S&P Global Ratings

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Summary:

Capital Region Water, Pennsylvania; Water/Sewer

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Summary:

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Credit Profile		
US$62.24 mil wtr rev bnds ser 2018 due 07/15/2038		
Long Term Rating	A+/Stable	New
Capital Region Water federally taxable wtr rev rfdg bnds		
Long Term Rating	A+/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'A+' rating to Capital Region Water (CRW), Pa.'s series 2018 water revenue bonds. At the same time, we affirmed our 'A+' rating on the issuer's outstanding parity 2016 and 2008 water revenue bonds. The rating reflects our opinion of CRW's very strong enterprise risk profile and strong financial risk profile. The outlook is stable.

Our assessment of the very strong enterprise risk profile reflects:

- The strong service area economy of the Harrisburg metropolitan statistical area (MSA), which we consider broad and diverse and is 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 (OMA) of "good," supported by an ample raw-water supply and treatment capacity.

Our assessment of the strong financial risk profile reflects:

- Strong historical and projected annual all-in coverage, ranging from 1.2x to 1.5x in the last three years, which we believe is sustainable;
- Liquidity that has strengthened for four straight years, to $16.2 million in available reserves at the end of fiscal 2016, which represents 800 days' cash on hand;
- Very high system leverage with a debt-to-capitalization ratio of almost 120% following the 2018 issuance, but with modest additional debt plans for the next five years; and
- A financial management assessment (FMA) of "good," supported by proactive capital and financial planning and management efforts to strengthen financial policies.

The bonds are secured by a first-lien pledge on the receipts and revenues of CRW's water system. The proceeds of the series 2018 bonds will be used to refund the water system's outstanding series 2008 bonds, make capital improvements, make a deposit to the debt service reserve (DSR) fund, and pay the costs of issuance. It is our understanding that following the 2018 issuance, a springing clause in the 2016 bond covenant will be triggered and all outstanding water revenue debt will be at parity. A common DSR, a portion of which will be 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 provides additional liquidity. Under the rate covenant, up to 20 basis points of the 1.2x coverage requirement can be satisfied with transfers in from the rate stabilization fund (RSF), although the RSF has no specific minimum balance requirements. Once the springing provisions are triggered, the coverage test will be based on a 1.2x MADS (historical) or 1.25x MADS (projected) coverage test; the springing covenants go into effect with the issuance of the series 2018 bonds. The legal provisions established in the original indenture and supplements are, in our opinion, generally credit neutral.

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. Harrisburg and the surrounding 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). Unemployment in the county in February 2018 was 4.7%, slightly higher than the national rate of 4.4%. The median household effective buying income (MHHEBI) for Dauphin County is 102% that of the national average; however, income levels in Harrisburg (where 83% of accounts are located) are only 68% of the national average at less than $32,000.

Under the new governance and management structure, both base and volumetric rates have increased every year. We understand the pro forma financial projections have also outlined recommendations for further rate adjustments each year through fiscal 2021. The monthly bill of $50 for 4,500 gallons of water service, which management reported was average household consumption, represents 1.7% of service area MHHEBI. We believe this affords management considerable rate-setting flexibility, although affordability may be pressured over time depending on the size of future rate increases.

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 OMA of "good" includes a secure long-term water supply by way of the CRW-owned-and-operated Dehart Dam and reservoir as well as back-up source capacity from the Susquehanna River that, combined with existing treatment facilities, provides the system with more than twice its peak day demand requirements. Nonrevenue water and distribution system rehabilitation and replacements have been the main focus of the capital improvement program (CIP) in recent years, and there has been significant progress, although there is still more to be made. In the next five years, repairs to the Dehart Dam and spillway represent the bulk of the CIP; the initial study was completed in 2017 and a comprehensive geotechnical evaluation is underway.

Financial risk profile

Management has worked in recent years to strengthen the financial risk profile of CRW. All-in coverage has been consistent for the last five years, ranging from 1.2x in 2015 to 1.5x in 2016 and 2017 (based on unaudited results). Based on the current rate plan and our review of management forecasts, we expect coverage to remain near 1.5x, although further rate increases will be needed due to rising debt service associated with the 2018 issuance and an anticipated 2018 Pennvest loan. The authority has built liquidity, which increased from less than $5 million in 2013 to over $16 million at the end of fiscal 2016, representing 800 days' cash. Management plans to spend approximately $5 million annually on capital investment projects; at this level of spending, we believe this level of liquidity should be sustainable. 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.

The system is highly leveraged, which we anticipate will continue for the foreseeable future. With nearly $130 million in outstanding debt at the end of fiscal 2016, the debt-to-capitalization ratio is well over 100%. Management also anticipates modest additional borrowing in the next few years, with a 2018 Pennvest loan planned, as well as approximately $20 million in additional revenue bonds split between 2020 and 2022. The five-year CIP is almost $50 million, largely due to $30 million in planned renovations to the Dehart Dam.

A FMA of "good" indicates that CRW's finance department maintains adequate policies in most key areas but may lack formal detail and institutionalization, and may not include best practices. For example, management has a liquidity policy of maintaining operating cash reserves equal to at least 140 days of operating expenses in addition to the 60 days required under the indenture and has targeted and achieved debt service coverage of at least 1.35x for the last two years. Management also uses a five-year financial forecast, which includes the financing costs of the CIP and helps inform the rate-setting process. 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 website that includes consulting engineer reports, rate studies, and other financial documents.

Outlook

The stable outlook reflects our expectation that planned rate increases will allow management to continue to achieve strong coverage and liquidity metrics as it works through its CIP. We do not expect to change the rating in the next two years due to the significant capital work that remains, as well as the stable but modest service area economy.

Upside scenario

Upward rating movement could occur should there be an improvement in the economic fundamentals of the service area, or if management is able to establish a consistent pattern of stronger financial metrics as it progresses through its CIP.

Downside scenario

We currently view the water system's liquidity and reserves as an area of strength. Therefore, financial results that indicate underperformance relative to projections or a precipitous drop in total reserves would likely cause downward pressure on the rating. Alternately, if the geotechnical investigation of the dam reveals greater capital needs that require significantly more debt than is currently forecast, we could lower the rating.

Ratings Detail (As Of April 13, 2018)		
Capital Region Water wtr rev rfdg bnds		
Long Term Rating	A+/Stable	Affirmed
Capital Region Water wtr (BAM)		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.