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The Philadelphia Gas Works: Challenges and Solutions

Executive Summary



ECONOMY LEAGUE
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Executive Summary

In the 13 years since the Economy League's last study of the Philadelphia Gas Works found it had become a risk to the City and its customers, the City-owned utility has taken strides in the right direction. Better billing practices and enforcement tools have repaired PGW's once-chronically deficient collection rates. PGW has repaid an eight-year-old loan from the City, and the utility's improved credit outlook could lower future capital costs. With a management plan to build on this momentum, a new administration in City Hall, and new mayoral appointees on PGW's executive board, it is time to ask whether a lasting remedy is finally within reach.

Impediments and Remedies

Although PGW is no longer in crisis, its ailments have merely shifted from acute to chronic. Despite improvements, its rates still outpace the cost of gas service in Philadelphia's peer cities. PGW remains too troubled for the City to profitably sell, yet keeping it will require difficult decisions about reducing subsidies to low-income customers, seeking even higher rates, allowing its workforce to shrink, and spending tens of millions to improve its efficiency. If the City declines to make fundamental changes, it will continue to forgo any return on PGW's considerable assets, PGW's debt will keep mounting, and residents will be saddled with ever-higher gas bills.

Five fundamental impediments require reform:

A Labyrinthine Governance Structure

PGW's capacity for reform will hinge on management's flexibility and responsiveness. Yet, more than 30 elected and appointed officials have their hands on the PGW steering wheel. The resulting governance gridlock convolutes even mundane operational processes, thwarts coherent policy, and increases already-high operating costs.

Remedy: Governance reform. A streamlined governance structure is essential to improve management's flexibility and responsiveness and should be considered a prerequisite to continued City ownership.

A Low-Income Customer Base

PGW's strictly urban service area leaves it particularly vulnerable to Philadelphia's shrinking population and high concentration of poverty. One in four PGW customers receives heavily subsidized service, which drives up costs to the extent that full rate-paying customers are forced to pay the highest natural gas rates in Pennsylvania.

To aid PGW's many low-income customers, its largest social program is based on income rather than usage and therefore gives participants no incentive to conserve gas. As a result, these customers use 47 percent more gas than customers paying the full rate. Rising commodity prices will increase the cost of this overuse, ensuring that the rates paid by full-freight customers have nowhere to go but up.

Remedy: Reform Social Programs. Low-income residents will always require some degree of aid, whether provided directly by PGW or through some other government program. Still, the City must rein in the skyrocketing cost of its social programs, which will require an appropriate balance between PGW’s dual roles as a gas works and social welfare agency. Potential strategies:

- Create incentives for conservation by discounting bills rather than basing them on income.
- Make this “hidden tax” on full-fare customers more transparent and equitable by paying social program costs out of the City’s general fund.
- Cap the program’s costs.

Onerous Capital Obligations

Limited cash flow over the past 12 fiscal years has forced PGW to continually use short-term loans to fund certain operations—akin to using a credit card to pay monthly bills. PGW also continually borrows money to finance the bulk of repairs and replacement of its infrastructure—like paying down a mortgage and then taking out a home equity loan for the same amount. As a result, PGW incrementally adds to its long-term debt burden each year.

To keep its debt from rising faster, PGW has kept its capital spending reined in. This has helped control debt service obligations and improve PGW’s credit outlook, but it has caused some to question the prudence of postponing replacement of the utility’s aging, City-owned physical assets.

Remedy: Enhance Cash Flow. Management’s Business Transformation initiative could produce sustainable, long-term cost savings. However, the City has funded only a scaled-back portion of the initiative that is unlikely to change PGW’s fundamentally flawed cost structure. Longer-term initiatives would require a much larger upfront investment but offer a more substantial payoff.

Rising Energy Prices

Although bill collections have improved even amid escalating costs and the highest rates in Pennsylvania, the recent rise in energy prices poses a threat. Increased commodity costs will mean even higher bills for PGW’s unsubsidized customers. Any resulting increase in delinquent payments would limit PGW’s ability to meet revenue expectations and control bad debt expenses. PGW can do little to mitigate the impact of this trend: Commodity costs are directly passed through to PGW customers and represent an increasingly large portion of customer bills.

Remedy: Strategic Energy Initiatives. Strategically leveraging the City’s other utility operations could mitigate PGW’s lack of business diversification and create a more cost-effective, sustainable and profitable enterprise for the whole City. Potential strategies:

- Search for potential synergies with the operations of the Philadelphia Water Department.
- Acquire the assets of competitor energy commodities to tap commercial and industrial markets.
- Promote natural gas as a clean energy source, burnishing PGW as an environmentally friendly alternative.

High Labor Costs

PGW's staffing ratios are far out of line with industry standards partly because of the unique demands of distributing natural gas in a wholly urban environment. PGW also requires a labor force with the institutional knowledge to handle its unique operating environment. Looming retirements put that institutional knowledge at risk—by 2011, more than 600 of PGW's 1,700 employees will become eligible to retire, which would leave behind a younger, less experienced staff.

Remedy: Succession Planning and Planned Attrition. Retirements present an opportunity to better align staffing ratios with industry standards. Succession planning would mitigate the deleterious consequences of losing institutional knowledge and leverage labor attrition as a way to reduce operating costs.

Potential Strategic Alternatives

The City would lose money by selling PGW in its present state. An updated valuation as part of this report found that the City would likely have to pay another entity to take PGW off its hands.

This reality does not necessarily rule out a sale. The City's decision should be driven by its objectives. If the City's priority is eliminating PGW as an ongoing financial liability, it could sell PGW at a loss. If the City considers PGW a strategic asset, it could adopt policies to encourage civic objectives such as economic development and sustainability. To sift through these options, policymakers must first establish clear goals. The City has three ownership options:

Sell Assets to a Private Firm

Selling PGW would remove its liabilities from the City's balance sheet. Although a new operating structure ultimately could lower the cost to customers, selling PGW would take months and cost the City millions.

The price would hinge in part on the type of transaction. Options include:

- An immediate sale by standard auction.
- A deferred sale via an operating and maintenance contract.
- A two-step sale of PGW's liquefied natural gas and distribution assets.

Retain City Ownership

Retaining PGW would allow the City to act to protect the public interest. Yet, many would argue that the City's actions regarding PGW to date have not been in the public interest and that City control has been anything but a safeguard. Without strategic action, the public interest will continue to be at risk.

Continued City ownership would also allow any savings realized from improvements to accrue to the City and its customers. However, the City is constrained in its ability to improve PGW's existing position.

Because the City has limited resources to fund such reform, continued ownership represents a financial risk. As long as the City owns PGW, it will remain exposed to the consequences of inaction.

The City can take several steps to shield itself from this escalating financial risk:

- Support internal managerial reform: Invest in policies and programs to make PGW operate more efficiently and effectively.
- Enter into an operating and maintenance contract: A private operator would take on PGW's operating responsibilities, while the City would retain ownership of physical assets and liabilities.
- Give PGW employees an ownership stake in the utility: Lease PGW to a private equity firm, giving PGW employees equity shares in the company and a natural incentive to boost efficiency.

Create a New Authority

Transferring PGW's assets and liabilities to a new, independent authority would allow the City to eliminate the financial risk of PGW from its balance sheets while retaining a degree of representation in the authority's governance, a voice in setting rates, and greater flexibility to explore other potential strategic initiatives, such as expanding its role into alternative energy markets or energy conservation. Continued public employment would limit any labor backlash, and tax-exempt status would minimize the new entity's capital—and therefore customer—costs.

The process of conveyance would be costly and time-consuming to the City and would require sustained political and legal cooperation among all stakeholders, while not necessarily correcting PGW's underlying structural impediments.

Such an authority could assume control of:

- PGW assets and liabilities only.
- Metropolitan gas assets and liabilities by joining PGW with PECO Gas.

A Need for Action

Business as usual is not a viable alternative; the City must act while it still can. If nothing is done to remedy PGW's fundamental flaws, it will continue to deteriorate, and it will do so at an increasing cost to the City and its rate-paying customers. Eventually, PGW will be on life support, and decision-makers will be left with an impossible choice between throwing more money into an enterprise with no hope of survival and simply pulling the plug.