Fitch Upgrades Philadelphia, PA's Gas Works Rev Bonds; Outlook Stable

Fitch Ratings-New York-22 July 2015: Fitch Ratings has assigned a 'BBB+' rating to the following revenue bonds issued by the city of Philadelphia on behalf of the Philadelphia Gas Works (PGW):

--Approximately $274,395,000 Gas Works Revenue Refunding Bonds, Thirteenth Series (1998 General Ordinance).

The bonds are scheduled to price via negotiation Aug. 4. The bonds will refund all bonds currently outstanding under the General Gas Works Revenue Bond Ordinance of 1975 (effectively terminating the lien), refund a portion of bonds currently outstanding under the General Gas Works Revenue Bond Ordinance of 1998 for level interest cost savings, and pay issuance costs.

In addition, Fitch upgrades the following ratings:

--$133.9 million gas works revenue bonds, various series, (1975 general ordinance) to 'A-' from 'BBB+';
--$859.1 million gas works revenue refunding bonds, various series (senior 1998 general ordinance) to 'BBB+' from 'BBB'.

The Rating Outlook is Stable.

SECURITY

The 1998 general ordinance bonds are secured by net revenues of the gas works utility subordinate to the prior pledge of the 1975 general ordinance bonds. Outstanding 1975 general ordinance bonds are secured by a closed first lien on net revenues of the gas works utility. Upon issuance of the proposed refunding bonds, the General Gas Works Ordinance of 1975 will be terminated.

KEY RATING DRIVERS

LARGE GAS DISTRIBUTION SYSTEM: PGW is the largest municipally-owned gas distribution utility in the nation, serving slightly more than 500,000 accounts located entirely within the City of Philadelphia (general obligation bonds rated 'A-'/Outlook Stable). The system provides natural gas on a retail basis to a considerably diverse and largely residential customer base exhibiting no concentration among users.

SUSTAINED IMPROVEMENT IN FINANCIAL PERFORMANCE: The rating upgrades are driven primarily by a sustained improvement in financial metrics and a continued reduction in debt levels. Contributing factors include prior rate relief, greater cost recovery through various surcharges, historically low natural gas prices and PGW's ability to current fund its capital needs and maintain healthier collection rates. Fitch expects these trends will continue based on the latest financial forecast.

STABLE FINANCIAL METRICS: Fitch calculated debt service coverage has averaged a solid 1.5x over the prior five years while coverage of full obligations, which reflects the annual transfer made to the city's general fund, has also remained at a healthy level, averaging 1.4x since 2010. Liquidity continued at an acceptable level in fiscal 2014, equal to 65 days of cash on hand.

RATE REGULATED: PGW's ability to establish its rates is subject to oversight by the Pennsylvania Utility Commission (PUC), potentially limiting needed rate increases and overall financial flexibility. Positively, the utility's relationship with the PUC has remained constructive and supportive in recent years.

WEAK BUT STABLE DEMOGRAPHICS: The city's economy continues to strengthen and is well anchored by several large health care and higher education institutions. However, wealth indicators throughout the service area remain weak, contributing to chronically below average collection rates and sizeable write-offs.

PRIORITY LIEN RECOGNIZED: The 'A-' rating on the 1975 general ordinance bonds reflects their priority lien in the flow of funds, which is closed to future bond issues, as well as the distinct separation between the 1975 and 1998 ordinances.

RATING SENSITIVITIES

LIMITED FINANCIAL FLEXIBILITY: Despite the overall improvement in Philadelphia Gas Works' credit quality in recent years, Fitch expects the utility's exceptionally high rates, the service area's low income levels and a regulatory environment that includes state and local oversight will continue to limit financial flexibility. A return to weaker collection rates, diminished cash flow and an inability to gain needed rate relief and recover costs would exert downward pressure on the ratings.

CREDIT PROFILE

IMPROVED CREDIT QUAILITY

PGW's financial performance has exhibited a generally more favorable trend since gaining rate relief beginning in fiscal 2010, with metrics supportive of the upgraded ratings. Fitch calculated debt service coverage of total debt has averaged a solid 1.5x over that span, compared to 1.1x between fiscals 2006 -2009.

Liquidity has also remained sound. Unrestricted cash and investments have equaled about 60 days on hand since 2010, despite management's prudent decision to use cash flow to defease or accelerate bond principal by approximately $50 million in recent years. Authorization to issue up to $150 million in commercial paper notes for working capital provides additional cushion, although no borrowings under the authorization have occurred since fiscal 2009.

Leverage ratios have steadily improved to a more moderate but still elevated level over the last several years with the current funding of capital projects. The ratios of equity to capitalization and debt to funds available for debt service (FADS) improved to 28% and 6.2x, respectively, at the close of fiscal 2014 compared to 17.8% and 8.8x in 2010. Based on borrowing plans incorporated into the most recent capital improvement program, Fitch expects a moderate increase in total debt outstanding by 2018, although the related change in leverage ratios should be tolerable at the current rating category.

SOCIOECONIOMIC CHARACTERISTICS COMPOUND HIGH RATES

PGW's exceptionally high rates, the city's challenging demographics and the state's regulation of retails rates continue to constrain PGW's operating flexibility. Residential rates are comparatively higher than all other gas distribution systems operating within the state due to historically weak collections and extensive utility-sponsored discount programs that benefit low-income customers. The city's 26.5% poverty rate is nearly twice the national rate, and median household income (MHI) approximates just 70% of the state and national averages. Consequently, PGW's accounts receivable balances and annual write-offs are routinely high relative to most utilities. However, after remaining consistently below 90% prior to 2004, revenue collection has averaged a more acceptable 96% over the prior 10 years.

HEIGHTENED REGULATORY ENVIRONMENT

PGW operates within a heightened regulatory environment with the gas commission, city council and the PUC maintaining oversight of the utility's operations and its ability to raise rates. While the regulatory bodies have been increasingly more supportive over the last several years, Fitch believes the multiple layers of oversight will continue to limit the utility's financial flexibility,

Fitch notes the PUC's ratemaking methodology is designed to ensure PGW recovers its costs, meets its rate covenant of 1.5x coverage on senior and subordinate lien obligations, and continues to fund a required $18 million annual utility payment to the city.

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Applicable Criteria

U.S. Public Power Rating Criteria (pub. 18 May 2015)
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