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RESEARCH

Philadelphia, Pennsylvania; Gas

Publication date: 26-Mar-2007
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Credit Profile		
US$191. mil gas works rev bnds (1998 Gen Ordinance) ser 7TH due 09/01/2035		
Long Term Rating	BBB-/Stable	New
US$14.75 mil gas works rev bnds (1975 Gen Ordinance) ser 19TH due 07/01/2026		
Long Term Rating	BBB-/Stable	New
Philadelphia gas wks		
Long Term Rating	BBB-/Stable	Outlook Revised
Philadelphia gas wks VRDB (1998 General Ordinance) ser SIXTH (FSA)		
Long Term Rating	AAA/A-1+/Stable	Affirmed
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised

Rationale

The rating outlook on Philadelphia Gas Works' (PGW) bonds issued under the 1975 (closed lien) and 1998 (working senior lien) ordinances and subordinate-lien bonds has been revised to stable from negative, reflecting improved collections and the grant back of PGW's annual dividend payment to the city of Philadelphia, resulting in the restoration of adequate coverage levels. Further credit improvement hinges on PGW's establishing a track record for consistent billed revenue collections across diverse heating and economic conditions, as well as maintenance of financial operations that adequately cover debt and other obligations (such as dividend payments and loan repayments to the city) while providing enhanced liquidity.

The 'BBB-' Standard & Poor's underlying rating (SPUR) and 'BB+' SPUR have been affirmed.

The ratings on PGW reflect:

- A sizable service territory (with weak demographics) that is subject to open competition for gas supply and transmission, but not distribution;
- Dependence on Pennsylvania Public Utility Commission approval for base rate increases, coupled with already high rates;
- improving collections, financial operations, and coverage levels, balanced by marginal liquidity augmented by a CP program dependent on LOC renewal; and
- Moderately high debt levels.

Serving to stabilize the rating at the current level is recent improvement in collection of billed revenue following the implementation of a new billing system, the legislative enactment of more stringent collection tools, and a relatively mild winter. The enhanced collections, coupled with supportive actions taken by the city of Philadelphia (deferral of dividend payments and loan repayment) have helped PGW to restore coverage of fixed obligations to adequate levels for the current rating.

PGW's rates are subject to approval by the PUC. On Dec. 22, 2006, PGW filed for a $100 million base rate increase and a $10 million increase to capture capacity release funds that are currently being passed through to customers through its gas cost rate (GCR). Management has stated that funds provided by the base rate increase would be used by PGW to

- Cover increased health care and pension costs, interest expense, and margin losses;
- Enhance working capital;
- Repay its $45 million loan to the city;
- Reduce the use of short-term CP; and
- Provide a source of internal funds for capital expenditures and debt reduction.

The PUC is expected to rule on the base rate request by Sept. 22, 2007.

While granting of the rate increase would have a positive benefit on coverage and liquidity, the upward rate pressure may negatively affect collections and erode some gains that PGW made in this area over the past few years. PGW's rates are 42% higher than other utilities in the state, a function of historically weak collections, sizable bad debt expense, and a customer responsibility and senior citizen discount programs.

Coverage of debt service (including senior and subordinate liens, and CP) was 1.41x in 2006. The 2006 coverage level was an improvement over fiscals 1999-2003, when PGW posted coverages ranging from 0.86x-1.08x. However, the 2006 coverage does not include annual dividend payments to the city, which has been deferred over past three years. Had the city not been willing to defer its annual $18 million dividend payment from PGW, coverage would have been 1.2x (2006). Moreover, some of the improvement was attributable to a one-year decrease in debt service as PGW took up-front savings associated a refunding in January 2006.

Deferral of the dividend payment has been budgeted by the city for 2007, and the city has included the deferral for 2008-2011 in its five-year plan. In addition to the dividend deferral, the city granted PGW deferred repayment of a $45 million loan, which is now due in August 2008.

Liquidity is weak, with cash and investments ($6.7 million) totaling three days' operating expenses at fiscal year-end 2006, but augmented by a $150 million CP program, backed by a letter of credit from JP Morgan through May 2007. PGW recently received authorization to increase the CP program to $200 million, and a consortium of banks has committed to LOCs totaling $150 million through 2010, and a supplemental LOC for $50 million that would be extended under certain stress conditions . Extension of the LOC, or identification of alternate sources of liquidity, are essential for maintenance of PGW's rating.

PGW is the nation's largest municipally owned gas utility, serving about 506,000 customers in Philadelphia. PGW had been plagued by low collection rates for several years. The collection rates are a function of the service territory's demographics, which include low incomes (74% of the national average), 25% population decline since 1960, and a population dependent on fixed transfer payments (44% above the national average). Historically, under-collections of billed revenues have become acute in years with colder-than-normal winter months and high gas prices. In 2003 (which was 5% colder than normal), PGW's collection rates fell to an historically low 87%. In the past two years, collection rates showed improvement (in the 95% range) due to warmer-than-normal winter months. Also contributing to the improved collection rates is the recent implementation of more stringent enforcement tools to address delinquent accounts. The recently enacted Responsible Utility Customer Protection Act (Act 201) should provide PGW with tools for sustaining higher-than-historical collection rates because of its more liberal shut-off policies and stricter deposit requirements.

PGW has an above-average debt burden. Debt represents about 83% of the utility's capitalization and average debt per customer is about $2,400. Reduction of these ratios is largely dependent on PUC approval of PGW's base rate increase request. PGW's five-year capital plan totals $379 million.

Since 2003, PGW has operated in an environment of open competition for gas supply, but continues to retain an exclusive distribution service area. Since then, a modest number of interruptible customers have switched suppliers, but insofar as PGW earns no margin on gas supply sales and never purchased firm transmission for these customers, there is no impact to credit.

PGW has been assigned a debt derivative profile of '2' on Standard & Poor's four-point DDP scale with '1' representing the lowest risk and '4' the highest risk. The overall score of '2' reflects Standard & Poor's Ratings Services' view that PGW's single swap represents a neutral credit risk at this time.

Outlook

The outlook has been revised to stable from negative. The outlook revision reflects improved collections and coverage levels, as well as the expected extension of the grant back of PGW's annual dividend payment to the city. However, despite the improvement, there are several challenges that have the potential to erode the utility's credit quality. Despite the benefits of stronger collection enforcement tools, the utility needs to demonstrate an ability to sustain recent improvements in collection rates in the face of higher commodity costs and the system's customers' weak demographic profile. PUC support for PGW's recent filing for a base rate increase could aid PGW in addressing these issues. However further rate increases would add to already high rates and exacerbate the utility's weak competitive position, and may ultimately prove counterproductive in its impact on collections and coverage, eroding recent improvement in these areas.

In lieu of the base rate increase, PGW needs to formulate a concrete credit-protective strategy for addressing the 2011 expiration of the city's current annual refund of PGW's dividend payment and the city's $45 million loan to PGW, which is due in August 2008.

Service Territory And Markets

PGW serves as supplier of last resort to a service area exhibiting weak demographics, which has contributed to historical weak collection of billed revenue and sensitivity to rates.

PGW has approximately 506,000 customers within the city limits, and the service area covers 129 square miles. Residential customers comprise roughly 71% of revenue, while the commercial and industrial sectors comprise roughly 26%. Two thirds of commercial/industrial sales are firm sales, the bulk of the remainder are interruptible. Leading customers are diverse, with the 10 leading accounting for just 3.7% of revenue.

Approximately 45,000 senior citizens are eligible to receive a 20% discount. These customers were "grandfathered in" in 2003.

Consistent with general population decline in Philadelphia, PGW has experienced 3% decline in customers over 2002-2005. Wealth levels are low, with median household effective buying incomes at only 74% of the national average. Unemployment rates were above average at 5.8% at December 2006, compared with 4.5% for the nation.

Collections

PGW had been plagued by low collection rates for several years. The collection rates are a function of the service territory's demographics. Historically, undercollections of billed revenues have become acute in years with colder-than-normal winter months and high gas prices. In 2003 (which was 5% colder than normal), PGW's collection rates fell to an historically low 87%. In the past three years, collection rates showed improvement (about 95% in 2005 and 2006), in part due to warmer-than-normal winter months. Also contributing to the improved collection rates is the recent implementation of more stringent enforcement tools to address delinquent accounts. The recently enacted Responsible Utility Customer Protection Act (Act 201) should provide PGW with tools for sustaining higher-than-historical collection rates because of its more liberal shut-off policies and stricter deposit requirements.

These improvements, coupled with relatively mild winters in 2005 and 2006, have resulted in collection rates improving from 87% in 2003 to 91.7% in 2004, 96% in 2005, and 96.6% in 2006. The 2006 collection rates were bolstered by a winter that was 16.7% milder than average, though mitigated by higher gas prices in the wake of Hurricanes Rita and Katrina.

Pennsylvania Act 201 "The Responsible Utility Customer Protection Act" has provided PGW with enhanced collection tools. It allows PGW to:

- Shut off service to delinquent customers above 150% of the federal poverty level threshold without PUC approval during the winter months.
- Collect delinquent bills (or set up payment plans) and charge reconnect fees and deposits for reinstatement of service.
- Collect deposits for customers without credit history, whereas the previous law held that "no" history must be treated as "good" history, especially important given the large student population in Philadelphia, many of whom would walk away from their bills.

Before Act 201 there was inconsistent interpretation of rules governing reestablishing service for delinquent customers, which led to lengthy repayment plans. Act 201 removed the inconsistency by defining the length of the agreement and initial up front payments by household income and occupancy. Act 201 also limited the number of times the utility must offer a new agreement once it has been broken. This change reduced the number of repeat and first-time repayment agreements.

The process of shutting off is dictated by regulation. However, any delinquent customer is eligible for shutoff unless they have protection under regulation (i.e. medical reason, high bill dispute, payment arrangement, complaint filed with the PUC, etc.). PGW has automated the selection process of determining what delinquent customers will be placed on the credit and collection path.

Political willingness to make winter shutoffs and difficulty in accessing a large segment of shut off valves complicates the process. Nevertheless, the ability to turn off service has leveraged improved collections.

Operations

PGW has firm gas supply contracts for its firm supply customers under take and pay contract. Firm gas supply under contract for the current winter season represents roughly 91% of firm transmission capacity.

PGW has nine city gate stations served by two pipelines--Texas Eastern Transmission Corp (TETCO) and Transcontinental Gas Pipeline Corp. (TRANSCO). Metering pressure controls are present at each gate. The distribution system consists of 3,019 miles of main, 446,281 service lines, and 515,464 meters (503,347 active). Roughly 53% of gas mains are cast iron, half of which are wrapped and cathodically protected. One-third of mains are steel and the reminder are ductile iron. Service lines are 60% plastic and 40% steel (16% protected).

In 2006, PGW had 728,000 DT design day requirements. This demand was met through firm transportation (41%), storage (23%) and liquefied natural gas (LNG) (34%). The two interstate pipeline companies serving PGW cannot meet PGW storage requirements in peak winter months. As a result PGW has contracted with four pipeline operating storage facilities and produces LNG to meet the peak needs, as well as future demand.

PGW operates two natural gas facilities--Richmond and Passyunk--each with LNG capabilities. Passyunk received LNG via cryogenic trailer shipments from the Richmond plant, one of the largest in the nation. The phase one upgrade of the Richmond LNG plant, which enables year-round production, was completed in 2005. The phase one upgrade allows for liquefaction capability of 16,000 mcf per day. Phase 2 of the project, which will boost capacity and provide for backup and redundancy, is expected to cost $27 million and is included in the capital plan.

Competitive Landscape

In 1999, the state passed the Gas Choice Act, opening up competition for gas supply and requiring unbundling of rates. PGW restructured rates in 2002, and has been subject to open competition since 2003, with customers able to choose alternative suppliers of gas and gas transportation services, but not distribution services. Since September 2003, there have been 143 dual fuel customers that have switched to third-party suppliers. These customers come under the provisions of the PGW Interruptible Transportation Tariff. PGW never purchased firm transportation for these customers when they were PGW customers, so with regard to firm transportation utilization, there has been no financial effect. However, since August 2006, PGW has two approved firm suppliers that have begun to service a small but growing volume of firm customers. As of Oct. 18, 2006, approximately 300 firm customers have enrolled with third party suppliers. PGW is a supplier of last resort for customers unable to secure supply elsewhere.

PGW's residential rates are, on average, 42% above those charged by other suppliers in the region. This is largely a function of the weak collections and high bad debt expense, as well as funding of low income customer assistance (LICAP) and senior citizen discount programs. PGW has roughly 76,000 LICAP customers (15% of total customers) that, based on incomes, pay reduced rates. The cost of providing the subsidy is passed on to other ratepayers. Also placing upward pressure on rates is roughly $50 million of annual bad debt expense.

PGW filed for a $100 million base rate increase in December 2006. Management has stated that funds provided by the base rate increase would be used by PGW to cover increased health care and pension costs, enhance working capital, repay its $45 million loan to the city, reduce the use of short-term CP, and provide a source of internal funds for capital expenditures and debt reduction. The PUC is expected to rule on the base rate request by Sept. 22, 2007. While granting of the rate increase would have a positive benefit on coverage and liquidity, the upward rate pressure may negatively affect collections and erode some gains that PGW made in this area over the past few years.

PGW's rate structure includes a base rate and a GCR that passes through to ratepayers fluctuations in commodity costs, transportation, and storage on a quarterly basis, with an annual true-up spread over the ensuing year. PGW maintains a Weather Normalization Adjustment (WNA) for heating customers in certain rate classes (including residential). The WNA smoothes out customer bills across seasons, and preserves margins against year-to-year fluctuations that might otherwise result from abnormal weather patterns.

Regulatory Environment

The PUC sets rates for PGW. The rates set by the PUC must honor provisions in the bond documents (relative to the rate covenant) and the PUC must use the same rate setting methodology that PGW used before the Gas Choice Act (PGW uses a cash flow methodology). The PUC can not require PGW to take actions that are in violation of its adopted financial plan.

The previous rate setting methodology called for rates to be, at a minimum, sufficient to cover O&M (including depreciation, employee retirement costs, the management fee, expense of the gas commission, debt service, and applicable rate covenants), and an annual $18 million payment to the city, and provide appropriation for debt reduction and capital additions not provided for in the capital improvement plan but deemed necessary by the gas commission and approved by the city council, and provide for appropriation for additions to working capital as deemed necessary by management and approved by the PUC.

PGW last sought PUC approval for a base rate increase in 2003 ($60 million), but the PUC approved a base rate increase for half that amount. As mentioned above, PGW filed for a $100 million base rate increase in December 2006, and the PUC is expected to rule on the request by Sept. 22, 2007.

Finances And Capital

Fiscal 2006 coverages improved to an adequate level. However, mitigating some of the improvement in fiscal 2006 are reduced debt service requirements for the fiscal year, as PGW took up-front savings in its February 2006 refunding. Coverage of debt service (including senior and subordinate liens, and CP) was 1.21x, 1.19x, and 1.41x in fiscals 2004, 2005, and 2006. However, these coverages do not include annual dividend payments to the city, which were deferred over this period. Had the city not been willing to defer its annual $18 million dividend payment from PGW, coverage would have been 1.02x (2004), 1.00x (2005), and 1.20x (2006). Over fiscals 1999-2003, PGW posted coverages ranging from 0.86x-1.08x.

Deferral of the dividend payment has been budgeted by the city for 2007, and the city has included the deferral for 2008-2011 in its five-year plan. However, there is currently no guarantee that such deferral will actually be enacted beyond 2007. In addition to the dividend deferral, the city granted PGW deferred repayment of a $45 million loan, which is now due in August 2008.

Liquidity is weak, with cash and investments ($6.7 million) totaling three days' operating expenses at fiscal year-end 2006, but augmented by a CP program that was increased 50% in January 2006 to $150 million, backed by a letter of credit from JP Morgan through May 2007. The LOC does not contain a term-out provision, which could pressure the city's ability to meet financial obligations if the city needs to reimburse the LOC provider. PGW recently received authorization to extend the CP program to $200 million and has received commitments for LOCs totaling $150 million through 2010, and a supplemental $50 million that would be activated under certain conditions. At fiscal year-end 2006, PGW had $55 million of CP outstanding, up slightly from the previous two fiscal year ends. Extension of the LOC, or identification of alternate sources of liquidity are essential for maintenance of PGW's rating.

PGW has a high debt burden. Debt represents about 83% of the utility's capitalization and average debt per customer is about $2,400. As of Aug. 31, 2006, the utility's $1.08 billion of outstanding debt obligations consisted of $301 million senior closed-lien 1975 ordinance bonds, $740 million senior 1998 ordinance bonds, $13 million subordinate 1998 series bonds, and a $45 million loan from the city. Debt levels are expected to continue to increase in the short term because this issuance, which is part of PGW's $379 million five year capital plan. However, should the PUC grant PGW's base rate increase request, management has indicated its intend to accelerate debt retirement, and lower debt burden. In past years, PGW issued debt to fund its capital program on approximately a two-year cycle, but no additional debt is anticipated after the March issuance.

The company's gas supply contracts contain adequate assurance provisions, which provide counterparties with the right to demand prepayment if a supplier has reasonable grounds for citing insecurity regarding PGW's ability to perform financial obligations created under the contract, including a material change in PGW's creditworthiness.

Debt Derivative Profile (DDP)

PGW has been assigned a debt derivative profile of '2' on Standard & Poor's four-point DDP scale with '1' representing the lowest risk and '4' the highest risk. The overall score of '2' reflects Standard & Poor's Ratings Services' view that PGW's single swap represents a neutral credit risk at this time. PGW has entered into a floating-to-fixed swap in connection with the issuance of variable rate demand refunding bonds. The swap follows the guidelines established by Philadelphia's adopted derivative policy. The swap counterparty is JP Morgan Chase Bank, N.A. (AA-). The risk of swap termination and the exposure to a termination payment are remote because of the swap counterparty's high rating relative to the termination triggering rating of 'BBB+', and the presence of bond insurance that removes the risk that the sixth series bonds' currently-enhanced rating will fall to its termination trigger rating of 'BBB+'. PGW is not exposed to collateral requirements while the bond insurance is in effect.

While a change in the mode of the variable-rate bonds from a weekly rate to a fixed or term mode would terminate the swap, such a mode change is unlikely because the issuer would only change modes if it were economical to do so and would have to factor any potential termination payment into the calculation of the economics of a mode change.

Under the swap, PGW tenders fixed payments and receive variable payments. The variable payments are not directly tied to actual variable rate debt service on the bonds. Rather, the swap counterparty's variable payments to PGW will equal the Bond Market Association Municipal Swap Index (BMA) to and including Aug. 1, 2011, and thereafter a floating rate payment equal to 70% of one-month LIBOR, times the notional amount thereafter. The swap's duration is for the life of the bonds. PGW has assumed basis risk for any difference between the bonds' actual interest rate and the interest received from the swap counterparty. However, there is strong empirical evidence to suggest that BMA and, thereafter, 70% of LIBOR, should closely correlate with the interest expense on these weekly rate bonds.

Ratings Detail (As Of 26-Mar-2007)

Philadelphia gas wks Eighteenth ser (1975 Gen Ordinance) (CIFGNA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks (ASSURED GTY)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks (Sub1998 Gen Ordinance) ser C (FSA)		
Unenhanced Rating	BB+(SPUR)/Stable	Outlook Revised
Philadelphia gas wks (1975 Gen Ordinance) Seventeenth ser (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks (1975 Gen Ordinance) (AMBAC)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks (1998 General Ordinance) (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks (1998 Gen Ordinance) ser A (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks (1998 Gen Ordinance) ser B (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks (1998 Gen Ordinance) THIRD ser (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks 16th ser (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks 2nd ser (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised
Philadelphia gas wks 4th series (1998 Gen Ordinance) (FSA)		
Unenhanced Rating	BBB-(SPUR)/Stable	Outlook Revised

Many issues are enhanced by bond insurance.