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Philadelphia Gas Works, Pennsylvania; Gas; Joint Criteria

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Credit Profile		
US$65.0 mil gas wks rev rfdg bnds (1998 General Ordinance) ser 10TH SER due 07/01/2024		
Long Term Rating	BBB+/Stable	New
US$17.0 mil gas wks rev rfdg bnds (1975 General Ordinance) ser 20TH SER due 07/01/2015		
Long Term Rating	BBB+/Stable	New
Philadelphia gas wks (1998 Gen Ordinance)		
Long Term Rating	BBB+/Stable	Affirmed

Rationale

Standard & Poor's Ratings Services assigned its 'BBB+' rating and stable outlook to Philadelphia Gas Works (PGW), Pa.'s revenue refunding bonds (20th series under the 1975 ordinance and 10th series under the 1998 ordinance). Standard & Poor's also affirmed its long-term and underlying ratings (SPURs) on outstanding parity obligations as well as its 'BBB+' long-term rating, with a stable outlook, on PGW's closed senior lien debt issued under its 1975 ordinance, its 'BBB+' rating on outstanding subordinate lien debt issued under PGW's 1998 ordinance, and its 'BBB' rating on PGW's junior subordinate bonds. Standard & Poor's also affirmed its 'AAA/A-1' rating on certain series of bonds, reflecting application of Standard & Poor's Joint Support Criteria, after previously upgrading the ratings in 2010.

The ratings reflect our opinion of:

- Solid collections which enhance PGW's financial stability. Although partially resulting from above-average temperatures which make bills more affordable but cannot be counted on prospectively, the improved collections are also a function of lower and more stable gas prices, as well as the utility's enhanced billing and collection procedures, both of which are expected to continue in the near future;
- Management's expectation that it will not need to seek regulatory approval of a rate increase prior to 2014;
- Good financial metrics highlighted by strengthened debt service coverage, stronger cash flow, and better liquidity. However, we note that the utility has not historically cash-funded its actuarially required contribution to meet its post employment benefit obligation; and
- Management's expectation that it will not add additional debt until 2014-2015, enabling PGW to reduce leverage.

In addition, the ratings reflect what we consider PGW's strong management team and a credit-supportive rate structure that insulates margins from weather variability and automatically passes gas costs to ratepayers through quarterly adjustments.

Somewhat mitigating these factors, in our view, are PGW's:

- Mutual interdependence with the city of Philadelphia ('BBB' GO rating), of which PGW is a component unit;
- Weak service area demographics which contribute to above-average rates, historically exposing PGW to

collection difficulties during periods of high gas costs and/or below-average temperatures;
- Dependence on the Public Utilities Commission (PUC) for approval for base rate increases, with a mixed history of support for PGW fillings;
- A service territory subject to open competition for gas supply and transmission, but not distribution;
- Debt levels that, while expected to decline, are moderately high.

PGW's rates are subject to approval by the PUC. On July 28, 2010, the PUC approved a settlement between PGW and six interveners to make permanent a $60 million extraordinary rate increase and to adopt rate increases needed to provide $16 million in annual funding for other postemployment benefits (OPEB) over a 30-year period. We believe the move to build funding of the ARC into base rates is credit-supportive and will improve PGW's future financial flexibility.

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 three years. We understand PGW could seek a temporary base rate increase in the case of an emergency. Because of its improved collections and cash flow, PGW's financial projections indicate the utility does not plan to do either through 2014.

Despite the recent approval of PGW's rate case, we believe the PUC has generally not supported PGW base rate filings. Between 2000 (when the PUC began regulating PGW rates) and October 2008, the PUC approved only 42% of the total amount of base rate increases requested by PGW, although we note that all gas cost rate (GCR) adjustments have been received in full and on timely bases.

Monthly residential bills are between 36% and 87% higher than other utilities in the state, which we consider 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.

In our opinion, PGW has a mutually interdependent relationship with Philadelphia. The city has recently commissioned a study to examine the privatization of PGW, although we note that such studies have historically been conducted to no effect.

Historically, the city received an $18-million annual dividend payment from PGW. With PGW facing cash flow problems, the city forgave the payment in 2004 and has annually granted the payment back to PGW since 2005. (Additionally, the city loaned PGW $45 million, which PGW has since repaid.) Standard & Poor's has long evaluated PGW's financial metrics under two scenarios—with and without the annual dividend grant back. We believe good financial metrics under both scenarios support the rating on PGW.

With the grant-back, debt service coverage was 1.29x, 1.48x, and 1.76x, over fiscal 2008-2010, respectively. Had PGW not received the grant-back, coverage would have been adequate at 1.11x, 1.31x, and 1.57x.

However, we believe these coverage levels somewhat overstate PGW's historical financial condition. PGW did not cash fund its actuarially required contribution to fund its other postemployment benefit obligation. Had PGW cash-funded the contribution (roughly $26 million annually over fiscal 2008-2010), coverage (assuming no grant-back) would have been decidedly slimmer at 0.85x, 1.07x, and 1.3x in fiscal 2008-2010, respectively.

The combination of PGW's improving finances and the impact of the economy on Philadelphia's budget have resulted in a re-examination of the status of the city's financial and operational relationship with PGW. The city's five-year financial plan (2011-2016) does not contain continued support for granting-back of the dividend payment to PGW. Nevertheless, coverage levels are expected to remain solid. Assuming collection levels consistent with the past five years, management projects coverage of debt service will range from 1.41x to 1.62x over 2011-2016, levels that we consider supportive of the current rating.

We consider PGW's liquidity good. Roughly $79 million in unrestricted cash and investments at fiscal year-end 2010 is supplemented by $90 million in available lines of credit backing its commercial paper program. Liquidity has improved over the past three fiscal years, from 55 days in 2008 to 77 days in 2009 and 104 days in 2010.

PGW is the nation's largest municipally owned gas utility, on average for 2011 serving about 491,000 customers in Philadelphia. Low collection rates have plagued PGW for several years. We believe PGW's collection rates are highly influenced by natural gas price volatility, weather conditions, and the service territory's demographics. In 2003 (which was 5% colder than normal), PGW's collection rates fell to a historically low 87%. In the past five years, collection rates have been in the 94%-99% range but accompanied by warmer-than-normal winter months and recent declines in natural gas prices that have reduced heating bills. Also contributing to the improved collection rates is the recent implementation of more stringent enforcement tools to address delinquent accounts.

In our opinion, PGW has an above-average debt burden. Debt represents about 85% of the utility's capitalization and average debt per customer is about $2,500.

PGW has a Debt Derivative Profile (DDP) score of '2' on Standard & Poor's four-point DDP scale, with '1' representing the lowest risk and '4' the highest risk. The '2' score reflects our view that PGW's single swap represents a neutral credit risk at this time.

Outlook

The stable outlook reflects our opinion of the utility's improved collection levels and financial metrics enabling it to manage potential fluctuation in these areas, while providing a cushion as the city suspends the grant-back of the dividend.

Service Territory And Markets

PGW serves as supplier of last resort to a service area exhibiting what we consider weak demographics. We believe this has contributed to historically weak collection of billed revenue and sensitivity to rates.

PGW has approximately 464,000 service lines within the city limits, and the service area covers 129 square miles. Residential customers constitute roughly 72% of revenue, while the commercial and industrial sectors make up roughly 25%. About two-thirds of commercial/industrial sales are firm sales; only 2% of PGW's revenue comes from interruptible customers. The customer base is diverse, with the 10 leading customers accounting for less than 5% of revenue.

Approximately 31,000 senior citizens are eligible to receive a 20% discount (down from 70,000 in 2004). These customers were "grandfathered-in" in 2003.

Consistent with general population decline in Philadelphia, management expects a 4.1% decline in customers over 2011-2016. Wealth levels are low, with median household effective buying income at only 74% of the national average. Unemployment rates were above-average at 10.2% in May 2011.

Collections

Low collection rates have plagued PGW for several years. We believe the collection rates are a function of the interplay of natural gas prices, weather conditions, economic conditions, and the service territory's demographics. 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 declined to a historically low 87%. In the past four years, collection rates showed improvement, partially resulting from warmer-than-normal winter months and recent declines in natural gas prices. Also contributing to the improved collection rates is the recent implementation of what we consider more stringent enforcement tools to address delinquent accounts. We expect the recently enacted Responsible Utility Customer Protection Act (Act 201) will provide PGW with tools for sustaining higher-than-historical collection rates because of its more liberal shut-off policies and stricter deposit requirements.

Pennsylvania Act 201, "The Responsible Utility Customer Protection Act," 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; and
- 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.

We believe that before Act 201 there was inconsistent interpretation of rules governing reestablishing service for delinquent customers, which led to lengthy repayment plans. In our opinion, 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, we believe the ability to turn off service has leveraged improved collections.

We believe these improvements, coupled with relatively mild winters over 2005-2008, have resulted in collection rates improving from 87% in 2003 to 91.7% in 2004, 96% in 2005, 97% in 2006, 96% in 2007, and 95% in 2008. However, the 2006-2008 collection rates were bolstered by winters that were each 17% milder than average. In 2009 collections declined to 94%, as cooler weather returned, but bounced back in 2010 to 99% as temperatures were warmer once again.

Operations

Since 2003, PGW has operated in an environment of open competition for gas supply, but it 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 firm gas supply contracts for its firm supply customers under take-and-pay contract.

PGW has nine city gate stations served by two pipelines—Spectra and TRANSCO-Williams. Metering pressure controls are present at each gate. The distribution system consists of roughly 3,000 miles of main, 464,000 service lines, and 512,000 active meters. Roughly 52% of gas mains are cast iron, one-third of mains are steel, 11% are plastic, and the reminder are ductile iron. Service lines are 66% plastic and 34% steel.

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 receives LNG via cryogenic trailer shipments from the Richmond plant, one of the largest in the nation. An upgrade of the Richmond LNG plant in 2005 enables year-round production, providing a liquefaction capability of 16,000 mcf per day.

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. 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 regarding firm transportation utilization there has been no financial effect. PGW is a supplier of last resort for customers unable to secure supply elsewhere.

PGW's residential rates are 36%-87% higher than other Pennsylvania utilities. We believe 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 84,000 LICAP customers (19% of total customers) who, 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 a somewhat sizable annual bad debt expense, which was $35 million in 2010, $42 million in 2009, and $37 million in 2008—sizable but significantly reduced from the $70 million recorded in 2005. The accumulated provision for uncollectible accounts was $103 million in 2010. However, given its high residential load, PGW is not as exposed to competitive pressures as it would be if it had a greater industrial base.

PGW's rate structure includes a base rate and a GCR that passes through to ratepayers fluctuations in commodity costs, transportation, and storage quarterly, 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 cannot require PGW to take actions in violation of its adopted financial plan.

The previous rate-setting methodology called for rates to be, at 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, to 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 to provide for appropriation for additions to working capital as deemed necessary by management and approved by the PUC.

In November 2008, PGW filed with the PUC an extraordinary or emergency base rate increase of $60 million (5.2%). PGW received approval on Dec. 19, 2010, which became effective Jan. 1, 2009. At the same time, the PUC ordered a $100-million Gas Cost Rate (GCR) reduction and a $35-million Universal Service Rate reduction for LICAP customers. The combined actions resulted in a $42-million reduction in PGW revenue. PGW filed a formal rate case in December 2009 to make the emergency base rate increase permanent. Having reached settlement with interveners in 2010, PGW received PUC approval in July 2010.

PGW has historically received PUC approval for roughly 42% of requested base rate increases, although the utility has received approval for all gas cost rate adjustments.

Finances And Capital

With the grant-back, coverage of debt service requirements were 1.29x, 1.48x, and 1.76x, over fiscal 2008-2010, respectively. Had PGW not received the grant-back of the dividend payment to the city, coverage would have been 1.11x, 1.31x, and 1.51x.

Assuming collection levels consistent with the past five years and no further grant-backs, management projects debt service coverage will range from 1.4x to 1.6x over 2011-2016. We believe these coverage levels are marked improvements over fiscal 1999-2003, when PGW posted debt service coverages ranging from 0.86x-1.08x.

The grant-back of the annual payment has been not been included in the city's 2011-2016 financial plan.

PGW has a high debt burden. Debt represents about 85% of the utility's capitalization, and average debt per customer is about $2,500. Debt levels are expected to decrease, as PGW anticipates excess margins being utilized to fund the majority of capital needs over the next several years, and because of the expected PUC approval for the recently filed rate case, which contains funding for the annual required contribution (ARC) to amortize other postemployment benefits (OPEB). PGW's OPEB liability totals roughly $654 million. PGW expensed but did not fund $26 million to $27 million in OPEB liabilities in each of fiscal 2007-2010.

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 under the contract, including a material change in PGW's creditworthiness.

Related Criteria And Research

- USPF Criteria: Electric Utility Ratings, June 15, 2007
- USPF Criteria: Municipal Applications For Joint Support Criteria, June 25, 2007

Ratings Detail (As Of August 22, 2011)		
Philadelphia gas wks rev rfdg bnds (1998 Gen Ordiance) ser 8TH B		
Long Term Rating	AAA/A-1+	Affirmed
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks rev rfdg bnds (1998 Gen Ordiance) ser 8TH C		
Long Term Rating	AAA/A-1+	Affirmed
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks rev rfdg bnds (1998 Gen Ordiance) ser 8TH D due 08/01/2031		
Long Term Rating	AAA/A-1	Affirmed
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks rev rfdg bnds (1998 Gen Ordiance) ser 8TH E due 08/01/2031		
Long Term Rating	AAA/A-1+	Affirmed
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks (1998 Gen Ordinance) ser NINTH (AGM)		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks (1998 Gen Ord) (wrap of insured) (AMBAC & AGM) (SEC MKT)		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks Eighteenth ser (1975 Gen Ordinance) (CIFGNA)		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks (Gen Ordinance)		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks (Sub1998 Gen Ordinance) ser C		
Unenhanced Rating	BBB(SPUR)/Stable	Affirmed
Philadelphia gas wks (1975 Gen Ordinance) Seventeenth ser		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks (1998 General Ordinance)		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks (1998 Gen Ordinance) ser A		

Ratings Detail (As Of August 22, 2011) **(cont.)**		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks (1998 Gen Ordinance) THIRD ser		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks 16th ser		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks 2nd ser		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed
Philadelphia gas wks 4th series (1998 Gen Ordinance)		
Unenhanced Rating	BBB+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.