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COUNCILMAN - 5TH DISTRICT

**To:** Honorable Michael A. Nutter, Mayor

**From:** Philadelphia City Council

**Date:** October 27, 2014

**Re:** Proposed Sale of Philadelphia Gas Works - Recommendations and Next Steps

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In March 2014, the City Administration presented City Council with a proposed Asset Purchase Agreement between the City of Philadelphia and UIL Holdings Corporation (UIL) for the sale of the Philadelphia Gas Works (PGW). Council has done its due diligence, including retaining an independent consultant, Concentric Energy Advisors, Inc., for two separate but related engagements: (1) act as City Council's financial advisor for its evaluation of the proposed sale; and (2) prepare a Highest and Best Use (HBU) study of PGW independent of the proposed sale. City Council has reviewed and evaluated Concentric's reports and the information made available by the Administration, UIL, PGW, and other stakeholders. City Council does not endorse the sale of PGW as proposed by the Administration. Instead, Council recommends that PGW and the City resolutely pursue the HBU opportunities outlined in Concentric's HBU Report as well as additional actions outlined in this memo.

### **Background**

The proposed sale of PGW to UIL is the result of a Request for Proposal (RFP) process initiated by the City Administration. The Administration's decision to pursue a sale of PGW was informed by two reports performed by its advisor, Lazard Frères & Co. LLC (Lazard), which was retained to help evaluate the City's strategic options for PGW. Lazard identified and evaluated five management and ownership alternatives for PGW: (1) "enhanced" status quo; (2) strategic sale; (3) public-private partnership (PPP); (4) independent public offering (IPO); and (5) management services agreement; and recommended that the City pursue a strategic sale. Lazard noted that a successful privatization of PGW would require that the City develop a plan to build broad support from City Council, the City Administration, Commonwealth Offices, the Pennsylvania Public Utility Commission (PUC), and PGW Management and that "a privatization process should also incorporate a comprehensive strategy addressing the concerns/positions of each PGW stakeholder (e.g., ratepayers, City taxpayers, unions, PA PUC, Buyer, etc.)."

The Administration's RFP solicited proposals only for the sale of PGW. Specific proposals for any other alternatives were not sought by the City Administration nor did its process allow for the exploration of any of the above alternatives.

## Overview

As part of Concentric's assessment of the proposed sale transaction, it reviewed a significant amount of materials, held meetings and interviews with various stakeholders, and performed independent analyses. In brief, Concentric concluded that the solicitation process was competitive, the proposed sale price reasonably reflected PGW's value, and the proposed transaction terms are generally customary. However, Concentric found that a number of considerations or objectives important to City Council and the public it represents were either not explicitly addressed by the Asset Purchase Agreement or that the provisions addressing them were limited in duration or scope. For example:

- Most employment-related conditions are linked to the expiration date of the current Collective Bargaining Agreement (CBA) on May 15, 2015, and the commitment to maintain at least 1,350 PGW employees is limited to three years;
- Rate-related commitments are dependent on PUC approval; there are no contractual commitments after the initial tariff filing for programs other than the Senior Citizen Discount; there is no contractual commitment to maintaining the low-income Customer Responsibility Program as it currently exists; and there are no specific commitments to continue the existing energy efficiency programs for low-income and other customers or the existing hardship fund (Utility Emergency Services Fund);
- UIL has only committed to a three-year base rate freeze, subject to certain exceptions. Base rates account for about 50% of customer bills, and the proposed agreement allows bills to increase through other mechanisms, i.e., automatic rate adjustment riders, charges, and surcharges;
- There is no restriction on UIL's right to dispose of all or some of PGW's assets at any time;
- The sale agreement does not require UIL to provide an Economic Opportunity Plan until after the transaction closes;
- The proposed agreement does not preclude UIL from either foreclosing on PGW liens for unpaid gas bills or selling those liens to a third party for collection/enforcement;
- There is no commitment by UIL to maintain a local presence beyond its guarantee to keep PGW headquarters in Philadelphia for three years;
- PGW employees would no longer be required to be City residents;
- Local government oversight of PGW and control of its spending priorities (which directly impact its rates) will be greatly diminished if the sale is approved; and
- Potential acceleration of the cast iron main replacement program is unaddressed.

The Administration stated that the net proceeds of the transaction would be in the range of \$400 million to \$600 million. However, the permanent loss of PGW's annual \$18 million City payment (which was valued by Concentric to be in the range of \$170 million to \$200 million) would reduce the net benefit to

\$200 million to \$400 million.

When this reduced net benefit is weighed against the additional short-term and long-term, direct and indirect costs associated with the factors listed above, the actual benefit to the City of the proposed sale is further diminished.

Concentric advised that, in determining whether the proposed sale of PGW is better for the citizens of Philadelphia than continued ownership now and for the future, Council should consider the myriad of financial, employment, rate, public policy, economic development, and social considerations as well as the programs and functions that PGW provides as a City-owned utility. Having done so, Council has determined that the sale as proposed by the Administration would not be better for the citizens of Philadelphia than continued ownership by the City.

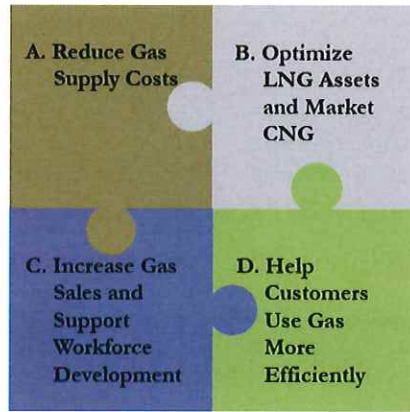
### **Highest and Best Use Study**

The assessment of the “highest and best use” of PGW examines the potential and credible use of PGW’s assets to increase their value for its customers, owner, employees, and the citizens of Philadelphia. Concentric identified six specific opportunities for PGW to contribute to the City of Philadelphia’s economic growth and public welfare, while enhancing its own financial strength. Significantly, all of these opportunities derive from PGW’s core gas business: the sale and delivery of natural gas and related products and programs that help customers use less energy. PGW is already engaged in several of these activities and Concentric proposed that it either continue or expand these efforts. While the opportunities can be considered individually or in subsets, Concentric crafted them as an integrated collection that can work together to achieve the following goals:

- Minimize PGW’s gas supply and delivery costs over the long-run;
- Contribute to Philadelphia’s economy by retention and attraction of businesses and by providing employment opportunities to its citizens;
- Grow top-line and net revenues from traditional regulated services and emerging competitive market opportunities to enhance PGW’s financial position;
- Increase energy efficiency of PGW customers in the near term, and improve the efficiency of buildings in Philadelphia over the long-run; and
- Support Philadelphia’s economic and social policy goals.

The six opportunities are summarized in the following figure from Concentric's HBU Report.

### PGW Opportunities



**PGW's Customers:**

- Lower gas bills from PGW cost savings, increased throughput, efficiency gains, and margins from sales of LNG to regional businesses

**Philadelphia:**

- More affordable gas service
- Economic growth
- More efficient infrastructure

**PGW:**

- Stronger financially

**Six HBU Opportunities => \$27 - \$33 Million/Year for PGW**

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| <p><b>A.</b> ① Diversify the Gas Supply Portfolio</p> <p>④ Pursue CHP, Help Businesses Grow and Convert Customers to Gas</p> <p><b>C.</b> ⑤ Support Energy Industry Workforce Training Programs</p> | <p><b>B.</b> ② Optimize LNG Assets</p> <p>③ Support Development of a Regional NGV Market</p> <p><b>D.</b> ⑥ Invest in Customer Premises to Lower Energy Bills</p> |
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### Council's Recommended Next Steps

This section of this memorandum will rely and build on the findings of the HBU Report.

#### A. Implement the Six HBU Opportunities

PGW needs to be actively involved in the development and execution of implementation plans for the HBU opportunities in order for them to be successful. To implement certain opportunities, PGW may require the services of outside firms.

**1) Diversify PGW's Gas Supply Portfolio:** PGW currently purchases all of its gas from Gulf Coast sources despite the fact that Philadelphia is located very close to the Marcellus – the largest source of natural gas in the country. Shifting a portion of PGW's existing direct supply from the Gulf to the Marcellus is perhaps the biggest opportunity for PGW and can potentially generate at least \$17 million in savings. Every PGW customer will benefit from lower gas supply costs, including the City's largest industrial customers that buy their own gas in the Philadelphia area and rely on PGW to deliver it to their facilities. Several companies are interested in building new pipelines to deliver relatively low-cost natural gas from the Marcellus to markets. They need

customer commitments in order to finance their projects. PGW is a large enough “anchor” customer to give some pipeline projects a development advantage over others.

**Recommended Actions:**

- (1) PGW management should update the City Administration and Council on any discussions it has had with developers that are interested in building pipelines that will deliver natural gas to Philadelphia or nearby markets; and
- (2) PGW’s gas supply team should report to the Administration and Council regarding the potential for and net benefits of terminating and/or renegotiating existing PGW pipeline transportation contracts and replacing them with contracts with potential new pipelines.

**2) Optimize PGW’s Liquid Natural Gas (LNG) Assets:** PGW (whether municipally or privately owned) is not currently positioned to compete in the LNG export business for several reasons, but can expand sales to new LNG transportation markets by adding liquefaction capacity at its Richmond LNG facility which has one of the largest storage tanks in the Northeast. This facility can meet the needs of PGW’s sales customers during extended stretches of cold weather but lacks adequate liquefaction capacity to support an increase in sales to transportation markets. PGW is already considering making this capital investment. Similar to PGW’s preliminary estimates, Concentric estimated an investment of approximately \$50 million would be required but could have a payback in the 4 to 8 year range based on new net revenues of \$8 million to \$10 million per year. PGW is strong enough financially to consider doing this alone but might also consider doing this with a private partner.

**Recommended Actions:**

- (1) PGW should develop a more detailed site-specific design study and firm up the estimated capital costs;
- (2) PGW should confirm the strength of the emerging markets and its competitive position; and
- (3) PGW and the City should address any legal issues associated with a public-private partnership (PPP), assuming that this is an option that PGW would like to consider.



**3) Support Development of a Regional Natural Gas Vehicle (NGV) Market:** PGW has recently acquired 24 Compressed Natural Gas (CNG) sedans in an effort to spur the growth of a local NGV market.<sup>1</sup> Several local businesses are considering converting their fleets to CNG. The City owns other vehicles that can be converted or replaced with natural gas vehicles. NGVs do not travel as far on a tank of gas as gasoline vehicles, making them ideally suited for urban use. But it is difficult to market to privately owned fleets without more refueling stations and the refueling stations require a market to make them financially viable. PGW is currently focused on increasing throughput by providing natural gas sales and transportation service at high pressures to public and private refueling stations that decide to locate within Philadelphia. PGW has retained a consultant (Gladstein, Neandross & Associates) that has been evaluating the business opportunities.

**Recommended Actions:**

- (1) PGW and/or its consultant should develop the first draft of an implementation plan; and
- (2) The City should work with PGW to maximize the potential for siting additional CNG fueling stations in Philadelphia, including linking these to potential conversion of City and other fleet vehicles.

**4) Pursue CHP, Help Businesses Grow, and Convert Customers to Gas:** While PGW serves a large proportion of the City's homes and businesses, there are still opportunities for PGW to sell more natural gas to Philadelphia businesses by working with firms that are considering relocating to or expanding within the City. We need to foster an environment in which the public sector and the business community view PGW as a vital partner. One of the most exciting opportunities is to take advantage of a technology that allows large customers to save on their electricity bills while efficiently generating energy to meet heating and cooling needs. This is called combined heat and power or CHP. PGW has already installed CHP at its headquarters, the Four Seasons Hotel, and at a few apartment and office buildings in Philadelphia. PGW is marketing CHP aggressively to many of the City's largest energy users – who are also among the City's largest employers.

**Recommended Actions:**

- (1) PGW should continue its aggressive marketing efforts of CHP; and
- (2) The Administration should coordinate the engagement of City agencies and community business leaders with PGW in order to develop a more unified approach to attracting new businesses to Philadelphia and to helping existing businesses expand.

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<sup>1</sup> There are approximately 20 CNG refueling stations in Pennsylvania that are open to the public, including five in the Philadelphia area and one in the City.

**5) Support Energy Industry Workforce Training Programs:** As PGW begins to work more closely with other City agencies and the business community, there is an important role that PGW can serve to support the development of more natural gas industry and related jobs in the City by working with Philadelphia's education institutions and business community to help train City residents. There are opportunities for Philadelphia to help businesses decide to locate in the City, particularly businesses that depend on low natural gas prices. These businesses will need a trained workforce, a key driver in their location and expansion decisions.

**Recommended Actions:**

- (1) Council, the Administration, and other stakeholders (e.g., organized labor) should identify educational institutions, business organizations and large employers that may be interested in participating in the development of workforce training programs within Philadelphia; and
- (2) PGW can contribute to this by partnering with other Philadelphia businesses, the City, organized labor and educational institutions (high schools and universities) to design training programs to meet these needs and to connect Philadelphia workers to the jobs.

**6) Invest in Customer Premises to Lower Energy Bills:** It is particularly important that PGW help participants in its Customer Responsibility Program (CRP) use natural gas more efficiently, because the costs of this program are borne by all other PGW customers. While many of PGW's energy efficiency programs are targeted to this group of customers, PGW's efforts to improve the delivery, economics, and overall success of the program have been limited by challenges in the delivery of energy efficiency services to this customer segment, including high participation refusal rates (by customers or their landlords) and properties that require structural improvements in order for efficiency measures to be installed. PGW has been aggressively pursuing efforts to improve CRP, including the delivery of energy efficiency programs. A November 2012 report prepared by APPRISE made several recommendations that are being implemented by PGW that focus on customer participation, payment crediting and quality control.<sup>2</sup> Among other program changes recently approved by the PUC, PGW will implement a \$100 credit to reward CRP customers that achieve efficiency targets. The benefits of more efficient use of natural gas by CRP customers accrue directly to PGW's other customers, in the form of lower bills, in turn improving PGW's financial condition by reducing receivables. At the same time, an effort should be made to spend up to the budget for energy efficiency programs that target business customers. City Council has already mandated energy efficiency benchmarking for large commercial buildings (Bill No. 120428-A). This benchmarking data should generate interest in retrofit investments among PGW's commercial and industrial customers. PGW's current portfolio of energy efficiency programs will expire as of August 31, 2015, if not reauthorized by the PUC.

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<sup>2</sup> "PGW Universal Service Program Impact Evaluation Final Report," November 2012, prepared by Applied Public Policy Research Institute for Study and Evaluation (APPRISE).

**Recommended Actions:**

- (1) PGW should promptly file its proposal to the PUC to reauthorize its EnergySense programs (including the low-income customer energy efficiency programs) for another five years;
- (2) PGW should redouble its efforts to increase the effectiveness of energy efficiency programs targeted to the low-income customer segment; and
- (3) PGW should increase its marketing efforts associated with these programs.

**B. Enhance the Decision-Making and Operations of PGW**

The HBU Report noted that the fortunes of PGW and the City are inseparable to a degree that is unusual for a gas company and the communities it serves, starting with the fact that PGW serves only one city. A stronger PGW will be able to increase investment in the distribution network and provide new services to Philadelphia's businesses and citizens. To the extent that PGW can lower its costs of acquiring gas supply or make a profit by selling surplus LNG, this lowers the rates paid by all customers including businesses that can redirect savings to invest in their firms.

While not the focus of Concentric's two reports, Council recognizes that, in order to move PGW forward to achieve its HBU potential in an efficient and effective way, the City needs to take additional actions. First, we can and should modernize the current local governance structure. Council also believes that PGW can and should further accelerate its cast iron main replacement program, while continuing to achieve efficiencies in its operations.

- 1) **Modernize PGW's Governance:** While private corporations, including utilities, face their own governance challenges, their decision-making processes are more streamlined and project greater clarity for all stakeholders. The current local governance structure involves multiple entities including the Mayor and City Administration, City Council, the City Controller, the Philadelphia Gas Commission, as well as the Philadelphia Facilities Management Corporation (whose Board is appointed by the Mayor). While this structure was put in place to ensure that the fiduciary and other interests of the City (as owner) were appropriately protected, it should not be so cumbersome as to disadvantage PGW in competing with privately-owned companies in emerging natural gas markets which often require faster decision-making. In recent years, Council, the Administration, the Law Department, the Gas Commission, PGW and the Public Advocate successfully collaborated to respond to changing market conditions affecting PGW's procurement of gas supply (e.g., Bill No. 110109). This same approach could be used to explore other possible structural changes.



**Recommended Action:**

(1) The Administration and Council should take appropriate actions to enable PGW to operate “more like a business” to facilitate its increased participation in LNG, CNG and other new markets, while at the same time preserving the necessary accountability to its owners – the citizens of Philadelphia – and protecting the City and PGW from unnecessary business risks.

- 2) **Further Accelerate Main Replacement:** PGW faces a multi-decade challenge to replace its 1,501 miles of cast iron main as fast as is practically and financially feasible. Pursuant to its initial five-year Long Term Infrastructure Improvement Plan approved by the PUC in conjunction with approval of PGW’s Distribution System Improvement Charge (DSIC), and consistent with its capital budgets approved by City Council, PGW has recently increased the number of miles of cast iron main it replaces each year from 18 to 25. In FY 2014 PGW spent about \$38 million on cast iron main replacement and another \$17 million on the related replacement of services (about 70% of PGW’s services are now plastic). PGW’s replacement program is based on a sophisticated prioritization model that reflects the most recent break, leak and incident experience associated with different categories of cast iron mains and the resulting impacts on the risk profile. PGW’s accelerated replacement program will eliminate all 12-inch and 30-inch high pressure cast iron main within the next 10 years and all of its 8-inch & smaller low or intermediate pressure cast iron main within the next 50 years. But, PGW projects it will take an additional 20 to 30 years to replace the other 20% of its cast iron main inventory. PGW does not plan to replace other pipe (ductile iron and unprotected coated steel) assessed by PGW as presenting a lower risk until all cast iron main has been removed. It remains to be determined how much pipe PGW can safely and efficiently replace from a practical perspective taking into account operational requirements.

Council believes that it is feasible for PGW to further accelerate the pace of pipe replacement without unduly burdening customers or commerce in the City. If PGW’s DSIC were increased from 5% of distribution revenues to the 7.5% permitted by state law, an additional \$12 million per year could be generated to support these efforts. This would add about \$2 per month to typical customer bills but would allow PGW to further accelerate replacement of its small diameter mains by about 20 years. This would also create additional construction and paving work for contractors who currently supplement PGW’s workforce.

**Recommended Actions:**

- (1) PGW should immediately prepare a plan to further accelerate its cast iron main replacement efforts based on additional annual spending of about \$12 million, and submit the related capital budget to Council for approval; and
- (2) Upon Council’s budgetary approval, PGW should submit a petition to the PUC to increase the DSIC to 7.5% of distribution revenues.

- 3) **Continue Operational Efficiencies:** PGW's operational and financial progress, particularly during the past five to 10 years, culminated in the recent upgrade of its bond credit ratings by Standard & Poor's (S&P) to A-. As S&P observed in its October 21, 2014 ratings analysis, the upgrade reflected its "view of improving trends related to collections, coverage of fixed costs, liquidity and debt ratios for PGW, as well as the adoption of a number of credit supportive policies and procedures." PGW's improved operations and upgraded bond ratings are built upon the ongoing collaborative efforts of management and all segments of PGW's workforce. These measures have enabled PGW to do more pipe replacement, system leak surveys, meter change-outs and other field operations with the same or reduced numbers of personnel, while maintaining a stellar record of responding to gas odor calls well within the targeted 60 minute response time. PGW has attained other productivity, efficiency and financial goals through business transformation initiatives which automated collections processes, targeted and refined collections efforts, and utilized more flexible deployment of personnel to address seasonal workload variations. PGW is now nearing completion of a state-of-the-art Data Center housing its computer systems, which will meet its growing information technology needs while reducing the associated operating costs. Other potential business initiatives have been put on hold by the Administration because of its sale process. Potential untapped opportunities now need to be explored and appropriate action plans developed. This includes such possibilities as consolidating PGW's real estate footprint. PGW has already made changes in pension and other employment benefits, but to maintain and improve its stable financial condition, management and labor should continue to explore and identify other possible enhancements. PGW has recently forecasted the need for an additional \$40 million in revenues beginning in FY 2018, to be generated by a base rate increase, growth in top line revenues, cost reductions, or some combination thereof. Council views the collaborative pursuit of additional productivity enhancements and cost reductions to be an important adjunct to the potential \$27 million to \$33 million or more in annual revenue enhancements associated with the HBU opportunities, which together offer the opportunity to defer or reduce the need for future base rate increases.

**Recommended Action:**

(1) PGW should identify in its FY 2016 Operating and Capital Budgets a specific proposal for, and estimated cost reductions associated with, attaining additional operating efficiencies during the next five years.

-End-