FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Philadelphia PA's Gas Works Revs 'BBB+'; Outlook Positive

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Fitch Ratings - New York - 21 Apr 2020: Fitch Ratings has assigned a 'BBB+' rating to the following revenue bonds issued by the city of Philadelphia on behalf of Philadelphia Gas Works (PGW):

--Approximately $215 million Gas Works Revenues Bonds, Sixteenth Series A (1998 Ordinance);

--Approximately $51 million Gas Works Revenue Refunding Bonds, Sixteenth Series B (1998 Ordinance).

The bonds are scheduled to price via negotiation the week of May 18, 2020. Bond proceeds will be used to finance portions of PGW's capital improvement plan, currently refund a or portion of outstanding 1998 general ordinance Ninth Series revenue bonds, make a deposit into the sinking fund reserve, and pay the costs of issuance.

In addition, Fitch affirms the following ratings:

--Approximately $940 million of outstanding gas works revenue bonds, various series (senior 1998 ordinance) at 'BBB+'.

Fitch has assessed PGW's standalone credit profile (SCP) at 'bbb+'.

The Rating Outlook has been revised to Positive from Stable.

SECURITY

The senior 1998 general ordinance bonds are secured by net revenues of the city of Philadelphia's (the city) gas works utility, in addition to a debt service reserve fund.

ANALYTICAL CONCLUSION

The 'BBB+' rating and SCP reflect PGW's midrange revenue defensibility, supported by a diverse and growing customer base and midrange pricing characteristics, as well as its strong operating risk profile. PGW serves the city of Philadelphia ('A+'/Stable), which boasts a broad and growing regional economy rooted in healthcare and higher education services. The strong operating risk profile assessment is based on PGW's well-identified cost drivers (including labor costs and contracted purchases for natural gas supply), an ability to manage costs with shifts in demand, and manageable capital pressures. Fitch assesses PGW's financial profile to also be strong reflecting historically stable financial results that have improved over the past two years, leading to a lower leverage ratio of 5.1x in 2019. Leverage at these levels, if maintained, could support a higher rating.

Fitch expects a near-term rise in leverage in 2020 resulting from the approximate $215 million in new money from the 2020 bonds coupled with a decline in financial margins for the year resulting from anticipated economic and financial pressures related to the coronavirus pandemic, which are expected to continue for at least the next several months.

The Positive Outlook reflects Fitch's expectation of a return to leverage ratios similar to 2019 levels by 2021. The degree of improvement in the leverage profile after this period of stress will be influenced by the length and depth of the coronavirus pandemic on financial margins, as well as the Pennsylvania Public Utility

Commission's (PUC) response to PGW's recent rate plan request. PGW has requested $70 million in new revenue, which is a roughly 10% rate increase. Fitch expects some level of rate recovery to be approved later this year, and has incorporated a 6% rate increase in its forward-look analysis. A higher rating could be supported if leverage settles at a level below 8.0x following this expected short-term period of economic stress and the anticipated rate decision.

KEY RATING DRIVERS

Revenue Defensibility: 'Midrange'

PGW's midrange revenue defensibility assessment is underpinned by the city's solid demand characteristics including a growing service territory with mixed demographic indicators and strong employment growth. Customer growth has been steady and there is no significant customer concentration. The assessment also reflects a midrange pricing characteristic assessment led by a lack of independent rate setting as PGW's ability to establish rates is subject to oversight by the PUC, which often leads to a lag in potential needed revenue recovery and limits overall financial flexibility in Fitch's view. Positively, while rate changes are ultimately approved by the PUC, a generally supportive regulatory regime has provided PGW sufficient support to maintain a stable financial profile.

Operating Risk: 'Stronger'

The strong operating risk profile reflects the system's well-defined cost drivers including labor, pension and other operating expenses, contracted natural gas commodity costs , and manageable manageable life-cycle investment needs.

Financial Profile: 'Stronger'

PGW's historically stable financial profile has improved over the past few years as previous rate increases have led to greater cost recovery. This coupled with historically low natural gas prices and healthier collection rates have led to stronger financial performance and a stronger financial profile assessment. Fitch-calculated coverage of full obligations totaled 1.8x in 2019 and has averaged roughly 1.5x since 2013. Liquidity is neutral to the financial profile. PGW's leverage ratio declined for a second consecutive year to 5.1x in 2019 from a peak of 8.5x just two years prior.

ASYMMETRIC RISK ADDITIVE CONSIDERATIONS

There are no asymmetric additional risk considerations for the rating.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-- A combination of sufficient rate recovery and economic stability should allow leverage to remain well-below the 8.0x level, which is the threshold for the rating to achieve 'A' category.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-- An unexpected increase in financial leverage as a result of inadequate rate relief, higher bad debt expenses or a sustained decline in revenues could result in a revision of PGW's Outlook to Stable.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CREDIT PROFILE

PGW is owned by the city of Philadelphia and provides for the acquisition, storage and distribution of natural gas to residents and businesses/industry located entirely within the city's limits. The utility is accounted for as a component unit of the city and is operated by the Philadelphia Facilities Management Corporation (PFMC), a not-for-profit corporation created for the sole purpose of operating the utility. PFMC has operated the utility since 1973 pursuant to a two-year management agreement that extends automatically to successive two-year periods unless cancelled at least 90 days prior to the expiration date. PFMC is governed by a seven-member board of directors appointed by the mayor and is responsible for the hiring PGW executive staff.

REVENUE DEFENSIBILITY

Demand characteristics are midrange reflecting positive customer and population growth, but income levels that are well below the national average. The city's unemployment rate remains elevated compared to the U.S. average, but the economy has demonstrated strong employment growth trends over the past several years. Natural gas sales continue to fluctuate, but historical variations are more a function of year-over-year weather (winter temperature) variances than changes in local economic conditions. PGW's ability to normalize its revenues to account for weather variability helps stabilize margins and mitigate the significant sales variability in some years.

The system has demonstrated steady customer growth over the past five years reaching approximately 510,000 total customers in 2019 (a 1.2% overall increase since 2009). The customer base is mostly residential (totaling about 80% of total sales in 2019) and very diverse with the leading 10 account for less than 3% of total gas system revenues. PGW estimates it serves approximately 85% of the home heating market in the city, the remainder largely consisting of customers heating their homes with alternative sources.

Pricing characteristics are midrange given PGW's rates are subject to oversight by the PUC, which typically leads to limits and/or delays in needed rate increases and cost recovery. In addition, residential rates are somewhat high, which further limits flexibility particularly when coupled with the PUC's oversight and the service area's low income levels. The utility's relationship with the PUC has remained constructive and supportive in recent years, evidenced by an approximate 6.8% base rate increase that was approved and became effective December 2017 (for fiscal 2018), in addition to the approval of various surcharges for capital spending (dedicated funding for line replacement) and to pay other post-employment benefits (OPEB).

The average residential customer bill in 2019 during a winter peak month was $216 per month (assuming use of 15 thousand cubic feet, or Mcf), which is higher than most other providers in the Commonwealth. Various programs provide financial assistance for lower income customers, which helps mitigate the high local poverty levels and have improved collection rates over the past few years. The PUC approves rates to ensure all costs are recovered, bond covenants are satisfied and an $18 million annual payment continues to be made to the city.

The Gas Choice Act (effective July 1, 2000) makes PGW subject to regulation and provides customer choice among natural gas suppliers. In addition, PGW's rates are unbundled such that any customer may choose a commodity supplier that is different from its distribution provider. While this introduces some competition with respect to gas supplier, most of PGW's revenues are derived from primarily residential firm heating customers (distribution) with no direct third party suppliers for this service. Furthermore, gas distribution remains a regulated monopoly. The few gas transportation and commercial customers receiving direct service that can choose another supplier account for just $14 million in total PGW revenues. These amounts have been relatively consistent over the years and very few customers are lost due to provider choice. Lastly, if a customer chooses to switch gas suppliers, they are still subject to PGW distribution rates/charges.

PGW's rate structure incorporates a base rate, a gas cost rate (GCR), which consists of the purchased gas costs, transportation costs and off-system storage costs, a distribution charge and numerous surcharges imposed to recover costs associated with social programs, capital projects, other post-employment benefits and efficiency programs. A weather normalization adjustment is also deployed to compensate for lower heating demand and to stabilize cash flow. The GCR captures the increase or decrease in natural gas commodity costs. All of the various charges and surcharges provide PGW with a high degree of rate recovery in Fitch's view.

Recent Rate Adjustments

PGW filed for an increase in the distribution base rates with the PUC in early 2017. The filing requested $70 million (a roughly 11.6% increase) based on a 10-year normal weather assumption. The filing also included a request to increase the fixed customer charge component, as well as the volumetric delivery component of the base rates. In July of that year, PGW filed a petition for a partial settlement resulting in a general rate increase of $42 million calculated using a 20-year normal weather assumption. By November, the PUC approved the settlement filing without changes and the new rates became effective on Dec. 1, 2017. PGW was granted a change in its degree day average from a rolling 30-year average to a 20-year rolling average. In fiscal 2019, the actual level of degree days was 3,995, which is slightly lower than the 2018 level of 4,011 but still higher than the rolling 20-year average (by 1%).

PGW filed for a base rate increase in February 2020 to support the expected additional debt issuances. The request was for an additional $70 million in annual revenues, which is slightly higher than the previous expected range PGW provided Fitch during its 2018 credit review (in the $40 million-$60 million range). A decision is expected by November 2020 and PGW expects new rates to become effective later this year for fiscal 2021.

OPERATING RISK

Cost drivers are well-defined and changes in demand are not a significant risk for PGW as the majority of operating costs are tied to gas commodity costs, which are passed onto customers directly through the GCA. PGW utilizes physical hedging, various gas supply contracts with nearly a dozen suppliers, and owned storage/facilities (LNG) to manage commodity costs, and ultimately its operating expenses. A largely unionized labor force also provides some stability in labor costs. Labor contracts were recently extended for an additional two years.

Resource management is strong reflecting PGW's ample supply including a combination of flowing pipeline supplies, off-system underground storage and two city-owned/PGW-operated liquefied natural gas (LNG) facilities used for the liquefaction, storage, and vaporization of natural gas. The utility's off-system storage and LNG capability to purchase excess gas to store during off-peak months reduces the amount of capacity needed to be reserved during higher cost winter months.

Direct connections to interstate pipeline companies serving PGW (Spectra Energy and Transcontinental Gas Pipe Line Corporation [Transco-Williams]) through a total of nine city gate stations (eight of which are owned by Spectra and Transco-Williams, each accounting for approximately 50% of total contracted pipeline capacity) provide PGW's distribution facilities with the entirety of its gas supply needs. Various contracts for each city gate station each have ever-green provisions with automatic annual renewals.

The natural gas supply portfolio is relatively diverse. PGW enters into short-term (winter-only and summer-only) supply arrangements with about a dozen different suppliers with staggering terms. These arrangements provide baseload supply with indexed pricing or pricing that varies by arrangement and can be agreed upon in advance, providing some ability to hedge commodity prices. Approximately 40% of PGW's winter 2020 supply was purchased under such short-term arrangements. The remainder was supplied through long-term gas pre-pay agreements, spot market purchases and gas storage, including the LNG facilities.

Storage

Storage capabilities provide a physical hedge to natural gas prices by allowing PGW to purchase gas at points throughout the year when supply is typically high and prices are low (non-winter). During these periods of low demand, PGW can utilize the available capacity on the pipelines to purchase gas for delivery to off-system storage facilities or liquefy such gas for storage at its LNG facilities. Storage also provides PGW with a degree of redundancy if there were ever to be a short-term supply disruption for any reason. Transportation and storage costs account for approximately 30% of total gas supply expenses. These costs generally do not vary with the gas volumes and instead are determined by long-term contracts and tariff rates regulated by FERC.

The system's average age of plant in 2019 totaled just 16 years, indicating manageable life-cycle investment needs. PGW's capital improvement program (CIP) is developed based on the capital budget approved by the city council. The CIP is financed through a combination of revenue bonds, note sales, internal funds and DSIC surcharges. Replacement of cast iron mains is a significant part of the CIP. This is a long-term project, with full replacement originally expected by 2063. However, the pace of replacements has improved with an increase in the DSIC and PGW's accelerated replacement. The approved CIP through 2025 totals $744 million and is dominated by distribution system projects, including the long-term main replacement program.

State law permits public utilities to file a request with the PUC for the implementation of a system improvement surcharge to recover costs related to main and service replacement costs not already included in base rates. The legislation (Act 11) provides utilities with a supplemental recovery mechanism for distribution repair and replacement coasts, providing some flexibility to recover these costs outside of the operating budget. In fiscal 2019, over $35 million was billed to customers for capital improvement/replacement (which is about 50% if annual depreciation in 2019).

FINANCIAL PROFILE

PGW's historically stable financial profile has improved over the past few years as previous rate increases and lower natural gas prices have led to greater cost recovery, and stronger margins. As a result of a near-doubling of operating income since fiscal 2016, PGW's leverage ratio has improved significantly. With coverage of full obligations of 1.8x and a leverage ratio of 5.1x in fiscal 2019, the financial and leverage profiles are considered strong. Liquidity remains at an acceptable level as PGW has been funding capital needs with a combination of excess cash flows and debt.

However, Fitch expects an increase in leverage in light of the 2020 new money issuance and economic stress caused by the coronavirus pandemic, leading to a temporary uptick in leverage before margins improve from the expected PUC rate approval later this year (for 2021) and a return to more stable economic conditions. PGW's revenues are mainly driven by home heating customers, which have not yet demonstrated significant impact from local stay-at-home directives. Nonetheless, Fitch expects PGW will begin to see some revenue weakness, including a potential rise in payment delinquencies and bad debt write-offs.

Fitch Analytical Stress Test (FAST)

Fitch Ratings has adopted a baseline stress scenario related to the coronavirus. This sensitized baseline scenario anticipates that lockdown measures of varying degrees remain in place for several months resulting in a spike in unemployment, and for PGW a rise in uncollectible accounts and bad debt expenses. The sensitized scenario related to the coronavirus does not contemplate significant declines in sales as demand for gas utilities is much more sensitive to weather than changes in overall economic conditions.

The sensitized stress scenario is based on PGW's financial forecast but incorporates a roughly $30 million rise in operating expenses to account for a doubling pre-coronavirus provision for bad debt write-offs. This stress is expected to limit PGW's financial profile in the near term and cause a spike in the leverage ratio to approximately 7.7x in year one of the forward look (2020). Fitch's baseline scenario continues to include a reduction in operating expenses in year two to account for a return to more stable economic conditions. The resulting improvement in margins is also aided by a modeled rate increase of 6% in 2021, which leads to a decline in the leverage ratio to around 5.0x by the end of fiscal 2021.

Additional assumptions in Fitch's sensitized forward stress is based on PGW's financial forecast and include the 2020 new money issuance followed by an additional $235 million issuance in 2024, over $700 million in capital spending over the five-year period, the amortization of roughly $280 million in existing principal as currently scheduled over the next five years, and assumes PGW continues to make $18 million annual transfers to the city's general fund.

Fitch believes the 'BBB+'/Positive is supported by this sensitized stress scenario. However, PGW's financial margins, and consequently the leverage ratio, could be materially impacted by the ultimate effect of the stress of the coronavirus pandemic and the results of the current rate case. To the extent performance remains resilient through the near term and PGW's leverage ratio remains below 8.0x in 2021, positive rating action is possible.

Liquidity

PGW's liquidity profile assessment is neutral reflecting an adequate 90 days cash on hand in 2019. The liquidity cushion ratio, which is calculated as excess annual cash flow after debt service plus the sum of readily available cash and committed liquidity lines (or, in PGW's case uncommitted working capital commercial paper) over cash operating expenses prior to interest, was about 0.4x.

PGW makes an $18 million annual transfer to the city which is subordinate to operating expenses but on parity with debt service. However, the city has the right to obtain such payment from PGW in any lawful manner, including set off against payments the city would otherwise make to PGW.

ASYMMETRIC RISK ADDITIVE CONSIDERATIONS

Debt Characteristics

PGW's debt profile is also neutral to the rating. As of August 31, 2019, PGW's total debt outstanding was just over $1 billion consisting mostly of fixed rate, long-term revenue bonds. Variable rate debt comprises a manageable 15% of total debt outstanding, a level that that is expected to decrease further after issuance. PGW's net pension liability, adjusted by Fitch to include a more conservative 6% discount rate, increases total debt for calculating leverage by $338 million.

The bulk of PGW's variable rate debt is hedged with floating-to-fixed rate swaps with JP Morgan Chase ('AA-'/Stable). There are four fixed payor swaps that have a combined notional value of $122.8 million as of fiscal-end 2019 (8B -$27.4 million, 8C - $27.2 million, 8D - $40.8 million and 8E - $27.4 million) and the mark-to-market of the swaps was approximately negative $23.1 million.

After this issuance, total debt will increase by approximately $215 million with the proceeds of the new money series 2020 A bonds used for various system-wide capital projects. The series 2020 B refunding bonds will also be fixed rate bonds with proceeds used to current refund all or a portion of various series including some of PGW's outstanding variable rate debt. The refunding is expected to result in net present values savings and pay related swap termination payments. PGW will determine how large the refunding portion will depending on market conditions at the time of expected pricing in mid-May.

Existing debt service gradually declines to $92 million in 2024 with further declines in the years following. Fitch expects new debt service to be wrapped around existing bonds to keep annual obligations fairly level.

Governance and Management

Governance and management are neutral to the rating. PFMC is governed by a seven-member board of directors appointed by the Mayor and is responsible for the hiring PGW executive staff. Governance decisions require an adopted ordinance by the city council as well as the approval of a five-member gas commission (the commission), consisting of the city controller, two members appointed by city council and two members appointed by the mayor.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING
Philadelphia (PA) [Gas]	

ENTITY/DEBT	RATING		
• Philadelphia (PA) /Gas Revenues/1 LT	LT	BBB+	Affirmed
• Philadelphia (PA) /Standalone Credit Profile -	LT	BBB+	Affirmed

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Public Power - Fitch Analytical Stress Test Model, v1.1.2 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Philadelphia (PA)	EU Endorsed

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Utilities and Power US Public Finance North America United States