XII-2. IN FOOTNOTE 1 ON PAGE 3, IT STATES "PLEASE NOTE THAT FINANCIAL METRICS SHOULD NOT BE STATIC. IN A FUTURE PROCEEDING, THE DEPARTMENT SHOULD CONSIDER IF THE METRICS FIRST ACKNOWLEDGED IN THE 2018 RATE DETERMINATION SHOULD BE CHANGED TO STAY IN ALIGNMENT WITH THE EXPECTATIONS OF THE RATING AGENCIES, INDUSTRY NORMS, BEST PRACTICES, AND MARKET CONDITIONS." DOES THE PANEL AGREE THAT THE METRICS FROM THE 2018 RATE DETERMINATION ARE WITHIN THE EXPECTATIONS OF THE RATING AGENCIES? IF NO, PLEASE EXPLAIN YOUR RESPONSE.

RESPONSE:

The panel presumes that the "metrics from the 2018 Rate Determination" referenced above pertain to the Rate Board's approval of the following targeted metrics: (i) debt service coverage ratio target of 1.30x; (ii) "pay-go" capital funding percentage target of 20%; and (iii) combined target level of $150 million for the rate stabilization fund and the residual fund.

Rating agencies generally maintain broader expectations, using a score card approach to evaluate enterprise and financial risk profiles (e.g., utility's management team, operation performance, compliance with legal requirements, system's current condition, the endeavor to maintain a state of good working order, active collection of accounts receivables, and other financial metrics etc.) regarding the conduct of a water/sewer utility. However, rating agencies are neither determiners of policy nor 'sounding boards 'for potential policy actions. Policy is set by issuers and subsequently evaluated by the rating agencies. While rating agencies provide statements that prospective actions or policies are likely to have directional implications for a credit rating, any expectations they hold are implicitly caveated by the understanding that the rating agencies 'appraisal of the credit rating is a reaction to the actions of the issuer. Rating agencies provide an independent opinion of the credit worthiness of an issuer or a particular bond issue.

The panel agrees that the rating agencies are fully aware of the Rate Board's targeted metrics from the 2018 Rate Determination and incorporate same in the full consideration of their ratings.

RESPONSE PROVIDED BY: Acacia Financial Group, Inc. and PFM Financial Advisors LLC.

PA-XII-3. REFER TO PAGE 3, LINE 22 OF PWD STATEMENT 2B. THE PANEL STATES THAT PWD'S FINANCIAL METRICS ARE, IN GENERAL, SIGNIFICANTLY BELOW ITS PEER MEDIAN METRICS. DOES THE PANEL AGREE THAT SOME OF PWD'S PEER UTILITIES RATES ARE NOT REGULATED BY INDEPENDENT RATE-SETTING BOARDS?

RESPONSE:

Yes.

RESPONSE PROVIDED BY: Acacia Financial Group, Inc. and PFM Financial Advisors LLC.

PA-XII-4. REFER TO PAGE 4, BEGINNING AT LINE 10 OF PWD STATEMENT 2B. THE PANEL QUOTES AN S&P STATEMENT THAT ITS RATING COULD BE LOWERED IF RATE INCREASES ARE INSUFFICIENT TO MEET CURRENT DEBT SERVICE COVERAGE PROJECTIONS. DID S&P PREPARE ITS OWN INDEPENDENT COST OF SERVICE ON WHICH IT CALCULATED ITS DEBT SERVICE COVERAGE AND TO WHICH IT IS REFERRING? IF YES, PLEASE PROVIDE A COPY OF THE ANALYSIS.

RESPONSE:

The panel is not aware of whether S&P prepared its own independent cost of service study in the preparation of its ratings report.

RESPONSE PROVIDED BY: Acacia Financial Group, Inc. and PFM Financial Advisors LLC.

PA-XII-5. REFER TO PAGE 6, BEGINNING AT LINE 21 OF PWD STATEMENT 2B. PLEASE PROVIDE ANY STUDIES, ANALYSES OR EMPIRICAL EVIDENCE TO SUPPORT THE STATEMENT: "THE EFFECT OF A LOWER THAN REQUESTED RATE INCREASE IN A PARTICULAR YEAR NECESSITATES MARGINALLY HIGHER RATE INCREASES IN FUTURE YEARS TO RECOVER THE LOST REVENUE IN THE FIRST YEAR AS WELL AS THE LOST REVENUE FROM THE DEFERRED RATE INCREASE IN EACH SUBSEQUENT YEAR."

RESPONSE:

Empirically, any marginal rate increase that is not implemented in a particular year will result in reduced revenue recovered for that year as well as each subsequent year attributable to said non-implemented rate increase. Mathematically, this means that a marginal rate increase that is deferred or not implemented in a particular year yields less revenue in that year and in every subsequent year. Consequently, in order to achieve, in subsequent years, the stated targets for debt service coverage amounts, pay-go funding percentages and liquidity reserves, additional marginal rate increases will be mathematically necessary above what would have been required if the marginal rate increase was implemented in the initial year.

RESPONSE PROVIDED BY: Acacia Financial Group, Inc. and PFM Financial Advisors LLC.

PA-XII-6. REFER TO PAGE 5, BEGINNING AT LINE 10 TO PAGE 6, LINE 13 OF PWD STATEMENT 2B.

A. IS IT THE PANEL'S BELIEF OR OPINION THAT THE RATE BOARD IS EXPECTED TO SET RATES THAT GUARANTEE THAT PWD WILL ACHIEVE THE FINANCIAL METRICS?

B. DOES THE PANEL BELIEVE THAT COST CONTROL AND OPERATIONAL EFFICIENCY ARE AN ESSENTIAL COMPONENT OF PWD'S ABILITY TO ACHIEVE ITS FINANCIAL METRICS.

RESPONSE:

A. The panel presumes that the "financial metrics" stated above refer the following Rate Board approved targets from the Rate Board's 2018 Rate Determination: (i) debt service coverage ratio of 1.30x; (ii) "pay-go" capital funding percentage of 20%; and (iii) combined target level of $150 million for the rate stabilization fund and the residual fund.

The panel believes, consistent with the City of Philadelphia Rate Board Ordinance, that the Rate Board is expected to set rates such that "the rates and charges shall yield to the City at least an amount equal to operating expenses and debt service, on all obligations of the City in respect of the water, sewer, storm water systems and, in respect of water, [and] sewer and storm water revenue obligations of the City, such additional amounts as shall be required to comply with any rate covenant and sinking fund reserve requirements approved by ordinance of Council in connection with the authorization or issuance of water [and], sewer and storm water revenue bonds, and proportionate charges for all services performed for the Water Department by all officers, departments, boards or commissions of the City" and further "The rates and charges shall yield not more than the total appropriation from the Water Fund to the Water Department and to all other departments, boards or commissions, plus a reasonable sum to cover unforeseeable or unusual expenses, reasonably anticipated cost increases or diminutions in expected revenue, less the cost of supplying water to City facilities and fire systems and, in addition, such amounts as, together with additional amounts charged in respect of the City's sewer system, shall be required to comply with any rate covenant and sinking fund reserve requirements approved by ordinance of Council in connection with the authorization or issuance of water and sewer revenue bonds. Such rates and charges may provide for sufficient revenue to stabilize them over a reasonable number of years."

The panel believes that financial metrics approved by the Rate Board in the 2018 Rate Determination are reasonable and appropriate minimum financial metrics to target. Therefore, the panel believes that the setting of rates in conformance with the Rate Board Ordinance and as such to achieve the financial metrics recommended by the Rate Board in the 2018 Rate Determination is appropriate.

B. Yes.

RESPONSE PROVIDED BY: Acacia Financial Group, Inc. and PFM Financial Advisors LLC.

PA-XII-7. REFER TO THE MEMORANDUM ATTACHED TO PWD STATEMENT 2B AT PAGE 3. PLEASE PROVIDE THE SOURCE DOCUMENT SUPPORTING THE 2.3 DSC AND 511 DAYS CASH ON HAND.

RESPONSE:

See attached Moody's Ratings, Water and Sewer Utilities Sector Profile circa October 2024.

RESPONSE PROVIDED BY: Acacia Financial Group, Inc. and PFM Financial Advisors LLC.

PA-XII-8. PLEASE PROVIDE ALL CRITERIA USED TO SELECT PWD'S PEER UTILITIES AS DISCUSSED IN THE MEMORANDUM ATTACHED TO PWD STATEMENT 2B AT PAGE 6.

RESPONSE:

Peer utilities were selected from the mid-Atlantic and midwestern region for public utilities of similar size with service areas with industrial urban centers.

RESPONSE PROVIDED BY: Acacia Financial Group, Inc. and PFM Financial Advisors LLC.