

# Bond Case Briefs

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## S&P: Pending Federal Regulation Could Significantly Affect Thousands Of U.S Water Utilities

### **Key Takeaways**

- Per-and-polyfluoroalkyl substances (PFAS) contamination could pressure liquidity reserves and affordability in the U.S. water utilities sector, as the costs will likely be passed through to consumers
- Small utilities would be more vulnerable to credit deterioration due to the effects of the proposed regulation
- S&P Global Ratings views the impact of PFAS regulation on health and safety positively given heightened public awareness around potential forever chemical contamination

Proposed federal regulation related to emerging contaminants could affect the credit quality for thousands of U.S. water utilities, given the potential for increased capital and operating costs that could pressure rate flexibility.

In March 2023, the Environmental Protection Agency (EPA) proposed a national primary drinking water regulation for PFAS, otherwise known as forever chemicals, which is expected to be finalized in the next several months. For water utilities across the U.S., the proposed MCL might result in costly treatment upgrades, ongoing monitoring and asset replacement, disposal, and staffing.

S&P Global Ratings anticipates these costs will require meaningful rate increases in a rising-cost environment. Regulatory pressure, rising interest rates, and inflationary cost pressures are expected to weaken affordability for some utilities, especially smaller providers with vulnerable demographic characteristics. Failure to pass through mandated costs could weaken financial margins and credit quality.

### **Annual Financial Impact On Sector Could Approach \$3 Billion**

Initial costs might be limited to simple testing and ongoing monitoring of the water supply, but at the most stringent proposed MCL, the EPA estimates 4,300 water utilities will be affected by one or more PFAS contaminant. The American Water Works Association estimates that could grow to 7,000 utilities, with a total financial impact on the sector of nearly \$3 billion annually in additional operating and maintenance costs. Disposal of toxic biosolids, carbon filters, and any other contaminated treatment bioproducts is estimated to add \$3.5 billion in annual costs for U.S. utilities. In our view, these costs are substantial, but we view favorably the effects to health and human safety, with advanced treatment providing higher water quality and customer confidence in addition to upgrading technology, which can be used to meet further regulatory requirements.

We view smaller utilities and those with vulnerable economic metrics as particularly at risk, given the more limited ability to pass-through costs and thinner operating margins and nominal liquidity. We expect that if the proposal is implemented, utilities might seek regional partnership or consolidation to better manage capital expenses and leverage economies of scale, which we view favorably. Higher cost burdens will fall on utilities with less-diversified water-supply or have large

watersheds exposed to industrial use. In addition, identifying and sourcing a new water supply, if PFAS detections occur, can have significant cost implications for utilities. The proposal's three-year implementation period for utilities means demand for granular activated carbon, certified operators, and construction bids will grow and potentially escalate costs, exposing utilities to supply chain and inflationary challenges.

Many utilities have successfully implemented remediation efforts ahead of the finalized MCL, incorporating the capital and operating costs associated with enhanced treatment. We believe utilities that demonstrate strong relationships with major industrial customers and their rate-base will fare better in the long term as installation of pretreatment and timely adoption of rate increases assist in maintaining stable operating margins through the capital-intensive period. We believe transparency and accountability are critical to ratepayer trust, incorporated within our view of rate-setting flexibility through our Operational Management Assessment. Furthermore, financial costs could be defrayed by successful litigation against primary polluters such as 3M and Dupont, which are currently expected to pay approximately \$12 billion and \$1 billion, respectively. The U.S. government is also expected to provide grants and additional funding opportunities, which we view favorably. However, we note federal funding will not be available for operating costs past initial design and build.



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