STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

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Summary:

Capital Region Water, Pennsylvania; Water/Sewer

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Table Of Contents

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Credit Profile		
US$69.42 mil wtr rev rfdg bnds ser 2008 dtd 08/15/2008 due 07/15/2028		
Long Term Rating	A+/Stable	New
US$52.41 mil wtr rev rfdg bnds ser 2016A dtd 04/07/2016 due 07/01/2029		
Long Term Rating	A+/Stable	New
US$1.72 mil federally taxable wtr rev rfdg bnds ser 2016B dtd 04/07/2016 due 07/15/2017		
Long Term Rating	A+/Stable	New

Rationale

Standard & Poor's Ratings Services assigned its 'A+' rating and stable outlook to Capital Region Water, Pa.'s series 2016A and taxable series 2016B water revenue refunding bonds. At the issuer's request, we also assigned an 'A+' rating and stable outlook to CRW's series 2008 water revenue refunding bonds.

The rating is based on our opinion of CRW's water segment's general creditworthiness, reflecting an enterprise risk profile that we view as very strong and a strong financial risk profile.

Factors for which we are basing the enterprise risk profile include:

- The strong service area economy of the Harrisburg metropolitan statistical area (MSA), one that we view as broad and diverse and stabilized by the city's role as the state capital;
- Rates that remain relatively affordable despite a series of recent adjustments; and
- An operational management assessment of 'good', supported by an ample raw-water supply and treatment capacity.

Factors that we believe reflect the system's financial risk profile include:

- A closed flow of funds. The water system does not make transfers to support the city's general government or any other fund, including any legacy enterprises associated with the former Harrisburg Authority's incinerator project;
- Adequate projected annual debt service coverage (DSC) that we believe will trend toward a solid all-in coverage level of 1.4x, and
- No additional debt plans. However, the new management and governance structure includes an experienced team that is actively engaged in asset management, and executing a comprehensive analysis of the system to identify and prioritize future capital improvements.

The bonds are secured by a first-lien pledge on the receipts and revenues of CRW's water system. The proceeds of the series 2016A bonds will be used to refund the water system's series 2002A, 2002B, and 2004 bonds. The taxable series 2016B bonds will be used to refund the system's series 2002C and a portion of the series 2008 bonds. We understand that this will also take out a direct purchase arrangement with a financial institution, an agreement that had otherwise exposed the water system to acceleration. A debt service reserve funded with bond proceeds in the amount of the lesser of maximum annual debt service (MADS), 125% of average annual debt service or 10% of par-—as established in the supplemental resolution--provides additional liquidity. The legal provisions established in the original indenture and supplements are, in our opinion, generally credit neutral, save for a rate covenant that allows up to 20 basis points of the 1.2x coverage requirement to be satisfied with transfers in from the rate stabilization fund (RSF), although the RSF has no specific minimum balance requirements. The modernization of the master indenture also includes the elimination of the renewal and replacement fund. After the 2016 transaction is completed, the 2016 bonds, the unrefunded 2008 bonds, and an existing state loan will be on parity with one another. Additional parity bonds are permitted so long as DSC is at least 1.1x MADS, although once springing provisions are triggered, the coverage test will be based on a 1.2x (historical) or 1.25x (projected) coverage test; the springing covenants go into effect with the assent of the bondholders of two-thirds of the then-outstanding debt.

The flow of funds is closed, meaning no transfers out of surplus net revenues are permitted, and administrative fees paid to the city--once as high as $5.6 million--ceased in 2014. We view this as a credit positive given the recent history of the city being under state-directed receivership from 2011 to 2014, stemming in large part from a failed project to make pollution control and other improvements to the city's waste-to-energy facility. The project ultimately went over budget before finally being abandoned. Between that and investments in other nontraditional business lines, the city by 2010 began missing bond payments. Because there is not currently statutory authority for municipals and local governments in Pennsylvania to file for bankruptcy, the governor ultimately declared the state of fiscal emergency that led to Harrisburg's receivership.

CRW, rebranded in 2014 from what used to be known as the Harrisburg Authority, is the municipal authority that provides water, sanitary sewer, and drainage services to the city of Harrisburg as well as the surrounding area. In November 2013, as part of the emergence from state-mandated receivership, the city transferred operations and assets to CRW for each of those three utility divisions. Prior to 2013, the city operated the water system. Since fiscal 2014, CRW also does all billing and collections, and is no longer viewed as a component unit of the city.

Enterprise risk profile

CRW serves a modest-sized customer base of 21,000 retail metered water accounts throughout the city and in parts of Dauphin County. The city and MSA, in its role as the commonwealth's capital, is stabilized by both state and federal departments which combine to employ over 25,000. Other major employers in the region include Highmark Blue Shield (5,600 employees), Hershey Food Corp. (5,000) and the conglomerate Tyco Corp. (5,000). While governmental employment levels suffered as federal and state budgets shrank, the region also serves as a growing health care center that has offset some of the job losses in the past decade. This has helped keep stable the unemployment rate that as of January 2016 was 4.5%. The median household effective buying income (MHHEBI) for Dauphin County is 104% that of the U.S., much higher than that of the city itself.

Under the new governance and management structure, both base and volumetric rates have increased in each of fiscal 2014, 2015, and 2016. We understand the pro forma financial projections have also outlined recommendations for further rate adjustments each year through the remainder of the decade. Therefore, we believe the single-family residential bill of $53.50, based on Standard & Poor's universal assumption of 6,000 gallons of service, will be pressured over time. However, it is still a modest 1.4% of MHHEBI, affording CRW reasonable rate-raising flexibility.

Based on our Operational Management Assessment (OMA), we view Capital Region Water to be a '3' on a scale of 1-6, with '1' being the strongest. This indicates, in our view, that operational and organizational goals are generally well-aligned, even if some challenges exist. The OMA of "good" includes a secure long-term water supply by way of a CRW-owned-and-operated dam and reservoir on the Susquehanna River that, combined with existing treatment facilities, provides the system with more than twice its peak day demand requirements. We also note that nonrevenue water and distribution system rehabilitation and replacements will be the main focus of the capital improvement program in the coming years.

Financial risk profile

The water system's financial risk profile is an area of strength, with only minimal qualifications. The current management team has been very aggressive in ensuring that asset management and preventive maintenance are the focus of the capital improvement program. Therefore, the current five-year capital improvement plan (CIP) through 2020 has identified about $23.7 million in capital commitments, a number that has been verified by an external consulting engineer that provides annual updates to the general system condition and the financial forecast. However, given the efforts to update the composition and priority of projects in the CIP, it is our view that the goal of funding most of the investments with internally generated funds save for a recent PENNVEST loan could change over time. Specifically, the total CIP and use of debt could increase over time, depending on the results of ongoing studies. However, we have assumed that future financial results would generally be similar to recent historical performance, trending toward all-in DSC of between 1.3x and 1.4x with at most very infrequent use of the rate stabilization fund, and total working capital equivalent to nearly one year of operating expenses. We are also assuming that while use of the RSF is permitted toward satisfying the minimum covenanted financial performance, CRW will not be overly reliant on such reserves and that cash from operations will by itself be strong enough. Predictable financial performance is also made all the more likely by the 2016 transaction, which in addition to substantial savings will also be structured to create very level debt service over the next 25 years.

A Financial Management Assessment (FMA) of "standard" indicates that CRW's finance department maintains adequate policies in most, but not all, key areas. These policies often lack formal detail and institutionalization, and may not include best practices. For example, management has a liquidity policy of maintaining cash reserves equal to at least 140 days of operating expenses, a five-year financial forecast, and long-term capital improvement plan, but does not have formal policies for debt management or investments and cash management beyond the permitted investments guidelines outlined in CRW's governing documents. CRW, in our opinion, also gets high marks for its transparency and accountability sub-factor score, given that its continuing disclosure is enhanced by an investor relations web site that includes consulting engineer reports, rate studies, and other financial documents.

Outlook

The stable outlook reflects our expectation that planned rate increases will aid the new management team's focus on system reinvestments and overall financial consistency. While we understand CRW will fund the CIP with cash on hand, we have stressed the financial position by assuming that some additional debt may yet be needed, even if beyond the current five-year CIP. We expect that liquidity will remain at levels we view as strong. We do not expect to change the rating in the next two years.

Upside scenario

While not anticipated, additional upward rating movement could occur should there be an improvement in the economic fundamentals of the MSA--specifically the MHHEBI of the city itself--or sustained stronger all-in coverage metrics over time.

Downside scenario

We currently view the water system's liquidity and reserves as an area of strength. Total working capital, including other designated reserves, affords management some ability to use cash on hand towards what is now a primarily pay-as-you-go CIP, which we have incorporated into our assumptions. Therefore, financial results that indicate underperformance relative to projections projections or a precipitous drop in total reserves would likely cause downward pressure on the rating.

Related Criteria And Research

Related Criteria

- USPF Criteria: Rating Methodology And Assumptions For U.S. Municipal Waterworks And Sanitary Sewer Utility Revenue Bonds, Jan. 19, 2016
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Jan. 11, 2016