STANDARD & POOR'S RATINGS SERVICES
McGRAW HILL FINANCIAL

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Summary:

Philadelphia, Pennsylvania; Gas; Joint Criteria

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Summary:

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Philadelphia gas wks (1998 Gen Ord) (wrap of insured) (AMBAC & AGM) (SEC MKT)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Philadelphia gas wks (1975 Gen Ordinance) Seventeenth ser		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Philadelphia gas wks (1998 General Ordinance)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded

Rationale

Standard & Poor's Rating Services has raised its rating on Philadelphia, Pa.'s revenue bonds, issued for Philadelphia Gas Works (PGW) under its 1975 (closed senior lien) and 1998 ordinances (subordinate working lien) to 'A-' from 'BBB+'. The outlook is stable. At the same time, Standard & Poor's raised its ratings on Philadelphia's eighth series C and E bonds to 'AAA/A-1' from 'AA+/A-1', and affirmed its 'AAA/A-1+' rating on the eighth series B and D bonds, reflecting application of Standard & Poor's joint support criteria.

The upgrade reflects our view of improving trends related to collections, coverage of fixed costs, liquidity and debt ratios for PGW, as well as the adoption of a number of credit supportive policies and procedures.

The ratings reflect our view of the following factors:

- Solid coverage of fixed costs (which treat the annual dividend payment to the City of Philadelphia as an operating expense) and adequate liquidity, both of which PGW projects to continue;
- The funding of the bulk of the capital program through internally generated funds, leading to improved debt ratios;
- Generally solid collections that have enhanced PGW's financial stability. The improved collections are partially due to above-average temperatures and lower and more stable gas prices. These make bills more affordable, but cannot be counted on to continue. However, the improved collections are also a function of the utility's enhanced billing and collection procedures which are expected to continue;
- Management's expectation that it will next need a base-rate increase effective fiscal 2018;
- A credit-supportive rate structure that insulates margins from weather variability and automatically passes on gas costs to ratepayers through quarterly adjustments; and
- PGW's strong management team.

We believe credit-weaknesses include our views of PGW's:

- Weak service area demographics, which contribute to above-average rates, historically exposing the utility to collection difficulties during periods of high gas costs or below-average temperatures;

- Dependence on the Public Utility Commission (PUC) for approval for base-rate increases, with a mixed history of support for PGW filings;
- Mutual interdependence with Philadelphia, of which the utility is a component unit;
- A service territory subject to open competition for gas supply and transmission, but not distribution; and
- Debt levels that are still moderately high, although we note improvement.

Philadelphia is continuing to explore privatizing PGW. The city received numerous bids, including one from UIL Holdings Corp. The sale would require city council approval, which is uncertain, although the mayor has recommended this. We understand that council might hold hearings. If council approves the sale, PUC approval would also be necessary, and could take an additional six-to-nine months. We understand that UIL Holdings has offered $1.86 billion for all assets and liabilities of PGW (including $175 million working capital). The proceeds would pay off about $1 billion of PGW debt. The city would put the remaining money toward the the utility and city pension systems. PGW employees would become UIL employees, with UIL guaranteeing to not reduce staffing below 1,350 for three years, while substantially maintaining benefits at current levels. Insofar as council and PUC have yet to approve the sale, we have not factored this into the ratings. We understand that debt outstanding would be defeased as part of the sale.

PGW's rates are subject to PUC approval, which we view as a credit weakness. From 2000 (when the the commission began regulating utility rates) to October 2008, the PUC approved just 42% of the total amount of base rate increases the utility requested, although we do note that all gas cost rate (GCR) adjustments have been received in full and on timely bases.

In July 2010, the PUC approved a settlement between PGW and six interveners to make permanent a $60 million extraordinary base-rate increase and a $16 million surcharge to build funding of the annually required contribution for other postemployment benefits (OPEB). As part of the approved settlement, PGW agreed not to seek another base-rate increase for two years, and not to issue additional new money debt for a period of three years. We believe that the 2010 settlement has resulted in improved cash flow and financial flexibility. In the event that the sale of PGW does not proceed, the utility expects to seek a $40 million base rate increase in 2017 (effective for fiscal 2018.

PGW has not issued additional debt since 2010, and debt ratios have shown steady improvement. Debt per customer has declined nearly 25% since 2010, to $2,064, while debt has decline to 71% of total capitalization in 2014, down from 82% in 2010. PGW expects to issue about $99 million of commercial paper to provide interim financing of capital needs in fiscal years 2015 and 2016; long-term debt plans include a $250 million issuance in fiscal 2017 (new money and commercial paper take-out) and $100 million in fiscal 2020. Nevertheless, the utility expects debt-to-capitalization will continue to decline, reaching a projected 56% by 2020.

PGW's residential heating rates are 14%-65% higher than those of other utilities in the state. We believe that this is a function of historically weak collections, sizable bad debt expense, customer responsibility and senior citizen discount programs, and a high proportion of low income customers receiving subsidized service. Similar disparities exist among other customer classes as well. As such, much of the utility's growth is for unbundled service, with alternate suppliers supplying gas.

In our opinion, PGW has a mutually interdependent relationship with Philadelphia. Historically, the city received an

$18 million annual management fee from PGW, but with the utility facing cash flow problems, Philadelphia forgave the payment in 2004, and annually granted the payment back to PGW from 2005 through 2010. In fiscal years 2011-2014, the city retained the dividend payment. We understand that the decision was made in light of the utility's improving financial condition and the impact of the economy on Philadelphia's budget. The city's five-year financial plan anticipates PGW's sale, hence the discontinuation of the dividend payment; the utility's financial forecast conservatively does not assume this sale and continues to assume that the utility will make the annual dividend payment.

Standard & Poor's evaluates PGW's financial metrics assuming the annual dividend payment is made. In fiscal years 2008, 2009, and 2010, net available revenue (after deducting the dividend payment, regardless of its grant-back status) covered debt service 1.11x, 1.31x, and 1.57x, respectively. However, we believe that these coverage levels somewhat overstated PGW's financial condition, because the utility did not fully cash fund its actuarially required contribution related to its postemployment benefit obligation. Had PGW fully cash funded the contribution, coverage levels would have been significantly lower.

In fiscal years 2011-2013, coverage declined, but we believe they were more representative of PGW's financial condition, as the utility cash funded the bulk of its OPEB obligation. Coverage levels were solid at 1.39x in 2011, 1.18x in 2012 (the product of warmer weather), and a robust 1.71x in 2013 (the product of lower debt service requirements). Estimated results for fiscal year-end 2014 (Aug. 31) suggest 1.32x coverage, and management projects coverages will range from 1.31x-1.55x from 2015-2019. We believe that these projections are based on reasonable assumptions for growth, collections and fuel prices.

We consider PGW's liquidity to be good. About $101 million in unrestricted cash and investments at fiscal year-end 2013 supplemented $60 million in available letters of credit backing the commercial paper program. Liquidity measures 111 days of fiscal 2013 operating expenses, and management's projections suggest that solid levels should continue over the next five years.

PGW is the nation's largest municipally owned gas utility, serving about 500,000 customers in Philadelphia. Low collection rates have plagued it for several years. We believe that natural gas price volatility, weather conditions, and the service territory's demographics highly influence the utility's collection rates. In 2003 (which was 5% colder than normal), PGW's collection rates fell to a historically low 87%. From 2005-2012, collection rates were in the 94%-99% range. Although they dropped to 92% in 2013, we believe that the decline was due in part to the timing of receipts versus billings, and we note that collections appear to have rebounded for 2014. We believe that the general improvement in collection rates was in some part due to the implementation of more stringent enforcement tools. But we also note that the improvement was accompanied by warmer-than-normal winter months and declining natural gas prices during the latter half of the period accompanied the improvement. We remain uncertain whether this trend will continue under less optimal circumstances.

Outlook

The stable outlook reflects our assessment of solid financial metrics that we project will continue to support the higher

rating. Should privatization move forward, we understand that debt outstanding would be defeased as a component of the sale. Should the sale not move forward, we would not expect additional credit improvement during the next two years, as above average rates and weak demographics would constrain the ratings. Meanwhile, if privatization does not proceed, we could lower the rating if financial metrics in the next two years do not approximate levels that management's projections suggest.

Related Criteria And Research

Related Criteria

- USPF Criteria: Electric Utility Ratings, June 15, 2007
- USPF Criteria: Municipal Applications For Joint Support Criteria, June 25, 2007
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Oct. 15, 2014

Ratings Detail (As Of October 21, 2014)		
Philadelphia gas wks rev rfdg bnds (1975 General Ordinance)		
Long Term Rating	A-/Stable	Upgraded
Philadelphia gas wks rev rfdg bnds (1998 Gen Ordiance) ser 8TH B		
Long Term Rating	AAA/A-1+	Affirmed
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Philadelphia gas wks rev rfdg bnds (1998 Gen Ordiance) ser 8TH E due 08/01/2031		
Long Term Rating	AAA/A-1	Upgraded
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
City of Philadelphia, Pennsylvania, Gas Works Revenue Refunding Bonds, Eighth Series C (1998 General Ordinance)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Long Term Rating	AAA/A-1	Upgraded
City of Philadelphia, Pennsylvania, Gas Works Revenue Refunding Bonds, Eighth Series D (1998 General Ordinance)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Long Term Rating	AAA/A-1+	Affirmed
Philadelphia gas wks		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Philadelphia gas wks Eighteenth ser (1975 Gen Ordinance) (CIFGNA)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Philadelphia gas wks (Gen Ordinance)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Philadelphia gas wks 16th ser		

Ratings Detail (As Of October 21, 2014) (cont.)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded
Philadelphia gas wks 4th series (1998 Gen Ordinance)		
Unenhanced Rating	A-(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.

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