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BY WFM STAFF

Fitch Ratings: Debt for utilities would increase under proposed PFAS rules

According to Fitch Ratings, the U.S. Environmental Protection Agency's (EPA) recently proposed rule setting limits on per- and polyfluoroalkyl substances (PFAS) in drinking water would increase public water utilities' debt burden as a result of the added costs of compliance.

A recent press release from Fitch says the strong rate flexibility and capacity for additional debt exhibited by water systems is expected to limit the impact on credit quality, but will depend on the final scope of rule. EPA expects to finalize the rule by the end of 2023.

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The proposed National Primary Drinking Water Regulation (NPDWR) outlines maximum contaminant levels for six PFAS and would require utilities to monitor PFAS levels in drinking water systems, notify the public and reduce levels to comply with the regulated standard. The proposed limit is essentially the equivalent of non-detectable levels.

As with other sector-wide issues, we would assess the credit impact of this rule on utilities on a case by case basis, considering each system's capital budget, debt profile, preparedness, and rate flexibility. Technology risk is not a concern as the treatment technology is well known.

Some of our rated issuers are already addressing PFAS given state regulations. States such

as Massachusetts and California have implemented their own PFAS limits that are not as stringent as the proposed rule, and affected utilities have started, and in some cases even completed, treatment to meet those standards. Other utilities have disclosed that they do not have any detectable PFAS in their water supply.

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The enormous costs involved in PFAS remediation will be a primary consideration as utilities submit feedback to the EPA; the public comment period currently closes May 30, 2023. The EPA estimates that between 3,400 and 6,300 public water systems will need to reduce PFAS under the proposed rule, and that annual costs would total between $772 million and $1.2 billion, including capital and operational expenses. Once the rule is finalized, water systems would have three years to comply.

The costs of compliance will likely drive utilities to incur additional debt. While water utilities are expected to pass on higher operating and capital costs to customers through rate increases, those facing significant capital spending requirements or serving limited customer bases/service areas may be unable to immediately recoup upfront costs, leading to higher debt levels.

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However, rating actions are likely to be limited, as Fitch's water utility ratings reflect a stress scenario that already incorporates a 10 percent increase in capital spending. This level of

stress should encompass anticipated spending for most systems under the rule and the compliance timeline as currently proposed. Systems with significantly higher PFAS exposure and related spending requirements will be at higher risk for negative rating action.

Federal or other government grants will also help offset costs for some systems. The Bipartisan Infrastructure Law (BIL) provides up to $10 billion to address contaminants, including $4 billion through drinking water state revolving funds, $5 billion through EPA's Emerging Contaminants in Small or Disadvantaged Communities Grant Program, and $1 billion through clean water state revolving funds.

It is unclear if the costs of reducing PFAS levels will be shared by other entities. Some states and local governments have sued companies that used PFAS in an attempt to hold them accountable for clean up costs.

The market has anticipated increased regulation, including a federal PFAS rule. Fitch has a deteriorating sector outlook for US water and sewer utilities for 2023 that reflects economic and business conditions, including anticipated higher costs of compliance with environmental regulations, that create a more challenging operating environment relative to 2022. We note that more stringent regulatory requirements and shorter deadlines could cause further pressure, and based on the proposed limits and the three-year compliance timeline, the NPDWR would contribute to a sustained deteriorating outlook.

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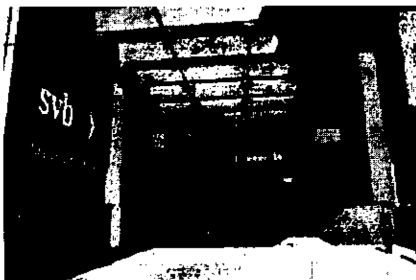

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