Global Power/North America
New Issue

Philadelphia, Pennsylvania
Philadelphia Gas Works

Ratings

New Issue

Gas Works Revenue Bonds, 19th Series (1975 Ordinance)……………………………..BBB
Gas Works Revenue Bonds, Seventh Series (1998 Ordinance)................................. …BBB–

Security Class	Current Rating	Previous Rating	Date Changed
Gas Works Rev. Bonds (1975 Ordinance)	BBB	NR	3/28/07
Gas Works Rev. Bonds (1998 Ordinance)	BBB–	NR	9/23/04
Sub. Gas Works Rev. Bonds (Junior 1998 Ordinance)	BBB–	NR	3/28/07

NR – Not rated

Rating Outlook..Stable

Analysts

Megan Neuburger
+1 212 908-0501
megan.neuburger@fitchratings.com

Karl H. Pfeil, III
+1 212 908-0516
karl.pfeil@fitchratings.com

Profile

PGW is a gas distribution utility owned by the city of Philadelphia. PGW is the largest municipally owned gas utility in the nation and provides for the acquisition, storage and distribution of gas to 497,000 accounts within the city limits of Philadelphia. PGW is subject to regulation by the Pennsylvania PUC, which must approve rate increases.

Key Credit Strengths

- Experienced management team.
- Stable customer base.
- Well-maintained system.
- State regulators willing to approve rate increases in recovery of commodity costs.

Key Credit Concerns

- Heavily reliant on external sources of liquidity for working-capital needs.
- Historically volatile collection rates.

April 10, 2007

■ Rating Rationale

The upgrade of the rating on the 1975 ordinance bonds reflects the stronger security provisions of the indenture. The 1975 bonds have a lien on pledged revenues that is senior to the 1998 bonds; in addition, as the 1975 lien is closed, additional bonds on this lien are limited to refunding of outstanding 1975 lien bonds. The upgrade of the rating on the 1998 subordinate lien bonds reflects improvement in the credit quality of Philadelphia Gas Works (PGW); Fitch Ratings now believes all liens reflect investment-grade quality credit. The Rating Outlook on all bonds is Stable.

The ratings on PGW are constrained by the utility’s tight liquidity position. The fulfillment of operating commitments, including debt service, relies heavily on external liquidity, including cash flow support from the city and a commercial paper letter of credit. However, this risk is mitigated by sustained improvement in collection rates since fiscal 2003, which has resulted in a stabilization of the utility’s liquidity position. In particular, Fitch views favorably financial improvement achieved in fiscal 2006 despite a sharp increase in gas commodity costs. Credit strengths include the utility’s strong management team and well-maintained system assets. In addition, a strengthening of the city’s financial position in recent years bodes well for the future fiscal health of the city-owned utility (Philadelphia’s general obligation [GO] bonds are rated ‘BBB+’ with a Stable Outlook by Fitch).

Fitch would view favorably a positive ruling by the Public Utility Commission (PUC) on PGW’s December 2006 rate filing, requesting an increase of $100 million in the base rate. The PUC must rule on the rate filing by September 2007, allowing PGW to implement the rate increase for the fiscal 2008 winter heating season. An increase in the base rate of the magnitude requested by PGW will allow the utility to reduce its dependence on financial support from the city and its commercial paper letter of credit. In addition, it would allow PGW to fund portions of its capital plan with cash resources, thereby limiting future debt issuance.

Collection rates have been volatile historically, with lower rates of collection correlating with colder winter heating seasons. After hitting a 15-year low of 86.6% in fiscal 2003, collection rates rebounded to a solid 96.6% for fiscal 2006. Although collection rates were bolstered by warmer than normal winters since fiscal 2003, PGW management has made significant progress in implementing policies to maintain these higher rates of collection, which Fitch believes may help to reduce future volatility in the collection rate. The fiscal 2007 budget assumes a 95.5% collection rate. Actual results through

Amendment

The New Issue Details section was added on page 2.

February 2007 indicate a 12-month rolling collection rate of 95.7%, and officials project that the collection rate by the close of the fiscal 2007 year ending Aug. 31 will be within 0.5% of budget. The effect on cash receipts of a 0.5% deviation from the budgeted collection rate is only about $5 million, compared with budgeted gas billing receipts of $860 million.

External sources of liquidity include cash flow support from the city and a $150 million commercial paper letter of credit. The letter of credit expires in May 2007, and PGW expects to renew it for a three-year period. PGW's owner, the city of Philadelphia, has deferred repayment of a $45 million loan to fiscal 2008 and plans to grants back the utility's annual $18 million return on investment payment through fiscal 2011.

Debt-service coverage based on audited results has improved substantially since the beginning of the decade. Coverage, inclusive of all long-term debt, was 1.7 times (x) based on audited fiscal 2006 results, compared with 1.1x in fiscal 2001. The current issuance is the only new money debt PGW plans to issue within the scope of its fiscal 2007–2012 capital improvement plan (CIP), which totals $433 million. The remainder of the funding for the CIP is expected to be generated from internal cash, assuming the PUC issues a favorable ruling on the rate filing.

■ New Issue Details

Approximately $200 million of the $220 million seventh series bonds will be used to fund capital projects of PGW. The balance of the proceeds of the seventh series will be used to refund outstanding 1998 ordinance bonds, while the $14.6 million 19th series bonds will be used to refund outstanding 1975 ordinance bonds. Savings on the refundings will be equal to at least 3% of the refunded par. The bonds are scheduled to price via negotiation with a syndicate led by Goldman Sachs and Co. on April 11, 2007.

■ Recent Developments

Base Rate Filing

PGW is subject to rate regulation by the state-regulated PUC. Favorably, the PUC has demonstrated a willingness to approve large increases in PGW's natural gas cost rate (GCR) to offset the rising cost of the commodity.

Since rate-setting authority was transferred from the Philadelphia Gas Commission to the PUC in July 2000, PGW has requested three base rate increases. The base rate is intended to cover costs not related to commodity costs, which is recovered through the GCR. In 2001, the PUC approved $33.6 million of PGW's $65 million base rate increase request and in 2002 approved $36 million of PGW's $60 million base rate increase request.

Most recently, PGW filed for a $100 million increase in its base rate in December 2006. In addition, PGW has requested approval to change the treatment of the proceeds of off-system sales by using these funds for debt retirement or construction projects, rather than applying them as a credit to customers against the gas commodity charge. Off-system sales revenues equal about $10 million annually. The base rate increase is necessary to offset increases in pension and health care costs since 2002, as well as to offset loss of revenue due to conservation measures.

The PUC is currently considering PGW's rate filing and is required to make a decision by September 2007, which would allow PGW to implement the base rate increase for the fiscal 2008 heating season. There is the possibility the rate filing will be settled prior to the September deadline. The PUC may approve a portion of the $100 million increase request or may approve the entire request.

In the event the PUC approves a sizeable base rate increase, the financial position of PGW is expected to improve, and PGW management expects to meet several goals. These include beginning each fiscal year with $50 million of internal liquidity (not including draws on commercial paper letter of credit) and funding annual capital expenditures from internal resources for several years.

Collection Rates

A major contributor to PGW's financial difficulties since the beginning of the decade was a dramatic rise in accounts receivable following a substantial rate increase in fiscal 2003. During that year, collection rates fell to a 15-year low of 86.6%. Favorable legislative changes have contributed to an improvement in collection rates over the past three fiscal years; fiscal 2006 ended with a 96.6% collection rate. Over the same time period, receivables as a percent of billed gas revenues dropped to 27.1% from 42.5%.

In addition to legislative changes, warmer than average winter heating seasons in fiscal 2004–2006 likely contributed to the upswing in collection rates. Historical collection rates have been closely correlated to winter heating season temperatures, with collection rates dipping in colder than average winters. PGW management believes favorable legislative changes and improved collection procedures may help to mitigate the effect of weather on collection rates, resulting in a less volatile pattern in future years.

Most notable among the legislative changes is Act 201, which was adopted into state law in December 2004. The legislation gives gas utilities statewide expanded power to shut off gas service to delinquent accounts, which provides PGW a strong tool to discourage delinquency. The most important provision of Act 201 was the modification of a winter gas shut-off moratorium for delinquent accounts, which applies between Dec. 1 and March 31 annually. Subject to certain conditions, PGW may shut off gas service during the winter months if household income is more than 150% of the poverty line and 50% of charges for the latest two months have not been paid. Other important legislative changes include an increase in the status of PGW's property lien status, which is now on par with water and sewer charges, and the stipulation that customers with their name listed on delinquent account cannot obtain service at a different address.

PGW does not expect the requested increase in the base rate to have a substantial negative effect on collection rates. Since a 29% increase in the GCR in fall 2005 to offset rising commodity costs, the GCR has been reduced twice. A $100 million increase in the base rate will not increase bills substantially beyond the level reached following the large GCR increase in fall 2005, which did not have a significant negative effect on collection rates.

Capital Plan

Historical capital-spending levels have averaged $60 million annually. Over the past 15 years, the majority of capital spending has been debt funded; PGW last funded a substantial amount of capital on a pay-as-you-go basis in fiscal 1992. The fiscal 2007–2012 CIP totals $433 million; 62% of planned spending is for distribution system projects, 11% is for gas processing projects, 11% is for field services, 4.4% is for fleet operations and the remainder is for miscellaneous projects.

Funding sources include the current $155 million new money bond issue. No additional debt is planned through fiscal 2012. PGW plans to use internally generated resources to fund the balance of the CIP. In the event the base rate increase is not approved or is approved in a lesser amount, PGW will reevaluate CIP spending levels.

A January 2007 engineer's report conducted by Black and Veatch states that the system's capital assets are in good condition.

■ Financial Summary

Due to improved collection efforts and a greater amount of bad debt writeoffs, net accounts receivable declined to $74.4 million at the close of fiscal 2006 from a 10-year high of $96.1 million at the close of fiscal 2001. The fiscal-year 2006 collection rate of 96.6% was above the budgeted 94.5% and much improved from a low of 86.6% for fiscal-year 2003. The fiscal 2007 budget assumes a 95.5% collection rate; based on a rolling 12-month average, collection rates through February 2007 equaled 95.7%. However, Fitch expects the collection rate will drop somewhat with the March billing due to cold weather patterns, resulting in higher customer bills.

Reflecting low-revenue yield, PGW continues to rely heavily on external liquidity, including cash flow support from the city and a $150 million commercial paper credit facility that will be expanded to $200 million upon its expiration in May 2007. Favorably, the utility will be able to extend its credit line to a three-year period from a 21-month period. Liquidity remained constrained during the first half of fiscal-year 2007. At the end of February 2007, the cash position net of $149 million in commercial paper outstanding and the $45 million city loan equaled a negative $101.6 million, which compares favorably with the negative $144.4 million position at the close of February 2006.

Debt-service coverage improved in fiscal 2006 compared with fiscal-year 2005. Aggregate coverage, inclusive of all long-term debt, was 1.7x in fiscal 2006 compared with 1.4x in fiscal 2005. The increase in coverage is attributable to improved collections, which bolstered revenues, as well as savings taken upfront on a refunding of outstanding debt, which reduced debt-service costs by $11 million.

Based on financial projections that assume a $100 million increase in the base rate, maintenance of

Philadelphia Gas Works Financials

($000, Coverage Calculated per the 1975 and 1998 Ordinances, Audited Years Ended Aug. 31)

							Projected*					
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Operating Revenues	758.1	621.2	800.0	816.1	883.3	984.3	1,001.8	1,131.99	1,095.6	1,034.5	1,011.9	1,038.0
Operating Expenses (Net of Depreciation)	648.4	511.4	684.7	699.8	753.0	841.2	864.3	904.5	871.4	811.9	809.4	806.6
Net Income Available for Debt Service	109.7	109.8	115.3	116.3	130.3	143.1	137.5	227. 5	224.2	222.6	202.5	231.4
Total Debt Service**	96.1	97.6	92.6	96.4	91.7	82.7	86.1	100.9	98.6	98.0	96.3	94.0
Total Coverage (x)	1.1	1.1	1.2	1.2	1.4	1.7	1.6	2.3	2.3	2.3	2.1	2.5

*Assumes $100 million base rate increase adopted in September 2007. **Includes debt service on the 1975 ordinance bonds and the 1998 ordinance senior and subordinate lien bonds.

a 95% collection rate and incorporating debt service on the current new money issuance, debt-service coverage through fiscal 2012 is expected to be above 2.0x. Should only $50 million of the base rate increase be approved by the PUC, coverage would range from 1.75–1.9x.