MOODY'S
INVESTORS SERVICE

New Issue: MOODY'S ASSIGNS Baa2 RATING TO PHILADELPHIA GAS WORKS $76.1 MILLION REVENUE REFUNDING BONDS; OUTLOOK REMAINS STABLE

Global Credit Research - 23 Aug 2011

AFFIRMS Baa2 RATING ON 1975 AND 1998 SENIOR GENERAL ORDINANCE BONDS AND AFFIRMS Baa3 RATING ON 1998 SUBORDINATE GENERAL ORDINANCE BONDS

Gas Utilities
PA

Moody's Rating

ISSUE		RATING
Gas Works Revenue Refunding Bonds, Twentieth Series (1975 General Ordinance)		Baa2
Sale Amount	$16,340,000	
Expected Sale Date	09/14/11	
Rating Description	Revenue Bonds	
Gas Works Revenue Refunding Bonds, Tenth Series (1998 General Ordinance)		Baa2
Sale Amount	$59,810,000	
Expected Sale Date	09/14/11	
Rating Description	Revenue Bonds	

Moody's Outlook Stable

Opinion

NEW YORK, Aug 23, 2011 -- Moody's Investors Service has assigned the credit rating of Baa2 to the $76.1 million City of Philadelphia Gas Works (PGW) Revenue Refunding Bonds, consisting of $16.3 million Gas Works Revenue Refunding Bonds, Twentieth Series (1975 General Ordinance) and $59.8 million Gas Works Revenue Refunding Bonds, Tenth Series (1998 General Ordinance). The outlook remains stable. Moody's has also affirmed the Baa2 rating on $982.2 million of outstanding parity 1998 Senior General Ordinance Bonds, and affirmed the Baa2 rating on $208 million of outstanding 1975 General Ordinance Bonds, and affirmed the Baa3 rating on $5.4 million of outstanding 1998 Subordinate General Ordinance Bonds.

PGW is also expected to retire $29.5 million of the $255 million 2008 variable rate demand obligation bonds and remarket the remaining $225.5 million under new or renewed liquidity agreements, as the current ones were extended until mid-October. PGW will also terminate the portion of the floating-to-fixed rate swap that matches the maturities of the $29.5 million of retired variable rate bonds.

RATING RATIONALE

The Baa2 rating reflects Philadelphia Gas Works' (PGW) adequate track record of regulatory approval of required rate increases to meet required cost recovery and its strong 1.5x rate covenant. The rating also factors PGW's strong management team that has built a constructive relationship with the state regulatory board; continues to improve the utility's operations yielding cost savings and improved financial metrics; and effectively manages gas supply costs. The rating further incorporates the utility's high leverage, improved yet still narrow internal liquidity, and narrow Moody's calculated net revenue debt service coverage ratio that has averaged 1.25x over the last five years, improving annually since fiscal 2007.

The Baa3 subordinate lien rating considers the bonds position in the flow of funds, the slightly lower but still satisfactory debt service coverage ratio on the subordinate bonds, and the expectation that the subordinate lien will likely not incur any additional debt in the medium term. The subordinate lien bonds mature in 2014.

OUTLOOK

The stable outlook reflects our expectation that PGW's strong management team will continue to effectively manage its operations to ensure its recently improved fiscal health is maintained.

What Could Change the Rating UP:

The rating could be upgraded should PGW maintain stronger all in net revenue debt service coverage ratios, improve its internal liquidity levels, and reduce its high leverage ratio.

What Could Change the Rating DOWN:

The rating could be downgraded should the accounts receivable problem return and/or forecasted costs are higher than expected, resulting in narrower margins and weakened liquidity.

USE OF PROCEEDS:

The bond proceeds will be utilized to refund various outstanding debt maturities for net present value savings and no extension of maturity.

LEGAL SECURITY:

Net natural gas system revenues with the 1975 Ordinance bonds having a superior lien position to the 1998 Ordinance bonds. Security provisions otherwise are similar for the 1975 and 1998 Ordinance bonds. There is a strong rate covenant requiring that net revenues must be 150% of debt service. Debt service reserves on both 1975 and 1998 Ordinance bonds must be funded at maximum principal and interest. No additional Series 1975 bonds can be issued other than to refund previously issued Series 1975 bonds. The indentures for both the 1975 and 1998 Ordinance bonds require PGW to operate and maintain the Gas Works as long as any bonds or notes are outstanding, effectively restricting any sale of PGW's assets.

INTEREST RATE DERIVATIVES:

PGW currently has one outstanding floating-to-fixed rate swap with JPMorgan Chase (senior unsecured rated Aa3/negative outlook) for a $255 million notional amount that synthetically fixes the variable interest rate on $255 million of outstanding variable rate demand bonds. The swap will be reduced to $225.5 million when a part of the principal of the variable rate bonds is retired. Under the swap agreement, PGW pays JP Morgan semiannual fixed rate payments of 3.6745% and receives a floating rate based on SIFMA until September 1, 2011 when PGW will receive floating payments based on 70% of 1-month LIBOR. The mark-to-market value on the swap was a negative $38.8 million as of July 31, 2011. PGW has no collateral posting requirement and the swap is insured by Assured Guaranty Municipal Corp (rated Aa3/negative outlook), whose rating is considered under the swap's additional termination event should the insurer's rating fall below A2 or A.

STRENGTHS

*Stable and strong utility management has demonstrated a strong record of ongoing operational improvements and strategic planning that has effectively streamlined PGWs operations and reduced costs

*Reasonably effective relationship with the state regulatory board and Philadelphia (A2/STA)

*More aggressive action on collection of receivables has yielded consistently strong collections

*Strong 1.5x rate covenant and The Public Utility Code requires the state regulatory board to establish rates that meet bond ordinance requirements

*Competitive commodity prices and significant storage allows for effective gas cost management

*Approval of new base rate has helped improve liquidity and financial flexibility

*Excess cash flow has improved, funding capital projects, early debt retirement, and self-insurance escrow

CHALLENGES

*Sizable low income residential population contributes to delinquencies that may grow as federal assistance programs are cut and these residents face higher monthly bills

*High residential rates compared to peers

*Highly leveraged utility with high debt ratio that will likely be maintained over time

*Philadelphia's general government budgetary pressure limits the city's ability to financially assist PGW and has resulted in the city no longer granting back PGW's $18 million annual payment starting in FY11

*Maintaining sufficient available liquidity to balance volatile gas prices, variable rate debt risks, and other general liquidity needs

RECENT DEVELOPMENTS:

PGW's liquidity support agreements for its $255 million 2008 variable rate demand bonds expire on October 19, 2011 and PGW has secured renewal or replacement liquidity providers at a much lower cost than on the expiring liquidity facilities. PGW will utilize $29.5 million of its own cash to retire a portion of the $255 million 2008 variable rate bonds, reducing the new remarketed amount to $225.5 million. PGW will also use cash to pay the estimated $6 million swap termination payment to terminate the swap associated with the maturities of the $29.5 million of retired variable rate bonds.

PGW ended fiscal 2010 (August 31) with better than expected debt service coverage and available liquidity due to better collection rates, overall expense savings, and lower debt service costs. The fiscal 2010 year-end unrestricted cash balance improved by $65 million, increasing to $79 million from $13.8 million in fiscal 2009. This improved internal liquidity lead to PGW's decision to reduce the size of its commercial paper program to $90 million from $120 million, as overall available liquidity remained stronger than in recent history when the commercial paper program was the primary source of PGW's available liquidity. No commercial paper has been issued since May 2009.

Preliminary fiscal 2011 reports indicate better performance than fiscal 2010, despite the fact that in fiscal 2011 the city did not return PGW's $18 million annual utility payment, as it has since 2004. Fiscal 2011 is projected to have a year-end cash balance on par with that of fiscal 2010 of about $80 million, despite the projected one-time use of $38.7 million to retire variable rate bonds ($29.5 million), pay a swap termination payment ($6 million), and fund a healthcare self-insurance escrow account ($3.2 million). PGW intends to fund this $38.7 million cash outlay with excess cash flow from operations ($20 million); the liquidation of overfunded reserve funds ($6 million); the release of interest earnings held in capital improvement funds ($10 to $12 million); and may also utilize a portion of accrued reimbursements owed from the pension fund ($12 to $14 million).

Moody's expects PGW's improved, yet still narrow financial and liquidity position to remain stable in the near term as higher than anticipated near term labor costs are balanced with lower healthcare costs due to PGW's move to a self-insured healthcare plan starting in fiscal 2012 and lower debt services costs due to a significant decline in the cost of liquidity support for PGW's variable rate bonds and commercial paper program. If the federally funded low income payment assistance programs are cut, as they are currently expected to be, PGW may experience a small, though not material, increase in delinquency rates as the higher costs are passed through to customers. Cash balances are projected to grow over the next couple of years before returning to current levels as cash is annually utilized to fund ongoing capital projects, especially main replacements.

PGW's Chief Executive Officer retired and was replaced with the Chief Operating Officer, ensuring continuity and minimizing disruption. Other senior level management changes have or will occur in the near term, but Moody's does not expect any material impact on PGW's operations given recent evaluations and overhauls of current operations.

MARKET POSITION/COMPETITIVE STRATEGY: WEAK SERVICE AREA WITH LOW SOCIOECONOMICS DRIVE MANAGEMENT'S FOCUS ON EFFICIENCY

The City of Philadelphia owns PGW, making it the largest municipally owned gas utility in the US, and as an operating enterprise of the city, PGW is considered an important municipal asset. The importance of PGW to the city is evidenced by the city's historic actions to improve PGW's liquidity through a $45 million city loan that PGW repaid in 2008 and the authorized same day return of the $18 million annual utility payment to the city from 2004 through 2010. However, the city's current weaker financial condition resulted in the city not returning the $18 million utility payment to PGW in fiscal 2011 and this is expected to continue, which may weaken PGW's recently improved liquidity position. Historic privatization proposals have failed given the significant amount of outstanding debt that would have to be retired, the system's sizeable unfunded OPEB liability, and the sizeable low-income service population.

PGW distributes natural gas to slightly more than 500,000 customers within the city boundaries. PGW also owns natural gas

liquefaction, storage, and vaporization facilities, with the on and offsite storage facilities key to the utilities gas supply strategy. The system typically locks in 50% to 60% of winter supply during the summer and about one-third of annual usage comes from its storage sites, allowing them to purchase and store gas during the lower priced summer months. On average, about 77% of gas sales are to residential customers, 20% to commercial and industrial customers, and 3% to municipal and housing customers. No dominant customer exists, yet residential customers have low income levels and a high poverty rate, thus it is hard to absorb higher gas bills. Despite this risk, improved collection and write-off procedures, coupled with increased federal funding of economic assistance programs, helped raise the collection rate to 98% in 2010 from 86.7% in 2003, though recent economic stress has yielded a 95.5% rate for 2011.

PGW provides service to the city's large disadvantaged population and as such provides multiple social programs that result in higher rates than its competitors. Positively, PGW received $35 million in LIHEAP funds to help aid its low-income population in 2010. It is estimated that about 14% of PGWs peak residential monthly bill is related to the surcharge for these programs. PGWs peak winter month residential rates are estimated to be about 44% higher than its closest competitor PECO (issuer rated A3/stable). On average, PGW's typical winter residential bill is estimated to be about 40% higher than the average Pennsylvania gas utility.

PGW is subject to the Pennsylvania Natural Gas Choice and Competition Act, which permits interruptible customers and transportation customers to buy gas from a competitive natural gas supplier. PGW is supplier of last resort for those customers who do not choose their own supplier. Regardless of whom a customer elects to get their natural gas from, the customer is required to use PGW's distribution system of mains and pipes to transport the gas and continue to pay PGW a distribution charge for that service. While current projections indicate a decline in residential gas sales and a corresponding increase in transportation only customers, PGW will continue to receive the transmission fees. Given the utility's gas cost rate directly offsets the gas supply costs, the transmission fee appropriately covers the system's other costs, resulting in a negligible revenue loss from customer switching.

PGW is regulated by the Pennsylvania Public Utility Commission (PUC) and Section 2212(b) of the Public Utility Code requires the PUC follow the same ratemaking methodology and requirements previously used by the Philadelphia Gas Commission to ensure PGW recovers its costs and meets bond covenants until the bonds are repaid. PGW's management has done a credible job of developing a constructive relationship with the PUC and establishing a defined rate process that is unique to a city-owned utility. PGW has effectively obtained approval for an automatic weather normalization adjustment, has consistently obtained timely approval of quarterly (or monthly) gas rate adjustments, and has received PUC approval for 48% of the total dollar amount of base rate increases requested to date. This approved amount has been adequate for PGW to satisfy its bond rate covenant, which the PUC is required to consider when approving a PGW base rate increase. PGW does not anticipate another base rate request for at least three to five years. Current legislation to establish an infrastructure surcharge for Pennsylvania local distribution gas companies is being considered, which would reduce the amount of future debt needs to support capital construction.

FINANCIAL POSITION/PERFORMANCE: IMPROVED FINANCIAL AND LIQUIDITY POSITION SUPPORTED BY RECENT BASE RATE INCREASE

Compared with other city-owned enterprises in the U.S., PGW's financial ratios reflect a utility in the Baa rating range and PGW's limited financial flexibility has always been a material credit weakness. However, approved base rate increases coupled with expense savings and efficiency improvements enabled PGW to improve its financial margins and liquidity position over the last four years. This trend is projected to continue in the near term. Moody's expects PGW to continue to maintain strong senior lien bond ordinance debt service coverage ratios and narrow total Moody's calculated total net revenue debt service coverage moving forward.

The system's liquidity has historically been very weak, but has recently improved, whereby PGW's fiscal year-end 2009 cash balance net of outstanding commercial paper (none at the time) was positive, $13.8 million, for the first time in a decade. This improving trend continued in 2010 and is projected to flatten in 2011. PGW continues to maintain its commercial paper program with $90 million available (about 55 days cash on hand), despite no draws since May 2009. The CP program may be reduced to $60 million prior to the renewal of the three letter of credit agreements in May 2012. Moody's expects any further reduction in the CP program to be balanced against an improved internal cash position, so as to maintain strong overall available liquidity.

Moody's rates the system's 1975 and 1998 Senior Ordinance Bonds both Baa2 given similar security features, despite the stronger coverage on the 1975 bonds and its closed lien position. The average debt service coverage for the combined 1975 and 1998 Senior Ordinance bonds from 2006 to 2010 averaged a solid 2.3x and 1.6x, on a bond ordinance and net revenue basis respectively, and is projected to average 2.0x through 2015. When including the small 1998 Subordinate Ordinance bonds and the interest on the CP program, PGW's total debt service coverage averaged a narrower 1.55x and 1.26x, bond ordinance and net revenue basis respectively, from 2006 to 2010 and is projected to remain above 1.7x on a bond ordinance basis until the subordinate debt matures in 2014. Moody's notes that the system is required to transfer $18 million to the city annually and in fiscal 2011 the city did not return this payment, so it is prudent to include it as an operating expense when calculating net revenue debt service coverage. When including the city payment as an operating expense, Moody's calculated total net revenue debt service coverage has averaged a narrow 1.07x over the last five years, but it was 1.3x in fiscal 2010

and is expected to remain above this level given recent rate increase and ongoing cost controls.

A key credit strength is the utility's bond covenants require bond ordinance debt service coverage of senior lien debt service to be 1.50 times and a fully-funded MADS debt service reserve must be maintained. The covenants have established minimum parameters that management has had to meet to stay in compliance. PGW is also required to conduct an independent engineering evaluation prior to issuing any bonds.

PGW's management has continued to closely manage financial operations amid difficult circumstances. PGW has made incremental improvements including bill collections, containment of near and long term operating costs, and other technological improvements that have enhanced monitoring efforts. Of note, the recent $16.5 million base rate increase is allocated to fund the system's sizeable unfunded OPEB liability (about $636 million) over the next 30 years with an annual $2.5 million system commitment. This plan will help alleviate this long-term liability pressure. PGW's pensions remain funded at about 83% with a 20-year amortization schedule established for the unfunded portion, up from a low of 68% in 2009.

CAPITAL PROGRAM: PGW IS HIGHLY LEVERAGED BUT NO NEW DEBT EXPECTED UNTIL 2016

PGW is expected to remain highly leveraged as it has historically with a debt ratio (net funded debt over net fixed assets + net working capital) that has been at or near 100% for several years and a debt-to-equity ratio averaging about 84%. Of note, these ratios do not include unfunded OPEB and pension liabilities, which present longer-term pressures for the system, with the former being addressed with the new base rate increase to be effective in fiscal 2011. The system's five-year capital improvement plan (2012-2016) calls for about $336 million of projects with 78% related to the natural gas distribution system, mostly line replacements. Positively, the $150 million 2010 debt issuance coupled with annual excess cash flow is expected to fund the plan with no new debt issuance projected until 2016.

KEY FACTS:

Legal Security: Net revenues of natural gas utility system

System Type: Acquisition, storage, and distribution of gas within the city of Philadelphia

2010 Customers: 502,000 (95% residential)

2010 Account Collection Rate: 98%

2011 Account Collection Rate (projected): 95%

2010 Natural gas purchases: $354 million ($192 million decrease from 2009)

2010 Debt Ratio: 89%

2010 Debt-to-equity Ratio: 84%

2010 Bond Resolution Debt Service Coverage:

Series 1975 Senior Ordinance Bonds: 6.28 times

Series 1998 Senior Ordinance Bonds: 2.44 times

2010 Moody's Calculated Net Revenue Debt Service Coverage:

Series 1975 Senior Ordinance Bonds: 4.82 times

Series 1998 Senior Ordinance Bonds: 1.77 times

Total Debt Service Coverage (includes 1998 Sub bonds and CP interest cost): 1.47 times

RATED DEBT OUTSTANDING (post-sale):

1975 General Ordinance Revenue Bonds (1st lien): $208 million

1998 Senior General Ordinance Revenue Bonds (2nd Lien): $982.2 billion

1998 Subordinate General Ordinance Revenue Bonds (3rd Lien): $5.4 million

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The principal methodology used in this rating was U.S. Public Power Electric Utilities published in April 2008. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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