FitchRatings

28 AUG 2024

Fitch Rates Philadelphia Gas Works Revs 'A-'; Outlook revised to Positive

Fitch Ratings - New York - 28 Aug 2024: Fitch Ratings has assigned an 'A-' rating to the following bonds issued by the city of Philadelphia on behalf of Philadelphia Gas Works (PGW, or the system):

--Approximately $339.7 million series Seventeenth Series A revenue bonds;

--Approximately $111.1. million, series Seventeenth Series B revenue refunding bonds.

Series A bond proceeds will be used to fund a portion of PGW's capital plan, make a deposit to the Sinking Fund Reserve, pay the cost of redeeming some of PGW's commercial paper notes, and pay costs related to the issuance. The Series B bond proceeds will be used to refund outstanding Thirteenth Series and Fifth Series A-2 Refunded Bonds. The bonds are expected to price on September 12 by negotiated sale.

Fitch has also affirmed the ratings on the following bonds issued by PGW at 'A-':

--Approximately $1.1 billion of outstanding gas works revenue bonds, various series (senior 1998 ordinance).

The Rating Outlook is revised to Positive from Stable.

PGW's Standalone Credit Profile (SCP) is assessed at 'a-'. The SCP represents the credit profile of the utility on a standalone basis irrespective of its relationship with and the credit quality of, the city of Philadelphia, PA (IDR, A+).

The 'A-' rating and Positive Outlook reflect Fitch's expectation that PGW will continue to maintain its improved financial profile amid increased near-term capital investments and planned debt financings. While Fitch does view the system's capex program as extensive, PGW's intended base rate increase in FY26 should buffer the effect of the financings and result in forward-looking financial metrics that are consistent with PGW's historically lower leverage and in line with a higher rating. PGW plans to invest approximately $1 billion in capital improvements between fiscal years 2024-2028. Much of the capex will be funded with the current financing and a potential additional financing in FY28 of approximately $393 million.

The rating further reflects PGW's strong revenue defensibility assessment which is supported by its mostly monopolistic position as a natural gas distribution services provider and affordable rate offerings, but is limited by a service area that is midrange and rate-setting authority that is subject to regulatory approval by the state's public utility commission (PUC). The system's midrange operating risk profile reflects an increased operating cost burden, substantial but manageable capital needs, and diverse natural gas supply sources.

Fitch's scenario stress analysis incorporates reductions in total operating revenues and operating income between fiscal years 2026 - 2028, and considers the possibility that PGW may not fully receive the $70 million base rate increase that it is requesting from PUC in FY26. Based on the scenario analysis, the leverage ratio, measured as net adjusted debt to adjusted funds available for debt service, is projected to increase from 5.4x in FY23 to over 6x after FY24 from the increased borrowings and rise in capital spending.

However, leverage remains below 8x through the forecast period and could warrant a higher overall rating based on the utility's sufficient leverage headroom. Additionally, if approved, the planned base rate increase will help to maintain healthy operating margins and boost funds available for debt service that will largely offset PGW's rising debt burden.

SECURITY

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

KEY RATING DRIVERS

Revenue Defensibility - 'a'

Rate Regulated System, Revenues Not Completely Monopolistic

The strong revenue defensibility assessment is underpinned by strong revenue source characteristics, a stable demand profile including a stable service territory with improving economic and demographic indicators. However, the system is subject to some degree of competition and rate regulation based on the Gas Choice Act.

The Gas Choice Act allows customers to choose gas supply from sources other than PGW and subjects PGW to rate regulation and approval by the PUC, which are limiting factors in the overall assessment. While PGW's service area is subject to customer choice for gas supply, the vast majority of customers choose PGW as the supplier and, as a regulated monopoly, all retail customers within PGW's service territory receive gas distribution services only from PGW.

Rates that are subject to regulatory approval often lead to a lag in potential 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 the system with sufficient support to maintain a stable financial profile.

Operating Risk - 'bbb'

Midrange Operating Cost Burden, Elevated but Manageable Life-cycle Needs

The system's midrange operating risk profile is driven by its higher operating cost burden and historical capital spending patterns that are commensurate with system needs. The system's operating cost burden was roughly $14/MCF in FY23, up from approximately $13/MCF the year prior. Year-over-year natural gas costs increased by 66% in FY22 due to elevated natural gas prices. As of FY23, PGW's natural gas costs decreased by roughly 18% year-over-year, but the cost burden remained elevated given lower natural gas sales. Costs are not expected to rise sharply in the near-term, but management is projecting moderate cost increases in its five-year financial forecast.

Operating cost flexibility is assessed as neutral based on varying supply arrangements, and adequate storage and distribution infrastructure. PGW receives gas through nine city gate stations from two interstate natural gas pipeline companies. The system's purchasing activities include long-term, seasonal, spot and swing gas transactions which are supplemented by off-system storage and liquefaction capabilities.

Capital planning and management is considered strong based on the system's estimated age of plant of roughly 16 years and healthy capital spending for system needs. Capex to depreciation averaged 191% between fiscal years 2019-2023, which reflects substantial investment in the system. Fitch views future capital investment needs as elevated. The capital plan anticipates roughly $950 million in spending through 2028 which will be funded by additional debt financings, internally generated funds, capital grants, and a dedicated distribution system improvement surcharge (DSIC) on customers' bills.

Financial Profile - 'a'

Strong and Improving Financial Profile, Low Leverage

PGW's strong financial profile reflects its low leverage ratio of 5.4x in FY23, relatively stable financial performance, and strong liquidity position. PGW's leverage ratio averaged 5.4x over the past five years, reflecting very stable historical financial performance. The system has managed to preserve its financial performance due to effective management of its distribution and supply costs, timely base rate increases, and flexible and revenue-neutral rate mechanisms (particularly its Weather Normalization Adjustment) that allow the system to respond to lower demand and stabilize financial performance.

Coverage of full obligations (COFO) remains strong at 1.6x and liquidity is sufficient, with unrestricted cash equaling 97 days on hand. When factoring PGW's available lines of credit, the liquidity cushion rises to 177 days on hand and is considered neutral to the financial profile assessment.

Fitch's rating case scenario analysis indicates that leverage is expected to trend higher over the next five years and peak at 6.5x in 2027, as the utility undertakes its debt issuances and extensive capital plan. As part of its scenario analysis, Fitch assumed a reduction in expected total operating revenues and operating income in fiscal year 2026-2028. Fitch considered the possibility that the $70 million in additional operating revenue in FY26 that PGW projects to receive would not be fully granted.

Fitch, instead, assumed that PGW would receive less than half of the intended increase. Despite the imposed declines in total operating revenues, Fitch's forward look remains supportive of the rating and Positive Outlook based on leverage remaining below 8x even in Fitch's stress case.

Asymmetric Additional Risk Considerations

There are no additional asymmetric risks currently impacting the rating.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/ Downgrade

--Sustained leverage exceeding 8x in Fitch's rating case;

--An increase in competitive pressures or weakening service area demographics that leads to a weaker assessment for revenue defensibility;

--Lower than expected rate relief could drive the Outlook back to Stable.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/ Upgrade

--Leverage ratio consistently below 6.0x in Fitch' stress case;

--Adequate rate relief that supports an improved financial profile.

PROFILE

PGW is owned by the city of Philadelphia (A+/Stable) and provides for the acquisition, storage and distribution of natural gas to residents and businesses located entirely within the city's limits. PGW is the exclusive distributor of natural gas within the limits of the city. However, customers can choose an alternate gas supplier pursuant to the Natural Gas Choice and Competition Act of 1999 (the Gas Choice Act). PGW maintains a distribution system with over 3,000 miles of gas mains and approximately 473,000 service lines serving approximately 519,000 customers in 2023.

The system is managed by the Philadelphia Facilities Management Corporation (PFMC), a not-for-profit corporation created for the sole purpose of operating the utility. PFMC is governed by a seven-member board of directors appointed by the mayor and is responsible for the hiring of PGW executive staff. PFMC has operated the system 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.

Fitch considers the system to be a related entity to the city of Philadelphia for rating purposes given PGW is owned by the city and accounted for as a component unit. PGW makes annual transfer payments to the city, and oversight of the capital and operating budgets is provided by the Philadelphia Gas Commission, created by ordinance of the city council and consisting of the city's controller and two members appointed by the city council and the mayor. The rating on the bonds is not currently constrained by the IDR of the city. However, as a result of being a related entity, the bond rating could become constrained by a material decline in the general credit quality of the city.

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

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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Rating Actions

ENTITY/DEBT	RATING		RECOVERY	PRIOR
Philadelphia (PA) [Gas]				
• Philadelphia (PA) /Gas Revenues/ 1 LT — LT	A- ⊕	Affirmed		A- ◘

RATINGS KEY	OUTLOOK	WATCH
POSITIVE	⊕	⬘
NEGATIVE	⊖	⬙

RATINGS KEY	OUTLOOK	WATCH
EVOLVING	⭘	◆
STABLE	⭘	

Applicable Criteria

U.S. Public Power Rating Criteria (pub.08 Mar 2024) (including rating assumption sensitivity)

U.S. Public Sector, Revenue-Supported Entities Rating Criteria (pub.12 Jan 2024) (including rating assumption sensitivity)

Applicable Models

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

FAST Econometric API - Fitch Analytical Stress Test Model, v3.1.0 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

Philadelphia (PA)	EU Endorsed, UK Endorsed

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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch's website.

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