New Issue: **MOODY'S ASSIGNS Baa2 RATING TO PHILADELPHIA GAS WORKS $150 MILLION REVENUE BONDS, NINTH SERIES (1998 GENERAL ORDINANCE); OUTLOOK REVISED TO STABLE FROM NEGATIVE**

Global Credit Research - 06 Jul 2010

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

Philadelphia (City of) PA Gas Enterprise
Gas Utilities
PA

Moody's Rating

ISSUE		RATING
Gas Works Revenue Bonds, Ninth Series (1998 General Ordinance)		Baa2
Sale Amount	$150,000,000	
Expected Sale Date	07/15/10	
Rating Description	Gas Utility Revenue Bonds	

Moody's Outlook Stable

Opinion

NEW YORK, Jul 6, 2010 -- Moody's Investors Service has assigned the credit rating of Baa2 to the $150 million City of Philadelphia Gas Works (PGW) Revenue Refunding Bonds, Ninth Series A (1998 General Ordinance). The outlook has been revised to stable from negative. The bonds may be issued as Build America Bonds, and if so, PGW intends to budget for the full interest payments and receive the federal reimbursement as a revenue source. Moody's has also affirmed the Baa2 rating on $867 million of outstanding parity 1998 Senior General Ordinance Bonds, and affirmed the Baa2 rating on $239.5 million of outstanding 1975 General Ordinance Bonds, and affirmed the Baa3 rating on $7.05 million of outstanding 1998 Subordinate General Ordinance Bonds.

The Baa2 credit rating 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 1.5x rate covenant. The rating also factors PGW's strong management team that maintains a constructive relationship with the state regulatory board, continues to improve the utility's operations yielding cost saving efficiencies, and effectively manages gas supply costs. The rating also considers the utility's very high leverage and weak, albeit improved, internal liquidity, as well as solid debt service coverage ratios that have averaged above 2.0x for the past five years on a bond ordinance basis and above 1.6x on a net revenue basis for the systems 1975 and 1998 Senior General Ordinance Bonds.

The Baa3 subordinate lien rating considers the bonds position in the flow of funds, the 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 outlook was revised to stable due to PGW's ability to successfully obtain a long-term base rate increase, an improved liquidity position, stabilization of revenues as the economy begins to recover, and Moody's expectation that PGW's strong management team will continue to effectively monitor operations to obtain recurring cost savings while ensuring timely rate recovery and overall fiscal health.

USE OF PROCEEDS:

The bond proceeds will be utilized for general capital improvements over the next three years including line replacement and general upkeep.

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 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 variable rate bonds have liquidity support through a Direct Pay Letter of Credit with JPMorgan that expires in August 2011. 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 $39.2 million as of June 25, 2010. 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 (A1/NEG)

*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 provides some improved financial flexibility

Challenges:

*Sizable low income residential population contribute to delinquencies

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

*Philadelphia's general government budgetary pressure limits the city's ability to assist PGW with any financial assistance and may result in PGW aiding the city

*Weak liquidity at year-end, despite recent improvements

*High rates compared to peers

*Rollover risk related to LOC for VRDOs that expires in August 2011 given tight credit markets

Outlook

The stable outlook reflects our expectation that the newly approved base rate increase will provide sufficient cushion to offset operational fluctuations, as well as the utilities history of strong management of gas supply and operating costs, which is expected to continue.

What Could Change the Rating UP:

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

What Could Change the Rating DOWN:

The rating could be downgraded should the accounts receivable problem return, debt service coverage weakens, the recently approved base rate increase is stalled or halted, or significant rollover issues associated with the LOC renewal in 2011 that results in higher ongoing debt costs.

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 shore up 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 2015. The currently weak financial condition of the city may result in PGW transferring funds from the sale of real estate assets controlled by PGW but belonging to the City to help relieve the city's budgetary pressure, 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. In fiscal 2009, about 76% of gas sales were to residential customers, 21% to commercial and industrial customers, and 3% to municipal and housing customers. No dominant customer risk exists, yet residential customers have low socioeconomics and a high poverty rate, thus it is hard to absorb higher gas bills. Despite this risk, improved collection and write-off procedures, increased federal LIHEAP funds, have improved the ratio of billings to collections from 86.7% in 2003 to 95.5% in 2008 and up to 97% in 2010.

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 stimulus 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 34% higher than its closest competitor PECO (issuer rated A3/negative outlook). 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 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. 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 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 a city-owned utility. PGW has effectively obtained approval for a automatic weather normalization adjustment, has consistently obtained timely approval of quarterly (or monthly) gas rate adjustments, and has obtained approval for 42% of all base rate requests to date. PGW does not anticipate another base rate request for at least 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: SATISFACTORY DEBT SERVICE COVERAGE LEVELS 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. Moody's expects PGW to continue to maintain strong senior lien bond ordinance debt service coverage ratios and modest all in fixed charge coverage ratios moving forward, given a recently approved base rate increase and ongoing efficiency improvements. The system's liquidity has historically been very weak, but has recently improved, whereby the city'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 is projected to continue in 2010, but may moderate in 2011 given the city's request for financial assistance. The city continues to maintain its commercial paper program with $120 million available (about 74 days cash on hand), despite no draws in over a year. The

CP program may be reduced to $90 million and later $60 million, per the three letter of credit agreements, and PGW is uncertain if they would reduce the size of the program given uncertain gas costs and the modest LOC cost savings. However, given their improving internal liquidity trend, a reduction in the CP program to $90 million is not expected to impact overall liquidity given the projected fiscal year-end 2010 (ends August 31st) cash balance of $58 million, which is $45 million higher than fiscal 2009. This positive liquidity trend contributes to the utility's outlook change to stable.

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 2005 to 2009 averaged a solid 2.2x and 1.6x, on a bond ordinance and net revenue basis respectively, and is projected to remain in the 2.0x to 3.0x range through 2015. When including the small 1998 Subordinate Ordinance bonds and the interest on the CP program, PGW's all in fixed charge coverage has averaged a narrower 1.5x and 1.2x, bond ordinance and net revenue basis respectively, from 2005 to 2009 and is projected to remain at about 1.6x to 1.7x on a bond ordinance basis moving forward. Moody's notes that the system is required to transfer $18 million to the city annually, but the city has granted this money back to the system since 2004 and has approved the grant back through 2015. When including this payment in the fixed coverage charge ratio, debt service coverage averaged a narrow 1.3x and 1.0x over the last five years, on a bond ordinance and net revenue basis respectively. Moody's anticipates that all in fixed charge coverage, excluding the payment to the city, is likely to achieve 1.3x to 1.5x on a net revenue basis over the next five years given recent rate increase and ongoing cost controls.

A key credit strength is that the utility's bond covenants require bond ordinance net revenue coverage of senior debt service be 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. PGW is also required to conduct an independent engineering evaluation prior to issuing bonds.

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 2011 with no wage increase expected), and other technological improvements that have enhanced monitoring efforts. Of note, the recent $16 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 85% with a 20-year amortization schedule established for the unfunded portion.

CAPITAL PROGRAM: PGW IS HIGHLY LEVERAGED BUT NO NEW DEBT EXPECTED FOR THE NEXT THREE YEARS

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 83%. 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 (2011-2015) calls for about $347 million of projects with 78% related to the natural gas distribution system, mostly line replacements. Positively, the current debt issuance coupled with annual excess cash flow is expected to fund the first three years of the plan with no new debt issuance expected to occur until 2013 at the earliest.

KEY FACTS:

Legal Security: Net revenues of natural gas utility system

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

2009 Customers: 504,000 (95% residential)

2009 Account Collection Rate: 93%

2010 Account Collection Rate (projected): 97%

2009 Natural gas purchases: $546 million ($34 million increase over 2008)

2009 Debt Ratio: 89%

2009 Debt-to-equity Ratio: 83%

2009 Bond Resolution Debt Service Coverage:

Series 1975 Senior Ordinance Bonds: 5.65 times

Series 1998 Senior Ordinance Bonds: 2.13 times

Total Debt Service Coverage (includes 1998 Sub bonds and CP interest cost): 1.69 times

2009 Moody's Calculated Net Revenue Debt Service Coverage:

Series 1975 Senior Ordinance Bonds: 4.28 times

Series 1998 Senior Ordinance Bonds: 1.50 times

Total Debt Service Coverage (includes 1998 Sub bonds and CP interest cost): 1.28 times

RATED DEBT OUTSTANDING (post-sale):

1975 General Ordinance Revenue Bonds (1st lien): $240 million

1998 Senior General Ordinance Revenue Bonds (2nd Lien): $1.02 billion

1998 Subordinate General Ordinance Revenue Bonds (3rd Lien): $7.05 million

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PRINCIPAL METHODOLOGY USED AND LAST RATING ACTION

The principal methodology used in rating the current offering was the U.S. Public Power Utilities Methodology, published April 2008 which can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

The last rating action with respect to PGW was on July 20, 2009, when a Baa2 municipal scale rating with a negative outlook was assigned. That rating was subsequently recalibrated to Baa2 on the global scale with a negative outlook on May 3, 2010.

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