New Issue: Philadelphia (City of) PA

MOODY'S AFFIRMS Baa2 RATING ON PHILADELPHIA GAS WORKS REVENUE BONDS; STABLE OUTLOOK

BOND SALE FOR $234.3 MILLION SCHEDULED FOR APRIL

Gas Utilities
PA

Moody's Rating

ISSUE		RATING
Gas Works Revenue Bonds		Baa2
Sale Amount	$234,300,000	
Expected Sale Date	04/15/07	
Rating Description	Revenue Bonds	

Opinion

NEW YORK, Mar 28, 2007 -- Moody's Investors Service has assigned an underlying credit rating of Baa2 to the $234.3 million revenue bonds of City of Philadelphia including Gas Works Revenue Bonds, ($219,700,000) Seventh Series (1998 General Ordinance) and ($14,600,000) Nineteenth Series (1975 General Ordinance), which are expected to price the week of April 15. The current offering is expected to be insured by a leading municipal bond insurance company. Moody's has also affirmed the Baa2 rating on $302.1 million of senior lien 1975 General Bond Ordinance debt and $740.6 million of senior lien 1998 General Bond Ordinance debt. We have also affirmed the Baa3 rating on $12.2 million of subordinate 1998 General Bond Ordinance debt. The outlook on all rated debt is stable.

The Baa2 credit rating on the senior lien bonds takes into consideration Philadelphia Gas Works' (PGW) sound track record of regulatory approval of required rate increases to meet required cost recovery and its strong rate covenant. PGW's management has had a constructive relationship with the state regulatory board. PGW's management has continued to manage closely operations to ensure satisfactory debt service coverage. The rating also considers the utility's high debt leverage, high collection delinquencies related to the large low income customer base, and the weak internal liquidity. The subordinate lien rating of Baa3 reflects the lien position and weaker security provisions.

USE OF PROCEEDS: Series 1975 Ordinance bonds are being issued to refund outstanding Series 1975 Ordinance bonds for present value savings. The 1998 Ordinance bonds are being issued to fund PGW's capital improvement program, including upgrades to the existing billing system; maintenance and improvements to system pipelines; and the second phase of the improvements to PGW's existing liquefaction facility.

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: The city has an interest rate swap agreement with JP Morgan issued concurrently with the Sixth Series of Gas Works Revenue bonds. The city pays the swap provider semiannually a fixed rate payment of 3.664% on the notational amount of $313.4 million and the swap provider pays the city a floating rate equal to lesser of the rate on the Sixth Series bonds and the BMA Municipal Swap index until August 1, 2011, and thereafter a floating rate payment equal to 70% of one-month LIBOR on the notational amount then outstanding. PGW reports in its annual financial statement the details of the swap and risks associated with it. Credit and termination risks are mitigated by the strong counterparty. PGW would manage any exposure through its rate process.

STRENGTHS:

*Stable utility management has demonstrated a strong record of operational improvements and strategic planning

*Reasonably effective relationship with the state regulatory board and the City of Philadelphia(General Obligation bonds rated Baa1)

*More aggressive action on collection of receivables

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

*Competitive commodity prices

*Approval of new, proposed base rate would improve debt to equity ratio and provide improved financial flexibility

CHALLENGES:

*Sizable low income population is a factor in the high collection delinquencies related to winter heating bills

*Highly leveraged utility with above average debt ratios

*City of Philadelphia general government has limited capability to assist PGW with further financial assistance

*Weak liquidity at year-end

*Record high natural gas prices remain a pressure on customers and if sustained could result in increased payment delinquencies

MARKET POSITION/COMPETITIVE STRATEGY: PGW IS A MUNICIPAL EXTERPRISE PROVIDING SERVICE TO CITY CUSTOMERS

PGW is owned by the City of Philadelphia and as an operating enterprise of the city is considered by the city an important municipal asset. The importance of PGW to the city is evidenced by the decisive action city officials took to shore up enterprise liquidity during 2000, with the advance of a $45 million loan. The city loan does not bear interest and the term of the loan has been extended through 2008.

In the past when PGW was experiencing financial stress, privatization proposals were discussed but the proposals did not move forward. Any purchaser of PGW would have had to retire the outstanding revenue bonds given the 1975 Ordinance and 1998 Ordinance bond covenants that require PGW to operate the gas system until the outstanding revenue debt was paid. Also, the sizable low-income population served by PGW and the related accounts receivable problem was not attractive to private sector suitors.

PGW distributes natural gas to almost 500,000 customers within city boundaries. PGW also owns natural gas liquefaction, storage and vaporization facilities. About 71% of the gas sales are to residential customers, 26% to commercial and industrial customers and 3.4% to municipal and housing customers. No dominant customer risk exists. While controversial, PGW continues to provide service to the city's large disadvantaged population. PGW's rates are somewhat higher that its competitors given the various social programs it offers. Partly due to these costs, PGW's typical winter residential bill is estimated to be much higher than the average for utilities that serve in region.

PGW is subject to the Pennsylvania Natural Gas Choice and Competition Act, which permits interruptible customers and transportation customers to seek 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. PGW has been 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 the city-owned utility.

FINANCIAL POSITION/PERFORMANCE: STRONG BOND COVENANTS AND MANAGEMENT FOCUS ON FINANCIAL IMPROVEMENT HAVE BEEN KEYS TO PGW'S MAINTENANCE OF SATISFACTORY DEBT

SERVICE COVERAGE LEVELS

A key credit strength is that the utility's bond covenants require net revenue coverage of senior debt service by 1.50 times and that a fully-funded debt service reserve be maintained at maximum annual debt service. The covenants have established minimum parameters that management has had to meet to stay in compliance. The average debt service coverage ratio between 1998 to 2006 was 2.39 times for Series 1975 Ordinance bonds and 1.67 times on Series 1998 Ordinance bonds. Debt service coverage in 2006 was 3.41 and 3.08 respectively.

PGW is also required to conduct an independent engineering evaluation prior to issuing bonds. The independent engineer's report completed for the current offering indicates that PGW is expected to comply with its bond covenants.

Moody's calculation of total debt service coverage (including on subordinate bonds and commercial paper interest) from income statements reflects a more narrow coverage of 1.14 times between 1996 and 2006. Total debt service coverage in 2006 was 1.21 times.

PGW's management has continued to closely manage financial operations amid difficult circumstances. PGW has made incremental improvements including significant improvement in bill collections, containment of operating costs including stable union relationships (collective bargaining agreements extend through 2010). Additionally, PGW has had success in the rate setting process.

All PGW employees are now in managed care and co-pays have been increased. About 87% of PGW's pensions are funded, with a 20-year amortization schedule established for the unfunded portion. Post-retirement health care accounting will be part of the 2007 financial statements.

PGW has recently filed a $100 million rate increase with the state PUC with the objective to further improve financial flexibility including lowering PGW's debt to equity ratio by internally funding a significant portion of PGW's capital improvement plan. Public hearings are scheduled for April 2007 with potential action by the PUC by summer 2007.

Between 2000 and 2005 the purchased cost of natural gas has more than doubled from $266 million to $625 million. While PGW has the capability to pass those costs through to customers, PGW's customer base has a large low-income population who naturally find it hard to absorb the higher natural gas bills. Despite the significant increase in customer bills, the the ratio of billings to collections improved from 86.7% in 2003 to 96.6% in 2006. Much of the improvement can be attributed to PGW's implementation of tougher collection practices including provisions of State Act 201 which gave PGW new tools to help it collect payments.

PGW's limited financial flexibility has been a material credit weakness. Compared with other city-owned enterprises in the U.S., PGW's financial ratios reflect a utility in the Baa rating range. But PGW's access to a commercial paper line of credit and improved cash flow in 2007 due to lower commodity prices are positive considerations about PGW current financial position.

CAPITAL PROGRAM: PGW IS HEAVILY LEVERAGED

PGW'S net funded debt to net fixed assets and working capital has averaged 90% ,indicating a significant level of leverage for a municipal gas utility. PGW expects to fund more of its annual capital improvements from internally generated funds. The bulk of the capital improvements are upgrades to the city's natural gas distribution system including new and replacement mains and services and meter and regulator facilities.

Outlook

A stable credit outlook is assigned to reflect a confidence in the utility's management and its ability to implement measures and adhere to collection practices that will maintain a steady course required to maintain the financial margins consistent with the Baa2 rating.

What Could Change the Rating UP: The rating could be upgraded should PGW maintain stronger debt service coverage margins and make further improvements in debt-to-equity and internal liquidity ratios. The current rate case before the state regulatory board may, if implemented, provide improved financial flexibility.

What Could Change the Rating DOWN: The rating could be downgraded should the accounts receivable problem worsen and debt service coverage weaken.

KEY FACTS:

Bond Resolution Debt Service Coverage, 2006: Series 1975 Ordinance Bonds: 3.41 times

Series 1998 Ordinance Bonds: 3.08 times

Total Debt Service Coverage, 2006: 1.21 times

Natural gas purchases, 2000: $266.4 million

2006: $625.1 million

Customers, 1997: 511,337

2006: 499,323

Debt Ratio (%): 1998: 96.0 %

2006: 96.6%

Account Collection rate (%), 2001: 88.1%

2003: 86.6%

2006: 96.6%

DEBT STATEMENT:

Senior Lien Revenue Bonds, Series 1975 Ordinance and

Series 1998 Ordinance: $1,008, 020,000

First Series C Subordinate Revenue: $12,915,000

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