BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

REBUTTAL TESTIMONY OF

DANIEL J. HARTMAN

ON BEHALF OF
PHILADELPHIA GAS WORKS

Docket No. R-2020-3017206

Philadelphia Gas Works

General Rate Increase Request

TOPICS:

Financial Metrics
Rating Agency Considerations

July 13, 2020

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.

A. Daniel J. Hartman, Managing Director, PFM Financial Advisors LLC, 4350 North Fairfax Road, Arlington, Virginia 22203, (703) 741-0175. I am a financial advisor to state and local governments and authorities.

Q. DID YOU PREVIOUSLY SUBMIT TESTIMONY IN THIS PROCEEDING ON BEHALF OF PGW?

A. Yes. I submitted my direct testimony, PGW St. No. 3, on February 28, 2020.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The Philadelphia Gas Works ("PGW") asked me to respond to and comment on the direct testimonies submitted by Bureau of Investigation and Enforcement ("I&E") witness Anthony Spadaccio, the direct testimony submitted by Office of Consumer Advocate ("OCA") witness David S. Habr, and the direct testimony submitted by Office of Small Business Advocate ("OSBA") witness Robert Knecht.

Q. PLEASE SUMMARIZE YOUR COMMENTS ON I&E'S, OCA'S AND OSBA'S TESTIMONIES.

A. Based on the impact to PGW's financial health, bond ratings and access to capital in the municipal bond markets, I respectfully disagree with proposed financial metrics that I&E, OCA and OSBA put forward. Specifically, I disagree with I&E's proposed 2.13-times debt service coverage, 68 days cash, and 77% debt ratio for PGW, as well as OCA's proposed 1.88-times debt service coverage, 73 days cash, and 78.33% debt ratio. Finally, I do not agree with OSBA's suggestion that debt service coverage and days cash are irrelevant, and that the debt ratio should be materially higher.

The Pennsylvania Public Utility Commission ("Commission") should not accept I&E's, OCA's and OSBA's proposals because:

- The debt service coverage, days cash, and debt ratio metrics suggested in these proposals ignore prior Commission approved initiatives that were designed to bolster the financial health of PGW and have succeeded in bringing PGW back to financial stability in the last several years, and such recommendations would lead to significant deterioration in PGW"s financial position;

- I&E's, OCA's, and OSBA's proposals would create a decisively negative impact on PGW's credit ratings and standing in the municipal capital markets, leading to rating downgrades, more limited municipal market access (particularly within a COVID-19 market environment), and a higher cost of capital; and

- The end result of the near-sighted recommendations from I&E, OCA and OSBA would be materially higher costs to PGW and its customers in the longer term, which would effectively place an undue burden on PGW's ratepayers in the future.

As noted in my direct testimony, my recommendation is that PGW be afforded the rate increase that it has requested, such that PGW can maintain its financial position, which has stabilized after substantial long-term efforts since 2008, and can lead to stable bond ratings and better access to the capital markets. While PGW's financial metrics have improved in the last few years, they are not at levels that provide substantial cushion, and PGW still has less favorable credit metrics than most other "A" rated or higher municipal gas utilities in the country, as shown in PGW witness Harold Walker's benchmarking study (PGW St. 4, 4-R). To be sure, a delay in appropriate cost recovery can quickly lead to highly problematic results with rating agencies, credit providers, and investors alike. And the failure to get timely cost recovery from the Commission would ultimately lead to lower bond ratings and higher long-term costs and a large financial burden to PGW's ratepayers.

II. FINANCIAL METRICS

Q. DID I&E, OCA AND OSBA DIRECTLY COMMENT ON CERTAIN FINANCIAL METRICS AND PROVIDE RECOMMENDED METRICS FOR PGW?

A. As noted above, I&E witness Spadaccio recommended[1] 2.13-times debt service coverage, 68 days cash, and 77% debt ratio for PGW, while OCA witness Habr recommended[2]. 1.88-times debt service coverage, 73 days cash, and 78.33% debt ratio. Finally, OSBA witness Knecht states that debt service coverage and days cash are not relevant metrics, and suggests that the debt ratio is a more important element and should be materially higher.[3]

Q. DO YOU HAVE ANY OVERALL RESPONSE TO THESE RECOMMENDATIONS?

A. The recommended metrics, particularly from OCA and OSBA, are extremely near-sighted suggestions that will cause a material deterioration in PGW's financial condition and result in negative rating actions and more limited access to the capital markets. The suggested courses of action by I&E, OCA and OSBA are generally dependent upon adding substantial leverage to the PGW balance sheet in the face of clearly articulated concerns from the rating agencies (as recent as April 2020) and deferring or eliminating capital expenditures without regard to the long term consequences of such actions. PGW has undertaken a long-term financial program since 2008 to stabilize its financial condition, supported by the Commission's rate actions over the last several years. It is critically important that the Commission continue to support necessary rate increases,

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1 I&E Exhibit 1, Schedule 1 at 1 and 6.
2 OCA St. 3 at 7; OCA Exhibit MEG-3.
3 OSBA St. 1 at 9-12.

even in a difficult economic environment, just as it did in 2008-10 amidst a deep recession. As noted in direct testimony, the Commission's actions in 2008 and 2010 were really critical to the financial turnaround of PGW, and it would be imprudent to reverse course after the substantial progress of the prior several years. Municipal credit ratings are often very slow to rise (as evidenced by PGW's ratings since 2008) but can go down precipitously. Thus, it is critical to assure rating agencies and investors of the long-term commitment to cost recovery and stability of PGW's finances, and not just sufficiency for any given year.

Q. WHAT DO YOU BELIEVE ARE THE KEY CREDIT METRICS THAT THE COMMISSION SHOULD CONSIDER WITH RESPECT TO PGW AND THE REQUESTED RATE INCREASE?

A. The key credit metrics are debt service coverage, days cash on hand, and total leverage (debt to capitalization ratio), as embedded in the rating methodologies of the three key rating agencies – Fitch, Moody's and S&P. Further, these metrics are repeatedly voiced by the largest institutional investors in the municipal capital markets as the key indicators. Each of these metrics are specifically identified by the rating agencies, with slightly different weighting applied by each agency. Moody's has a primary focus on a municipal utility's adjusted debt service coverage, while Fitch's updated rating methodology for municipal utilities is more focused on overall leverage.

Q. FROM THE PERSPECTIVE OF RATING AGENCIES, CREDIT PROVIDERS AND INVESTORS, CAN YOU COMMENT ON PGW'S DEBT SERVICE COVERAGE LEVELS RELATIVE TO THOSE RECOMMENDED BY I&E WITNESS SPADACCIO AND OCA WITNESS HABR?

A. It is important to note that debt service coverage (net revenues of PGW divided by annual debt service) is an important metric to financial analysts because it is a measure of protection that bondholders have to changes in net revenues, whether driven by unexpected revenue declines or increased expenditures – and this becomes particularly important in light of the financial volatility driven by COVID 19. PGW has requested a revenue requirement that results in 2.34x coverage (without the City fee) and 2.13x coverage (with the City fee), while I&E witness Spadaccio recommended[4] 2.13x coverage (without the City fee) and 1.96x coverage (with the City fee) and OCA witness Habr, based on averages from 2010-2016, recommended[5] 1.88x coverage (without the City fee) and 1.71x coverage (with the City fee).

While these debt coverage numbers appear high relative to other municipal utilities, it is imperative to understand the unique circumstance of PGW and the impact of certain Commission approved charges that are earmarked for specific purposes and not available for the general use of PGW.[6] These designated charges include: $18 million for the City General Fund, $18.5 million for OPEB contributions, $8.5 million for pension costs, and $35 million for Distribution System Improvement Charges (DSIC). These combined charges total over $80 million with specific Commission approved uses, and do not provide any financial cushion to PGW or its bondholders. These charges really should be excluded from the debt service coverage calculation, making the adjusted debt coverage substantially lower. I would note that, even if all of the construction-related cash (internally generated funds and cash working capital) of about $63 million – which can be viewed as more discretionary[7] (than the other cash obligations I just described) –

[4] I&E Exhibit 1, Schedule 1 at 4.
[5] OCA St. 3 at 7; OCA Exhibit MEG-3.
[6] *See* PGW St. 2-R (Golden) at 22 (Figure 2).
[7] To be clear, I do not support reduction of the construction-related cash obligations. The construction projects include projects such as cast iron main replacement. As I stated in my direct testimony it is important for PGW to have ongoing "pay as you go financing" from rate based internally generated funds. Plus, I agree with PGW witness Golden (PGW St. 2-R) that costs to customers from debt issuance very quickly overtake the cost to customers of annual "pay-go" contributions in their rates.

are deemed to be available for other purposes, the remaining "mandatory" cash obligations (that total about $80 million) still effectively represent the need for an additional 0.8x debt service beyond the minimum coverages. It is important to note that many of these specific charges did not exist or were increased during 2010-2016; this is another reason that the OCA suggested methodology is inappropriate and does not provide sufficient coverage that rating agencies or investors expect.

Ultimately, what creates the difference in the suggested debt service coverage metrics is the allowance for internally generated funds to pay a portion of the non-DSIC capital program. The revenue requirement put forward by PGW includes approximately $40 million for pay-as-you-go capital funding, along with a substantial amount of bond financing for the capital program. The I&E and OCA cases either assume debt financing all of the non-DSIC capital program, or simply delay or eliminate those capital costs altogether, leaving critically necessary infrastructure unfunded. The I&E and OCA approach leave little cushion for bondholders and really provide limited debt coverage. Rating agencies and investors clearly understand this math, and prefer the path that funds the needed capital improvements with a balance of internally generated funds and debt financing. As such, PGW's recommended revenue requirement provides appropriate adjusted debt coverage for investors and credit providers, while striking an appropriate balance of debt and internally generated funds for necessary capital projects.

Q. I&E WITNESS SPADACCIO PROPOSES THAT PGW'S DEBT TO EQUITY RATIO BE NO LESS THAN 70% (WITH A 77% DEBT TO CAPITALIZATION RATIO WITH HIS RECOMMENDED RATE INCREASE) WHILE OCA

WITNESS HABR TARGETS A DEBT TO CAPITALIZATION RATIO OF 75-80%. PLEASE RESPOND.

A. PGW has intentionally tried to reduce its total debt in recent years, based on debt to equity ratios, with the ratio at 84.8% in FY 2019.[8] The rating agencies have all cited this high debt burden (relative to the peer municipal gas utility average of around 60%, per PGW's benchmarking study) as a limiting factor in the ratings, and investors have raised concerns, since a high debt burden minimizes the ability to fund necessary programs, if pay as you go funding (from current operations) is not viable moving forward. In other words, PGW cannot simply keep borrowing an ever increasing amount of dollars if the corresponding rate support is not there. As such, PGW's path toward a 65% debt to capitalization ratio clearly reflects the direct feedback from bond rating agencies and investors on this point. If the Commission were to deny the revenue requirement request of PGW, while forcing its capital program to be funded with debt without corresponding rate support, it would have an immediate material negative impact in the municipal capital markets for PGW, as clearly communicated in numerous rating reports (and discussed below).

Notwithstanding the longer term goal, PGW has continued to borrow funds for one half of its capital improvement program (CIP), including $273 million in August 2017 and a planned $240 million bond transaction in August 2020, to minimize near term rate increases. In part, these borrowings (while balancing its intent to de-lever itself with the objective to keep rate increases reasonable and low) pushed the debt to equity ratio back to 91% in FY 2018, although it has come down in the last couple of years. Assuming PGW receives the requested rate increase, PGW's projections continue to

[8] PGW Exhibit JFG-1.

show de-leveraging in the system over the next few years– particularly with the Commission approved cash funding for the distribution system repair and improvement program – and total debt to capitalization is projected to be lowered to 65% by FY 2023.[9] It is important to note that this deleveraging is exactly the outcome that the Commission intended with the ongoing cash funding of a portion of the capital program by the Commission approved DSIC charges. But to the extent that a material portion of PGW's requested rates is not received, it will force substantial additional leverage back on the system, quickly reversing the favorable trend and the flexibility that PGW would have obtained moving forward.

Q. PLEASE COMMENT ON THE RECOMMENDED DAYS CASH ON HAND BY I&E WITNESS SPADACCIO, OCA WITNESS HABR, AND OSBA WITNESS KNECHT.

A. I&E witness Spadaccio recommended[10] 68 days cash on hand ($91 million) (compared to PGW's proposed[11] 85 days of cash for FY 2021), while OCA witness Habr suggested[12] 73 days cash ($93.8 million) but ignored funding of $30 million of necessary capital projects that would lower the days cash on hand in the same amount. OSBA witness Knecht simply dismissed days cash on hand as not relevant.[13]

Notwithstanding the latter view, days cash on hand is unquestionably a key credit consideration for rating agencies and investors alike, and liquidity factors prominently in virtually every credit analysis by municipal analysts. In my direct testimony, I stated my

9 PGW Exhibit JFG-2-A.
10 I&E Exhibit 1, Schedule 1 at 1.
11 PGW St. 2 (Golden) at 22.
12 OCA St. 3 at 7; OCA Exhibit MEG-3. *See also* OCA St. 2 at 9; OCA St. 3 at 2, 4-5.
13 OSBA St. 1 at 9-12.

view that PGW needs to maintain a minimum of 70-90 days of direct cash on hand to maintain its current bond rating, apart from any commercial paper capacity. This range of cash on hand is consistent with rating agency commentary to date.

While days cash is always important to the capital markets participants, it is particularly true for PGW. Unlike many municipal utilities that can quickly raise rates, the regulatory process for PGW has an extensive timeframe and process, amplifying the importance for PGW to have substantial liquidity if full cost recovery cannot be obtained. Further, in an environment that we face today, with substantial uncertainties around the impact of COVID 19, liquidity becomes a key element to withstand the potential volatility from lost revenue or increased expenses. And there should not be a full reliance on commercial paper or other credit lines, as we have seen short-term markets have difficulties, particularly for those in the "A" rating or below category. All of this underscores the relevance of the 70-90 days of liquidity for PGW and why it is important for PGW and municipal bond investors alike. I conclude that the rate increases producing the days of cash recommended by the other parties are clearly inadequate and should be rejected.

III. RATING AGENCY CONSIDERATIONS

Q. WHAT IS THE RATING OBJECTIVE FOR PGW BASED ON THE TESTIMONY OF I&E WITNESS SPADACCIO, OCA WITNESS HABR AND OSBA WITNESS KNECHT?

A. While there are no specific rating targets identified in any of the testimony, the clear view voiced is that the current financial condition of PGW will allow it to maintain its current bond ratings under each of the proposed financial plans. And based on this current position, no specific efforts should be undertaken to address PGW's bond rating or outreach to PGW's investors. Notwithstanding the belief of causing no harm to PGW's bond ratings, OSBA witness Knecht does clearly state that the strategy for PGW should involve "the bare minimum to avoid a financial crisis" in the current rate case.

Q. WHAT WOULD BE THE RATING IMPACT TO PGW BASED UPON THE RECOMMENDATIONS MADE BY I&E, OCA AND OSBA?

A. The bond ratings of PGW and the reception in the municipal capital markets would be negatively impacted by the proposed recommendations with respect to PGW's revenue requirement, particularly those of OCA and OSBA. While the Commission's rate support during 2008-2017 (including the last base rate increase in 2017) has been very constructive in stabilizing and maintaining PGW's finances, any wavering of the Commission's support for PGW's necessary rate increases will be met with decisively negative reactions. Often in the area of municipal utility ratings, the minute that a regulatory body fails to objectively review and support a necessary rate increase, credit ratings and access to capital markets quickly deteriorate. As Fitch has already noted in its July 2018 rating report: "Failure to secure appropriate rate relief (moving forward) to support capital investment and related borrowings would likely have negative rating ramifications." Fitch also followed up in April 2020 with commentary that "an unexpected increase in financial leverage as a result of inadequate rate relief" could also lead to a negative rate action, and that "it expected some level of rate recovery [60%] to be approved this year".

As I've stated, municipal credit ratings are often very slow to rise (as evidenced by the slow recovery of PGW's ratings after the crisis in 2008), but can go down precipitously. Thus, it is critical to assure rating agencies and investors of the long-term commitment to cost recovery and stability of PGW's finances, not just sufficiency for any given year. Further, Moody's recent credit report clearly states that the factors that could lead to a downgrade are “a less supportive rate regulatory environment, financial metrics narrowing, and increased leverage without sufficient cost recovery or a material decline in liquidity.” The guidance from the rating agencies has been consistent and unambiguous. The inability for PGW to gain the majority of its revenue requirement request would be met with a decisively negative view, and could result in a reversal of PGW’s long-term upward rating trend, including a negative outlook or rating downgrade.

Q. HOW DO THOSE RATING IMPACTS TRANSLATE INTO THE COST OF FINANCING FOR PGW?

A. As identified in my direct testimony, even a modest change in ratings from the “A” category to the “BBB” category can cause substantial additional costs. Given the size of the PGW capital program, including planned borrowing of roughly $375 million in the next few years, the additional interest expense from a rating downgrade would range up to $36 million. Further, the ability to capture savings could be hampered by negative rating action, and the cost of maintaining credit facilities for its commercial paper program could increase by $1 million per year. These are expensive costs that could clearly be avoided for PGW’s ratepayers and would only add to the necessary revenue requirement.

Q. COULD THIS POTENTIAL COST IMPACT BE AMPLIFIED DURING THE COVID 19 ENVIRONMENT?

A. Yes. While the municipal capital markets are currently functioning fairly well, with access to debt markets at relatively low interest rates, there have been recent periods of time in which the market is closed or municipal debt costs have spiked significantly. Such increased costs have particularly been borne by lower rated credits in the municipal bond market, with ratings in the “BBB” category that are perceived as susceptible to the economic environment and/or not able to obtain cost recovery. Given the volatility caused by COVID 19 impacts on the economy, the municipal market is susceptible to this volatility, and it will be important for PGW to navigate these heightened investor concerns as it intends to market its $240 million debt offering to fund capital improvement needs later this year.

IV. CONCLUSION

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes. However, I reserve the right to supplement my testimony as additional issues arise during this proceeding.

VERIFICATION

I, Daniel J. Hartman, hereby state that: (1) I am Managing Director, PFM Financial Advisors LLC; (2) I have been retained by Philadelphia Gas Works ("PGW") for purposes of this proceeding; (3) the facts set forth in my testimony are true and correct to the best of my knowledge, information and belief; and (4) I expect to be able to prove the same at a hearing held in this matter. I understand that the statements herein are made subject to the penalties of 18 Pa. C.S. § 4904 (relating to unsworn falsification to authorities).

July 13, 2020
Dated

Daniel J. Hartman
Managing Director, PFM Financial Advisors LLC