KPMG

# PHILADELPHIA GAS WORKS

(A Component Unit of the City of Philadelphia)

Basic Financial Statements and Supplementary Information

August 31, 2014 and 2013

(With Independent Auditors' Report Thereon)

**PHILADELPHIA GAS WORKS**
(A Component Unit of the City of Philadelphia)

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KPMG LLP
1601 Market Street
Philadelphia, PA 19103-2499

# Independent Auditors' Report

The Controller of the City of Philadelphia and
Chairman and Members of the Philadelphia
Facilities Management Corporation
Philadelphia, Pennsylvania:

We have audited the accompanying financial statements of Philadelphia Gas Works (the Company), a component unit of the City of Philadelphia, Pennsylvania, as of and for the years ended August 31, 2014 and 2013, and the related notes to the financial statements, which collectively comprise the Company's basic financial statements as listed in the table of contents.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditors' Responsibility*

Our responsibility is to express opinions on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinions.

### *Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of Philadelphia Gas Works, as of August 31, 2014 and 2013, and the respective changes in financial position, and where applicable, cash flows thereof for the year then ended, in accordance with U.S. generally accepted accounting principles.

### *Other Matters*

*Required Supplementary Information*

U.S. generally accepted accounting principles require that management's discussion and analysis on pages 3-14 and the schedules of pension funding progress and other postemployment benefits funding progress on pages 57 and 58 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audits of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

KPMG LLP

Philadelphia, Pennsylvania
December 23, 2014

The narrative overview and analysis of the financial statements of Philadelphia Gas Works (the Company or PGW) for the years ended August 31, 2014 and 2013 have been prepared by PGW's management. The information presented here is unaudited and should be read in conjunction with additional information contained in PGW's financial statements.

**Financial Highlights**

- The Fiscal Year (FY) 2014 reflected a 3.2% colder than normal winter. The FY 2014 period was 13.3% colder than the prior year and firm gas sales increased by 3.8 billion Cubic Feet (Bcf). In addition, the Weather Normalization Adjustment (WNA), which was in effect from October 2013 through May 2014, resulted in heating customers receiving credits totaling $12.3 million as a result of the temperatures experienced during the period. FY 2013 was 10.2% warmer than normal. However, the FY 2013 period was 28.1% colder than the prior year and firm gas sales increased by 6.4 Bcf. In addition, the WNA, which was in effect from October 2012 through May 2013, resulted in heating customers receiving charges totaling $8.4 million as a result of the temperatures experienced during the period.
- PGW achieved a collection rate of 94.9% in the current period, 91.9% in FY 2013, and 96.6% in FY 2012. The increase in the collection rate of 3.0% between FY 2014 and FY 2013 was a return to normal historic levels after a brief dip in FY 2013. The collection rate is calculated by dividing the total gas receipts collected in FY 2014 by the total gas billings that were applied to PGW customers' accounts from September 1, 2013 through August 31, 2014. The same methodology was utilized in FY 2013 and FY 2012.
- PGW continues to have various business initiatives that pertain to improving collections, productivity, and operational efficiencies throughout the Company. PGW, at the end of FY 2014 and FY 2013, had no tax-exempt commercial paper outstanding and a cash balance of $105.7 million and $100.9 million, respectively. This reflects overall increases of $4.8 million and $25.1 million at the end of FY 2014 and FY 2013, respectively. PGW had a cash balance of $75.8 million at the end of FY 2012.
- *Liquidity/Cash Flow* – At December 19, 2014, $120.0 million was available from the commercial paper program. The cash balance at December 19, 2014 was $80.6 million.
- The Company's FY 2015 Capital Budget was approved by the City Council of the City of Philadelphia and funding was provided to continue the implementation of an 18-mile Cast Iron Main Replacement Program. Main replacement cost for this program in FY 2015 is expected to be $21.4 million. The total six-year cost of the Cast Iron Main Replacement Program is forecasted to be $136.4 million.
- The Company's recent debt activity is as follows:
  - On August 28, 2012, the Company accelerated payment of $20.2 million of principal for bonds issued under the 1998 General Ordinance with internally generated funds. The defeased bonds were for these respective series and amounts: Fourth Series – $3.1 million, Fifth Series – $2.9 million, Seventh Series – $6.1 million, Eighth Series A – $5.3 million, and Ninth Series – $2.8 million.
  - On September 28, 2011, the City of Philadelphia (the City) issued:
    - Gas Works Revenue Bonds, Twentieth Series (1975 General Ordinance) in the amount of $16.2 million for the purpose of refunding the entire Sixteenth Series Bond (1975 General

Ordinance), and paying the costs of issuing the bonds. The Twentieth Series Bonds, with fixed interest rates that range from 2.0% to 5.0%, have maturity dates through 2015.

– Gas Works Revenue Bonds, Tenth Series (1998 General Ordinance) in the amount of \$72.6 million for the purpose of refunding the entire First Series A, First Series C, Second Series, and Third Series Bonds (1998 General Ordinance), and paying the costs of issuing the bonds. The Tenth Series Bonds, with fixed interest rates that range from 3.0% to 5.0%, have maturity dates through 2026.

- On September 1, 2011, the City defeased \$29.5 million of the Eighth Series variable rate Bonds utilizing internally generated funds. As a result of this defeasance, a portion of the related interest rate swap agreement was terminated. The termination payment was approximately \$7.0 million. Concurrently, the letters of credit for the Eighth Series B, C, and D Bonds were extended and the Series E letter of credit was replaced. The remaining Eighth Series Bonds in the amount of \$225.5 million were then remarketed, with the remaining aggregate principal being reallocated among the Eighth Series B Bonds (\$50.3 million), the Eighth Series C Bonds (\$50.0 million), the Eighth Series D Bonds (\$75.0 million), and Eighth Series E Bonds (\$50.2 million). The related swap agreement was amended to reflect these new notional amounts for each of the issuances.

- The Company's only derivative instruments within the scope of GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, (GASB 53) are four interest rate swaps entered into to hedge the interest payments on its variable rate debt. These swaps originate from an interest rate swap used as a hedge of the Sixth Series Bonds. Because the hedges were effective at August 31, 2014, the change in the fair value of the swaps decreased \$5.4 million for FY 2014 and has been recorded as an increase in the interest rate swap liability and the related deferred outflow of resources. The balance of the interest rate swap liability at August 31, 2014 is \$38.8 million, and the related deferred outflow of resources balance is \$18.9 million. The difference between the balances is due to the impact of refunding the Sixth Series Bonds, which the original swap previously hedged, during FY 2009, and establishing a hedging relationship between the portion of the original swap remaining after the refunding (divided into four swaps) and the refunding Eighth Series Bonds. Because the hedges were determined effective for both periods presented, there was no impact on the Statements of Revenues and Expenses and Changes in Net Position for either year other than swap settlement payments.

**Overview of the Financial Statements**

The discussion and analysis are intended to serve as an introduction and overview of PGW's basic financial statements. PGW's financial statements comprise the following:

*Financial statements* provide both long-term and short-term information about PGW's overall financial condition, results of operations, and cash flows.

*The notes to financial statements* provide additional information that is essential to a full understanding of the data presented in PGW's financial statements. The notes can be found immediately following the basic financial statements.

The financial statements report information about PGW as a whole using accounting methods similar to those used by private sector business. The three statements presented are as follows:

*The statements of revenues and expenses and changes in net position* present revenues and expenses and their effects on the change in net position during the fiscal year. These changes in net position are recorded as soon as the underlying event giving rise to the change occurs, regardless of when cash is received or paid.

*The balance sheets* include all of PGW's assets and liabilities, with the difference between the two reported as net position. Over time, increases or decreases in net position are indicators of whether PGW's financial position is improving or deteriorating.

*The statements of cash flows* provide relevant information about the cash receipts and cash payments of an enterprise during a period and the impact on PGW's financial position.

**Condensed Statements of Revenues and Expenses**

(Thousands of U.S. dollars)

| | | **Years ended August 31** | | |
|---|---|---|---|---|
| | | **2014** | **2013** | **2012** |
| Total gas revenues | $ | 736,138 | 675,154 | 628,387 |
| Other revenues | | 22,998 | 18,317 | 16,596 |
| Total operating revenues | | 759,136 | 693,471 | 644,983 |
| Fuel expense | | 304,051 | 255,501 | 233,713 |
| All other operating expenses | | 334,199 | 318,510 | 316,625 |
| Total operating expenses | | 638,250 | 574,011 | 550,338 |
| Operating income | | 120,886 | 119,460 | 94,645 |
| Interest and other income | | 3,597 | 1,147 | 4,659 |
| Total interest expense | | (57,135) | (59,965) | (69,544) |
| Distribution to the City of Philadelphia | | (18,000) | (18,000) | (18,000) |
| Excess of revenues over expenses | $ | 49,348 | 42,642 | 11,760 |

***Operating Revenues***

Operating revenues in FY 2014 were $759.1 million, an increase of $65.6 million or 9.5% from FY 2013. The increase in FY 2014 was mainly due to increased heating demand and increased revenues associated with gas transportation service. Operating revenues in FY 2013 were $693.5 million, an increase of $48.5 million or 7.5% from FY 2012. The increase in FY 2013 was due to increased heating demand. Please see the discussion of the cost of fuel in the Operating Expenses section below.

Total sales volumes, including gas transportation deliveries, in FY 2014 increased by 6.9 Bcf to 79.1 Bcf or 9.6% from FY 2013 sales volumes of 72.2 Bcf. In FY 2013, total sales volumes, including gas transportation deliveries, increased by 9.9 Bcf to 72.2 Bcf or 15.9% from FY 2012 sales volumes of 62.3 Bcf. In FY 2014, firm gas sales of 48.5 Bcf were 3.8 Bcf or 8.5% higher than FY 2013 firm gas sales of 44.7 Bcf, which were 6.4 Bcf, or 16.7% higher than FY 2012. Interruptible customer sales increased by 0.2 Bcf compared to FY 2013, which increased by 0.7 Bcf compared to FY 2012. Gas transportation sales in FY 2014 increased by 2.9 Bcf to 29.4 Bcf from the 26.5 Bcf level experienced in FY 2013. In FY 2013, the volume of gas transportation sales increased by 2.1 Bcf to 26.5 Bcf from the 24.4 Bcf level experienced in FY 2012.

In FY 2014, the number of customers served by PGW decreased from the previous year and was approximately 500,000 customers. The number of customers served by PGW at the end of FY 2013 and FY 2012 was approximately 501,000 and 503,000, respectively. Commercial accounts were approximately 25,000 customers, reflecting no change from the previous two fiscal years. Industrial accounts were unchanged, from the previous two fiscal years at 700 customers. The number of residential accounts in FY 2014 decreased to approximately 474,300 customers, a decrease of 1,000 customers from the FY 2013 level and 3,000 customers from the 2012 level.

***Operating Expenses***

Total operating expenses, including fuel costs, in FY 2014 were $638.3 million, an increase of $64.3 million or 11.2% from FY 2013. The increase for FY 2014 reflects higher natural gas demand and higher costs associated with the gas processing, field services, and distribution departments. Total operating expenses, including fuel costs, in FY 2013 were $574.0 million, an increase of $23.7 million or 4.3% from FY 2012. The increase for FY 2013 reflects higher natural gas demand.

*Cost of Fuel* – The cost of natural gas utilized increased by $48.6 million or 19.0% to $304.1 million in FY 2014 compared with $255.5 million in FY 2013. The average commodity price per Thousand Cubic Feet (Mcf) increased by $0.83 or $44.3 million, while the volume of gas utilized increased by 2.8 Bcf, 5.6% or $10.6 million. In addition, pipeline supplier refunds in FY 2014 increased by $4.4 million while demand charges decreased by $1.9 million, compared to FY 2013. Cost of fuel includes all commodity charges and demand charges net of pipeline refunds.

The cost of natural gas utilized increased by $21.8 million or 9.3% to $255.5 million in FY 2013 compared with $233.7 million in FY 2012. The average commodity price per Mcf decreased by $0.13 or $6.6 million, while the volume of gas utilized increased by 7.2 Bcf, 16.6%, or $28.1 million. In addition, pipeline supplier refunds in FY 2013 increased by $0.1 million while demand charges increased by $0.4 million, compared to FY 2012.

Variations in the cost of purchased gas are passed through to customers under the Gas Cost Rate (GCR) provision of PGW's rate schedules. Over-recoveries or under-recoveries of purchased gas costs are subtracted from or added to gas revenues and are included in other current assets or other current liabilities, thereby eliminating the effect that recovery of gas costs would otherwise have on net income.

The average natural gas commodity prices for utilized gas for FY 2014, FY 2013, and FY 2012 were $4.63, $3.80, and $3.91 per Mcf, respectively.

*Other Operating Expenses* – Expenditures for street operations, infrastructure improvements, and plant operations in FY 2014 were $94.1 million, an $11.3 million or 13.6% increase from the FY 2013 total of $82.8 million. The increase in FY 2014 was caused by higher labor costs for distribution, field services, and higher costs associated with running the liquefied natural gas plants. The FY 2013 total of $82.8 million was $5.5 million higher than the FY 2012 total of $77.3 million as a result of higher labor costs for distribution and higher costs associated with running the liquefied natural gas plants.

Additionally, expenses of $116.1 million related to collection and account management, customer services, marketing, and the administrative area increased by $8.8 million or 8.2% in FY 2014 primarily due to higher healthcare expenses and an increase in insurance costs. This category decreased by $3.9 million or 3.5% in FY 2013 compared to FY 2012 primarily due to lower healthcare expenses and an increase in the credit to operating expenses associated with capital spending.

Pension costs increased in FY 2014 due to an increase in the factor utilized as a percentage of covered payroll to calculate pension expense. Additionally, the covered payroll reflected a decrease of $1.9 million from the FY 2013 level of $106.0 million. The new payroll factor is based on a new actuarial study applicable to FY 2014. Pension costs increased by $0.9 million or 3.8% to $24.5 million in FY 2014 as compared to FY 2013. Pension costs decreased $0.4 million to $23.6 million in FY 2013 as compared to FY 2012.

Other Postemployment Benefits (OPEB) costs decreased $3.1 million to $37.1 million in FY 2014 when compared to FY 2013. OPEB costs decreased $3.6 million to $40.2 million in FY 2013 when compared to FY 2012. OPEB costs decreased in both fiscal years due to lower normal cost, lower unfunded liabilities, which are amortized over a 30-year period, and lower interest on the net OPEB obligation. For FY 2014, the Company utilized a discount rate of 7.95%. For FY 2013, the Company utilized a discount rate of 8.0% which are both driven by higher balances in the OPEB Trust Fund (the Trust). The higher Trust balances created higher investment income and lower unfunded liabilities, which are amortized over a 30-year period. These factors lowered OPEB costs.

The annual OPEB cost is recorded in the Statements of Revenue and Expenses and Changes in Net Position. For the year ended August 31, 2014, approximately $11.2 million was recorded to other postemployment benefits expense and $25.9 million was recorded to administrative and general expense. For the year ended August 31, 2013, approximately $16.5 million was recorded to other postemployment benefits expense and $23.7 million was recorded to administrative and general expense.

The net OPEB obligation was $101.8 million for the fiscal year ended August 31, 2014, a $7.3 million decrease from the $109.1 million obligation at August 31, 2013. This decrease was caused by a decrease in the annual OPEB cost and an increase of contributions made during the year. The net OPEB obligation for the fiscal year ended August 31, 2012 was $111.1, which was $2.0 higher than the August 31, 2013 net OPEB obligation.

*Provision for Uncollectible Accounts* – The provision for uncollectible accounts in FY 2014 totaled $38.8 million, a decrease of $1.2 million or 3.0% lower than FY 2013. The decrease in the provision for uncollectible accounts is mainly due to higher collection rates achieved in FY 2014. The provision for uncollectible accounts in FY 2013 totaled $40.0 million, an increase of $3.3 million or 9.0% higher than FY 2012. The accumulated provision for uncollectible accounts at August 31, 2014 reflects a balance of $107.3 million, compared to the $105.6 million balance in FY 2013 and $97.8 million in FY 2012. PGW is committed to continuing its collection efforts in an attempt to reduce outstanding delinquent account balances and to provide assistance to those customers who qualify for low-income grants and payment programs to help those customers maintain their gas service.

*Net Depreciation Expense* – Net depreciation expense increased by \$0.7 million in FY 2014 compared with FY 2013. Net depreciation expense increased by \$0.9 million in FY 2013 compared with FY 2012. The effective composite depreciation rates for FY 2014, FY 2013, and FY 2012 were 2.2%, 2.2%, and 2.3%, respectively. Cost of removal is charged to expense as incurred.

*Interest and Other Income* – Interest and other income in FY 2014 was \$2.5 million higher than FY 2013, primarily due to the loss in FY 2013 as a result of the termination of the Guaranteed Investment Contract related to the 1998 General Ordinance Bonds. Interest and other income in FY 2013 was \$3.6 million lower than FY 2012 due to the termination of the Guaranteed Investment Contract related to the 1998 General Ordinance Bonds.

*Interest Expense* – Total interest expense was \$57.1 million in FY 2014 a decrease of \$2.9 million or 4.8% when compared with FY 2013. Interest expense was lower in FY 2014 primarily due to lower principal debt balances. Total interest expense was \$60.0 million in FY 2013 a decrease of \$9.5 million or 13.7% when compared with FY 2012. In FY 2013, interest expense was lower primarily due to a swap termination payment made in FY 2012. Other interest costs decreased in FY 2014 by \$1.3 million or 12.1%, primarily due to the reduction of expenses for losses on reacquired debt and other variable bond fees. Other interest costs decreased in FY 2013 by \$6.1 million or 36.3% due to the swap termination payments made in FY 2012.



(Continued)

*Excess of Revenues over Expenses* – In FY 2014, the Company's excess of revenues over expenses was $49.3 million, an increase of $6.7 million from FY 2013. The Company had an excess of revenues over expenses of $42.6 million in FY 2013, an increase of $30.8 million from FY 2012.

**Condensed Balance Sheets**

(Thousands of U.S. dollars)

| | | Years ended August 31 | | |
|---|---|---|---|---|
| **Assets** | | **2014** | **2013** | **2012** |
| Current assets: | | | | |
| Accounts receivable (net of accumulated provision for uncollectible accounts of $107,349, $105,577, and $97,758 for 2014, 2013, and 2012, respectively) | $ | 101,457 | 97,749 | 81,997 |
| Restricted investment funds | | 5,820 | 49,875 | 94,657 |
| Other current assets and deferred debits, cash and cash equivalents, cash designated for capital expenditures, gas inventories, materials, and supplies | | 204,944 | 197,363 | 183,851 |
| Total current assets | | 312,221 | 344,987 | 360,505 |
| Non-current assets: | | | | |
| Utility plant, net | | 1,193,552 | 1,154,987 | 1,125,650 |
| Unamortized bond insurance costs | | 14,136 | 15,736 | 17,417 |
| Sinking fund, revenue bonds | | 105,909 | 105,280 | 105,312 |
| Other assets | | 37,528 | 33,097 | 30,996 |
| Total non-current assets | | 1,351,125 | 1,309,100 | 1,279,375 |
| Total assets | | 1,663,346 | 1,654,087 | 1,639,880 |
| **Deferred outflows of resources** | | | | |
| Accumulated fair value of hedging derivatives | | 18,879 | 12,059 | 34,712 |
| Unamortized losses on reacquired debt | | 37,051 | 44,868 | 53,241 |
| Total assets and deferred outflows of resources | $ | 1,719,276 | 1,711,014 | 1,727,833 |



(Continued)

**Condensed Balance Sheets**

(Thousands of U.S. dollars)

| Net Position and Liabilities | | Years ended August 31 2014 | 2013 | 2012 |
|---|---|---|---|---|
| Net position | $ | 407,935 | 358,587 | 315,945 |
| Total long-term debt | | 980,749 | 1,033,976 | 1,086,502 |
| Current liabilities: | | | | |
| Current portion of long-term debt | | 53,227 | 52,406 | 30,545 |
| Other current liabilities | | 98,100 | 88,614 | 88,396 |
| Total current liabilities | | 151,327 | 141,020 | 118,941 |
| Other non-current liabilities | | 179,265 | 177,431 | 206,445 |
| Total net position and liabilities | $ | 1,719,276 | 1,711,014 | 1,727,833 |

***Assets***

*Accounts Receivable* – In FY 2014, accounts receivable (net) of $101.5 million increased by $3.8 million or 3.9%, from FY 2013 due to higher gas billings during FY 2014, which resulted from a robust winter heating season. In FY 2013, accounts receivable (net) of $97.7 million increased by $15.7 million or 19.1%, from FY 2012 due to higher gas billings during FY 2013, which resulted from colder winter heating conditions. The accumulated provision for uncollectible accounts, totaling $107.3 million increased by $1.7 million in FY 2014 and totaled $105.6 million in FY 2013 and $97.8 million in FY 2012.

*Cash and Cash Equivalents, Cash Designated for Capital Expenditures, Gas Inventories, Materials, and Supplies, and Other Current Assets* – In FY 2014, cash and cash equivalents totaled $105.7 million, an increase of $4.8 million from the FY 2013 total of $100.9 million and totaled $75.8 million in FY 2012. In FY 2014, gas inventories, materials, and supplies totaled $70.0 million, a decrease of $10.2 million from the FY 2013 total of $80.2 million. Gas inventories, materials, and supplies totaled $81.1 million in FY 2012. In FY 2014, gas storage decreased by $10.6 million or 14.9% when compared to FY 2013. The decrease in gas inventory reflects a decrease in the volume of gas in storage and a decrease in the cost per Mcf. In FY 2013, gas storage decreased by $2.4 million or 3.3% compared to FY 2012. The decrease in gas inventory for FY 2013 reflects a decrease in the volume of gas in storage. Other current assets totaled $19.2 million in FY 2014, an increase of $3.0 million from FY 2013, primarily as a result of an increase in the deferred GCR. In FY 2013, other current assets totaled $16.2 million, a decrease of $10.7 from FY 2012, primarily as a result of a decrease in the deferred GCR.

Cash designated for capital expenditures was created in FY 2014 by designating $10.0 million of cash for capital spending only.

*Capital Improvement Fund, Workers' Compensation Escrow Fund, and Health Insurance Escrow Fund* – The Capital Improvement Fund decreased by $44.1 million in FY 2014 due to proceeds being drawn from the Capital Improvement Fund to fund capital expenditures. A drawdown of the accrued interest in the Capital Improvement

Fund in the amount of $0.8 million was utilized for working capital purposes in FY 2014. Interest income on all funds, to the extent not drawn, is reflected as an increase of $0.4 million in FY 2014, $0.4 million in FY 2013, and $0.6 million in FY 2012. Pursuant to the Pennsylvania Department of Labor and Industry Bureau of Workers' Compensation Self Insurance policy, the Company has established and maintained a restricted trust account. As of August 31, 2014 and 2013, the trust account balances were $2.6 million. PGW is self-insured for the healthcare of active employees and retirees under the age of 65. Retirees over the age of 65 are insured on an experience rated basis. Per the terms of the self-insured program, PGW established a Health Insurance Escrow Fund that at August 31, 2014 was funded in the amount of $3.2 million.

*Utility Plant, Non-Current Assets and Deferred Outflow of Resources* – In FY 2014, non-current assets including utility plant, net, unamortized bond insurance costs, unamortized losses on reacquired debt and accumulated fair value of hedging derivatives totaled $1,407.1 million, an increase of $41.0 million from FY 2013. In FY 2013, non-current assets, including utility plant, net, unamortized bond insurance costs, unamortized losses on reacquired debt, and accumulated fair value of hedging derivatives totaled $1,366.1 million. Utility plant, net, totaled $1,193.6 million in FY 2014, an increase of $38.6 million or 3.3% compared with the FY 2013 balance of $1,155.0 million. The FY 2013 balance increased by $29.3 million or 2.6% compared with the FY 2012 balance of $1,125.7 million. Capital expenditures for construction of distribution facilities, purchase of equipment, information technology enhancements, and other general improvements were $80.2 million in FY 2014 compared to $70.4 million in FY 2013 and $54.7 million in FY 2012. PGW funded capital expenditures through drawdowns from the Capital Improvement Fund in the amounts of $34.1 million, $44.8 million, and $33.5 million in FY 2014, FY 2013, and FY 2012, respectively. The major capital expenditures are associated with PGW's gas supply infrastructure, namely, gas mains, and customer service lines, including capital expenditures for the Long-Term Infrastructure Improvement Plan for which PGW will request recovery through a Distribution System Improvement Charge (DSIC).

In early 2012, Act 11 was enacted by the Pennsylvania Legislature, which permitted public utilities to file a request with the PUC for the implementation of a DSIC. A DSIC permits natural gas distribution companies to recover the costs related to main and service replacement not already recovered in base rates. This legislation provides utility companies with a supplemental recovery mechanism for costs related to incremental/accelerated distribution system repair, improvement, and replacement. Act 11 permits gas utilities to recover 5.0% of their non-gas revenues via the recovery mechanism and permits greater percentage increases if the PUC so permits. The Company started billing customers a DSIC surcharge as of July 1, 2013. In FY 2014, the Company billed customers $19.4 million for the DSIC surcharge. In FY 2013, the Company billed customers $0.7 million for the DSIC surcharge. The DSIC surcharge is fully reconcilable on a calendar year basis and at the fiscal year-end the over-billed or under-billed amount is recorded as an adjustment to revenue. For additional information, see note 1(h) *Revenue Recognition* of the Financial Statements.

***Liabilities***

*Long-Term Debt* – Long-term debt, including the current portion and unamortized discount and premium, totaled $1,034.0 million in FY 2014. This was $52.4 million less than the previous year primarily as a result of normal debt principal payments. This represents 71.7% of total capitalization in FY 2014. Long-term debt, including the current portion and unamortized discount and premium, totaled $1,086.4 million in FY 2013, $30.6 million less than the previous year primarily as a result of normal debt principal payments. Long-term debt, including the current portion and unamortized discount and premium, totaled $1,117.0 million in FY 2012. Long-term debt represented 75.2% of total capitalization in FY 2013 and 77.7% of total capitalization in FY 2012. For additional information see note 8, *Long-Term Debt and Other Liabilities* of the Financial Statements.

*Debt Service Coverage Ratio and Ratings* – PGW has a mandatory debt service coverage ratio of 1.50 times debt service on both the 1975 and 1998 Ordinance Bonds. In FY 2014, the debt service coverage was at 6.15 times debt service on the outstanding 1975 Ordinance Bonds and at 2.11 times debt service on the Senior 1998 Ordinance Bonds compared to debt service coverage ratios of 5.58 and 2.90 times, respectively, in FY 2013, and 4.75 and 1.75 times, respectively, in FY 2012. PGW's current bond ratings are "Baa2" from Moody's Investors Service (Moody's), and "A-" from Standard & Poor's Rating Service (S&P).

*Short-Term Debt* – Pursuant to the provisions of the City of Philadelphia Note Ordinances, PGW may sell short-term notes to either support working capital requirements or pay the costs of certain capital projects and other project costs. PGW may sell short-term notes in a principal amount, which, together with interest, may not exceed $150.0 million outstanding to support working capital requirements. PGW may also sell additional short-term notes in an aggregate principal amount, which may not exceed $120.0 million outstanding at any time to pay the costs of certain capital projects and other project costs. All notes are supported by two irrevocable letters of credit and a security interest in PGW's revenues. The letters of credit supporting PGW's combined commercial paper programs fixed the maximum level of outstanding notes plus interest at $120.0 million in FY 2014. In FY 2013 and FY 2012, the letters of credit supporting PGW's working capital commercial paper program fixed the maximum level of outstanding notes plus interest at $60.0 million. There were no outstanding notes payable at August 31, 2014, 2013, and 2012.

*Other Current Liabilities* – In FY 2014, other current liabilities totaled $19.3 million, an increase of $10.2 million from FY 2013, mainly due to deposits from a third-party supplier and receipts for a project that will be paid for in FY 2015. In FY 2013, the total was $9.1 million, a decrease of $1.2 million from FY 2012.

*Accounts Payable* – In FY 2014, accounts payable totaled $58.9 million, a decrease of $0.5 million or 0.8% compared with FY 2013 primarily due to a decrease in natural gas payables of $4.5 million, which was offset by an increase in trade payables of $4.0 million. In FY 2013, accounts payable totaled $59.4 million, an increase of $2.3 million or 4.0% compared with FY 2012 primarily due to an increase in natural gas payables of $3.1 million, which was partially offset by a decrease in trade payables of $0.8 million.

*Other Non-Current Liabilities* – In FY 2014, other non-current liabilities totaling $179.3 million, an increase of $1.9 million compared to FY 2013. The increase in FY 2014 is primarily due to the change in the value of the swap. In FY 2013, other non-current liabilities totaling $177.4 million decreased $29.0 million compared to FY 2012. The decrease in FY 2013 is primarily due to the favorable change in the value of the swap.

**Other Financial Factors**

On March 2, 2014, following a competitive bidding process, the City entered into an agreement to sell PGW to UIL Holdings Corporation, subject to authorization by City Council and the Public Utility Commission. On December 4, 2014, UIL exercised its option to withdraw from the agreement after no authorizing ordinance was introduced in City Council.

***Recent Rate Filings***

On December 18, 2009, PGW submitted a base rate filing with the PUC (1) to maintain the $60.0 million base rate increase that the PUC granted in 2008; and (2) to fund PGW's OPEB liability in the amount of $42.5 million. PGW also moved to consolidate the Company's Demand Side Management Program, an energy efficiency and conservation plan, into the base rate filing. On May 19, 2010, PGW, along with all active parties to the proceeding, submitted a Petition for Proposed Settlement of the proceeding (the Settlement) and the PUC approved the Settlement on July 29, 2010. Under the Settlement, PGW will be permitted to maintain virtually all of the extraordinary base rate relief, will receive an incremental rate increase of $16.0 million annually, and will be required to fund $18.5 million of the OPEB liability in each of the years 2011 through 2015. The Settlement also permitted the implementation of the Demand Side Management Program.

**Defeasance and Remarketing of Debt**

On August 28, 2012, the Company defeased $20.2 million of principal for bonds issued under the 1998 General Ordinance with internally generated funds. The defeased bonds were for these respective series and amounts: Fourth Series – $3.1 million, Fifth Series – $2.9 million, Seventh Series – $6.1 million, Eighth Series A – $5.3 million, and Ninth Series – $2.8 million.

On September 1, 2011, the City defeased $29.5 million of the Eighth Series variable rate Bonds utilizing internally generated funds. As a result of this defeasance, a portion of the related interest rate swap agreement was terminated. The termination payment was approximately $7.0 million. Concurrently, the letters of credit for the Eighth Series B, C, and D Bonds were extended and the Series E letter of credit was replaced. The remaining Eighth Series Bonds in the amount of $225.5 million were then remarketed, with the remaining aggregate principal being reallocated among the Eighth Series B Bonds ($50.3 million), the Eighth Series C Bonds ($50.0 million), the Eighth Series D Bonds ($75.0 million), and Eighth Series E Bonds ($50.2 million). The related swap agreement was amended to reflect these new notional amounts for each of the issuances.

***Refunding of Bonds***

On September 28, 2011, the City issued Gas Works Revenue Bonds, Twentieth Series (1975 General Ordinance) in the amount of $16.2 million for the purpose of refunding the entire Sixteenth Series Bond (1975 General Ordinance), and paying the costs of issuing the bonds. The Twentieth Series Bonds, with fixed interest rates that range from 2.0% to 5.0%, have maturity dates through 2015.

On September 28, 2011, the City issued Gas Works Revenue Bonds, Tenth Series (1998 General Ordinance) in the amount of $72.6 million for the purpose of refunding the entire First Series A, First Series C, Second Series, and Third Series Bonds (1998 General Ordinance), and paying the costs of issuing the bonds. The Tenth Series Bonds, with fixed interest rates that range from 3.0% to 5.0%, have maturity dates through 2026.

### Impact of New Accounting Pronouncement

As discussed in note 10 to the financial statements, the Company currently does not reflect a net pension obligation on its balance sheet because the annual required contribution has been made each year. GASB No. 68, *Accounting and Financial Reporting for Pensions – an amendment of GASB Statement No. 27*, is effective for the Company's fiscal year ending August 31, 2015. The primary objective of this Statement is to improve accounting and financial reporting by state and local governments for pensions. This Statement will result in the Company's net pension liability being reflected on the balance sheet, measured as the portion of the present value of projected benefit payments to be provided to current and inactive employees that is attributed to those employees' past periods of service (total pension liability), less the amount of the pension plan's fiduciary net position. Under this new pronouncement, the unfunded actuarial liability for the plan is approximately $205.2 million at August 31, 2014.

### Contacting the Company's Financial Management

This financial report is designed to provide the citizens of Philadelphia, customers, investors, and creditors with a general overview of PGW's finances and to demonstrate PGW's accountability for the money it receives. If you have questions pertaining to this report or need additional financial information, please contact Philadelphia Gas Works, 800 W. Montgomery Avenue, Philadelphia, PA 19122 or on the Web at www.pgworks.com.

**PHILADELPHIA GAS WORKS**
(A Component Unit of the City of Philadelphia)

Balance Sheets

August 31, 2014 and 2013

(Thousands of U.S. dollars)

| **Assets** | | **2014** | **2013** |
|---|---|---|---|
| Current assets: | | | |
| Cash and cash equivalents | $ | 105,734 | 100,933 |
| Cash designated for capital expenditures | | 10,000 | — |
| Accounts receivable (net of provision for uncollectible accounts of $107,349 and $105,577 for 2014 and 2013, respectively) | | 101,457 | 97,749 |
| Gas inventories, materials, and supplies | | 69,989 | 80,234 |
| Capital improvement fund | | — | 44,055 |
| Workers' compensation escrow fund | | 2,597 | 2,597 |
| Health insurance escrow fund | | 3,223 | 3,223 |
| Other current assets | | 19,221 | 16,196 |
| Total current assets | | 312,221 | 344,987 |
| Non-current assets: | | | |
| Utility plant, at original cost: | | | |
| In service | | 2,018,234 | 1,951,546 |
| Under construction | | 57,206 | 44,409 |
| Total | | 2,075,440 | 1,995,955 |
| Less accumulated depreciation | | 881,888 | 840,968 |
| Utility plant, net | | 1,193,552 | 1,154,987 |
| Unamortized bond insurance costs | | 14,136 | 15,736 |
| Sinking fund, revenue bonds | | 105,909 | 105,280 |
| Other non-current assets | | 37,528 | 33,097 |
| Total non-current assets | | 1,351,125 | 1,309,100 |
| Total assets | | 1,663,346 | 1,654,087 |
| **Deferred outflows of resources** | | | |
| Accumulated fair value of hedging derivatives | | 18,879 | 12,059 |
| Unamortized losses on reacquired debt | | 37,051 | 44,868 |
| Total assets and deferred outflows of resources | $ | 1,719,276 | 1,711,014 |



(Continued)

**PHILADELPHIA GAS WORKS**
(A Component Unit of the City of Philadelphia)

Balance Sheets

August 31, 2014 and 2013

(Thousands of U.S. dollars)

| **Liabilities and Net Position** | | **2014** | **2013** |
|---|---|---|---|
| Current liabilities: | | | |
| Current portion of revenue bonds | $ | 53,227 | 52,406 |
| Accounts payable | | 58,888 | 59,379 |
| Customer deposits | | 2,245 | 2,305 |
| Other current liabilities | | 19,321 | 9,107 |
| Accrued accounts: | | | |
| Interest, taxes, and wages | | 14,646 | 14,823 |
| Distribution to the City | | 3,000 | 3,000 |
| Total current liabilities | | 151,327 | 141,020 |
| Non-current liabilities: | | | |
| Long-term revenue bonds | | 980,749 | 1,033,976 |
| Other non-current liabilities | | 179,265 | 177,431 |
| Total non-current liabilities | | 1,160,014 | 1,211,407 |
| Net position: | | | |
| Net investment in capital assets | | 159,576 | 112,660 |
| Restricted (debt service) | | 111,729 | 111,100 |
| Unrestricted | | 136,630 | 134,827 |
| Total net position | | 407,935 | 358,587 |
| Total liabilities and net position | $ | 1,719,276 | 1,711,014 |

See accompanying notes to basic financial statements.

**PHILADELPHIA GAS WORKS**
(A Component Unit of the City of Philadelphia)

Statements of Revenues and Expenses and Changes in Net Position

Years ended August 31, 2014 and 2013

(Thousands of U.S. dollars)

| | | 2014 | 2013 |
|---|---|---|---|
| Operating revenues: | | | |
| Gas revenues: | | | |
| Non-heating | $ | 39,610 | 35,262 |
| Gas transport service | | 41,217 | 37,078 |
| Heating | | 655,311 | 602,814 |
| Total gas revenues | | 736,138 | 675,154 |
| Appliance and other revenues | | 8,317 | 8,333 |
| Other operating revenues | | 14,681 | 9,984 |
| Total operating revenues | | 759,136 | 693,471 |
| Operating expenses: | | | |
| Natural gas | | 304,051 | 255,501 |
| Gas processing | | 19,637 | 17,592 |
| Field services | | 37,577 | 34,926 |
| Distribution | | 36,929 | 30,259 |
| Collection and account management | | 11,273 | 11,297 |
| Provision for uncollectible accounts | | 38,848 | 39,971 |
| Customer services | | 11,187 | 11,102 |
| Marketing | | 7,783 | 6,789 |
| Administrative and general | | 85,872 | 78,206 |
| Pensions | | 24,521 | 23,614 |
| Other postemployment benefits | | 11,228 | 16,492 |
| Taxes | | 7,687 | 7,220 |
| Total operating expenses before depreciation | | 596,593 | 532,969 |
| Depreciation | | 47,428 | 45,912 |
| Less depreciation expense included in operating expenses above | | 5,771 | 4,870 |
| Net depreciation | | 41,657 | 41,042 |
| Total operating expenses | | 638,250 | 574,011 |
| Operating income | | 120,886 | 119,460 |
| Interest and other income | | 3,597 | 1,147 |
| Income before interest expense | | 124,483 | 120,607 |
| Interest expense: | | | |
| Long-term debt | | 48,261 | 49,655 |
| Other | | 9,380 | 10,740 |
| Allowance for funds used during construction | | (506) | (430) |
| Total interest expense | | 57,135 | 59,965 |
| Distribution to the City of Philadelphia | | (18,000) | (18,000) |
| Excess of revenues over expenses | | 49,348 | 42,642 |
| Net position, beginning of year | | 358,587 | 315,945 |
| Net position, end of year | $ | 407,935 | 358,587 |

See accompanying notes to basic financial statements.

**PHILADELPHIA GAS WORKS**
(A Component Unit of the City of Philadelphia)

Statements of Cash Flows

Years ended August 31, 2014 and 2013

(Thousands of U.S. dollars)

| | 2014 | 2013 |
|---|---|---|
| Cash flows from operating activities: | | |
| Receipts from customers | $ 724,500 | 657,900 |
| Payments to suppliers | (458,344) | (406,932) |
| Payments to employees | (114,366) | (109,260) |
| Claims paid | (2,965) | (3,307) |
| Other receipts | 17,300 | 9,700 |
| Net cash provided by operating activities | 166,125 | 148,101 |
| Cash flows from non-capital financing activities: | | |
| Interest and fees | 1,049 | (2,084) |
| Distribution to the City of Philadelphia | (18,000) | (18,000) |
| Net cash used in non-capital financing activities | (16,951) | (20,084) |
| Cash flows from capital and related financing activities: | | |
| Purchases of capital assets | (80,222) | (70,380) |
| Principal paid on long-term debt | (49,800) | (27,720) |
| Interest paid on long-term debt | (48,540) | (50,111) |
| Drawdowns on capital improvement fund | 34,055 | 44,783 |
| Interest income (loss) on capital improvement fund | (23) | 132 |
| Interest income (loss) on sinking fund | (349) | (44) |
| Other investment income | 506 | 430 |
| Net cash used in capital and related financing activities | (144,373) | (102,910) |
| Net increase in cash and cash equivalents | 4,801 | 25,107 |
| Cash and cash equivalents at the beginning of the year | 100,933 | 75,826 |
| Cash and cash equivalents at the end of the year | $ 105,734 | 100,933 |
| Reconciliation of operating income to net cash provided by operating activities: | | |
| Operating income | $ 120,886 | 119,460 |
| Adjustments to reconcile operating income to net cash provided by operating activities: | | |
| Depreciation and amortization expense | 41,658 | 41,042 |
| Provision for uncollectible accounts | 38,848 | 39,971 |
| Change in assets and liabilities: | | |
| Receivables, net | (42,556) | (55,723) |
| Gas inventories, materials, and supplies | 10,245 | 852 |
| Other current assets | (3,026) | 10,744 |
| Other assets | (11,250) | 20,552 |
| Accounts payable | (491) | 2,253 |
| Customer deposits | (60) | (144) |
| Other current liabilities | 10,214 | (1,159) |
| Accrued accounts | (177) | (732) |
| Other liabilities | 1,834 | (29,015) |
| Net cash provided by operating activities | $ 166,125 | 148,101 |

See accompanying notes to basic financial statements.

## (1) Summary of Significant Accounting Policies

The accounting methods employed by the Philadelphia Gas Works (the Company or PGW) are in accordance with U.S. generally accepted accounting principles (U.S. GAAP) and are in conformity with City of Philadelphia (the City) reporting requirements.

As described in note 2, the Company is a component unit of the City, and consequently follows accounting principles promulgated by the Governmental Accounting Standards Board (GASB) as they apply to proprietary fund-type activities. Under the Regulated Operations guidance within GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements* (GASB 62), assets or liabilities may be created by certain actions of regulatory bodies.

The principal accounting policies within this framework are described as follows:

### *(a) Regulation*

Prior to July 1, 2000, the Company was under the regulatory jurisdiction of the Philadelphia Gas Commission (PGC). The PGC had the authority to set the Company's rates and tariffs. The PGC also approved the Company's annual Operating Budget and reviewed the Company's Capital Budget prior to approval by the City Council of the City (City Council).

Effective July 1, 2000, and pursuant to the passage of the Pennsylvania Natural Gas Choice and Competition Act (the Act), the Company came under the regulatory jurisdiction of the Pennsylvania Public Utility Commission (PUC). Under the PUC's jurisdiction, the Company filed a restructuring plan on July 1, 2002, which among other things, provided for an unbundled tariff permitting customer choice of the commodity supplier by September 1, 2003. Under the Act, the PUC is required to follow the "same ratemaking methodology and requirements" that were previously applicable to the PGC when determining the Company's revenue requirements and approving overall rates and charges. The PGC continues to approve the Company's Operating Budget and review its Capital Budget. The Company's Capital Budget must be approved by City Council.

The Company, as of September 1, 2003, is operating under its Restructuring Compliance Tariff. The Restructuring Compliance Tariff Rates are designed to maintain revenue neutrality and the Tariff Rules and Regulations are designed to comport with the Pennsylvania Public Utility Code.

### *(b) Operating Budget*

On May 23, 2014, PGW filed a proposed Fiscal Year (FY) 2015 Operating Budget with the PGC. The PGC Hearing Examiners conducted Informal Discovery (ID) sessions beginning on June 9, 2014 and an additional ID meeting took place on June 24, 2014. On July 23, 2014, a public hearing was convened by the Hearing Examiners to address PGW's Operating Budget. On August 19, 2014, a recommended decision was rendered by the Hearing Examiners, which proposed adjustments to the Operating Budget as filed. At the PGC meeting held on September 23, 2014, the PGC approved, with adjustments, PGW's FY 2015 Operating Budget. PGW filed a Compliance Budget with the PGC on October 3, 2014.

On May 24, 2013, PGW filed a proposed FY 2014 Operating Budget. After appropriate discovery and hearings, the PGC approved the FY 2014 Operating Budget on September 17, 2013.

On May 24, 2012, PGW filed a proposed FY 2013 Operating Budget. After appropriate discovery and hearings, the PGC approved the FY 2013 Operating Budget on January 16, 2013.

### *(c) Capital Budget*

On January 2, 2014, PGW filed with the PGC its proposed FY 2015 Capital Budget in the amount of $89.2 million. The PGC's review culminated in deliberations taken at a public meeting held on April 8, 2014 whereby the PGC endorsed a FY 2015 Capital Budget in an amount not to exceed $89.5 million. The endorsed budget was approved by City Council on June 12, 2014. The Bill was signed by the Mayor on June 19, 2014.

On January 2, 2013, PGW filed with the PGC its proposed FY 2014 Capital Budget in the amount of $110.5 million. The PGC's review culminated in deliberations taken at a public meeting held on April 15, 2013 whereby the PGC endorsed a proposed FY 2014 Capital Budget in an amount not to exceed $102.5 million. The endorsed budget was approved by City Council on June 6, 2013. The ordinance was signed by the Mayor on June 17, 2013.

Subsequent to City Council's approval, the PGC endorsed a FY 2014 Capital Budget amendment in the amount of $0.4 million to support the purchase of 24 Compressed Natural Gas (CNG) sedans and a CNG refueling station. This amendment to the FY 2014 Capital Budget was approved by City Council on October 17, 2013. The Mayor signed the ordinance on October 30, 2013.

On January 6, 2014, PGW filed with the PGC a request to further amend the FY 2014 Capital Budget by $3.4 million to provide for the incremental replacement of approximately three additional miles of small diameter cast iron main. The PGC endorsed an amendment to the FY 2014 Capital Budget that inserted a new line item, Long-Term Infrastructure Plan – Accelerated Cast Iron Main for $3.4 million, and concurrently reduced two other line items that resulted in no increase in the FY 2014 Capital Budget. This second amendment was approved by City Council on June 12, 2014 and signed by the Mayor on June 19, 2014.

On January 3, 2012, PGW filed with the PGC a proposed FY 2013 Capital Budget of $93.3 million. At a public meeting held on April 19, 2012, the PGC endorsed a FY 2013 Capital Budget in the amount of $90.9 million. City Council approved PGW's FY 2013 Capital Budget on June 21, 2012. The Mayor signed the ordinance on June 27, 2012.

### *(d) Base Rates*

On December 18, 2009, PGW submitted a base rate filing with the PUC (1) to maintain the $60.0 million base rate increase that the PUC granted in 2008 and (2) to fund PGW's Other Postemployment Benefits (OPEB) liability in the amount of $42.5 million. PGW also moved to consolidate the Company's Demand Side Management Program, an energy efficiency and conservation plan, into the base rate filing. On May 19, 2010, PGW, along with all active parties to the proceeding, submitted a Petition for Proposed Settlement of the proceeding (the Settlement) and the PUC approved the Settlement on July 29, 2010. Under the Settlement, PGW will be permitted to maintain virtually all of the extraordinary base rate relief, will receive an incremental rate increase of $16.0 million annually, and will be required to fund $18.5 million of the OPEB liability in each of the fiscal years 2011 through 2015. The new rates were effective September 1, 2010. The Settlement also permitted the implementation of the Demand Side Management Program.

### *(e) Weather Normalization Adjustment Clause*

The Weather Normalization Adjustment Clause (WNA) was approved by PUC Order dated August 8, 2002. The purpose of the WNA is to neutralize the impact of weather on the Company's revenues. This allows the Company to achieve the recovery of appropriate costs as authorized by the PUC. The WNA results in neither a rate increase nor a rate decrease, but acts as a billing adjustment. The main benefits of the WNA are the stabilization of cash flow and the reduction of the need for short-term borrowing from year to year. The WNA is applied to customer invoices rendered during the period of October 1st through May 31st of each year for each billing cycle. The adjustment for the year ended August 31, 2014 was a decrease in billings of $12.3 million. The WNA resulted in an increase in billings of $8.4 million for the year ended August 31, 2013.

### *(f) Gas Cost Rate*

The Company's single greatest operating expense is the cost of natural gas. The rate charged to the Company's customers to recover these costs is called the Gas Cost Rate (GCR). The GCR reflects the increases or decreases in natural gas costs and other costs. This GCR mechanism provides the flexibility to rapidly reflect current conditions without the time delay inherent in full base rate alteration. The intent is to achieve an annual balance between the costs incurred for fuel and their pass through to customers.

At the end of the fiscal year, costs recovered through the GCR and surcharges adjustment are compared to the actual cost of fuel and other specific costs. Customers are then credited or charged for the over-recovery or under-recovery of costs. The GCR and surcharges charge/credit may be updated quarterly or in the subsequent fiscal year to reflect the under-recovery or over-recovery. Changes in the GCR impact the reported amounts of gas revenues but do not affect operating income or net income because they are passed through to the customer without markup. At August 31, 2014, approximately $15.2 million was recorded in other current assets for the GCR and surcharges under-recovery. At August 31, 2013, approximately $8.8 million was recorded in other current assets for the GCR and surcharges under-recovery. The GCR is comprised of the purchased gas costs plus the gas adjustment charge minus the interruptible revenue credit.

**GCR effective dates and rates**
(Amounts in U.S. dollars)

| Effective date | | GCR rate per Mcf* | Change |
|---|---|---|---|
| December 1, 2014 | $ | 5.9976 | 0.1306 |
| September 1, 2014 | | 5.8670 | (0.6972) |
| June 1, 2014 | | 6.5642 | 0.5626 |
| March 1, 2014 | | 6.0016 | 0.5543 |
| December 1, 2013 | | 5.4473 | 0.0214 |
| September 1, 2013 | | 5.4259 | (0.6450) |
| June 1, 2013 | | 6.0709 | (0.3282) |
| March 1, 2013 | | 6.3991 | 0.6668 |
| December 1, 2012 | | 5.7323 | 0.5076 |
| September 1, 2012 | | 5.2247 | 0.5118 |

* Mcf – thousand cubic feet

### *(g) Utility Plant*

Utility plant is stated at original cost. The cost of additions, replacements, and betterments of units of property is capitalized and included in the utility plant accounts. The cost of property sold or retired is removed from the utility plant accounts and charged to accumulated depreciation. Normal repairs, maintenance, the cost of minor property items, and expenses associated with retirements are charged to operating expenses as incurred.

In a previous rate order, the PGC disallowed the accrual of the net negative salvage component in depreciation. Cost of removal in the amounts of $2.7 million and $2.9 million was charged to expense as incurred in FY 2014 and FY 2013, respectively, and is included in depreciation expense in the statements of revenues and expenses and changes in net position. Depreciation is calculated on an asset-by-asset basis on the estimated useful lives of plant and equipment on a straight-line method. The composite rate for FY 2014 and FY 2013 was 2.2%. The composite rates are supported by a depreciation study of utility plant as of August 2009. The effective composite depreciation rates, as a percentage of cost, for FY 2014 were as follows:

| | |
|---|---|
| Production plant | 2.19% |
| Transmission, distribution, and storage | 2.05 |
| General plant | 3.33 |

The next depreciation study is scheduled to be completed in FY 2015 for the plant activity subsequent to the last depreciation study and through FY 2014.

Allowance for Funds Used During Construction (AFUDC) is an estimate of the cost of funds used for construction purposes. The AFUDC, as calculated on borrowed funds, reduces interest expense. The AFUDC rate applied to construction work in progress was 4.93% and 5.16% in FY 2014 and FY 2013, respectively.

The following is a summary of utility plant activity for the fiscal years ended August 31, 2014 and 2013 (thousands of U.S. dollars):

| | August 31, 2014 | | | |
|---|---|---|---|---|
| | **Beginning balance** | **Additions and transfers** | **Retirements and transfers** | **Ending balance** |
| Land | $ 5,595 | — | — | 5,595 |
| Distribution and collection systems | 1,481,218 | 61,971 | (3,965) | 1,539,224 |
| Buildings and equipment | 464,733 | 8,682 | — | 473,415 |
| Total utility plant, at historical cost | 1,951,546 | 70,653 | (3,965) | 2,018,234 |
| Under construction | 44,409 | 83,449 | (70,652) | 57,206 |
| Less accumulated depreciation for: | | | | |
| Distribution and collection systems | (701,621) | (32,274)* | 3,847 | (730,048) |
| Buildings and equipment | (139,347) | (12,493)* | — | (151,840) |
| Utility plant, net | $ 1,154,987 | 109,335 | (70,770) | 1,193,552 |

* Cost of removal of approximately $2.7 million was charged to expense as incurred in FY 2014 and is not included in accumulated depreciation.

| | August 31, 2013 | | | |
|---|---|---|---|---|
| | **Beginning balance** | **Additions and transfers** | **Retirements and transfers** | **Ending balance** |
| Land | $ 5,595 | — | — | 5,595 |
| Distribution and collection systems | 1,435,353 | 67,419 | (21,554) | 1,481,218 |
| Buildings and equipment | 453,181 | 14,438 | (2,886) | 464,733 |
| Total utility plant, at historical cost | 1,894,129 | 81,857 | (24,440) | 1,951,546 |
| Under construction | 53,851 | 72,416 | (81,858) | 44,409 |
| Less accumulated depreciation for: | | | | |
| Distribution and collection systems | (691,151) | (31,018)* | 20,548 | (701,621) |
| Buildings and equipment | (131,179) | (12,019)* | 3,851 | (139,347) |
| Utility plant, net | $ 1,125,650 | 111,236 | (81,899) | 1,154,987 |

* Cost of removal of approximately $2.9 million was charged to expense as incurred in FY 2013 and is not included in accumulated depreciation.

### *(h) Revenue Recognition*

The Company is primarily a natural gas distribution company. Operating revenues include revenues from the sale of natural gas to residential, commercial, and industrial heating and non-heating customers. The Company also provides natural gas transportation service. Appliance and other revenues primarily consist of revenue from the Company's parts and labor repair program. Revenue from this program is recognized on a monthly basis for the life of the individual parts and labor plans. Additional revenue is generated from collection fees, reconnection charges, and bulk Liquefied Natural Gas (LNG) sales contracts. Other operating revenues primarily consist of finance charges assessed on delinquent accounts.

In early 2012, Act 11 was enacted by the Pennsylvania Legislature, which permitted public utilities to file a request with the PUC for the implementation of a Distribution System Improvement Charge (DSIC). A DSIC permits natural gas distribution companies to recover the costs related to main and service replacement not already recovered in base rates. This legislation provides utility companies with a supplemental recovery mechanism for costs related to incremental/accelerated distribution system repair, improvement, and replacement. Act 11 permits gas utilities to recover 5.0% of their non-gas revenues via the recovery mechanism and permits greater percentage increases if the PUC so permits. The Company started billing customers a DSIC surcharge as of July 1, 2013. In FY 2014, the Company billed customers $19.4 million for the DSIC surcharge. In FY 2013, the Company billed customers $0.7 million for the DSIC surcharge. The DSIC surcharge is fully reconcilable on a calendar year basis and at the fiscal year-end, the over-billed or under-billed amount is recorded as an adjustment to revenue.

The Company bills customers for the cost of natural gas and the related costs incurred through the processing, distribution, and delivery of natural gas to residential, commercial, and industrial heating and non-heating customers.

Revenue includes amounts related to gas that has been used by customers but has not yet been billed. Revenues are recognized as gas is distributed. Estimated revenues from gas distributed and unbilled, less estimated uncollectible amounts, are accrued and included in operating revenues and were $7.3 million for the years ended August 31, 2014 and 2013, respectively.

### *(i) Operating Expenses*

The Company recognizes costs incurred as part of the Company's regular business activities on the statements of revenue and expenses and changes in net position as operating expenses. These costs include distribution, marketing, gas processing, and other similar costs.

Costs incurred that do not involve normal business operations are recognized as non-operating expenses.

### *(j) Provision for Uncollectible Accounts*

The Company estimates its accumulated provision for uncollectible accounts based on a financial analysis and a collectibility study performed as of the fiscal year-end. The methodology used in performing the collectibility study has been reviewed by the PGC. For FY 2014 and FY 2013, management has provided an accumulated provision for uncollectible accounts in excess of the collectibility study results based on its analysis of historical aging data. The actual results of the Company's collection efforts could differ significantly from the Company's estimate.

Due to the seasonal nature of the business, the Company carries credit balances in accounts receivable primarily as a result of prepayment by budget customers. Credit balances of $16.5 million and $17.0 million for FY 2014 and FY 2013, respectively, have been reclassified to accounts payable.

### *(k) Gas Inventories, Materials, and Supplies*

Gas inventories, materials, and supplies, consisting primarily of fuel stock, gases stored to meet peak demand requirements, and spare parts, are stated at average cost at August 31, 2014 and 2013, as follows (thousands of U.S. dollars):

| | | 2014 | 2013 |
|---|---|---|---|
| Gas inventory | $ | 60,089 | 70,638 |
| Material and supplies | | 9,900 | 9,596 |
| Total | $ | 69,989 | 80,234 |

### *(l) Unamortized Bond Insurance Costs, Debt Discount, and Premium*

Discounts or premiums and bond insurance costs arising from the sale of revenue bonds are amortized using the interest method over the term of the related bond issue. Other costs of bond issuance are expensed as incurred.

### *(m) Unamortized Losses on Reacquired Debt*

Losses on reacquired debt are recorded as deferred outflows of resources and amortized, using the interest method, to interest expense over the shorter of the life of the refunding bond issue or the remaining original amortization period.

### *(n) Pensions and Postemployment Benefits*

The City sponsors a single employer defined-benefit pension plan, the Philadelphia Gas Works Pension Plan (the Pension Plan) to provide pension benefits for all of PGW's employees. In December 2011, the Pension Plan was amended by Ordinance and a new deferred compensation plan was authorized by Ordinance as well. Newly hired employees have an irrevocable option to join either a new deferred compensation plan created in accordance with Internal Revenue Code Section 401 or the existing defined benefit plan. The defined-contribution plan provides for an employer contribution equal to 5.5% of applicable wages. The defined benefit plan provides for a newly hired employee contribution equal to 6.0% of applicable wages. The Ordinance did not affect the retirement benefits of active employees, current retirees and beneficiaries, or terminated employees entitled to benefits but not yet receiving them. The Pension Plan covers all employees and provides for retirement payments for vested employees at age 65 or earlier under various options, which includes a disability pension provision, a preretirement spouse or domestic partner's death benefit, a reduced pension for early retirement, various reduced pension payments for the election of a survivor option, and a provision for retirement after 30 years of service without penalty for reduced age. In accordance with Resolutions of the PGC, Ordinances of City Council, and as prescribed by the City's Director of Finance, the Pension Plan is being funded with contributions by the Company to the Sinking Fund Commission of the City. Management believes that the Pension Plan is in compliance with all applicable laws.

The Company sponsors a single employer defined benefit healthcare plan and provides postemployment healthcare and life insurance benefits in accordance with their retiree medical program to 2,053 and 2,044 retirees, their beneficiaries, and dependents for FY 2014 and FY 2013, respectively. The Company also offers such benefits to 1,631 and 1,636 active employees and their dependents for FY 2014 and FY 2013, respectively, by charging the annual insurance premiums to expense.

The difference between the annual OPEB cost (AOC) and the Company's contributions results in an increase or decrease to the net OPEB obligation, which is recorded in other non-current liabilities and expensed.

***(o) Cash and Cash Equivalents***

For the purpose of reporting cash and cash equivalents, all highly liquid investments with original maturities of three months or less are considered cash equivalents, except those held for long-term purposes in the Sinking Fund, Capital Improvement Fund, Workers' Compensation Escrow Fund, and Health Insurance Escrow Fund as described in note 3.

Cash designated for capital expenditures consisted of cash held by the Company, which was segregated into separate accounts that are not contractually restricted but, based on the Company's intention, are not available for the payment of general corporate obligations. These amounts will be utilized by the Company in the future for capital expenditures.

***(p) Reserve for Injuries and Damages***

The Company is principally insured through insurance carriers. However, the Company is required to cover settlement of claims, which are excluded under the provisions of such insurance policies. An estimated liability has been established, in accordance with PGC regulations, for settlements to be paid by the Company in the next fiscal year.

Estimated losses from claims for occurrences not covered by insurance, which will not be paid in the next fiscal year, have been accrued. Such liabilities have been established based upon Company history and consultation with counsel. Such expenses are expected to be recovered through future rates. Reductions to the reserve are made as claims are settled.

***(q) Segment Information***

All of the Company's assets and operations are employed in only one segment, local transportation and distribution of natural gas in the City.

***(r) Estimates***

In preparing the financial statements in conformity with U.S. GAAP, management uses estimates. The Company has disclosed in the financial statements all estimates where it is reasonably possible that the estimate will change in the near term and the effect of the change could be material to the financial statements.

***(s) Pollution Remediation***

Under Pennsylvania Act 2, *Land Recycling and Environmental Remediation Standards Act of 1995* (Act 2), the Notice of Intent to Remediate (NIR) process was conducted by the Company in October 2004 and a total of four Public Involvement Plan meetings were conducted at multiple City Recreation Centers throughout Philadelphia during February and March 2005. In March 2005 (after the public meetings were conducted), the Company submitted a series of five Remedial Investigation Reports (RIRs) to the Act 2 for review. In July 2005, the Act 2 program approved all five RIRs submitted in March 2005.

The Company estimates its pollution remediation obligations using the effective cash flow method, in which measurement is based on the outlays expected to be incurred as a sum of probability-weighted amounts in a range of possible estimated amounts. The Company's liability is based on a combination of internal and external cost estimates for the specific remediation activities agreed to as part of Act 2 and Pennsylvania Act 32, *Storage Tank and Spill Prevention Act of 1989* (Act 32).

Estimated site liabilities are determined based upon existing remediation laws and technologies, specific site consultants' engineering studies, or by extrapolating experience with environmental issues at comparable sites. Estimates may change substantially as additional information becomes available regarding the level of contamination at specific sites, available remediation methods, and changes in price, technology, proposed land use, or applicable regulations.

The Company recorded an additional liability for pollution remediation obligations of $4.0 million and $0.5 million for FY 2014 and FY 2013, respectively. The pollution remediation liability is reflected in other non-current liabilities and in other current liabilities. In accordance with U.S. GAAP for regulated entities, the Company has also recognized the long-term portion of its environmental remediation liability as a regulatory asset because based on available evidence it is probable that the previously incurred costs will be recovered through rates.

### *(t) Reclassifications*

Certain prior-year amounts have been reclassified for comparative purposes. Specifically, the annual distribution to the City has been reclassified from an equity reduction to a non-operating expense.

### *(u) New Accounting Pronouncements*

As discussed in note 10, the Company currently does not reflect a net pension obligation on its balance sheet because the annual required contribution has been made each year. GASB No. 68, *Accounting and Financial Reporting for Pensions – an amendment of GASB Statement No. 27*, is effective for the Company's fiscal year ending August 31, 2015. The primary objective of this Statement is to improve accounting and financial reporting by state and local governments for pensions. This Statement will result in the Company's net pension liability being reflected on the balance sheet, measured as the portion of the present value of projected benefit payments to be provided to current and inactive employees that is attributed to those employees' past periods of service (total pension liability), less the amount of the pension plan's fiduciary net position. Under this new pronouncement, the unfunded actuarial liability for the plan is approximately $205.2 million at August 31, 2014.

## (2) Ownership and Management and Related-Party Transactions and Balances

The Company is a component unit of the City. As of January 1, 1973, under the terms of a two-year agreement automatically extended for successive two-year periods unless canceled upon 90 days notice by the City, the Company is being managed by the Philadelphia Facilities Management Corporation (PFMC). The agreement, as amended, provides for reimbursement to PFMC of actual costs incurred in managing the Company, not to exceed a total of the prior fiscal year's maximum amount adjusted to reflect the percentage change in the Consumer Price Index for All Urban Consumers (CPI-U) All Items Index, Philadelphia, Pennsylvania, United States Department of Labor, Bureau of Labor Statistics, as most recently published and available to the Director of Finance of the City on March 1 of each such fiscal year. In FY 2014 and FY 2013, the applicable maximum amount was calculated to be $1.2 million. The agreement requires the

Company to make annual payments of $18.0 million to the City. In FY 2014 and FY 2013, the Company made the annual payment of $18.0 million to the City.

The Company engages in various other transactions with the City. The Company provides gas service to the City. Operating revenues include $7.5 million and $7.3 million in FY 2014 and FY 2013, respectively, relating to sales to the City. Net amounts receivable from the City were $0.2 million at August 31, 2014 and 2013. Water and sewer services and licenses are purchased from the City. Such purchases totaled $1.4 million and $0.9 million in FY 2014 and FY 2013, respectively.

Certain activities of the PGC are paid for by the Company. Such payments totaled $0.8 million in both FY 2014 and FY 2013.

## (3) Cash and Cash Equivalents, and Investments

### *(a) Cash and Cash Equivalents*

Cash and cash equivalents consist primarily of bank deposits, money market accounts, and investments purchased through various brokerage relationships. Bank balances of such deposits, accounts, and investments at August 31, 2014 and 2013 were $105.3 million and $100.8 million, respectively. Book balances of such deposits and accounts at August 31, 2014 and 2013 were $105.7 million and $100.9 million, respectively. Federal depository insurance on these balances at August 31, 2014 and 2013 was $0.5 million. The remaining balances are not insured. Investments are primarily in money market accounts, U.S. Treasury bills, U.S. government agencies and instrumentalities, and corporate obligations (short-term investments).

The highest balance of short-term investments during FY 2014 and FY 2013 was $102.6 million and $85.0 million, respectively. Short-term investments with a carrying amount (at fair value) of $102.6 million and $84.2 million at August 31, 2014 and 2013, respectively, are included in the balances presented above.

PGW transferred $10.0 million from short-term investments to cash designated for capital expenditures at the end of FY 2014. These unexpended funds were designated for the purchase of utility plant. In FY 2014 and FY 2013, the Company utilized the Capital Improvement Fund to provide liquidity for the additions to utility plant.

### *(b) Sinking Fund, Capital Improvement Fund, Workers' Compensation Escrow Fund, and Health Insurance Escrow Fund*

The investments in the Company's Sinking Fund, Capital Improvement Fund, Workers' Compensation Escrow Fund, and Health Insurance Escrow Fund consist primarily of U.S. Treasury and government agency obligations, corporate obligations, and money market accounts. These investments are maintained by the City or in the Company's name by its agent. The balance of the Capital Improvement Fund at August 31, 2014 and 2013 was $0.0 million and $44.1 million, respectively.

Investments are recorded at fair value except for certain money market funds recorded at amortized cost. The adjustment to market value for the Capital Improvement Fund resulted in no gain or loss in

FY 2014 and a loss of $0.1 million in FY 2013. The adjustment to market value for the Sinking Fund resulted in a gain of $0.3 million in FY 2014 and a loss of $0.2 million in FY 2013.

Pursuant to the Pennsylvania Department of Labor and Industry Bureau of Workers' Compensation Self-Insurance policy, the Company has established and maintained a restricted trust account. As of August 31, 2014 and 2013, the trust account balances were $2.6 million.

PGW is self-insured for the healthcare for active employees and retirees under the age of 65. Retirees over the age of 65 are insured on an experience rated basis. The self-insured model requires the Company to establish and maintain a restricted escrow account. The balance in the Health Insurance Escrow Fund was $3.2 million as of August 31, 2014 and 2013.

The following is a schedule that details the Company's investments in the Capital Improvement Fund for FY 2013 (thousands of U.S. dollars). There was no balance at the end of FY 2014:

| | August 31, 2013 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| U.S. government obligations: | | | | |
| U.S. Treasury notes | $ 1,700 | 0.0333 | AAA/AA+ | Moody's/S&P |
| U.S. government agencies and instrumentalities: | | | | |
| Federal National Mortgage Association medium term notes | 6,313 | 0.3000 | AAA/AA+ | Moody's/S&P |
| Federal Home Loan Bank bonds | 8,962 | 0.1881 | AAA/AA+ | Moody's/S&P |
| Federal Home Loan Mortgage Corporation medium term notes | 6,629 | 0.3698 | AAA/AA+ | Moody's/S&P |
| Federal Farm Credit Bank bonds | 2,311 | 0.4917 | AAA/AA+ | Moody's/S&P |
| Federal Home Loan Banks discount notes | 100 | 0.0889 | | Moody's/S&P |
| Federal National Mortgage Association discount notes | 1,980 | 0.0285 | AAA/AA+ | Moody's/S&P |
| Total U.S. government agencies and instrumentalities | 26,295 | | | |
| Corporate obligations: | | | | |
| New York Life Global Funding | 924 | 0.2861 | AAA/AA+ | Moody's/S&P |
| Berkshire Hathaway Financial | 281 | 0.3203 | AA2/AA+ | Moody's/S&P |
| Massmutual Global Funding | 254 | 0.3203 | AA2/AA+ | Moody's/S&P |
| XTO Energy Inc | 913 | 0.2917 | AAA/AAA | Moody's/S&P |
| Walmart Stores | 283 | 0.3697 | AA2/AA | Moody's/S&P |
| Microsoft | 500 | 0.2917 | AAA/AAA | Moody's/S&P |
| Total corporate obligations | 3,155 | | | |


(Continued)

| | August 31, 2013 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| Foreign issues: | | | | |
| Shell International Financial | $ 734 | 2.5623 | AA1/AA | Moody's/S&P |
| Total fair value of investments | 31,884 | | | |
| Money market: | | | | |
| First American Prime Obligations Class Z | 12,010 | — | * | * |
| Morgan Stanley Prime Portfolio Institutional Class | 100 | — | * | * |
| Total money market | 12,110 | | | |
| Other | 61 | — | * | * |
| Total fair value of investments, including cash deposits | $ 44,055 | | | |
| Portfolio weighted modified duration | | 0.2752 | | |

* The credit of this investment is unrated.

The following is a schedule that details the Company's investments in the Sinking Fund (thousands of U.S. dollars):

| | | August 31, 2014 | | | |
|---|---|---|---|---|---|
| **Investment type** | | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| U.S. government obligations: | | | | | |
| U.S. Treasury notes | $ | 26,837 | 7.1615 | AAA/AA+ | Moody's/S&P |
| U.S. government agencies and instrumentalities: | | | | | |
| Federal National Mortgage Association medium term notes | | 9,390 | 0.6125 | AAA/AA+ | Moody's/S&P |
| Federal Home Loan Mortgage Corporation medium term notes | | 7,513 | 1.3230 | AAA/AA+ | Moody's/S&P |
| Federal Home Loan Bank bonds | | 5,770 | 0.1889 | AAA/AA+ | Moody's/S&P |
| Federal Home Loan Bank discounted notes | | 915 | 0.1763 | AAA/AA+ | Moody's/S&P |
| Federal Farm Credit Bank bonds | | 11,304 | 0.6389 | AAA/AA+ | Moody's/S&P |
| Federal National Mortgage Corporation Debt Securities | | 7,525 | 1.6167 | AAA/AA+ | Moody's/S&P |
| Total U.S. government agencies and instrumentalities | | 42,417 | | | |
| Total fair value of investments | | 69,254 | | | |
| Corporate obligations: | | | | | |
| Walmart Stores | | 1,269 | 2.5036 | AA2/AA | Moody's/S&P |
| National Australia Bank NY | | 2,598 | 3.3868 | AA2/AA | Moody's/S&P |
| General Electric Capital Corporation | | 1,596 | 5.8879 | A1/AA+ | Moody's/S&P |
| Berkshire Hathaway Financial | | 537 | 1.4311 | AA2/AA | Moody's/S&P |
| Total corporate obligations | | 6,000 | | | |

| | August 31, 2014 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| Foreign issues: | | | | |
| Bank of Nova Scotia | $ 2,961 | 1.9396 | AA2+/A+ | Moody's/S&P |
| Total Capital S.A. | 3,070 | 5.7167 | AA1+/AA- | Moody's/S&P |
| Westpac Banking Corporation | 1,788 | 2.7128 | AA2+/AA- | Moody's/S&P |
| Total foreign issues | 7,819 | | | |
| State obligations: | | | | |
| Pennsylvania ST Second Ser | 762 | — | AA3/AA | Moody's/S&P |
| Cash and cash equivalents: | | | | |
| Credit Agricole N A commercial paper | 2,250 | — | * | * |
| BNP Paribus Finance Inc commercial paper | 2,074 | — | * | * |
| Rabobank USA Financial Corporation commercial paper | 2,124 | — | * | * |
| UBS Finance Delaware commercial paper | 2,072 | — | * | * |
| Toyota Motor Credit Corporation commercial paper | 1,798 | — | * | * |
| HSBC Americas Inc commercial paper | 3,225 | — | * | * |
| JP Morgan Securities commercial paper | 2,748 | — | * | * |
| Societe Generale NA C P | 2,900 | — | * | * |
| Deutsche Bank Financial LLC commercial paper | 2,574 | — | * | * |
| Money market: | | | | |
| First American Government Obligations Fund Class Z | 131 | — | * | * |
| Total cash and cash equivalents | 21,896 | | | |

| | August 31, 2014 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| Other | $ 177 | — | * | * |
| Total fair value of investments, including cash deposits | $ 105,908 | | | |
| Portfolio weighted modified duration | | 0.7673 | | |

* The credit of this investment is unrated.

| | August 31, 2013 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| U.S. government obligations: | | | | |
| U.S. Treasury notes | $ 60,705 | 0.9007 | AAA/AA+ | Moody's/S&P |
| U.S. government agencies and instrumentalities: | | | | |
| Federal National Mortgage Association medium term notes | 12,979 | 1.4567 | AAA/AA+ | Moody's/S&P |
| Federal Home Loan Bank bonds | 9,689 | 1.1265 | AAA/AA+ | Moody's/S&P |
| Federal Farm Credit Bank bonds | 4,005 | 1.5111 | AAA/AA+ | Moody's/S&P |
| Total U.S. government agencies and instrumentalities | 26,673 | | | |
| Total fair value of investments | 87,378 | | | |

| | August 31, 2013 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| Corporate obligations: | | | | Moody's/S&P |
| Walmart Stores | $ 2,302 | 0.1906 | AA2/AA | |
| Berkshire Hathaway Financial | 550 | 0.1696 | AA2/AA | Moody's/S&P |
| General Electric Capital Corporation | 1,840 | 0.1938 | A1/AA+ | Moody's/S&P |
| Total corporate obligations | 4,692 | | | |
| State obligations: | | | | |
| Pennsylvania ST Second Ser | 797 | — | AA2/AA | Moody's/S&P |
| Cash and cash equivalents: | | | | |
| Bank of Tokyo Mitsubishi commercial paper | 2,802 | — | * | * |
| BNP Paribus Finance Inc commercial paper | 2,074 | — | * | * |
| Rabobank USA Financial Corporation commercial paper | 2,818 | — | * | * |
| UBS Finance Delaware commercial paper | 2,072 | — | * | * |
| Toyota Motor Credit Corporation commercial paper | 1,199 | — | * | * |
| General Electric Capital Corporation commercial paper | 1,275 | — | * | * |
| Money market: | | | | |
| First American Government Obligations Fund Class Z | 173 | — | * | * |
| Total cash and cash equivalents | 12,413 | | | |
| Total fair value of investments, including cash deposits | $ 105,280 | | | |
| Portfolio weighted modified duration | | 1.0442 | | |

* The credit of this investment is unrated.

The following is a schedule that details the Company's investments in the Workers' Compensation Escrow Fund (thousands of U.S. dollars):

| | August 31, 2014 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| Money market: | | | | |
| Fidelity Governmental Fund | $ 2,597 | — | * | * |
| Total fair value of investments, including cash deposits | $ 2,597 | | | |

* The credit of this investment is unrated.

| | August 31, 2013 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| Money market: | | | | |
| Fidelity Governmental Fund | $ 2,597 | — | * | * |
| Total fair value of investments, including cash deposits | $ 2,597 | | | |

* The credit of this investment is unrated.

The following is a schedule that details the Company's investments in the Health Insurance Escrow Fund (thousands of U.S. dollars):

| | August 31, 2014 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| Money market: | | | | |
| Fidelity Governmental Fund | $ 3,223 | — | * | * |
| Total fair value of investments, including cash deposits | $ 3,223 | | | |

* The credit of this investment is unrated.

| | August 31, 2013 | | | |
|---|---|---|---|---|
| **Investment type** | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| Money market: | | | | |
| Fidelity Governmental Fund | $ 3,223 | — | * | * |
| Total fair value of investments, including cash deposits | $ 3,223 | | | |

* The credit of this investment is unrated.

### *(c) Interest Rate Risk*

It is the policy of the City to diversify its investment portfolios. Portfolio diversification is employed as a way to control risk. Investments shall be diversified as to maturities, and as to kind of investments to minimize the risk of loss, which might result from over concentration of assets in a specific maturity, in a specific kind of a security, or from a specific issuer or industry.

### *(d) Credit Risk*

The City has adopted an investment policy relating to the investments of the Company. Per the investment policy, the Company's allowable investments are: (1) bonds or notes of the U.S. government; (2) U.S. Treasury obligations, including separate trading of registered interest and principal securities (STRIPS); receipts indicating an undivided interest in such U.S. Treasury obligations; and stripped coupons held under book-entry with the New York Federal Reserve Bank; (3) obligations of the following U.S. government-sponsored agencies; Government National Mortgage Association, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Federal Farm Credit System, Federal Home Loan Bank, Resolution Funding Corporation, and Tennessee Valley Authority; (4) collateralized banker's acceptances and certificate of deposit denominated in U.S. dollars and issued by a city code authorized depository certificate of deposit must be secured by acceptable collateral with a total market value equal to 102.0% of the deposit; (5) commercial paper with a stated maturity of 270 days or less, which is rated P1 by Moody's or A1+ by Standard & Poor's (S&P). The senior long-term debt of the commercial paper issuer, or the entity providing and explicit guarantee, must be rated not lower than A2 by Moody's or A by S&P; (6) asset-backed commercial paper (ABCP), which does not have a long-term rating, is an allowable investment if it meets the short-term rating requirements but is only allowed up to the ABCP sublimit; (7) general obligation bonds of corporations rated Aa2 or better by Moody's or AA or better by S&P with a final maturity of two years or less; (8) collateralized mortgage obligations and pass-through securities directly issued by a federal agency or instrumentality of the United States, the underlying security for which is guaranteed by an agency or instrumentality of the United States and with a final maturity of two years or less, the rating must be no lower than Aa2 by Moody's or AA by S&P; (9) money market mutual funds, as defined by the Securities and Exchange Commission money markets funds must have assets over $15 billion, have the highest rating from Moody's, S&P, and Fitch, and contain only government securities; (10) repurchase agreements that are fully collateralized in bonds or notes of the U.S. government pledged to the City and held in the City's name and deposited at the time the investment is made with an entity or a third party selected and approved by the City the market value of the collateral shall be at least 102.0% of the funds being disbursed; and (11) obligations of the Commonwealth of Pennsylvania (the Commonwealth) or any municipality or other political subdivision of the Commonwealth with a final maturity of two years or less and a rating of at least AA by Moody's or S&P.

Authorized investments for Sinking Fund Portfolios are dictated by the First Class City Revenue Bond Act of the General Assembly of the Commonwealth of Pennsylvania, approved October 18, 1972. This also includes any investment vehicle permitted for any Commonwealth state agency.

The Company's investment policy provides for the following percentage limitations of authorized investments, valued at market:

| | Percent of portfolio allowed | Percent of portfolio per issuer | Percent of outstanding securities per issuer |
|---|---|---|---|
| U.S. government | 100% | 100% | N/A |
| U.S. Treasury | 100 | 100 | N/A |
| U.S. Agencies | 100 | 33 | N/A |
| Certificates of Deposit | | | |
| Banker's Acceptances, Eurodollar Deposits, and Euro Certificates of Deposit | 15 | 3 | — |
| Commercial Paper | 25 | 3 | 3% |
| Corporate Bonds | 25 | 3 | 3 |
| Collateralized Mortgage Obligation and Passthroughs | 5 | 3 | 3 |
| Money Market Mutual Funds | 25 | 10 | 3 |
| Repurchase Agreements | 25 | 10 | N/A |

More than 47.2% of the Company's investments as of August 31, 2014 are in the following: Federal Home Loan Mortgage Corporation medium term notes (12.2%), Freddie Discounts (14.0%), and Federal Home Loan Bank bonds (21.0%). These investments are in accordance with the City's investment policy.

***(e) Custodial Credit Risk***

The Company has selected, as custodial bank, a member of the Federal Reserve System to hold its investments. Delivery of the applicable investment documents to the Company's custodian is required for all investments. For secured transactions, such as repurchase agreements, either the title to or a perfected security interest in the securities, along with any necessary transfer documents, must be transferred to the custodian. Such transactions will always use delivery versus payment procedures.

## (4) Recoverable Costs

In compliance with orders issued by the PGC, the cost of projects that produce benefits over an extended period is recorded on the balance sheet as a recoverable cost in other assets. There is no return on the asset being charged to the customers. There were no unamortized costs included in other assets as of August 31, 2014 and 2013. There were no unamortized costs in other current assets at August 31, 2014. The unamortized costs included in other current assets were $0.2 million as of August 31, 2013.

In accordance with U.S. GAAP for regulated entities, the Company has recognized the long-term portion of its environmental remediation liability as a regulatory asset because based on available evidence it is probable that the previously incurred costs will be recovered through rates. In FY 2014, settlements by the Company's insurance carriers provided less than $0.1 million associated with environmental remediation costs. Environmental remediation costs of approximately $0.6 million in FY 2014 were offset by these insurance settlements, and the remainder was recorded on the balance sheet as a recoverable cost in other assets. The Company estimates additional expenditures to be approximately $34.7 million.

## (5) Deferred Compensation Plan

The Company offers its employees a deferred compensation plan (the Plan) created in accordance with Internal Revenue Code Section 457. The Plan, available to all Company employees with at least 30 days of service, permits them to defer a portion of their salary until future years. The Company provides an annual 10.0% matching contribution of applicable wages that immediately vests to the employee. The Company contributed $0.4 million in FY 2014 and $0.3 million in FY 2013.

## (6) Notes Payable

Pursuant to the provisions of certain ordinances and resolutions of the City, the Company may sell short-term notes in a principal amount that, together with interest, may not exceed $150.0 million outstanding at any time. These notes are intended to provide additional working capital. They are supported by irrevocable letters of credit and a subordinated security interest in the Company's revenues.

The commitment amount is $120.0 million under the current credit agreements. The expiration date of the credit agreements is August 14, 2017.

There were no outstanding notes payable at August 31, 2014 and 2013.

Commercial paper activity for the year ended August 31, 2014 was as follows (thousands of U.S. dollars):

| | Year ended August 31, 2014 | | | |
|---|---|---|---|---|
| | **Beginning balance** | **Additions** | **Deletions** | **Ending balance** |
| Commercial paper | $ — | 400 | 400 | — |

## (7) GCR Tariff Reconciliation

During the fiscal year ended August 31, 2014, the Company's actual gas costs were above its billed gas costs by approximately $13.4 million. This amount was recorded in other current assets for FY 2014. Actual gas costs were $6.9 million lower than billed gas costs in FY 2013.

### *Natural Gas Pipeline Supplier Refund*

The Company received refunds including interest of approximately $4.5 million in FY 2014 and $0.1 million in FY 2013, related to Federal Energy Regulatory Commission (FERC)/Pipeline Rate Cases. This amount was utilized as a reduction in the cost of gas for reconciliation purposes in the calculation of the applicable GCR.

## (8) Long-Term Debt and Other Liabilities

The following summary of long-term debt consists primarily of bonds issued by the City under agreements whereby the Company must reimburse the City for the principal and interest payments required by the bond ordinances for the fiscal years ended August 31, 2014 and 2013 (thousands of U.S. dollars):

| | | August 31, 2014 | | | August 31, 2013 | | |
|---|---|---|---|---|---|---|---|
| | | Current portion | Long-term | Total | Current portion | Long-term | Total |
| Revenue bonds | $ | 50,975 | 964,945 | 1,015,920 | 49,800 | 1,015,920 | 1,065,720 |
| Unamortized discount | | (234) | (1,926) | (2,160) | (248) | (2,160) | (2,408) |
| Unamortized premium | | 2,486 | 17,730 | 20,216 | 2,854 | 20,216 | 23,070 |
| Total revenue bonds | $ | 53,227 | 980,749 | 1,033,976 | 52,406 | 1,033,976 | 1,086,382 |

The following is a summary of activity related to revenue bonds and other liabilities and the respective balances for the fiscal years ended August 31, 2014 and 2013 (thousands of U.S. dollars):

| | | Year ended August 31, 2014 | | | |
|---|---|---|---|---|---|
| | | Beginning balance | Additions | Reductions | Ending balance |
| Revenue bonds | $ | 1,065,720 | — | (49,800) | 1,015,920 |
| Other liabilities: | | | | | |
| Claims and judgments | | 5,486 | — | (270) | 5,216 |
| Environmental clean-up | | 29,522 | 3,977 | — | 33,499 |
| Other postemployment benefits | | 109,060 | — | (7,272) | 101,788 |
| Interest rate swap liability | | 33,363 | 5,399 | — | 38,762 |
| Other current liabilities | | 9,107 | 10,214 | — | 19,321 |
| Total other liabilities | | 186,538 | 19,590 | (7,542) | 198,586 |
| Less current portion | | 9,107 | 10,214 | — | 19,321 |
| Total other non-current liabilities | $ | 177,431 | 9,376 | (7,542) | 179,265 |

| | Year ended August 31, 2013 | | | |
|---|---|---|---|---|
| | **Beginning balance** | **Additions** | **Reductions** | **Ending balance** |
| Revenue bonds | $ 1,093,440 | — | (27,720) | 1,065,720 |
| Other liabilities: | | | | |
| Unamortized balance of Guaranteed Investment Contract in Sinking Fund | 5,309 | — | (5,309) | — |
| Claims and judgments | 3,438 | 2,048 | — | 5,486 |
| Environmental clean-up | 29,195 | 327 | — | 29,522 |
| Other postemployment benefits | 111,068 | — | (2,008) | 109,060 |
| Interest rate swap liability | 57,435 | — | (24,072) | 33,363 |
| Other current liabilities | 10,265 | — | (1,158) | 9,107 |
| Total other liabilities | 216,710 | 2,375 | (32,547) | 186,538 |
| Less current portion | 10,265 | — | (1,158) | 9,107 |
| Total other non-current liabilities | $ 206,445 | 2,375 | (31,389) | 177,431 |

Principal maturities and scheduled interest payments for revenue bonds and estimated payments on the interest rate swaps are as follows (thousands of U.S. dollars):

| | Revenue bonds | | | |
|---|---|---|---|---|
| | **Principal** | **Interest** | **Net swap amount** | **Total** |
| Fiscal year ending August 31: | | | | |
| 2015 | $ 50,975 | 46,756 | 8,039 | 105,770 |
| 2016 | 49,155 | 44,091 | 8,039 | 101,285 |
| 2017 | 49,895 | 41,723 | 8,039 | 99,657 |
| 2018 | 49,355 | 39,238 | 7,978 | 96,571 |
| 2019 | 50,190 | 36,909 | 7,497 | 94,596 |
| 2020 – 2024 | 266,245 | 148,748 | 28,627 | 443,620 |
| 2025 – 2029 | 241,000 | 89,419 | 9,385 | 339,804 |
| 2030 – 2034 | 139,770 | 44,115 | — | 183,885 |
| 2035 – 2039 | 109,895 | 13,777 | — | 123,672 |
| 2040 – 2041 | 9,440 | 496 | — | 9,936 |
| Total | $ 1,015,920 | 505,272 | 77,604 | 1,598,796 |

Future debt service is calculated using rates in effect at August 31, 2014 for variable rate bonds. The variable rate received under the swaps is 70.0% of LIBOR until maturity.

### *(a) Bond Issuances*

In September 2011, the underlying variable rate bonds were remarketed and were backed by letters of credit. As of August 31, 2014, the Company's Eighth Series variable rate debt was backed by letter of credit agreements, which either extend to August 1, 2016 (Eighth Series B, C, and D) or August 30, 2016 (Eighth Series E).

Interest rates and maturities of the outstanding revenue bonds are detailed as follows (thousands of U.S. dollars):

| | Interest rates | Maturity date (fiscal year) | | Balance outstanding August 31, 2014 | Balance outstanding August 31, 2013 |
|---|---|---|---|---|---|
| 4th Series | 4.00% – 5.25% | 2032 | $ | 77,825 | 81,075 |
| 17th Series | 4.00% – 5.38% | 2026 | | 101,160 | 110,940 |
| 5th Series | 4.00% – 5.25% | 2034 | | 106,310 | 109,310 |
| 5th Series A-2 | Variable* | 2035 | | 30,000 | 30,000 |
| 18th Series | 5.00% – 5.25% | 2021 | | 27,050 | 30,360 |
| 19th Series | 5.00% | 2024 | | 14,450 | 14,450 |
| 20th Series | 2.00% – 5.00% | 2015 | | 2,725 | 9,595 |
| 7th Series | 4.00% – 5.00% | 2038 | | 179,685 | 183,460 |
| 7th Series Refunding | 5.00% | 2029 | | 28,360 | 28,385 |
| 8th Series A | 4.00% – 5.25% | 2017 | | 37,905 | 48,035 |
| 8th Series B | Variable | 2028 | | 50,260 | 50,260 |
| 8th Series C | Variable | 2028 | | 50,000 | 50,000 |
| 8th Series D | Variable | 2028 | | 75,000 | 75,000 |
| 8th Series E | Variable | 2028 | | 50,260 | 50,260 |
| 9th Series | 2.00% – 5.25% | 2040 | | 138,895 | 141,835 |
| 10th Series | 3.00% – 5.00% | 2026 | | 46,035 | 52,755 |
| | | | $ | 1,015,920 | 1,065,720 |

* As of August 31, 2014, the interest rate was 0.03%.

### *(b) Debt Coverage and Sinking Fund Requirements*

Under the terms of both general ordinances, the City is required to maintain rates to allow the Company to satisfy 1975 and 1998 revenue bond debt coverage ratio requirements.

Also provided by both general ordinances is the establishment of a sinking fund into which deposits are made to meet all principal and interest requirements of the bonds in an amount equal to the maximum annual debt service requirement on the bonds of each respective general ordinance in any fiscal year.

Funds in the Sinking Fund Reserve are to be applied to the payment of debt service if, for any reason, other funds in the Sinking Fund should be insufficient.

The revenue bonds are, and will be, equally and ratably collateralized by a security interest in all of the Company's project revenues, as defined in the general ordinances, and monies in the Sinking Fund.

Portions of certain revenue bonds were issued as zero coupon securities. Interest on these securities is accrued and compounded on the payment dates of the current interest bonds within the issue. The accrued interest in the amount of $10.5 million and $10.8 million in FY 2014 and FY 2013, respectively, is reported as a component of accrued accounts.

### *(c) Interest Rate Swap Agreements*

In January 2006, the City entered into a fixed rate payer, floating rate receiver interest rate swap to create a synthetic fixed rate for the Sixth Series Bonds. The interest rate swap was used to hedge interest rate risk.

The swaps have a maturity date of August 1, 2031 and require the City to pay a fixed rate of 3.6745% and receive a variable rate equal to 70.0% of one-month LIBOR until maturity.

In August 2009, the City terminated approximately $54.8 million of the notional amount of the swap, issued fixed rate refunding bonds related to that portion and kept the remaining portion of the swap to hedge the Eighth Series variable rate refunding bonds backed with letters of credit. The Company paid a swap termination payment of $3.8 million to the counterparty to partially terminate the swap.

The original swap confirmation was amended and restated on August 12, 2009 to reflect the principal amount of the Eighth Series B Bonds, with all other terms remaining the same. The remainder of the notional amount was divided among separate trade confirmations with the same terms as the original swap that was executed with the counterparty for the Eighth Series C Bonds through the Eighth Series E Bonds.

In September 2011, the underlying variable rate bonds were remarketed with new letters of credit. During the remarketing, PGW partially redeemed portions of the longest three maturities of the bonds, and reallocated remaining principal amongst the bond subseries. At the same time, the City terminated an aggregate notional amount of $29.5 million of the swaps, keeping the remaining portion of the swap to hedge the remaining variable rate bonds backed with letters of credit. The partial termination was competitively bid, with the winning swap counterparty providing the lowest cost of termination/assignment. PGW paid a swap termination payment of $7.0 million to partially terminate the swaps. The remaining notional amounts of each of the swaps were adjusted to match the reallocation of the underlying bonds.

In April 2013, each of the swaps was amended to include additional language specifying the exact process to be used to calculate a termination amount in the event of an optional termination at the request of the City on or before April 1, 2015.

In August 2013, two subseries of the underlying variable rate bonds (8th Series C and 8th Series D) were remarketed with new letters of credit. The letters of credit for the remaining two subseries (8th Series B and 8th Series E) were extended with the existing providers.

As of August 31, 2014, the swaps had a notional amount of $225.5 million and the associated variable rate debt had a $225.5 million principal amount, broken down by series as follows:

- The Series B swap had a notional amount of $50.3 million and the associated variable rate bonds had a $50.3 million principal amount. The interest rate at August 31, 2014 for the underlying bonds is approximately 0.04%.
- The Series C swap had a notional amount of $50.0 million and the associated variable rate bonds had a $50.0 million principal amount. The interest rate at August 31, 2014 for the underlying bonds is approximately 0.04%.
- The Series D swap had a notional amount of $75.0 million and the associated variable rate bonds had a $75.0 million principal amount. The interest rate at August 31, 2014 for the underlying bonds is approximately 0.04%.
- The Series E swap had a notional amount of $50.2 million and the associated variable rate bonds had a $50.2 million principal amount. The interest rate at August 31, 2014 for the underlying bonds is approximately 0.04%.

The final maturity date for all swaps is on August 1, 2028.

As of August 31, 2014, the swaps had a combined negative fair value of approximately $38.8 million. The fair values of the interest rate swaps were estimated using the zero coupon method. That method calculates the future net settlement payments required by the swap, assuming current forward rates are implied by the current yield curve for hypothetical zero coupon bonds due on the date of each future net settlement on the swaps.

As of August 31, 2014, the City is not exposed to credit risk because the swaps had a negative fair value. Should interest rates change and the fair value of the swaps become positive, the City would be exposed to credit risk in the amount of the swaps' fair value. The swaps include a termination event additional to those in the standard ISDA master agreement based on credit ratings. The swaps may be terminated by the City if the rating of the counterparty falls below A3 or A – (Moody's/S&P), unless the counterparty has (i) assigned or transferred the swap to a party acceptable to the City; (ii) provided a credit support provider acceptable to the City whose obligations are pursuant to a credit support document acceptable to the City; or (iii) executed a credit support annex, in form and substance acceptable to the City, providing for the collateralization by the counterparty of its obligations under the swaps.

The swaps may be terminated by the counterparty if the rating on the Company's bonds falls below Baa2 or BBB (Moody's/S&P). However, because the City's swap payments are insured by Assured Guaranty Municipal Corporation, as long as Assured Guaranty Municipal Corporation is rated at or above A2 or A (Moody's/S&P), the termination event based on the City's ratings is stayed. At the present time, the rating for Assured Guaranty Municipal Corporation is at A2/AA – (Moody's/S&P).

The City is exposed to (i) basis risk, as reflected by the relationship between the rate payable on the bonds and 70.0% of one-month LIBOR received on the swap, and (ii) tax risk, a form of basis risk, where the City is exposed to a potential additional interest cost in the event that changes in the federal tax system or in marginal tax rates cause the rate paid on the outstanding bonds to be greater than the 70.0% of one-month LIBOR received on the swap.

The impact of the interest rate swaps on the financial statements for the years ended August 31, 2014 and 2013 is as follows (thousands of U.S. dollars):

| | | **Interest rate swap liability** | **Deferred outflow of resources** |
|---|---|---|---|
| Balance, August 31, 2013 | $ | 33,363 | 12,059 |
| Change in fair value through August 31, 2014 | | 5,399 | 6,820 |
| Balance, August 31, 2014 | $ | 38,762 | 18,879 |

| | | **Interest rate swap liability** | **Deferred outflow of resources** |
|---|---|---|---|
| Balance, August 31, 2012 | $ | 57,435 | 34,712 |
| Change in fair value through August 31, 2013 | | (24,072) | (22,653) |
| Balance, August 31, 2013 | $ | 33,363 | 12,059 |

The interest rate swap liability is included in other non-current liabilities on the balance sheet.

There are no collateral posting requirements associated with the swap agreements.

***(d) Guaranteed Investment Contracts in Sinking Fund***

On August 23, 2002, the City entered into Guaranteed Investment Contracts (GICs) in connection with a portion of its 1975 and 1998 Ordinance Sinking Fund Reserves for the Company. At settlement, approximately 65.0% of the Sinking Fund Reserves, from the two ordinances, totaling $61.4 million were invested in the GICs. In exchange for this investment, the Company received an up-front payment of $21.8 million in lieu of receiving interest payments over the life of the GICs.

In March 2013, the City terminated the GICs in connection with 1975 and 1998 Ordinance Sinking Fund Reserves for the Company. At settlement, the Company paid $4.8 million to terminate the portion related to the 1975 Ordinance and $4.2 million to terminate the portion related to the 1998 Ordinance Sinking Fund Reserves for the Company. As a result of the termination of the GICs, in FY 2013 the Company expensed $4.2 million to Interest and Other Income.

## (9) Defeased Debt

Defeased debt of the Company (bonds issued by the Company payable from the proceeds of irrevocably pledged assets) at August 31, 2014 was as follows (thousands of U.S. dollars):

| | Latest date maturing to | Interest rate | Bonds outstanding |
|---|---|---|---|
| 12th Series B | 5/15/20 | 7.00% | $ 28,755 |

Defeased debt of the Company (bonds issued by the Company payable from the proceeds of irrevocably pledged assets) at August 31, 2013 was as follows (thousands of U.S. dollars):

| | Latest date maturing to | Interest rate | Bonds outstanding |
|---|---|---|---|
| 12th Series B | 5/15/20 | 7.00% | $ 32,510 |

The investments held by the trustee and the defeased bonds are not recognized on the Company's balance sheets in accordance with the terms of the Indentures of Defeasance. The investments pledged for the redemption of the defeased debt have maturities and interest payments scheduled to coincide with the trustee cash requirements for debt service.

The assets pledged, primarily noncallable U.S. government securities, had a market value of $30.3 million at August 31, 2014, bearing interest on face value from 0.00% to 5.89%.

The assets pledged, primarily noncallable U.S. government securities, had a market value of $34.1 million at August 31, 2013, bearing interest on face value from 0.00% to 7.74%.

## (10) Pension Costs

### *(a) Plan Description*

The Pension Plan sponsored by the City provides pension benefits for all eligible employees of the Company and other eligible class employees of PFMC and the PGC. The Company's annual covered payroll was $104.1 million and $106.0 million at August 31, 2014 and 2013, respectively.

At September 1, 2014, the beginning of the plan year of the last actuarial valuation, the Pension Plan membership consisted of:

| | |
|---|---|
| Retirees and Beneficiaries Currently receiving benefits and terminated employees entitled to benefits, but not yet receiving them | 2,343 |
| Participants: | |
| Vested | 1,140 |
| Nonvested | 251 |
| Total participants | 1,391 |
| Total membership | 3,734 |

The Pension Plan provides retirement benefits as well as death and disability benefits. Retirement benefits vest after five years of credited service. Employees who retire at or after age 65 are entitled to receive an annual retirement benefit, payable monthly, in an amount equal to the greater of:

- 1.25% of the first $6,600 of Final Average Earnings plus 1.75% of the excess of Final Average Earnings over $6,600, times years of credited service, with a maximum of 60.0% of the highest annual earnings during the last 10 years of credited service or
- 2.0% of total earnings received during the period of credited service plus 22.5% of the first $1,200 annual amount, applicable only to participants who were employees on or prior to March 24, 1967.

Final Average Earnings are the employee's average pay, over the highest five years of the last 10 years of credited service. Employees with 15 years of credited service may retire at or after age 55 and receive a reduced retirement benefit. Employees with 30 years of service may retire without penalty for reduced age.

Covered employees are not required to contribute to the Pension Plan. The Company is required by statute to contribute the amounts necessary to fund the Pension Plan. Benefit and contribution provisions are established by City Ordinance and may be amended only as allowed by City Ordinance.

In December 2011, the Pension Plan sponsored by the City was amended by Ordinance and a new deferred compensation plan was authorized by Ordinance as well. Newly hired employees will have an irrevocable option to join either a new deferred compensation plan created in accordance with Internal Revenue Code Section 401 or the existing defined benefit plan. The deferred compensation plan provides for an employer contribution equal to 5.5% of applicable wages. The defined benefit plan provides for a newly hired employee contribution equal to 6.0% of applicable wages. The Ordinance did not affect the retirement benefits of active employees, current retirees and beneficiaries, or terminated employees entitled to benefits but not yet receiving them.



(Continued)

The City issues a publicly available financial report that includes financial statements and required supplementary information for the Pension Plan. The report may be obtained by writing to the Office of the Director of Finance of the City.

***(b) Annual Pension Cost, Contributions Required, and Contributions Made***

The normal cost, amortization of the unfunded balance, and annual required and actual contributions for FY 2014 and the two preceding fiscal years were as follows (thousands of U.S. dollars):

| | | Normal cost | Amortization of the underfunded balance | Annual required and actual contributions |
|---|---|---|---|---|
| Fiscal year ended August 31: | | | | |
| 2014 | $ | 8,533 | 15,988 | 24,521 |
| 2013 | | 8,782 | 14,832 | 23,614 |
| 2012 | | 8,171 | 15,801 | 23,972 |

Beneficiary payments of $43.2 million were made in FY 2014. Withdrawals from the pension assets of $21.8 million were utilized to meet these beneficiary payments. Additionally, $0.8 million was due to the Company from the pension fund at the end of FY 2014.

The Company's annual pension cost is equal to its annual required contribution (ARC). The ARCs were determined based on an actuarial study, or updates thereto, using the projected unit credit method. Significant actuarial assumptions used for the above valuation include a rate of return on the investment of present and future assets of 7.95% per year compounded annually; with salary increases assumed to reach 4.5% per year; and retirements that are assumed to occur prior to age 62, at a rate of 10.0% at ages 55 to 61 and 100.0% at age 62. The assumptions did not include postretirement benefit increases. These actuarial assumptions are consistent with the prior fiscal year.

The actuarial asset value is equal to the value of the fund assets as reported by the City with no adjustments. The unfunded actuarial accrued liability is being amortized over 20 years.

The Pension Plan funding policy provides for periodic employer contributions at actuarially determined rates that, expressed as percentages of annual covered payroll, are sufficient to accumulate assets to pay benefits when due. Level percentages of payroll employer contribution rates are determined using the Projected Unit Credit actuarial funding method. The actuarial value of assets, actuarial accrued liability, unfunded actuarial accrued liability, funded ratio, covered payroll and the unfunded actuarial accrued liability of covered payroll for FY 2014, and the two preceding fiscal years were as follows (thousands of U.S. dollars):

| Actuarial valuation date | | (a) Actuarial value of assets | (b) Actuarial accrued liability (AAL) | (b)-(a) Unfunded AAL (UAAL) | (a/b) Funded ratio | | Covered payroll | UAAL as a percent of covered payroll |
|---|---|---|---|---|---|---|---|---|
| September 1, 2013 | $ | 462,691 | 623,612 | 160,921 | 74.2% | $ | 104,123 | 154.5% |
| September 1, 2012 | | 437,780 | 585,632 | 147,852 | 74.8 | | 106,000 | 139.5 |
| September 1, 2011 | | 421,949 | 572,190 | 150,241 | 73.7 | | 106,308 | 141.3 |

The ARCs, contributions made, and net pension obligation for FY 2014 and the two preceding fiscal years were as follows (thousands of U.S. dollars):

| | | 2014 | 2013 | 2012 |
|---|---|---|---|---|
| Annual required contribution | $ | 24,521 | 23,614 | 23,972 |
| Contributions made | | (24,521) | (23,614) | (23,972) |
| Net pension obligation | $ | — | — | — |

## (11) Other Postemployment Benefits

### *(a) Plan Description*

The Company sponsors a single employer defined-benefit healthcare plan and provided postemployment healthcare and life insurance benefits to approximately 2,053 and 2,044 participating retirees and their beneficiaries and dependents in FY 2014 and FY 2013, respectively, in accordance with their retiree medical program. The annual covered payroll (which was substantially equal to total payroll) was $115.2 million and $110.1 million at August 31, 2014 and 2013, respectively.

The Company pays the full cost of medical, basic dental, and prescription coverage for employees who retired prior to December 1, 2001. Employees who retire after December 1, 2001 are provided a choice of three plans at the Company's expense and can elect to pay toward a more expensive plan. Retirees may also contribute toward enhanced dental plan and life insurance coverage. PGW pays 100% of the cost for the prescription drug plan after drug co-pays. Union employees hired on or after May 21, 2011 and Non-Union employees hired on or after December 21, 2011 are entitled to receive postretirement medical, prescription, and dental benefits for five years only. Currently, the Company provides for the cost of healthcare and life insurance benefits for retirees and their beneficiaries on a pay-as-you-go basis.

Total expense incurred for healthcare and life insurance related to retirees amounted to $25.9 million and $23.7 million in FY 2014 and FY 2013, respectively. In addition, the Company expensed $18.5 million of funding for the OPEB Trust and retirees contributed $0.4 million towards their healthcare in both FY 2014 and FY 2013. These contributions represent the additional cost of healthcare plans chosen by retirees above the basic plan offered by the Company. Total premiums for group life insurance were $2.2 million in both FY 2014 and FY 2013, which included $1.8 million and $1.7 million for retirees. Retirees contributed $0.1 million towards their life insurance in both FY 2014 and FY 2013.

***(b) Annual Postemployment Benefit Cost, Contributions Required, and Contributions Made***

The amount paid by the Company for retiree benefits in FY 2014 was $44.4 million, consisting of $24.3 million of healthcare expenses, $1.6 million of life insurance expenses, and $18.5 million contributed to the OPEB trust. In FY 2013, the Company paid $42.2 million, consisting of $22.2 million of healthcare expenses, $1.5 million of life insurance expenses, and $18.5 million contributed to the OPEB trust. The difference between the AOC and the Company's contributions resulted in a decrease in the OPEB obligation of $7.3 million and $2.0 million in FY 2014 and FY 2013, respectively, which was recorded to other non-current liabilities and expensed.

**Funded Status**

The actuarial accrued liability for benefits at August 31, 2014 and 2013 was $450.3 million and $436.5 million, respectively. The ratio of the unfunded actuarial accrued liability to the covered payroll was 312.1% as of August 31, 2014 and 340.3% as of August 31, 2013.

Historical trend information reflecting funding progress and contributions made by the Company is presented in the Schedule of Other Postemployment Benefits Funding Progress (Required Supplementary Information).

**Assumptions**

Actuarial valuations involve estimates of the value of reported amounts and assumptions about the probability of events far into the future, and are subject to continual revision as actual amounts are compared to past expectations and new estimates are made about the future. Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and the plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.



(Continued)

The assumptions used to determine the AOC for the current year and the funded status of the plan include:

| | |
|---|---|
| Actuarial cost method | Projected unit credit |
| Method(s) used to determine the actuarial value of assets | Fair value of plan assets held in the OPEB trust |
| Investment return assumption (discount rate) | 7.95%, which represents the long-term expected investment return on OPEB trust assets |
| Mortality | 2014 Static Annuitant and Non-Annuitant Mortality Table |
| Amortization method | Level dollar amount |
| Amortization period | Open period of 30 years |

Healthcare cost trend rates are as follows:

| | Healthcare cost trend rates | | | |
|---|---|---|---|---|
| **Year** | **Medical (pre-65)** | **Medical (post-65)** | **Prescription** | **Dental** |
| 2014 | 9.0% | 7.0% | 7.0% | 4.5% |
| 2015 | 8.0 | 6.0 | 6.0 | 4.5 |
| 2016 | 7.0 | 5.0 | 5.0 | 4.5 |
| 2017 | 6.5 | 4.5 | 4.5 | 4.5 |
| 2018 | 6.0 | 4.5 | 4.5 | 4.5 |
| 2019 | 5.5 | 4.5 | 4.5 | 4.5 |
| 2020 | 5.0 | 4.5 | 4.5 | 4.5 |
| 2021+ | 4.5 | 4.5 | 4.5 | 4.5 |

The following table shows the components of the Company’s annual OPEB cost for FY 2014 and FY 2013, the amount actually contributed to the plan, and the Company’s net OPEB obligation (thousands of U.S. dollars):

| | **2014** | **2013** |
|---|---|---|
| Annual required contribution | $ 38,062 | 41,216 |
| Interest on net OPEB obligation | 8,670 | 8,885 |
| Adjustment to the annual required contribution | (9,642) | (9,866) |
| Annual OPEB cost | 37,090 | 40,235 |
| Contributions made | (44,362) | (42,242) |
| Net OPEB obligation as of prior year | 109,060 | 111,067 |
| Net OPEB obligation as of August 31 | $ 101,788 | 109,060 |


(Continued)

The annual OPEB cost is recorded in the Statements of Revenue and Expenses and Changes in Net Position. For the year ended August 31, 2014, approximately $11.2 million was recorded to other postemployment benefits expense and $25.9 million was recorded to administrative and general expense. For the year ended August 31, 2013, approximately $16.5 million was recorded to other postemployment benefits expense and $23.7 million was recorded to administrative and general expense.

The Company's annual OPEB cost, the percentage of annual OPEB cost contributed to the plan, and the net OPEB obligation for FY 2014 and the two preceding fiscal years were as follows (thousands of U.S. dollars):

| | Annual OPEB cost | Percentage of annual OPEB cost contributed | Net OPEB obligation |
|---|---|---|---|
| Fiscal year ended August 31: | | | |
| 2014 | $ 37,090 | 119.6% | $ 101,788 |
| 2013 | 40,235 | 105.0 | 109,060 |
| 2012 | 46,105 | 96.5 | 111,067 |

### *(c) Other Coverage Information*

PGW is self-insured for the healthcare of active employees and retirees under the age of 65. Retirees over the age of 65 are insured on an experience rated basis. At August 31, 2014, the Company has in place $192.3 million of group life insurance coverage for both active and retired employees, which is retrospectively rated on a monthly basis.

## (12) Pollution Remediation

The pollution remediation obligations at August 31, 2014 and 2013 were $34.7 million and $30.8 million, respectively, which reflect the impact of GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*.

## (13) Risk Management

The Company is exposed to various risks of loss related to torts, theft of, damage to, and destruction of assets, errors and omissions, injuries to employees, and natural disasters. While self-insured for many risks, the Company purchases insurance coverage where appropriate. The Company's real and personal property is insured against the risk of loss or damage in the amount of $250.0 million, subject to a $0.5 million per accident deductible at the Richmond and Passyunk Plants and a $0.1 million per accident deductible at all other locations. There are separate sublimits for flood and earth movement at select locations. The Company's Property Insurance includes coverage for damage incurred from a terrorist attack. In addition, the Company maintains Blanket Crime, which is a form of Property Insurance.

The Company maintains $210.0 million in liability (including terrorism) coverage, insuring against the risk of damage to property or injury to the public with a per occurrence self-insured retention of $1.0 million.

The Company maintains statutory limits for Workers' Compensation (including terrorism) with a $0.5 million per occurrence self-insured retention.

The Company maintains a $30.0 million Public Officials Liability (Directors and Officers Liability) policy with a $0.5 million retention as well as a $60.0 million Fiduciary Liability policy with a $0.2 million self-insured retention.

The Company has evaluated all open claims as of August 31, 2014 and has appropriately accrued for these claims on the balance sheet.

Claims and settlement activity for occurrences excluded under the provisions of insurance policies for injuries and damages are as follows (thousands of U.S. dollars):

| | | Beginning of year reserve | Current year claims and adjustments | Claims settled | End of year reserve | Current liability amount |
|---|---|---|---|---|---|---|
| Fiscal year ended August 31: | | | | | | |
| 2014 | $ | 10,411 | 2,498 | (2,965) | 9,944 | 4,728 |
| 2013 | | 11,102 | 2,616 | (3,307) | 10,411 | 4,925 |
| 2012 | | 10,697 | 3,725 | (3,320) | 11,102 | 7,664 |

## (14) Commitments and Contingencies

Commitments for major construction and maintenance contracts were approximately $25.1 million and $21.6 million, as of August 31, 2014 and 2013, respectively.

The Company is committed under various noncancelable operating lease agreements to pay minimum annual rentals as follows (thousands of U.S. dollars):

| | | |
|---|---|---|
| Fiscal year ending August 31: | | |
| 2015 | $ | 654 |
| 2016 | | 379 |
| 2017 | | 334 |

Rent expense for the fiscal years ended August 31, 2014 and 2013 amounted to $1.5 million and $1.4 million, respectively.

The Company, in the normal course of conducting business, has entered into long-term contracts for the supply of natural gas, firm transportation, and long-term firm gas storage service. The Company's cumulative obligations for demand charges for all of these services are approximately $5.0 million, per month.

The Company has entered into seasonal contracts with suppliers providing the Company the ability to fix the price of the purchase of natural gas during the period from November 1, 2014 through March 31, 2015.

The Company's amended FY 2015 Capital Budget was approved by City Council in the amount of $89.5 million. Within this approval, funding was provided to continue the implementation of an 18-mile Cast Iron Main Replacement Program. Main replacement cost for this program in FY 2015 is expected to be $21.4 million. The total six-year cost of the Cast Iron Main Replacement Program is forecasted to be $136.4 million. In addition to this program, the FY 2015 Capital Budget includes funding for an incremental Cast Iron Main Replacement Program for which PGW will request recovery through a DSIC. This incremental program in FY 2015 is expected to cost $17.3 million. The total six-year cost of this incremental program is forecasted to be $128.6 million. The FY 2015 Capital Budget also includes $2.3 million for the purchase of replacement Automatic Meter Reading (AMR) units. The total six-year cost of this program to replace AMR units is approximately $15.9 million.

**(15) Subsequent Events**

The Company has evaluated events and transactions that occurred between August 31, 2014 and December 23, 2014, which is the date the financial statements were available to be issued, for possible disclosure and recognition in the financial statements and noted the following:

On March 2, 2014, following a competitive bidding process, the City entered into an agreement to sell PGW to UIL Holdings Corporation, subject to authorization by City Council and the Public Utility Commission. On December 4, 2014, UIL exercised its option to withdraw from the agreement after no authorizing ordinance was introduced in City Council.

On October 21, 2014, Standard & Poor's Rating Services raised the rating on PGW revenue bonds, issued under its 1975 (closed senior lien) and 1998 ordinances (subordinate working lien) to "A-"from "BBB+". Rationale sited for the rating upgrades included improving trends related to coverage of fixed costs, liquidity, debt ratios and collections, as well as the adoption of a number of credit supportive policies and procedures.

The Company's 5th Series A-2 variable rate bonds are backed by irrevocable letters of credit, which were extended on November 1, 2014 for a term of one year expiring on December 31, 2015.

**PHILADELPHIA GAS WORKS**
(A Component Unit of the City of Philadelphia)

Required Supplementary Information (Unaudited)

Schedule of Pension Funding Progress

(Thousands of U.S. dollars)

| **Actuarial valuation date** | | **(a) Actuarial value of assets** | **(b) Actuarial accrued liability (AAL)** | **(b)-(a) Unfunded AAL (UAAL)** | **(a/b) Funded ratio** | | **Covered payroll** | **UAAL as a percent of covered payroll** |
|---|---|---|---|---|---|---|---|---|
| September 1, 2013* | $ | 462,691 | 623,612 | 160,921 | 74.2% | $ | 104,123 | 154.5% |
| September 1, 2012** | | 437,780 | 585,632 | 147,852 | 74.8 | | 106,000 | 139.5 |
| September 1, 2011*** | | 421,949 | 572,190 | 150,241 | 73.7 | | 106,308 | 141.3 |
| September 1, 2010+ | | 381,975 | 533,630 | 151,655 | 71.6 | | 106,125 | 142.9 |
| September 1, 2009++ | | 355,499 | 519,773 | 164,274 | 68.4 | | 106,003 | 155.0 |
| September 1, 2008+++ | | 430,390 | 495,155 | 64,765 | 86.9 | | 107,918 | 60.0 |

* The required supplementary information is based on an actuarial valuation of the pension fund for the plan year September 1, 2013 through August 31, 2014, updated for contributions and additional accrued benefits in the subsequent fiscal year.

** The required supplementary information is based on an actuarial valuation of the pension fund for the plan year September 1, 2012 through August 31, 2013, updated for contributions and additional accrued benefits in the subsequent fiscal year.

*** The required supplementary information is based on an actuarial valuation of the pension fund for the plan year September 1, 2011 through August 31, 2012.

\+ The required supplementary information is based on an actuarial valuation of the pension fund for the plan year September 1, 2009 through August 31, 2010, updated for contributions and additional accrued benefits in the subsequent fiscal year.

++ The required supplementary information is based on an actuarial valuation of the pension fund for the plan year September 1, 2009 through August 31, 2010.

+++ The required supplementary information is based on an actuarial valuation of the pension fund for the plan year September 1, 2007 through August 31, 2008, updated for contributions and additional accrued benefits in the subsequent fiscal year.

See accompanying independent auditors' report.

**PHILADELPHIA GAS WORKS**
(A Component Unit of the City of Philadelphia)

Required Supplementary Information (Unaudited)

Schedule of Other Postemployment Benefits Funding Progress

(Thousands of U.S. dollars)

| Actuarial valuation date | | (a) Actuarial value of assets | (b) Actuarial accrued liability (AAL) | (b)-(a) Unfunded AAL (UAAL) | (a/b) Funded ratio | | Covered payroll | UAAL as a percent of covered payroll |
|---|---|---|---|---|---|---|---|---|
| August 31, 2014* | $ | 90,838 | 450,289 | 359,451 | 20.2% | $ | 115,174 | 312.1% |
| August 31, 2013** | | 61,796 | 436,527 | 374,731 | 14.2 | | 110,120 | 340.3 |
| August 31, 2012*** | | 38,860 | 443,982 | 405,122 | 8.8 | | 106,308 | 381.1 |
| August 31, 2011+ | | 17,886 | 485,722 | 467,836 | 3.7 | | 106,125 | 440.8 |

* The required supplementary information is based on an actuarial valuation of the OPEB fund for the plan year September 1, 2013 through August 31, 2014.

** The required supplementary information is based on an actuarial valuation of the OPEB fund for the plan year September 1, 2012 through August 31, 2013.

*** The required supplementary information is based on an actuarial valuation of the OPEB fund for the plan year September 1, 2011 through August 31, 2012.

\+ The required supplementary information is based on an actuarial valuation of the OPEB fund for the plan year September 1, 2010 through August 31, 2011.

See accompanying independent auditors’ report.