



Fitch Rates Philadelphia Gas Works, PA's \$150MM Ninth Series Gas Revs 'BBB-'; Outlook Stable

Ratings

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Fitch Ratings-New York-30 July 2010: Fitch Ratings assigns a 'BBB-' rating to the Philadelphia Gas Works' (PGW) \$150 million gas revenue bonds, ninth series (senior 1998 general ordinance).

The bonds are expected to sell via negotiation in August 2010 and are separately secured by the City of Philadelphia's (the city) net gas revenues, subordinate only to the outstanding 1975 general ordinance gas revenue bonds.

In addition, Fitch affirms the following PGW outstanding debt:

- \$866.62 million gas revenue bonds (senior 1998 general ordinance) at 'BBB-';
- \$239.53 million as revenue bonds (1975 general ordinance) at 'BBB'.

Bond proceeds will be used to finance expenditures as required by the capital improvement program.

The Rating Outlook is Stable.

RATING RATIONALE:

- The 'BBB-' rating reflects adequate debt service coverage, a tight but improving liquidity position, a challenged area economy and manageable capital program. PGW's unaudited third quarter 2010 results show signs of improved financial performance reflected in stronger liquidity levels and supported by continued improvement in PGW's collection rates.
- The improved financial performance appears to be accompanied by a more supportive relationship with the Pennsylvania Public Utility Commission (PUC) which regulates PGW's rates. The improved working relationship between the PUC and PGW is increasingly important as PGW continues to manage its overall limited financial flexibility due to PGW's high residential gas rates compared to other gas utilities.
- PGW's cash position is still tight but improved from 2008 to 2009 as PGW paid off its outstanding commercial paper. FY 2009 and 2010 are expected to reflect the first two consecutive years in the past 15 years that PGW has had positive cash balances and no outstanding commercial paper.
- PGW's demonstrated capital market access with the issuance of the eighth series (fixed and variable rate) bonds in 2009 and ability to secure a long-term letter of credit are important credit strengths. A portion of the proceeds were used to terminate a \$54.8 million swap. While PGW still has a swap of \$255 million outstanding, given its structure, it will effectively hedge the eighth series of outstanding variable rate bonds, providing a synthetic fixed rate.
- PGW's customer base and usage continue to slowly decline reflecting the winnowing population of the city. A large segment of PGW's residential customer base is enrolled in the 'Customer Responsibility Program' (CRP) which provides an affordable payment plan for low income customers which should help support PGW's improved collection rates.
- The city continues to grant back to PGW its annual \$18 million city fee and has expressed its intention to do so through 2015.
- The 'BBB' rating on the 1975 general ordinance bonds reflects their priority lien in the flow of funds which is closed to future bond issues.

KEY RATING DRIVERS:

- The recent settlement with the PUC which institutionalized a \$60 million base rate increase and \$16 million partial funding of post employment benefits should serve to stabilize PGW's financial position through the projection period. While the Outlook remains Stable, a continuation of these trends could provide positive credit momentum.
- Further demonstration of PGW's objective to break the cycle of borrowing for capital improvements and fund a larger share of capital improvements from internally generated monies as well as to continue letter of credit utilization at zero through 2016 are key rating drivers.
- Continued demonstration by the city to maintain a financially sound gas utility and the working relationship with the PUC will be important to PGW's longer-term success.

SECURITY:

The ninth series bonds are being issued on parity with the outstanding senior 1998 ordinance bonds. The parity senior 1998 ordinance bonds are secured by a lien on net revenues of the gas works system, subordinate only to debt service on the outstanding 1975 ordinance bonds.

CREDIT SUMMARY:

PGW is the largest municipal gas distribution utility in the nation and is owned by the City of Philadelphia. Through diverse supply arrangements, PGW acquires natural gas supply and delivers gas service through its various gas storage and distribution facilities. The service area consists of an urban area located in the southeast portion of Pennsylvania along the Delaware River that includes the city. In 2009, PGW provided gas service to its 503,963 residential, commercial and industrial customers with total firm gas sales of approximately 50 million cubic feet (MMcf). Approximately 84,000 of PGW customers (18% of PGW's total residential customer base) are enrolled in the CRP which provides an affordable payment plan for low income customers as well as promoting conservation and filing for low income grant assistance. The success of this program, combined with the precipitous drop in the cost of natural gas from 2008 through 2009, resulted in improved accounts receivable collections from 93.8% for Fiscal Year end Aug. 31, 2009 to 98.9% as of the nine months ending May 31, 2010.

During the recent economic downturn the city demonstrated its willingness to maintain a financially viable gas utility through the issuance of a \$45 million loan, since repaid as well as providing a grant back of the annual payment that is normally paid by PGW to the city. PGW has identified several 'Business Transformation Initiatives' that are being implemented in 2010. While the restructuring of the 'supply chain' is still subject to Philadelphia Gas Commission approval, the initiatives identify several opportunities to generate operating savings and minimize the use of long-term debt to fund the ongoing capital improvement program.

Applicable criteria available on Fitch's web site at 'www.fitchratings.com':

'Public Power Rating Guidelines', dated June 11, 2009.

'Revenue-Supported Rating Criteria', dated Dec. 29, 2009.

Contact: Christopher Jumper +1-212-908-0594 or Eric V. Espino +1-212-908-0574, New York.

Media Relations: Cindy Stoller, New York, Tel: +1 212 908 0526, Email: cindy.stoller@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

Related Research:

Revenue-Supported Rating Criteria

Public Power Rating Guidelines

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