S&P Global
Ratings

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Summary:

Philadelphia
Philadelphia Gas Works; Gas; Joint Criteria

Primary Credit Analyst:
Alexandra Rozgonyi, Englewood + 1 (303) 721 4824; alexandra.rozgonyi@spglobal.com

Secondary Contact:
Jeffrey M Panger, New York + 1 (212) 438 2076; jeff.panger@spglobal.com

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Credit Profile		
US$339.69 mil gas wks rev bnds (Philadelphia Gas Works) ser 17TH A due 08/01/2054		
Long Term Rating	A/Stable	New
US$111.1 mil gas wks rev bnds (Philadelphia Gas Works) ser 17TH B due 08/01/2034		
Long Term Rating	A/Stable	New
Philadelphia gas (1998 Gen Ordinance)		
Long Term Rating	A/Stable	Affirmed
Philadelphia JOINTCRIT		
Long Term Rating	AA+/A-1+	Affirmed
Unenhanced Rating	A(SPUR)/Stable	Affirmed

Credit Highlights

- S&P Global Ratings assigned its 'A' long-term rating to the City of Philadelphia's gas works (PGW) series 2024 seventeenth series A (approximately $339.7 million) and B (about $111.1 million) revenue bonds, issued under its 1998 general ordinance.
- At the same time, S&P Global Ratings affirmed its 'A' long-term rating and underlying rating (SPUR) on PGW's outstanding revenue bonds.
- S&P Global Ratings also affirmed its 'AA+/A-1+' rating on the following issues rated under its joint support criteria (low correlation): the 1998 ordinance, 8th series B, C, D, and E bonds, jointly supported by a letter of credit from TD Bank N.A.
- The outlook, where applicable, is stable.

Security

The seventeenth series A bonds will have a par amount (excluding premium) of approximately $339.7 million and will be used to fund capital improvements and take out existing tax-exempt commercial paper (CP). The seventeenth series B will have a par amount (excluding premium) of about $111.1 million and be used to refund the thirteenth series fixed-rate bonds and the fifth series A-2 variable-rate bonds. The bonds are secured by a pledge of gas works revenues net of operating expenses. Additionally, the ratings on the joint support debt referenced above are also secured by letters of credit. At fiscal year-end Aug. 31, 2023, PGW had $943.2 million in debt outstanding.

Credit overview

PGW is the nation's largest municipally owned gas utility. In our opinion, the rating reflects PGW's history of robust financial performance, demonstrated by extremely strong fixed-charge coverage (FCC) and a stable cash position. PGW is further underpinned by a deep and diverse, primarily residential home-heating customer base that has experienced stable demand patterns and collection rates.

In our view, these positive credit factors are offset somewhat by PGW's large capital plan, high rates, below-average income levels, and exposure to volatile and unhedged natural gas prices. We also view PGW's rate-setting, which is governed by the Pennsylvania Public Utility Commission (PAPUC), as a credit limitation. On Feb. 27, 2023, PGW filed a request to increase rates to increase revenues by about 10% or $85.8 million (distribution base rate) per year to partially fund the acceleration of the cast-iron main replacement program; in December 2023, it got approval for 31% of the requested amount. Future financial metrics could be pressured, depending on the amount approved for future base rates, with another projected application of $70 million in fiscal 2026.

PGW's credit strengths include:

- A diverse customer base with minimal customer concentration, offset by below-average incomes (72% of the nation), which limits rate-raising flexibility and can heighten the risk of a spike in delinquencies during periods of high inflation and volatile natural gas prices, with a historical collection rate of around 96%, and which improved to 99.14% as of June 30, 2024, due to increased collection resources that boosted the five-year average to 97%;
- Credit-supportive planning and policies, which include a number of dedicated surcharges that support capital improvements and other postemployment benefits (OPEB), a weather-normalization adjustment that insulates margins from weather variability, and a gas cost rate adjustor that automatically passes on gas costs to ratepayers on a quarterly basis; and
- Extremely strong coverage of fixed costs (debt service payments after the annual transfer to the city of Philadelphia's general fund) at 2.3x and robust liquidity and reserves, reflecting $139 million in unrestricted cash and $259 million when including the $120 million CP in fiscal 2023.

PGW's limiting credit factors include:

- Limited financial flexibility due to very high rates, below-average incomes, and the need to obtain PAPUC approval for base-rate changes;
- Limited ability to hedge gas costs as PGW is not empowered to enter into financial hedges, although physical hedges--including pre-payment discounted gas, storage, and liquefied natural gas (LNG)--provide modest protection against commodity price volatility; and
- Declining leverage to about 60% for fiscal 2023, down from about 80% in 2019, and our anticipation that this ratio will rise again modestly given the current new-money issuance but stay below around 60% through fiscal 2028.

Environmental, social, and governance

We believe the utility, as a natural gas utility, could be exposed to potential future regulation and legislation from the state and federal levels that restrict carbon dioxide emissions and fracking. In addition, PGW has aging cast-iron mains but has been making progress through its main replacement program; with about 38% remaining that are cast iron, at the current replacement rate, they will be completed by 2058. PGW received $10 million in federal funding and provisionally $75 million to be spent tentatively in 2025-2029. In 2021, PGW developed a methane reduction program that outlines plans to reduce methane emissions by 80% by 2050. We also note that the city of Philadelphia has committed to achieving carbon neutrality by 2050, but we are uncertain how that would be fully achieved for the gas utility. However, the replacement of old cast-iron pipes will reduce fugitive methane emissions, as cast iron is more susceptible to leaks and breaks.

We view social risk related to rate affordability aselevated, given PGW's low-income levels and limited ability to hedge natural gas costs. We continue to monitor the strength and stability of gas utilities' revenue streams for evidence of delinquent payments or other revenue erosion. Although the rate of inflation as measured by the Consumer Price Index (CPI) has softened, Bureau of Labor Statistics data shows that natural gas price inflation continues to outpace the broader CPI. The amalgam of increases in delinquent credit card, consumer, and auto loans, along with financial pressures associated with the resumption of student loan payments and weaker than historical household savings rates, will likely compound the financial pressures gas consumers face. Potentially exacerbating issues of natural gas affordability are weakening economic indicators, such as S&P Global Economics' forecast of a 25%-30% recession risk within the next 12 months, which is elevated relative to the historical baseline. A cooling labor market, geopolitical risks, and a potentially disruptive election, might add to recessionary pressures. (See "A Cooling U.S. Labor Market Sets Up A September Start For Rate Cuts," published Aug. 6, 2024, on RatingsDirect.)

We view PGW's governance factors to be constraining to credit quality, demonstrated by its need to obtain PAPUC approval for base-rate, distribution system improvement charge (DSIC), other postemployment benefits and the weather normalization adjustment increases and its inability to enter into financial hedges. In the past, the PAPUC has been supportive of surcharge rate approvals, but in recent years has approved 50% or less than the requested base rate. However, we believe that the utility's robust financial metrics and numerous well-funded dedicated surcharges are credit supportive. PGW also has robust long-range financial and capital forecasting in addition to various liquidity, debt, and investment policies that further support the rating.

Outlook

The stable outlook reflects our view of PGW's transparent and sound financial and operational management, which has resulted in robust financial performance. We believe PGW's financial metrics are sufficient to provide temporary cushion should gas prices rise again and boost delinquencies and potentially pressure cash flows.

Downside scenario

We could lower the rating if future approved rate increases are substantially lower than requested, or inflationary pressures or volatile gas prices stress operations and demand, resulting in materially weaker financial performance.

Upside scenario

We do not anticipate raising the rating over the two-year outlook given the large capital plan and our anticipation that FCC and liquidity will decline prior to rebounding to historical levels. The forecasts incorporate a $70 million base rate approval, and if approved base rate increases are significantly below what was requested, financial metrics could be pressured further.

Credit Opinion

Enterprise risk

PGW's customer base is stable and primarily residential, with about 70% of gas retail revenue coming from residential customers. Pennsylvania ratepayers have the ability to choose their gas supplier. If gas is taken from a third-party supplier, the customer continues to take and pay for distribution service from PGW. We believe that, in this way, PGW's margins aren't materially affected by whether a customer chooses a third-party supplier or elects to continue taking the fully bundled service. The total number of customers served by PGW decreased to approximately 518,000 in 2023 from around 522,000 in 2022, primarily driven by customer disconnects following the pandemic and a return to normal.

The PAPUC is the approving body for PGW's base-rate requests, which include the distribution and customer charge. In February 2023, PGW requested an overall rate increase of $86 million per year and only received 31% of this, or $26.2 million. PAPUC approvals have been sufficient for PGW to maintain robust financial metrics; however, if the PAPUC continues to approve a lower percentage of the requested amount, financial performance could be pressured. We note that PGW does not need PAPUC's approval to change its gas cost rate), which adjusts automatically each quarter (with recovery spread over a full year), which we view positively.

PGW's rates are unbundled, which we believe allows PGW to sufficiently recover costs. However, rates are high relative to those of other Pennsylvania utilities due to several surcharges associated with various social programs, energy efficiency programs, recovery of OPEB trust contributions, recovery of capital costs associated with the main replacement program, and the weather normalization adjustment (which mitigates risk of warmer-than-normal winter season). Additionally, the social programs like the customer responsibility program (CRP) and senior citizen discounts (which combined are about 11% of total customers) shift costs onto other ratepayers via the universal service charge. Additionally, about 9% of PGW total customers are recipients of the Low-Income Home Energy Assistance Program (LIHEAP). The federally funded program provides funds to individual states and is directly paid to PGW in the form of a credit to the customer's account. PGW's LIHEAP funding has ranged from $14.8 million in fiscal year 2024 to a high of $38.9 million in fiscal year 2022.

PGW is primarily a distribution utility, accessing two interstate pipelines at nine city gates, providing the system with credit-protective operational redundancies. PGW also has firm transportation rights for all customers taking gas supply from the utility, which in our view is an important protection, as pipeline constraints might otherwise challenge deliveries during periods of heightened throughput demand. Financial hedging is not permitted under PGW's current gas purchasing authorizations by the Philadelphia Gas Commission and the city council, and we view this as a material credit weakness, particularly given the volatility of natural gas costs. However, PGW has modest physical hedging through the combination of storage, LNG, and prepay agreements. In 2023, PGW's gas supply consisted of about 40% long-term contracts and 60% short-term contracts. About 40% was purchased at discount to index through prepays, and 0.2% of throughput was from LNG, with 11% storage. This mix of natural gas supply allows PGW to lock in future pricing (first of month pricing) in its seasonal short-term contracts and long-term contracts to help mitigate intramonth price volatility.

Financial risk

PGW's FCC has been a credit strength. Coverage of fixed costs after the annual $18 million transfer to the city has been maintained at above about 2.0x during the past three fiscal years (2021-2023). In our opinion, PGW has a mutually interdependent relationship with Philadelphia. Transfers to the city's general fund are, by formal policy, a flat $18 million. About 11% of all customers are under the CRP, and they pay a fixed rate based on the lower of their average bill and a percentage of their monthly incomes, but a minimum of $25 per month. This does not cover PGW's cost of providing service; the shortfall, along with cost shifts associated with PGW's senior citizen discount (1% of all customers) and low-income weatherization programs, are reallocated to other customers via the utility's universal service charge. We understand that costs are shifted to the universal service charge, preserving cash flows and enabling PGW to maintain robust coverage metrics and solid liquidity. Based on management-provided projections, which include the new-money issuance and $70 million of base rate revenue in 2026, FCC is projected to dip to 1.7x in fiscal 2025 as the new debt begins amortizing and then rise to above 2.0x by fiscal 2026. However, this is contingent on future base rate approval from the PAPUC and/or other cost measures.

PGW had $259 million of liquidity available at Aug. 31, 2023, representing 191 days of operating expenses. Unrestricted cash and investments were $139 million, while the utility had $120 million of available CP capacity that could be used for any working capital purpose. PGW also has $150 million authorization for CP for capital project purposes. However, PGW has covenanted to have only up to $120 million of the combined outstanding at any time. PGW's financial forecast indicates a drawdown in liquidity to below 150 days of operating expenses based on our internal calculations by fiscal 2025 and 2026, prior to a rebound. If liquidity does not rebound and is sustained at below 150 days, the rating could be pressured.

In our view, PGW's debt-to-capitalization ratio is high but improved to about 60% in fiscal 2023. We expect it will rise again given the current new-money issuance as a part of the $1.2 billion capital plan during the next five years, which management plans to fund with debt (50%) and internally generated funds, including the DSIC (50%). In fiscal 2024, management drew down $35 million on its tax-exempt CP. Funding sources include DSIC revenue between $36 million and $37 million annually, and PGW received $10 million federal funding in fiscal 2024 and was provisionally awarded $75 million for 2025 through 2029. A major driver of capital spending is the replacement of cast-iron mains, which is expected to be completed by 2058.

Philadelphia Gas Works--key credit metrics			
	--Fiscal year ended Aug. 31--		
	2023	2022	2021
Operational metrics			
Gas customer accounts	518,600	522,000	524,000
% of gas retail revenues from residential customers	70	64	69
Top 10 gas customers' revenues as % of total gas operating revenue	4	3	3
Service area median household effective buying income as % of U.S.	72	73	73
Financial metrics			
Gross revenues ($000s)	725,026	803,914	648,069
Total operating expenses less depreciation and amortization ($000s)	482,241	499,542	364,848
Debt service ($000s)	99,144	98,430	97,383
Debt service coverage (x)	2.4	3.1	2.9
Fixed-charge coverage (x)	2.3	2.9	2.7
Total available liquidity ($000s)*	259,302	235,637	278,265

Philadelphia Gas Works--key credit metrics (cont.)			
	--Fiscal year ended Aug. 31--		
	2023	2022	2021
Days' liquidity	196	171	278
Total on-balance-sheet debt ($000s) (Includes bond premium)	1,120,444	1,114,889	1,188,026
Debt-to-capitalization (%)	61	64	73

*Total available liquidity includes available committed credit line balances, where applicable. Debt service coverage--Revenues minus expenses divided by debt service. Fixed-charge coverage--Sum of revenues minus expenses minus total net transfers out plus capacity payments (or their proxy), divided by the sum of debt service plus capacity payments (or their proxy).

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

Ratings Detail (As Of August 27, 2024)		
Philadelphia gas wks rev rfdg bnds ser EIGHTH D due 08/01/2031		
Long Term Rating	AA+/A-1+	Affirmed
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia gas wks rev rfdg bnds 14th series (1998 gen ordinance) ser 2016 due 10/01/2016-2037		
Long Term Rating	AA/Stable	Affirmed
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia gas wks (AGM) (SEC MKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia gas works rev rfdg bnds RMKT		
Long Term Rating	AA+/A-1+	Affirmed
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia gas (BAM)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia gas (BAM) (SECMKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia gas (BAM) (SECMKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia gas (BAM) (SECMKT)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia gas (1998 Gen Ordinance) (AGM)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia gas (1998 Gen Ordinance) (AGM)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Philadelphia JOINTCRIT		
Long Term Rating	AA+/A-1+	Affirmed
Unenhanced Rating	A(SPUR)/Stable	Affirmed

Ratings Detail (As Of August 27, 2024) (cont.)		
Philadelphia JOINTCRIT		
Long Term Rating	AA+/A-1+	Affirmed
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Many issues are enhanced by bond insurance.		

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.spglobal.com/ratings for further information. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings.