Credit Impacts of Inflationary Cost Increases

Presented by:
Eric Brown, Director

December 7, 2022

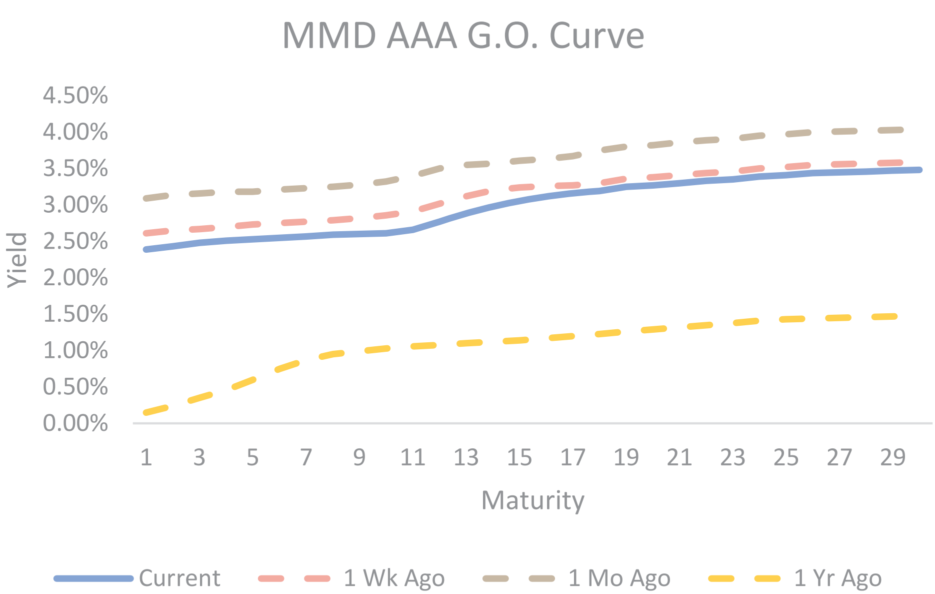
PFM Financial Advisors LLC

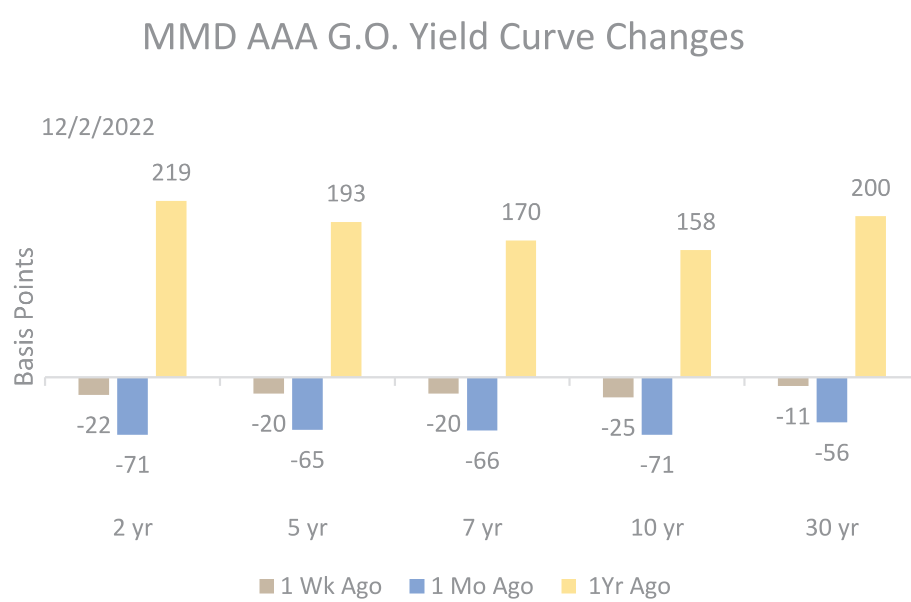
4350 N. Fairfax Drive
Suite 590
Arlington, VA 22203

703.741.0175
pfm.com

Inflation Behind Soaring Interest Rates and Financing Costs

- Inflation being experienced by municipal utilities across the nation is impacting expenditures in operating, capital, and financing areas
- Interest rates have dramatically increased over the calendar year, reflecting (in large part) actions taken by the Federal Reserve in response to elevated measures of inflation and labor market, and market expectations for future actions
  - Federal Reserve put in place exceptionally accommodative monetary policy in early stages of COVID-19 pandemic to support financial markets and strengthen US economy
  - Fed seeks to dampen inflation without triggering recession by increasing the cost of money and constraining consumer spending and business activity





Cost Increases Are Driving Increased Rating Agency Scrutiny

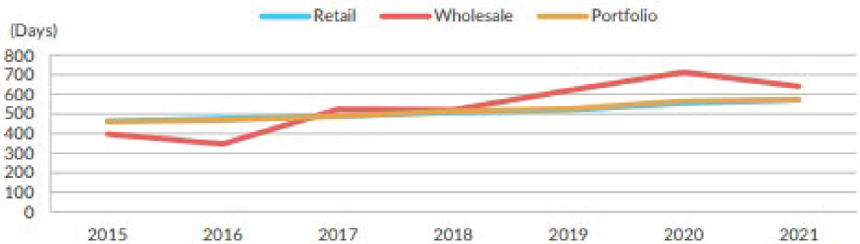
- Rating agencies are focused on these increased costs (operating, capital and financing) for water and sewer utilities and seek to identify utilities with ratings that are vulnerable to these cost pressures
- Increased operating, capital, and financing costs can create rating vulnerability where they substantially weaken financial metrics and commensurate rate adjustments cannot or will not be implemented
  - Willingness and ability to raise rates to maintain appropriate financial metrics is perhaps the most critical factor in credit rating analysis for not-for-profit utilities, which generally have autonomous ratemaking authority
  - High inflation and resultant reduced affordability can create resistance to rate increases that are necessary to recover higher operating, capital, and financing costs, potentially eroding debt service coverage and liquidity
  - Rating agencies closely watch opposition to rate increases needed to address rising costs, as these barriers can erode financial performance in a way that accelerates over time
- Over longer term, inflation that drives rate increases that outpace wage growth can aggravate affordability, which could adversely influence credit ratings even if rate increases are implemented to shore up credit metrics
- Vulnerabilities can additionally present themselves in several ways:
  - Deferral of critical projects rather than paying materially higher costs can be a particular risk for issuers with pressing needs to replace or repair critical infrastructure
  - Issuance of additional debt and draws on reserves will reduce flexibility to respond to revenue shortfalls and unanticipated needs in the future

Sources: Moody's Investors Service: "Inflation increases construction costs, threatens to delay or downsize infrastructure projects", August 17, 2022. S&P Global Ratings: "Inflation Could Weigh On U.S. Not-For-Profit Utilities' Credit Ratings", February 24, 2022. S&P Global Ratings: "Construction Cost Inflation Weighs On U.S. Public Infrastructure Investment", April 14, 2022. Fitch Ratings: "Inflation, Rate Rises and Stagflation Risks Drive Deterioration in Sector Outlooks", June 21, 2022. S&P Global Ratings: "U.S. Public Power Rates Can Withstand Inflation, Rising Commodity Prices, And Higher Borrowing Costs--For Now", September 7, 2022.

Effective Financial Planning Requires Understanding of Inflationary Impacts

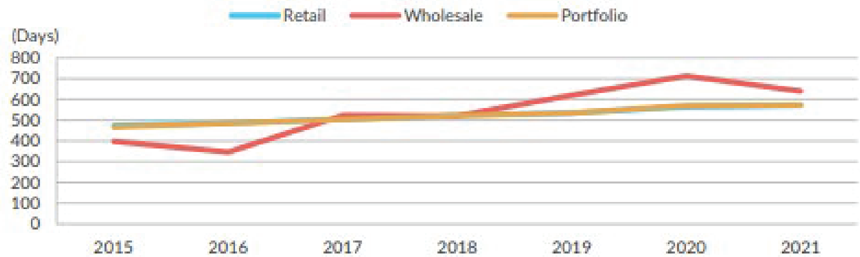
- Ultimately, credit ratings are forward-looking, and rely heavily on assessments of management planning capabilities (and transparency)
  - Understanding and planning for the range of potential impacts of these costs on future financial metrics is critically important to demonstrate to rating agencies
- Rating agencies recognize that financial metrics may temporarily drop, and that most water and sewer utilities are well-prepared to weather the storm

Current Days Cash on Hand
(Indicates financial flexibility, specifically cash and cash equivalents, relative to expenses.)



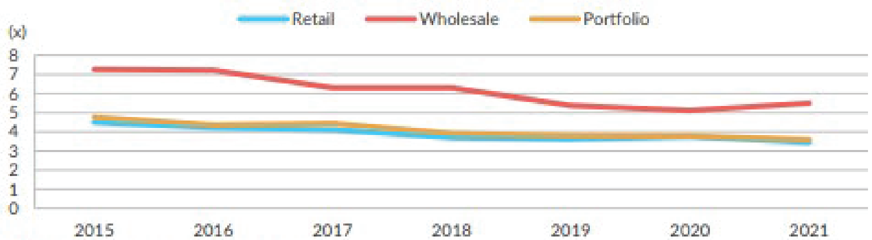
Source: Fitch Ratings.

Liquidity Cushion Ratio
(Indicates financial flexibility, including all available sources of cash and liquidity, relative to expenses.)



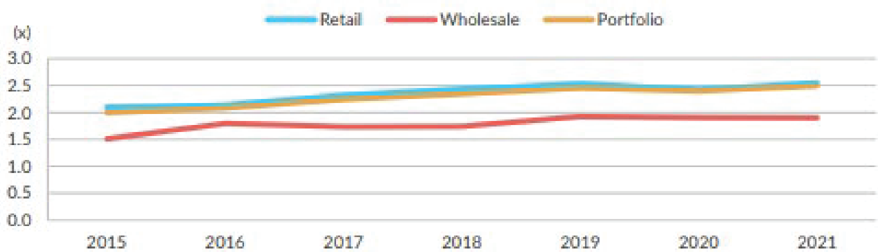
Source: Fitch Ratings.

Net Adjusted Debt/Adjusted FADS
(Indicates the size of debt compared with the margin available for debt service.)



FADS – Funds available for debt service.
Source: Fitch Ratings.

Fitch-Calculated Total Debt Service Coverage
(Indicates the margin available to meet current debt service requirements.)



Source: Fitch Ratings.

Sources: Fitch Ratings, "U.S. Water and Sewer: Peer Review 2022", August 23, 2022. S&P Global Ratings: "U.S. Public Power Rates Can Withstand Inflation, Rising Commodity Prices, And Higher Borrowing Costs--For Now", September 7, 2022