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Ratings

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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$47.5 mil swr sys rev bnds ser 2017 dtd 03/23/2017 due 07/15/2047		
Long Term Rating	A+/Stable	New

Rationale

S&P Global Ratings assigned its 'A+' long-term rating to Capital Region Water (CRW), Pa.'s 2017 sewer system revenue bonds. The rating reflects, in our opinion, the combination of a very strong enterprise risk profile and a strong financial risk profile. The outlook is stable.

The enterprise risk profile reflects our view of the system's:

- 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;
- Very low industry risk as a monopolistic service provider of an essential public utility;
- Rates that remain relatively affordable despite a series of recent adjustments; and,
- An operational management assessment (OMA) of "good" and significant ongoing capital investment.

The financial risk profile reflects our view of the system's:

- Exceptionally strong liquidity, with nearly $18 million or 728 days' available reserves at the end of fiscal 2015;
- Very strong debt service coverage in recent years, but increasing annual debt service and additional debt plans; and
- Good financial management practices and policies.

The 2017 bonds are being issued to refund CRW's 2014 sewer revenue bonds, pay for capital expenditures with respect to its sewer system, fund a debt service reserve (DSR) fund, and pay the costs of issuance. After the issuance of series 2017 bonds, the total bonds outstanding will be approximately $68.3 million, including parity PENNVEST notes.

The bonds have a pledge of the net revenues of CRW's sewer system; they are not supported by water system revenues. There is a rate covenant of 1.20x annual debt service including transfers from the rate stabilization fund, or 1.0x coverage without such transfers. There are a number of additional bonds tests, including a look-back provision of 1.20x maximum annual debt service (MADS) in 12 of the 18 preceding months, and a projected provision of 1.25x MADS. The bonds will have a DSR funded to a three-pronged test.

Enterprise risk

CRW serves a modest-sized customer base of retail sewer customers throughout the city as well as wholesale service to six suburban communities. The city and MSA, in its role as the commonwealth's capital, is stabilized by both state and federal employment, which alone 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 last decade. This has helped stabilize 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 regularly. We understand the pro forma financial projections have also outlined recommendations for significant rate adjustments for each of the next three years. Therefore, we believe the single-family residential bill of $36.30 for sewer, when combined with water rates ($96.05 combined), based on S&P Global Ratings' universal assumption of 6,000 gallons of service, will be pressured over time. However, it is still a modest 2.5% of MHHEBI, affording CRW reasonable rate-raising flexibility.

Based on our OMA, we view CRW 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 advanced wastewater treatment facility (AWTF) is a 45-million gallon per day (mgd) secondary treatment plant that is the largest in Pennsylvania that discharges into the Chesapeake watershed. In August 2015, CRW entered into a partial consent decree with the Department of Justice, the U.S. Environmental Protection Agency, and the commonwealth Department of Environmental Protection concerning the operation of its collection system, pump stations, and the AWTF; this is helping generate an aggressive capital plan for the sewer system.

Consistent with "Methodology: Industry Risk" (published Nov. 19, 2013, on RatingsDirect), we consider industry risk for the system to be very low, the most favorable assessment possible on a '1' to '6' scale, with '1' being the best.

Financial risk

Our assessment of the system's financial risk profile as strong reflects the exceptionally strong financial metrics reported in recent years, but the significant changes in those metrics anticipated as the system increases leverage and uses some of its cash to implement its capital plan. Debt service is likely to increase significantly. From less than $743,000 in 2015, annual debt service is projected to rise to $7.4 million in 2019-2021; the debt-to-capitalization ration is expected to increase from 43% to 61% over the same period. This has a significant effect on all-in coverage, although based on our review of management projections, we expect coverage metrics to be consistent with levels S&P Global Ratings views as strong. CRW has fully funded its pension liabilities since its establishment and has $741,000 unfunded liability for other postemployment benefits associated with employees who transferred from the city.

Liquidity is a strength for the system, with nearly $18 million in available reserves at the end of fiscal 2015, or 728 days' cash on hand. The system also had an additional $3.7 million in the renewal, replacement, and redemption fund. We expect management to draw down some of these available reserves in the coming years to cash-fund approximately 30% of the 2017-2021 capital plan; however, we expect management to continue to exceed the target of 180 days' cash on hand in the two-year horizon.

Management assumptions for future revenue and expenses seem reasonable and consistent with recent experience, although some assumptions are simpler than those used by the highest-rated systems. Likewise, financial planning and management are sufficient for system needs, although some policies are informal. Financial reporting and disclosure are excellent.

Outlook

We do not expect to change the rating in the next two years due to the stresses of managing over $60 million in capital investment, and the 2017 rate study recommendation to increase sewer rates by 10% or more annually during that period.

Upside scenario

If financial results stabilize at levels consistent with a higher rating, we would consider raising the rating.

Downside scenario

If financial results are significantly lower than current projections, or if the system uses available reserves to meet any of the requirements under its indenture, we would consider lowering the rating.