KPMG

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

Basic Financial Statements and Supplementary Information

August 31, 2007 and 2006

(With Independent Auditors' Report Thereon)

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

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KPMG

**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 balance sheets of Philadelphia Gas Works (the Company), a component unit of the City of Philadelphia, as of August 31, 2007 and 2006, and the related statements of revenues and expenses, cash flows, and changes in fund equity, as of and for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion 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 of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Philadelphia Gas Works as of August 31, 2007 and 2006, and changes in its financial position and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

The required supplementary information of management's discussion and analysis on pages 3 to 11 and the schedules of pension funding progress, postemployment benefits funding progress, and postemployment benefit employer contributions on pages 51 through 53 is not a required part of the basic financial statements but is supplementary information required by U.S. generally accepted accounting principles. This supplementary information is the responsibility of the Company's management. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and express no opinion on it.

Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information included on pages 54 to 57 is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

As discussed in note 1(n), the Company adopted the provisions of Governmental Accounting Standards Board Statement (GASB) No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, and GASB Statement No. 50, *Pension Disclosures*, as of September 1, 2006.

KPMG LLP

January 9, 2008

The narrative overview and analysis of the financial statements of Philadelphia Gas Works (the Company or PGW) for the years ended August 31, 2007 and 2006 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) 2007 heating season reflected a 16.6% warmer-than-normal winter. The FY 2007 period was 1.2% warmer than the prior year; however, firm gas sales increased by 2.0 Bcf. In addition, the Weather Normalization Adjustment (WNA), which was in effect from October 2006 through May 2007, resulted in heating customers receiving charges totaling $6.5 million as a result of the temperatures experienced during the period. The FY 2006 heating season reflected a 16.1% warmer-than-normal winter. The FY 2006 period was 11.7% warmer than the prior year and firm gas sales declined by 7.6 Bcf. This decrease in gas sales volumes was offset by higher commodity prices for natural gas.
- PGW achieved a collection rate of 95.8% in the current period, 96.6% in FY 2006 and 96.0% in FY 2005. The collection rate of 95.8% is calculated by dividing the total gas receipts collected in FY 2007 by the total gas billings that were applied to PGW customers' accounts from September 1 through August 31. The same methodology was utilized in FY 2006 and FY 2005, respectively.
- PGW issued $245.4 million of Seventh Series and Nineteenth Series revenue bonds during FY 2007. The proceeds from the sale of the Seventh Series refunding revenue bonds of $30.9 million were utilized to refund a portion of the Second Series B, Third Series, and Fourth Series revenue bonds in the amounts of $7.5 million, $3.1 million, and $20.0 million, respectively. The Seventh Series revenue bonds also contained new money debt issued in the amount of $200.0 million. Additionally, the Company issued $14.5 million of Nineteenth Series revenue bonds. The proceeds from the sale of the Nineteenth Series refunding revenue bonds were utilized to refund $14.8 million of the Fifteenth Series revenue bonds. The refunding of this existing debt resulted in an accounting loss of $2.2 million. This loss is being deferred and amortized as interest expense over the life of the new bonds. The refunding generated a present value savings of $2.1 million.
- Governmental Accounting Standards Board Statement (GASB) Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefit Other Than Pensions*, becomes effective for the Company's fiscal year beginning September 1, 2007. The Statement requires the Company to account for and report the value of its future other postemployment benefit (OPEB) obligations currently rather than on a pay-as-you-go basis. The Company has adopted GASB Statement No. 45 as of September 1, 2006 and had a zero net OPEB obligation at transition. PGW adopted GASB Statement No. 45 a year earlier than required by GASB because the Company is a component unit of the City for financial reporting requirements and its FY 2007 financial statements will be consolidated into the City's financial statements for the FY ended June 30, 2008. The difference between the FY 2007 Annual Required Contribution (ARC) of $45.2 million and the expenses paid by the Company of $18.8 million resulted in a liability of $26.4 million which has been recorded in other liabilities and deferred credits and expensed in FY 2007.

## 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 are comprised of:

*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 four statements presented are:

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

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

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

*The statement of changes in fund equity* provides a rollforward of the fund equity balance of PGW based upon the results from the statement of revenues and expenses.

Condensed Statements of Revenues and Expenses

(Thousands of dollars)

| | | Years ended August 31 | | |
|---|---|---|---|---|
| | | **2007** | **2006** | **2005** |
| Total gas revenues | $ | 840,105 | 929,961 | 830,550 |
| Other revenues | | 19,246 | 24,007 | 32,807 |
| Total operating revenues | | 859,351 | 953,968 | 863,357 |
| Total operating expenses | | 819,748 | 880,040 | 793,012 |
| Operating income | | 39,603 | 73,928 | 70,345 |
| Interest and other income | | 13,073 | 8,518 | 4,778 |
| Total interest expense | | (68,780) | (65,687) | (63,851) |
| Excess (deficiency) of revenues over (under) expenses | $ | (16,104) | 16,759 | 11,272 |

***Operating Revenues***

Operating revenues in FY 2007 were $859.4 million, a decrease of $94.6 million or 9.9% from the FY 2006 level. The decrease in FY 2007 was principally due to lower fuel costs which are a component of operating revenues through the Gas Cost Rate (GCR). Please see the discussion of the cost of fuel in the Operating Expenses section below. Operating revenues increased by $90.6 million or 10.5% in FY 2006 compared to FY 2005. This increase was primarily due to higher customer billings reflecting the rise in natural gas costs. The degree days during the FY 2007 heating season totaled 3,773, a decrease of 46 degree days, or 1.2% from the 3,819 degree days experienced in the FY 2006 heating season. The degree days for the FY 2006 heating season were 508 degree days, or 11.7% less than the 4,327 degree days experienced in the FY 2005 heating season.

Total sales volumes, including gas transportation deliveries, in FY 2007 increased by 4.4 Bcf to 63.8 Bcf or 7.4% from FY 2006 sales volumes of 59.4 Bcf; whereas, in FY 2006, it decreased by 10.5 Bcf or 15.0% from FY 2005 sales volumes of 69.9 Bcf. Firm gas sales of 47.9 Bcf were 1.7 Bcf or 3.7% higher than FY 2006 firm gas sales of 46.2 Bcf and 7.6 Bcf or 14.1% lower than FY 2005. Interruptible customer sales increased by .3 Bcf compared to FY 2006 and decreased by 2.1 Bcf in FY 2006 as compared to FY 2005. Gas transportation sales in FY 2007 increased by 2.4 Bcf to 13.1 Bcf from the 10.7 Bcf level experienced in FY 2006 and decreased by .9 Bcf to 10.7 Bcf from the 11.6 Bcf level experienced in FY 2005.

The number of customers served by PGW at the end of FY 2007 increased by 4.1% from the previous year to approximately 506,000 customers. Commercial accounts were approximately 25,000, reflecting no change from the previous two fiscal years. Industrial accounts decreased by 10.0% from the prior year’s level to 900. Industrial accounts approximated 1,000 customers in FY 2006 and FY 2005. Residential customers increased to approximately 480,000 customers, an increase of 20,000 from the prior year. The number of residential customers in FY 2006 reflected an increase of approximately 4,000 over the FY 2005 level.

***Operating Expenses***

Total operating and maintenance expenses, including fuel costs, in FY 2007 were $819.7 million, a decrease of $60.3 million or 6.9% from FY 2006. Total expenses increased by $87.0 million or 11.0% from FY 2006 compared to FY 2005. This decrease for FY 2007 reflects substantially lower natural gas prices. The increase for FY 2006 over FY 2005 reflects substantially higher natural gas prices.

*Cost of Fuel* – The cost of natural gas utilized decreased by $85.8 million or 13.7% to $539.3 million in FY 2007 compared with $625.1 million in FY 2006. The average commodity price per Mcf decreased by nearly $2.02 or $117.2 million, while the volume of gas utilized increased by 3.0 Bcf, 5.4% or $30.6 million, in FY 2007 despite a 1.2% decrease in degree days from FY 2006. In addition, pipeline supplier refunds in FY 2007 decreased by $.2 million while demand charges increased by $.7 million, compared to FY 2006.

The cost of natural gas utilized increased from $509.7 million in FY 2005 to $625.1 million in FY 2006. The average commodity price per Mcf increased by nearly $3.55 or $195.6 million, while the volume of gas utilized decreased by 9.9 Bcf, 15.2% or $66.1 million, in FY 2006 due to an 11.7% decrease in degree days from FY 2005. Pipeline supplier refunds in FY 2006 increased $.2 million, while demand charges decreased by $13.9 million compared to FY 2005.

Variations in the cost of purchased gas are passed through to customers under the gas cost rate 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 current assets or 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 2007, FY 2006, and FY 2005 were $8.23, $10.25, and $6.70 per Mcf, respectively.

*Other Operating Expenses* – Expenditures for street operations, infrastructure improvements, and plant operations were $69.5 million, up from the prior year total of $66.1 million and $62.2 in FY 2005, as a result of reclassing, from the administrative area, the value of gas used by utility from the time a customer requested shutoff to the occupancy of the premise by a subsequent customer. This cost was partially reduced by lower operating expenses due to warmer weather conditions. In addition, the cost for customer services, collection and account management, marketing, and the administrative area decreased by $4.1 million or 4.5%, and $4.5 million or 4.7% in FY 2007 and FY 2006, respectively, which were offset somewhat by higher premiums for (active and retired) employee health insurance coverage. Pension costs decreased by $2.3 million in FY 2007 and increased by $2.9 million in FY 2006 above the prior year's level, based on the most recent actuarial valuation of the retirement fund.

*Bad Debt Expense* – Bad debt expense in FY 2007 totaled $40.0 million, a decrease of $.1 million or .3% lower than FY 2006, which totaled $40.1 million, a decrease of $30.3 million or 43.0% compared to FY 2005 based on the most recent accounts receivable collectibility evaluation. The accumulated provision for uncollectible accounts at August 31, 2007 reflects a balance of $150.2 million, compared to the $168.9 million balance in FY 2006 and $207.5 in FY 2005. 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.

*Depreciation Expense* – Depreciation expense increased by $1.7 million in FY 2007 compared with FY 2006. Depreciation expense decreased by $.3 million in FY 2006 compared with FY 2005. The effective composite depreciation rate for FY 2007 and FY 2006 was 2.3% and the rate was 2.4% for FY 2005. Cost of removal is charged to expense as incurred.

*Interest and Other Income* – Interest and other income was $4.6 million greater than FY 2006 as the result of increased earnings rates and higher restricted fund balances. In FY 2006 interest and other income was $3.7 million greater than FY 2005 as the result of increased earnings rates and higher restricted fund balances.

*Interest Expense* – Total interest expense increased by $3.1 million or 4.7% in FY 2007 compared with FY 2006 and increased by $1.8 million or 2.9% in FY 2006 compared with FY 2005. Interest on long-term debt was $.3 million higher than the FY 2006 level as a result of the increase in the amount of long-term debt following the issuance of the Seventh Series and Nineteenth Series revenue bonds totaling $245.4 million. Interest on long-term debt was $2.1 million lower in FY 2006 compared to FY 2005, reflecting the additional debt principal payments, which were offset by the impact of the issuance of $313.4 million of revenue bonds during FY 2006. Other interest costs rose by $2.2 million or 14.6% in FY 2007 and rose by $4.0 million or 36.4% in FY 2006 reflecting additional costs associated with PGW's commercial paper program and the amortization of the loss on reacquired debt.

*Excess (Deficiency) of Revenues Over (Under) Expenses* – In FY 2007, the Company's excess of revenues over expenses was $10.3 million prior to recording the expense of $26.4 million related to postemployment benefits. As a result, the Company ended with a deficiency of revenues under expenses of $16.1 million. The Company had an excess of revenues over expenses of $16.8 million in FY 2006 and $11.3 million in FY 2005.

Condensed Balance Sheets

(Thousands of dollars)

| | | August 31 | | |
|---|---|---|---|---|
| **Assets** | | **2007** | **2006** | **2005** |
| Utility plant, net | $ | 1,040,373 | 1,007,648 | 981,722 |
| Restricted investment funds | | 277,139 | 135,625 | 208,810 |
| Current assets: | | | | |
| Accounts receivable (net of accumulated provision for uncollectible accounts of $150,231, $168,889, and $207,480 for 2007, 2006, and 2005, respectively) | | 71,452 | 74,360 | 87,634 |
| Other current assets and deferred debits, cash and cash equivalents, gas inventories, materials, and supplies | | 205,083 | 181,394 | 147,837 |
| Total current assets | | 276,535 | 255,754 | 235,471 |
| Other assets and deferred debits | | 103,727 | 106,983 | 93,819 |
| Total assets | $ | 1,697,774 | 1,506,010 | 1,519,822 |
| **Fund Equity and Liabilities** | | | | |
| Fund equity | $ | 223,301 | 239,405 | 222,646 |
| Total long-term debt | | 1,201,792 | 1,076,131 | 1,075,830 |
| Current liabilities: | | | | |
| Note payable | | 51,600 | 55,000 | 49,900 |
| Current portion of long-term debt | | 86,995 | 39,591 | 42,271 |
| Other current liabilities and deferred credits | | 86,110 | 73,854 | 104,992 |
| Total current liabilities | | 224,705 | 168,445 | 197,163 |
| Other liabilities and deferred credits | | 47,976 | 22,029 | 24,183 |
| Total fund equity and liabilities | $ | 1,697,774 | 1,506,010 | 1,519,822 |

***Assets***

*Utility Plant* – Utility plant, net of depreciation, totaled $1,040.4 million in FY 2007, an increase of $32.7 million or 3.3% above the FY 2006 balance of $1,007.6 million. The FY 2006 balance increased $25.9 million or 2.6% above the FY 2005 balance of $981.7 million. Capital expenditures for construction of distribution facilities,



(Continued)

purchase of equipment, information technology enhancements, and other general improvements were $69.1 million in FY 2007 compared to $60.7 million in FY 2006 and $66.0 million in FY 2005. During FY 2007, PGW funded $60.7 million of capital expenditures through drawdowns from the Capital Improvement Fund. In FY 2006 and FY 2005, respectively, PGW funded $63.1 million and $67.3 million of its capital expenditures through drawdowns from its Capital Improvement Fund. The major capital expenditures are associated with PGW's gas supply infrastructure, namely, gas mains and customer service lines.

*Restricted Investment Funds* – Restricted investment funds increased by $141.5 million in FY 2007 primarily due to the issuance of a new bond in May 2007, with proceeds totaling $193.2 million, to support PGW's FY 2007, FY 2008, and FY 2009 capital construction programs. Interest income on these funds, to the extent not drawn, is reflected as an increase and approximated $6.8 million in FY 2007 and $3.7 million in FY 2006. A drawdown from the Sinking Fund's capitalized interest account in the amount of $.1 million was utilized to offset the debt service payment in FY 2007 compared to $6.0 million in FY 2006.

*Accounts Receivable* – In FY 2007 accounts receivable (net) of $71.5 million decreased by $2.9 million, or 3.9% from FY 2006. Accounts receivable (net) decreased by $13.3 million, or 15.1% in FY 2006 compared to FY 2005, due to increased write-offs. The accumulated provision for uncollectible accounts, totaling $150.2 million decreased by $18.7 million in FY 2007 and totaled $168.9 million in FY 2006 and $207.5 million in FY 2005.

*Other Current Assets and Deferred Debits, Cash and Cash Equivalents, Gas Inventories, Materials, and Supplies* – In FY 2007 cash and cash equivalents were $51.7 million, an increase of $45.0 million from FY 2006, and totaled $15.2 million in FY 2005. Gas storage decreased by $1.5 million or 1.1%. The decrease in gas inventory reflects lower natural gas prices. Materials and supplies of $147.8 million, which principally include gas inventory, maintenance spare parts, and material, decreased by $1.6 million and were $149.4 million in FY 2006. Other current assets and deferred debits totaled $5.6 million in FY 2007, down $19.6 million from FY 2006, primarily due to the recovery of under-recovered GCR amounts from the prior year. In FY 2006 other current assets and deferred debits totaled $25.3 million, up $22.6 million from FY 2005, mainly due to the $19.4 million deferred under-recovery associated with the FY 2006 GCR.

*Other Assets and Deferred Debits* – In FY 2007 other assets and deferred debits including unamortized bond issuance costs, unamortized loss on reacquired debt, and a deferred regulatory asset for environmental expenses totaled $103.7 million, a decrease of $3.3 million from FY 2006, mainly due to the workers' compensation injuries and damages reserve. In FY 2006 the total was $107.0 million and reflected an increase of $13.2 million from FY 2005. The major portion of this change was related to the bond issuance costs on the $313.4 million of debt issued in FY 2006, offset partially by deferred environmental costs.

***Liabilities***

*Long-Term Debt* – Long-term debt, including the current portion and unamortized debt discount, premium, and note payable – City Loan totaled $1,288.8 million in FY 2007, $173.1 million greater than the previous year as a result of principal payments on outstanding debt and the issuance of the Seventh Series and Nineteenth Series revenue bonds during FY 2007. This represents 85.2% of total capitalization in FY 2007. Long-term debt, including the current portion and unamortized debt discount, premium, and note payable – City Loan totaled $1,115.7 million in FY 2006. This was $2.4 million lower than the previous year as a result of principal payments on outstanding debt, net of the issuance of the Sixth Series refunding bonds during FY 2006. This represented 82.3% of total capitalization in FY 2006. The total long-term debt for FY 2005 totaled $1,118.1 million, which represented 83.4% of total capitalization.

*Ratios, Coverages, and Ratings* – PGW has a mandatory debt service coverage ratio of 1.50 times debt service on the 1975 Ordinance Bonds and the 1998 Ordinance Bonds, respectively. In FY 2007, the debt service coverage was at 3.70 times debt service on the outstanding 1975 Ordinance Bonds and 2.00 times debt service on the Senior 1998 Ordinance Bonds compared to debt service coverage ratios of 3.41 and 3.08 times, respectively, in FY 2006 and 3.36 and 1.94 times, respectively, in FY 2005. PGW's current bond ratings are "Baa2" from Moody's Investors Service, "BBB-" from Standard and Poor's Ratings Service, and "BBB-" from Fitch Ratings.

*Short-Term Debt* – Due to the highly seasonal nature of PGW's business, short-term debt is utilized to meet working capital requirements. PGW, pursuant to the provisions of the City of Philadelphia Note Ordinance, may sell short-term notes in a principal amount, which together with interest, may not exceed $200.0 million outstanding at any one time as compared to $150.0 million in FY 2006. The letter of credit supporting PGW's commercial paper program fixed the maximum level of outstanding notes plus interest at $150.0 million in FY 2007 and FY 2006, respectively. These notes are intended to provide additional working capital and are supported by an irrevocable letter of credit and a security interest in PGW's revenues. The notes outstanding at August 31, 2007 had an average interest rate of 3.95% and a remaining time to maturity of four days, maturing on September 4, 2007. The principal amounts outstanding at August 31, 2007 and 2006 were $51.6 million and $55.0 million, respectively. In addition, the City provided PGW with a $45.0 million, 0.0% interest loan in FY 2001. On August 31, 2007, PGW repaid $2.0 million of the loan leaving an outstanding balance of $43.0 million. The repayment date for the balance of the loan is August 2008.

*Liquidity/Cash Flow* – At November 30, 2007, $10.0 million was available from the Commercial Paper Program. Additionally, PGW had $233.4 million available in its Capital Improvement Fund to be utilized for construction expenditures. These funding sources may be utilized during the fall and early winter period to provide liquidity until billings from the winter heating season are collected. The cash balance at November 30, 2007 was $34.7 million.

*Accounts Payable* – In FY 2007 accounts payable increased $3.1 million or 7.8% compared to FY 2006 primarily from a $3.3 million increase in payables associated with natural gas partially offset by a $.2 million decrease in trade payables. In FY 2006 accounts payable decreased $23.6 million or 36.9% compared to FY 2005, primarily due to a lower amount of trade payables and payables associated with the purchase of natural gas at August 31, 2006.

*Other Liabilities and Deferred Credits* – In FY 2007 other liabilities and deferred credits totaling $48.0 million increased $26.0 million compared to FY 2006. In FY 2006 other liabilities and deferred credits totaling $22.0 million decreased $2.2 million compared to FY 2005. The increase in FY 2007 is the effect of recording the liability for other postemployment benefits in the amount of $26.4 million. The decrease in FY 2006 was primarily a reduction of the reserve for workers' compensation and a reduction of the deferred environmental liability.

**Other Financial Factors**

The City has made a major commitment to PGW by granting back its annual $18.0 million payment, thereby improving PGW's overall liquidity position. PGW must continue to focus its efforts on becoming a competitive utility in the deregulated marketplace. PGW remains committed to achieving its tradition of providing high-quality service to customers, while continuing as a valuable enterprise of the City.

The Company's total OPEB actuarial accrued liability as of August 31, 2007 was $573.7 million if the Company continued to provide for its OPEB obligations on a pay-as-you-go basis. The Company's actuarial accrued liability would be reduced to $382.7 million if the Company adopted a policy of funding its ARC. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal costs each year and amortize any unfunded actuarial liabilities (or funding excess) over a period of 30 years. The actuarial valuation utilized a discount rate of 8.25% for purposes of developing the liabilities and ARC to demonstrate the effect of funding the Plan. This rate is based on the investment return expected on investments segregated in a funded trust.

The annual OPEB cost was $45.2 million for the fiscal year ended August 31, 2007 and is projected to increase to $70.2 million per year over the ensuing 20-year period on a pay-as-you-go basis. The annual OPEB cost is projected to increase from approximately $39.0 million in FY 2007 to approximately $49.8 million per year over the ensuing 20-year period if the Company adopted a policy of funding its ARC.

GASB Statement No. 49 *Accounting and Financial Reporting for Pollution Remediation Obligations*, becomes effective for the Company's fiscal year beginning September 1, 2008. PGW will likely adopt GASB Statement No. 49 for its FY beginning September 1, 2007 because PGW is a component unit of the City for financial reporting purposes. PGW's financial statements for the FY ended August 31, 2008 will be consolidated into the financial statements of the City for their FY ended June 30, 2009. PGW has not yet evaluated the impact of GASB Statement No. 49 on its financial statements.

On December 22, 2006, PGW filed for a $100.0 million base rate increase with the PUC. On September 28, 2007, the PUC approved a rate increase of $25.0 million. PGW appealed this decision to Commonwealth Court on or about October 18, 2007 and this matter is still pending in the courts. The $25.0 million rate increase was implemented in November 2007.

On January 2, 2008 PGW filed the proposed FY 2009 Capital Budget and FY 2010-2014 Capital Forecast with the PGC seeking a positive recommendation to City Council for the approval of the budget. PGW requested $73.4 million in spending authorization for the FY 2009 Capital Budget and a forecast amount of $413.0 million.

**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, 2007 and 2006

(Thousands of dollars)

| **Assets** | | **2007** | **2006** |
|---|---|---|---|
| Utility plant, at original cost: | | | |
| In service | $ | 1,633,300 | 1,555,669 |
| Under construction | | 48,013 | 65,122 |
| Total | | 1,681,313 | 1,620,791 |
| Less accumulated depreciation | | 640,940 | 613,143 |
| Utility plant, net | | 1,040,373 | 1,007,648 |
| Restricted investment funds: | | | |
| Sinking fund, revenue bonds | | 102,438 | 94,352 |
| Capital improvement fund | | 172,134 | 39,636 |
| City of Philadelphia | | 643 | — |
| Workers' compensation escrow fund | | 1,924 | 1,637 |
| Total restricted investment funds | | 277,139 | 135,625 |
| Current assets: | | | |
| Cash and cash equivalents | | 51,698 | 6,697 |
| Accounts receivable (net of provision for uncollectible accounts of $150,231 and $168,889 for 2007 and 2006, respectively) | | 71,452 | 74,360 |
| Gas inventories, materials, and supplies | | 147,770 | 149,438 |
| Other current assets and deferred debits | | 5,615 | 25,259 |
| Total current assets | | 276,535 | 255,754 |
| Unamortized bond issuance costs | | 42,086 | 42,089 |
| Unamortized losses on reacquired debt | | 53,359 | 55,859 |
| Other assets and deferred debits | | 8,282 | 9,035 |
| Total assets | $ | 1,697,774 | 1,506,010 |

See accompanying notes to financial statements.



(Continued)

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

Balance Sheets

August 31, 2007 and 2006

(Thousands of dollars)

| **Fund Equity and Liabilities** | | **2007** | **2006** |
|---|---|---|---|
| Fund equity: | | | |
| Deficiency of capital assets, net of related debt | $ | (5,690) | (7,754) |
| Restricted | | 105,005 | 95,989 |
| Unrestricted | | 123,986 | 151,170 |
| Total fund equity | | 223,301 | 239,405 |
| Long-term debt: | | | |
| Revenue bonds | | 1,201,792 | 1,031,131 |
| Note payable – City Loan | | — | 45,000 |
| Total long-term debt | | 1,201,792 | 1,076,131 |
| Current liabilities: | | | |
| Note payable | | 51,600 | 55,000 |
| Current portion of revenue bonds | | 43,995 | 39,591 |
| Note payable – City Loan | | 43,000 | — |
| Accounts payable | | 43,449 | 40,316 |
| Customer deposits | | 9,049 | 8,628 |
| Other current liabilities and deferred credits | | 15,524 | 8,137 |
| Accrued accounts: | | | |
| Interest, taxes, and wages | | 15,088 | 13,773 |
| Distribution to the City | | 3,000 | 3,000 |
| Total current liabilities | | 224,705 | 168,445 |
| Other liabilities and deferred credits | | 47,976 | 22,029 |
| Total fund equity and liabilities | $ | 1,697,774 | 1,506,010 |

See accompanying notes to financial statements.

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

Statements of Revenues and Expenses

Years ended August 31, 2007 and 2006

(Thousands of dollars)

| | | 2007 | 2006 |
|---|---|---|---|
| Operating revenues: | | | |
| Gas revenues: | | | |
| Nonheating | $ | 90,798 | 113,356 |
| Gas transport service | | 12,949 | 6,459 |
| Heating | | 736,358 | 810,146 |
| Total gas revenues | | 840,105 | 929,961 |
| Appliance and other revenues | | 9,398 | 10,482 |
| Other operating revenues | | 9,848 | 13,525 |
| Total operating revenues | | 859,351 | 953,968 |
| Operating expenses: | | | |
| Natural gas | | 539,300 | 625,093 |
| Gas processing | | 16,240 | 15,234 |
| Field services | | 36,100 | 35,667 |
| Distribution | | 17,119 | 15,179 |
| Collection and account management | | 15,221 | 17,289 |
| Provision for uncollectible receivables | | 40,000 | 40,132 |
| Customer services | | 11,783 | 11,083 |
| Marketing | | 2,418 | 2,467 |
| Administrative and general | | 56,819 | 59,484 |
| Pensions | | 15,217 | 17,563 |
| Other postemployment benefits | | 26,421 | — |
| Taxes | | 6,730 | 6,124 |
| Total operating expenses before depreciation | | 783,368 | 845,315 |
| Depreciation | | 39,708 | 37,955 |
| Less depreciation expense included in operating expenses above | | 3,328 | 3,230 |
| Total depreciation | | 36,380 | 34,725 |
| Total operating expenses | | 819,748 | 880,040 |
| Operating income | | 39,603 | 73,928 |
| Interest and other income | | 13,073 | 8,518 |
| Income before interest expense | | 52,676 | 82,446 |
| Interest expense: | | | |
| Long-term debt | | 52,146 | 51,799 |
| Other | | 17,042 | 14,869 |
| Allowance for funds used during construction | | (408) | (981) |
| Total interest expense | | 68,780 | 65,687 |
| Excess (deficiency) of revenues over (under) expenses | $ | (16,104) | 16,759 |

See accompanying notes to financial statements.

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

Statements of Cash Flows

Years ended August 31, 2007 and 2006

(Thousands of dollars)

| | | 2007 | 2006 |
|---|---|---|---|
| Cash flows from operating activities: | | | |
| Receipts from customers | $ | 863,658 | 906,000 |
| Payments to suppliers | | (631,475) | (807,288) |
| Payments to employees | | (106,018) | (102,544) |
| Claims paid | | (2,958) | (3,259) |
| Other receipts | | 28,800 | 39,000 |
| Net cash provided by operating activities | | 152,007 | 31,909 |
| Cash flows from noncapital financing activities: | | | |
| Interest | | 4,766 | 3,445 |
| Interest payments on notes payable | | (8,098) | (5,968) |
| Net repayments of notes payable | | (3,400) | 5,100 |
| Loan from City of Philadelphia | | (2,000) | — |
| Restricted, City Loan deposit | | (643) | — |
| Distribution to the City of Philadelphia | | (18,000) | (18,000) |
| Grant back of distribution from the City of Philadelphia | | 18,000 | 18,000 |
| Net cash (used in) provided by noncapital financing activities | | (9,375) | 2,577 |
| Cash flows from capital and related financing activities: | | | |
| Proceeds from long-term debt issued | | 245,350 | 313,390 |
| Redemption of long-term debt | | (45,450) | (285,115) |
| Long-term debt issuance costs | | (5,652) | — |
| Long-term debt premium, discount, and issuance losses | | (4,133) | (5,579) |
| Purchases of capital assets | | (69,105) | (60,651) |
| Principal paid on long-term debt | | (38,045) | (31,216) |
| Interest paid on long-term debt | | (46,913) | (51,558) |
| Capital improvement fund deposits | | (193,170) | — |
| Drawdowns on capital improvement fund | | 60,672 | 63,065 |
| Interest income on capital improvement fund | | 4,497 | 2,115 |
| Interest income on sinking fund | | 1,996 | 1,380 |
| Sinking fund withdrawals (deposits) | | (8,086) | 10,178 |
| Other investment income | | 408 | 981 |
| Net cash used in capital and related financing activities | | (97,631) | (43,010) |
| Net increase (decrease) in cash and cash equivalents | | 45,001 | (8,524) |
| Cash and cash equivalents at the beginning of the year | | 6,697 | 15,221 |
| Cash and cash equivalents at the end of the year | $ | 51,698 | 6,697 |
| Reconciliation of operating income to net cash provided by operating activities: | | | |
| Operating income | $ | 39,603 | 73,928 |
| Adjustments to reconcile operating income to net cash provided by operating activities: | | | |
| Depreciation and amortization expense | | 36,732 | 36,275 |
| Change in assets and liabilities: | | | |
| Receivables, net | | 3,387 | 13,786 |
| Inventories | | 1,668 | (19,454) |
| Accounts payable | | 3,133 | (23,602) |
| Other liabilities and deferred credits | | 31,366 | (9,289) |
| Other assets and deferred debits | | 36,118 | (39,735) |
| Net cash provided by operating activities | $ | 152,007 | 31,909 |

See accompanying notes to financial statements.

**PHILADELPHIA GAS WORKS**
(A Component Unit of the City of Philadelphia)
Statements of Changes in Fund Equity
Years ended August 31, 2007 and 2006
(Thousands of dollars)

| | | 2007 | 2006 |
|---|---|---|---|
| Fund equity balance, beginning of the year | $ | 239,405 | 222,646 |
| Excess (deficiency) of revenues over (under) expenses | | (16,104) | 16,759 |
| Distribution to the City of Philadelphia | | (18,000) | (18,000) |
| Grant back of distribution from the City of Philadelphia | | 18,000 | 18,000 |
| Fund equity balance, end of the year | $ | 223,301 | 239,405 |

See accompanying notes to financial statements.

## (1) Summary of Significant Accounting Policies

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

As described in note 2, the Company, is accountable to and is a part of the City, and consequently follows accounting principles promulgated by the Governmental Accounting Standards Board (GASB) as they apply to proprietary fund-type activities. In accordance with GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, the Company does not apply accounting standards promulgated by the Financial Accounting Standards Board (FASB) issued after November 30, 1989. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, is applicable to the Company. Under FASB Statement No. 71, certain assets or liabilities may be created by 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 July 18, 2007, the Company filed its FY 2008 Operating Budget. The PGC conducted informal discovery and public hearings concerning this budget in August 2007. The PGC entered an Order, dated September 18, 2007, approving interim operating spending authority through January 31, 2008. The review process for the FY 2008 Operating Budget is still in process at this time, with a final approval not anticipated until sometime in January 2008.

On May 26, 2006, the Company filed its FY 2007 Operating Budget. The PGC conducted hearings concerning this budget in July 2006. Briefs were filed on August 9, 2006. The Hearing Examiner issued a Recommended Decision on August 24, 2006, providing Operating Budget adjustments for consideration by the Commissioners. The PGC's Motion giving final approval for the FY 2007 Operating Budget was passed on October 4, 2006. The approved budget incorporated the Company's proposed operating revenues and expenses with net adjustments of $4,178,000.

***(c) Capital Budget***

On January 2, 2007, the Company filed with the PGC its FY 2008 Capital Budget requesting spending authority in the amount of $118,243,000. This budget request was amended by the Company to reflect the deferral of two projects, Construction of Phase II Liquefied Natural Gas (LNG) Replacement and Implementation of Billing Collection Customer Service (BCCS) for a reduction of $47,300,000. The PGC conducted hearings concerning this budget in February 2007. Briefs were filed on March 13, 2007. The Hearing Examiner issued a Recommended Decision on March 27, 2007 for consideration by the Commissioners further reducing the budget by $295,000. The PGC's Resolution and Order recommending approval of the FY 2008 Capital Budget to City Council was passed on April 25, 2007. This recommendation of $70,648,000 was approved by City Council on June 15, 2007. The Mayor of the City signed the Ordinance approving the FY 2008 Capital Budget on September 20, 2007.

On December 23, 2005, the Company filed with the PGC its FY 2007 Capital Budget requesting spending authority in the amount of $71,447,000. This amount was revised to $74,687,000 by the Company during the proceeding. The PGC conducted hearings concerning this budget in February 2006. Briefs were filed on March 13, 2006. The Hearing Examiner issued a Recommended Decision on March 27, 2006 for consideration by the Commissioners. The Hearing Examiner recommended a downward adjustment in spending authority of approximately $1,901,000. The Company and Public Advocate filed Exceptions to the Recommended Decision on April 3, 2006. The PGC's final Order recommending approval of the FY 2006 Capital Budget, as revised, to City Council was passed on May 2, 2006, recommending the approval of program and spending authorization not to exceed $72,786,000. The Mayor signed the Ordinance initially approving the FY 2007 Capital Budget on September 14, 2006.

***(d) Base Rates***

Base rate increases and increases in the Gas Cost Rate (GCR) are required to maintain the Company's long-term financial stability.

On December 22, 2006, PGW filed for a $100,000,000 base rate increase with the PUC. The funds provided by this increase in base rates were to be used to pay increased operating and maintenance costs, establish an adequate level of working capital, repay the $45,000,000 City loan, reduce the outstanding level of short-term commercial paper, provide a source of internal funds for capital expenditures, meet bond covenant requirements in each fiscal year, and provide funds for long-term debt reduction. On September 28, 2007, the PUC approved a rate increase of $25,000,000 which was effective in November 2007. PGW appealed this decision to Commonwealth Court on or about October 18, 2007 and this matter is pending in the courts.

The previous increase in base rates of $36,000,000 was approved by the PUC on April 12, 2002.

### *(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 1 through May 31 of each year for each billing cycle. The WNA had an initial three-year pilot period that ended August 9, 2005. The WNA will continue in place unless the PUC issues an order directing that it be discontinued. The Company conducted a review of the costs and benefits of the WNA. The Company presented its conclusions regarding the WNA to the PUC with a request that the PUC acknowledge that the WNA should continue in place. Stipulations were filed in May 2006 acknowledging and agreeing that PGW's WNA shall continue unless and until the PUC issues a final order directing that it be terminated or modified. A determination will be made by the PUC at the end of the review as to whether the WNA will continue, continue with modifications, or be eliminated. The Company cannot predict when the PUC will complete its review of the WNA, and the review was not completed as of August 31, 2007. The Company reserved the right to file a petition seeking extraordinary rate relief in the event of a force majeure, significant regulatory change, or projected material change in the status of the Company's credit arrangements. The adjustments for the years ended August 31, 2007 and 2006 were a $6,438,000 increase in billings and a $13,406,000 increase in billings, respectively. The adjustments for the Firm Transportation customers of PGW were an increase in billings of $60,400 and $0 for the years ended August 31, 2007 and August 31, 2006, respectively.

### *(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 GCR factor. The GCR reflects the increases or decreases in natural gas costs and the cost of other raw materials. 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 are compared to the actual cost of fuel and other specific costs. Customers are then credited or charged for over-recovery or under-recovery of costs. The GCR may be adjusted 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 and operating expenses, but do not affect operating income or net income. The Company at August 31, 2007 deferred approximately $6,566,000 for GCR over-recovery.

**GCR effective dates and rates**

| Effective date | GCR rate per Mcf | Change |
|---|---|---|
| December 1, 2007 | $ 10.5779 | 0.4671 |
| September 1, 2007 | 10.1108 | (0.6143) |
| June 1, 2007 | 10.7251 | 0.2913 |
| March 1, 2007 | 10.4338 | (0.4781) |
| December 1, 2006 | 10.9119 | (0.3439) |
| September 1, 2006 | 11.2558 | — |
| June 1, 2006 | 11.2558 | (1.3074) |
| March 1, 2006 | 12.5632 | — |
| December 1, 2005 | 12.5632 | — |
| October 7, 2005 | 12.5632 | 2.8576 |
| Prior | 9.7056 | — |

### *(g) Utility Plant*

Utility plant is stated at original cost. The cost of additions, replacements, and betterments of units of property are 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 $2,542,000 and $2,566,000 was charged to expense as incurred in FY 2007 and FY 2006, respectively, and is included in depreciation expense in the statements of revenues and expenses. 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 2007 and FY 2006 was 2.3%. The composite rates are supported by a depreciation study of utility plant as of August 31, 2004. The effective composite depreciation rates, as a percentage of cost, for FY 2007 were as follows:

| | |
|---|---|
| Production plant | 0.39% – 4.12% |
| Transmission, distribution, and storage | 0.19% – 4.07% |
| General plant | 1.05% – 9.65% |

The next depreciation study is scheduled to be completed in FY 2010.

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 4.96% and 4.49% in FY 2007 and FY 2006, respectively.

The following is a summary of utility plant activity for the fiscal years ended August 31, 2007 and 2006, respectively (thousands of dollars):

| | August 31, 2007 | | | |
|---|---|---|---|---|
| | Beginning balance | Additions and transfers | Retirements and transfers | Ending balance |
| Land | $ 5,267 | — | — | 5,267 |
| Distribution and collection systems | 1,161,705 | 61,537 | (2,175) | 1,221,067 |
| Buildings and equipment | 388,697 | 25,500 | (7,231) | 406,966 |
| Total utility plant, at historical cost | 1,555,669 | 87,037 | (9,406) | 1,633,300 |
| Under construction | 65,122 | 70,055 | (87,164) | 48,013 |
| Less accumulated depreciation for: | | | | |
| Distribution and collection systems | (532,763) | (26,261) * | 2,404 | (556,620) |
| Buildings and equipment | (80,380) | (10,905) * | 6,965 | (84,320) |
| Utility plant, net | $ 1,007,648 | 119,926 | (87,201) | 1,040,373 |

| | August 31, 2006 | | | |
|---|---|---|---|---|
| | Beginning balance | Additions and transfers | Retirements and transfers | Ending balance |
| Land | $ 5,267 | — | — | 5,267 |
| Distribution and collection systems | 1,123,402 | 42,384 | (4,081) | 1,161,705 |
| Buildings and equipment | 386,794 | 11,784 | (9,881) | 388,697 |
| Total utility plant, at historical cost | 1,515,463 | 54,168 | (13,962) | 1,555,669 |
| Under construction | 57,883 | 61,407 | (54,168) | 65,122 |
| Less accumulated depreciation for: | | | | |
| Distribution and collection systems | (510,678) | (25,208) * | 3,123 | (532,763) |
| Buildings and equipment | (80,946) | (10,179) * | 10,745 | (80,380) |
| Utility plant, net | $ 981,722 | 80,188 | (54,262) | 1,007,648 |

* Cost of removal in the amounts of $2,542 and $2,566 was charged to expense as incurred in FY 2007 and FY 2006, respectively, 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 nonheating 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 and reconnection charges. Other operating revenues primarily consist of finance charges assessed on delinquent accounts.

Operating expenses include 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 nonheating 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.

***(i) Customers (unaudited)***

The Company's service territory encompasses the City of Philadelphia. Of the Company's approximately 506,000 customers at August 31, 2007, nearly 94.3% are residential. Of the Company's approximately 486,000 customers at August 31, 2006, nearly 95.0% were residential.

The Company offers a discounted payment plan for current receivables with a possible forgiveness of arrearages in three years. The total number of customers with discounted payment plans as of August 31, 2007 and 2006 was approximately 78,000 and 75,000, respectively.

The Senior Citizen Discount also provides customers with a discounted payment plan. The total number of customers receiving the discount as of August 31, 2007 and 2006 was approximately 44,000 and 49,000, respectively.

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

The Company estimates its accumulated provision for uncollectible accounts based on a financial analysis and a collectibility study performed at the fiscal year-end. The methodology used in performing the collectibility study has been reviewed with the PGC. For FY 2007 and FY 2006, 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 has credit balances at fiscal year-end in accounts receivable in the amounts of $17,166,000 and $18,053,000 for FY 2007 and FY 2006, respectively, primarily as a result of prepayment by budget customers.

### *(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, 2007 and 2006, as follows (thousands of dollars):

| | | 2007 | 2006 |
|---|---|---|---|
| Gas inventory | $ | 138,388 | 139,870 |
| Material and supplies | | 9,382 | 9,568 |
| Total | $ | 147,770 | 149,438 |

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

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

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

Losses on reacquired debt are deferred and amortized, using the interest method, to interest expense over the life of the refunding bond issue as required by the PGC and GASB.

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

The Company has a noncontributory pension plan (the Pension Plan) covering all employees and providing 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 health care and life insurance benefits to approximately 1,935 and 1,929 participating retirees and their beneficiaries and dependents for FY 2007 and FY 2006, respectively, in accordance with their retiree medical program. The Company also provides such benefits to approximately 1,720 and 1,749 active employees and their dependents for FY 2007 and FY 2006, respectively, by charging the annual insurance premiums to expense.

GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions,* becomes effective for the Company's fiscal year beginning September 1, 2007. This Statement requires the Company to account for and report the value of its future other postemployment benefit (OPEB) obligations currently rather than on a pay-as-you-go basis. The Company has early adopted GASB Statement No. 45 as of September 1, 2006. The Company had a zero net OPEB obligation at transition. As discussed in note 11, the difference between the FY 2007 Annual Required Contribution of $45,237,000 and the expenses paid by the Company of $18,816,000 resulted in a liability of $26,421,000 which has been recorded in other liabilities and deferred credits and expensed in FY 2007.

Additionally, the Company has early adopted the provisions of GASB Statement No. 50, *Pension Disclosures*, which more closely aligns the financial reporting requirements for pensions with those of OPEB.

### *(o) Statements of Cash Flows*

For the purpose of reporting cash flows, all nonrestricted highly liquid investments (stated at cost which approximates market) with original maturities of three months or less are considered cash equivalents.

### *(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 and deferred. Such liabilities have been established based upon Company history and consultation with counsel. Such expenses are expected to be recovered through future rates. Charges against the reserve are made as claims are settled.

### *(q) Investments*

Investments are recorded at fair value, except for certain money market investments, which are recorded at amortized cost.

### *(r) 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.

### *(s) Estimates*

In preparing the financial statements in conformity with U.S. generally accepted accounting principles, 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.

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

The Company is not a separately incorporated entity, but represents 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 of Philadelphia on March 1 of each such fiscal year. In FY 2007, the applicable maximum amount was calculated to be $976,000. In FY 2006, the applicable maximum amount was calculated to be $957,000. The agreement requires the Company to make annual payments of $18,000,000 to the City. In FY 2007 and FY 2006, the Company made the annual payment of $18,000,000 to the City. The City then granted the $18,000,000 back to the Company in both years.

The Company engages in various other transactions with the City. The Company provides gas service to the City. Operating revenues include $17,245,000 and $16,859,000 in FY 2007 and FY 2006, respectively, relating to sales to the City. Water and sewer services and licenses are purchased from the City. Such purchases totaled $615,000 and $593,000 in FY 2007 and FY 2006, respectively. Net amounts receivable from the City were $240,000 and $314,000 at August 31, 2007 and 2006, respectively.

Certain activities of the PGC are paid for by the Company. Such payments totaled $684,000 and $799,000 in FY 2007 and FY 2006, respectively.

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

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

Cash and cash equivalents consist primarily of bank deposits, money market accounts, and repurchase agreements. Bank balances of such deposits and accounts at August 31, 2007 and 2006 were $54,892,000 and $9,715,000, respectively. Book balances of such deposits and accounts at August 31, 2007 and 2006 were $51,698,000 and $6,697,000, respectively. Federal depository insurance on these balances at August 31, 2007 and 2006 was $222,000 and $217,000, respectively. The remaining balances are not insured.

For the Company's cash equivalents, the Company's cash balances fluctuate significantly during the year. Excess cash balances are usually invested in money market accounts and repurchase agreements.

The highest balance of money market accounts during the fiscal years ended August 31, 2007 and 2006 were $157,200,000 and $163,000,000, respectively. Money market accounts with a carrying amount (at market value) of $53,702,000 and $8,400,000 at August 31, 2007 and 2006, respectively, are included in the balances presented above.

The highest balance of repurchase agreements during the fiscal year ended August 31, 2007 was $145,000,000. There were no repurchase agreements outstanding at August 31, 2007 and 2006, respectively.

***(b) Restricted Investment Funds***

The investments in the Company's Sinking Fund, Capital Improvement Fund, Workers' Compensation Escrow Fund, and City Loan Escrow Account consist primarily of a Guaranteed Investment Contract (GIC), U.S. Treasury and government agency obligations, corporate obligations, state 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, 2007 and 2006 was $172,134,000 and $39,636,000, respectively. The unexpended Capital Improvement Fund proceeds are restricted to the purchase of utility plant. In FY 2007 and FY 2006, the Company utilized the Capital Improvement Fund to provide liquidity for the additions to utility plant.

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 a gain of $8,000 at August 31, 2007. There was no gain or loss at August 31, 2006 because the funds were held in a GIC. The adjustment to market value for the Sinking Fund resulted in a loss of $214,000 and $246,000 at August 31, 2007 and 2006, respectively.

The Company has established a City Loan Escrow account as a disbursement precondition to the utilization of the funds from the City Loan. The restricted account is interest bearing, the interest on which accrues to the benefit of the City. The Company may only draw on the account after providing details of the projected cash deficit that the draw will be utilized to fund. The Company, on a daily basis, must deposit excess cash into the restricted account. The balance at August 31, 2007 and 2006 was $643,000 and $0, respectively.

Pursuant to the Pennsylvania Department of Labor and Industry Bureau of Workers' Compensation Self-Insurance policy, PGW has to establish and maintain a restricted trust account. As of August 31, 2007 and 2006, the trust account balances were $1,924,000 and $1,637,000, respectively.

The following is a schedule that details the Company's investments in the Capital Improvement Fund (thousands of dollars):

**August 31, 2007**

| **Investment type** | | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
|---|---|---|---|---|---|
| U.S. government agencies and instrumentalities: | | | | | |
| Federal Home Loan Banks discount note | $ | 2,369 | 0.1917 | AAA/AAA | Moody's/S&P |
| Federal National Mortgage Association note | | 3,293 | 0.4194 | AAA/AAA | Moody's/S&P |
| Total U.S. government agencies and instrumentalities | | 5,662 | | | |
| Corporate obligations: | | | | | |
| American Express commercial paper | | 492 | 0.2861 | P1/A1 | Moody's/S&P |
| General Electric commercial paper | | 1,004 | 0.2889 | P1/A1 | Moody's/S&P |
| HSBC Finance commercial paper | | 1,003 | 0.2972 | P1/A1 | Moody's/S&P |
| JP Morgan Chase & Co Global Sr Holding Co note | | 992 | 0.4194 | AA2/AA- | Moody's/S&P |
| Goldman Sachs Group global note | | 994 | 0.3750 | AA3/AA- | Moody's/S&P |
| Total corporate obligations | | 4,485 | | | |
| Total fair value of investments | | 10,147 | | | |
| Money market | | 161,965 | N/A | N/A | |
| Accrued interest | | 22 | | | |
| Total fair value of investments, including cash deposits | $ | 172,134 | | | |
| Portfolio weighted modified duration | | | 0.3304 | | |



(Continued)

| August 31, 2006 | | | | | |
|---|---|---|---|---|---|
| **Investment type** | | **Fair value** | **Weighted average maturity (years)** | **Credit rating** | **Rating agency** |
| Guaranteed investment contract | $ | 39,636 | ** | * | * |
| Total fair value of investments, including cash deposits | $ | 39,636 | | | |

* The credit rating of this investment is unrated.

** There is a schedule of drawdowns and an expiration date for the GIC of May 15, 2007

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

**August 31, 2007**

| Investment type | | Fair value | Weighted average maturity (years) | Credit rating | Rating agency |
|---|---|---|---|---|---|
| Guaranteed investment contracts | $ | 49,504 | 13.5000 | * | * |
| Government obligations: | | | | | |
| U.S. Treasury notes | | 7,294 | 1.6153 | AAA/AAA | Moody's/S&P |
| U.S. government agencies and instrumentalities: | | | | | |
| Federal National Mortgage Corporation debentures | | 6,973 | 2.0417 | AAA/AAA | Moody's/S&P |
| Federal Farm Credit Bank bonds | | 4,680 | 1.3717 | AAA/AAA | Moody's/S&P |
| Federal Home Loan Mortgage Corporation bonds | | 10,396 | 1.9650 | AAA/AAA | Moody's/S&P |
| Federal Home Loan Mortgage Corporation debentures | | 8,810 | 1.8329 | AAA/AAA | Moody's/S&P |
| Federal National Mortgage Association notes | | 5,861 | 2.3328 | AAA/AAA | Moody's/S&P |
| Federal Home Loan Mortgage Corporation notes | | 6,358 | 1.3568 | AAA/AAA | Moody's/S&P |
| Total U.S. government agencies and instrumentalities | | 43,078 | | | |
| Corporate obligations: | | | | | |
| Procter & Gamble note | | 1,265 | 1.2917 | AA3/AA- | Moody's/S&P |
| U.S. Bank National Association | | 1,105 | 0.8750 | AA2/AA | Moody's/S&P |
| Total corporate obligations | | 2,370 | | | |
| Total fair value of investments | | 102,246 | | | |
| Money market | | 192 | N/A | N/A | |
| Total fair value of investments, including cash deposits | $ | 102,438 | | | |
| Portfolio weighted modified duration | | | 1.7806 | | |

* The credit rating of this investment is unrated.

**August 31, 2006**

| Investment type | Fair value | Weighted average maturity (years) | Credit rating | Rating agency |
|---|---|---|---|---|
| Guaranteed investment contracts | $ 53,597 | 14.5000 | * | * |
| U.S. government obligations: | | | | |
| U.S. Treasury notes | 8,508 | 1.8979 | Aaa/AAA | Moody's/S&P |
| U.S. Treasury notes bonds | 7,673 | 1.9880 | Aaa/AAA | Moody's/S&P |
| Total U.S. government obligations | 16,181 | | | |
| U.S. government agencies and instrumentalities: | | | | |
| Federal National Mortgage Association bonds | 2,191 | 2.2917 | Aaa/AAA | Moody's/S&P |
| Federal Farm Credit Bank notes | 1,831 | 1.3722 | Aaa/AAA | Moody's/S&P |
| Federal Farm Credit Bank bonds | 2,396 | 2.6250 | Aaa/AAA | Moody's/S&P |
| Federal Home Loan Mortgage Corporation bonds | 3,929 | 1.2338 | Aaa/AAA | Moody's/S&P |
| Federal Home Loan Mortgage Corporation debentures | 2,003 | 2.1250 | Aaa/AAA | Moody's/S&P |
| Federal National Mortgage Association notes | 2,190 | 1.3833 | Aaa/AAA | Moody's/S&P |
| Freddie Mac bonds | 2,146 | 1.9744 | Aaa/AAA | Moody's/S&P |
| Total U.S. government agencies and instrumentalities | 16,686 | | | |
| Corporate obligations: | | | | |
| U.S. Bank National Association Minneapolis Minnesota subordinate note | 356 | 1.8750 | Aa1/AA- | Moody's/S&P |
| U.S. Bank National Association Minneapolis Minnesota subordinate note | 764 | 0.9194 | Aa2/AA- | Moody's/S&P |
| Total corporate obligations | 1,120 | | | |
| State obligations: | | | | |
| Harrisburg PA Redevelopment Authority revenue bond | 996 | 24.2083 | AA- | S&P |
| Total fair value of investments | 88,580 | | | |
| Money market | 5,772 | N/A | N/A | |
| Total fair value of investments, including cash deposits | $ 94,352 | | | |
| Portfolio weighted modified duration | | 2.5396 | | |

* The credit rating of this investment is unrated.

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

**August 31, 2007**

| Investment type | | Fair value | Weighted average maturity (years) | Credit rating | Rating agency |
|---|---|---|---|---|---|
| Money market | $ | 1,924 | N/A | N/A | N/A |
| Total fair value of investments, including cash deposits | $ | 1,924 | | | |

**August 31, 2006**

| Investment type | | Fair value | Weighted average maturity (years) | Credit rating | Rating agency |
|---|---|---|---|---|---|
| Money market | $ | 1,630 | N/A | N/A | N/A |
| Accrued interest | | 7 | | | |
| Total fair value of investments, including cash deposits | $ | 1,637 | | | |

### *(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 interest rate risk. Investments shall be diversified as to maturities, and as to kind of investment to eliminate 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.

### *(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 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) U.S. agency obligations rated Aaa/AAA by Moody's Investor Services or Standard & Poor's; (4) collateralized certificates of deposit; (5) bankers acceptances, Eurodollars deposits, and Euro certificates of deposit that are collateralized; (6) commercial paper rated M1G1 or A1+ by Moody's Investor Services and Standard & Poor's, respectively; (7) general obligation bonds of corporations rated AA or better by Moody's Investor Services or Standard & Poor's, with a maturity of two years or less (except the Sinking Fund); (8) collateralized mortgage obligations and pass-through securities rated AA or better by Moody's Investor Services or Standard & Poor's or collateralized with securities that meet the Company's own investment criteria, with a maturity of two years or less (except the Sinking Fund); (9) money market mutual funds, as defined by the Securities and Exchange Commission; (10) repurchase agreements collateralized either through actual delivery of eligible collateral or through segregation of collateral by a depository that is holding the counterparty's securities, provided such collateral meets the Company's own investment criteria; and (11) obligations of the Commonwealth of Pennsylvania (the Commonwealth) or any municipality or other political subdivision of the Commonwealth, registered or otherwise as to principal and interest, with a maturity of two years or less (except the Sinking Fund).

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

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

The Company has selected custodian banks that are members of the Federal Reserve System to hold its investments. Delivery of the applicable investment documents (e.g., contracts, securities, and safekeeping receipts) 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. Safekeeping procedures of the custodian shall be reviewed annually by independent auditors, and a copy of their report shall be supplied to the Company for review.

***(f) Concentration of Credit Risk***

More than 5.0% of the Company's investments are in money markets within the Capital Improvement Fund and the GIC with FSA Capital Markets Services, LLC within the Sinking Fund. In FY 2007, these investments represent 58.6% and 17.9%, respectively, of the Company's total investments. In FY 2006, more than 5.0% of the Company's investments were in the GIC with Royal Bank of Canada and the GIC with FSA Capital Markets Services, LLC. These investments represent 29.2% and 39.5%, respectively, of the Company's total investments.

**(4) Deferred Costs**

In compliance with rate orders issued by the PGC, the cost of projects that produce benefits over an extended period is deferred. Such costs are being amortized to expense over a period matching their useful lives, which range from two to ten years. There is no return on the asset being charged to the customers. During FY 2007, there were costs of $540,000 incurred for rate case expenses that will be amortized over a five-year period. The unamortized costs included in other assets and deferred debits were $324,000 and $289,000 as of August 31, 2007 and 2006, respectively. The unamortized costs included in other current assets and deferred debits were $397,000 and $353,000 as of August 31, 2007 and 2006, respectively.


(Continued)

As a result of settlements during FY 2007 by PGW's insurance carriers associated with environmental remediation costs, the Company received $2,937,000 during FY 2007. Environmental remediation costs of approximately $1,091,000 in FY 2007 were offset by these insurance settlements, and the remainder was deferred. The Company estimates additional expenditures to be approximately $13,349,000 over the next six years as discussed in note 13.

As a result of settlements during FY 2006 by PGW's insurance carriers associated with environmental remediation costs, the Company received $2,319,000 during FY 2006. Environmental remediation costs of approximately $1,149,000 in FY 2006 were offset by these insurance settlements.

## (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 six months of service, permits them to defer a portion of their salary until future years. The Company provides a 10% matching contribution up to $500 that immediately vests to the employee.

The deferred compensation is not available to employees until termination, retirement, death, or unforeseeable emergency in accordance with the Internal Revenue Code.

During the fiscal year ended August 31, 1999, the Plan was amended to comply with Internal Revenue Code Section 457, subsection (g) through the creation of a trust in which all assets and income of the Plan are to be held for the exclusive benefit of participants and their beneficiaries. As a result, the Company no longer owns the assets of the Plan nor has a contractual liability to Plan participants.

The Company contributed $365,000 and $339,000 for the years ended August 31, 2007 and 2006, respectively.

## (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 $200,000,000 outstanding at any one time. These notes are intended to provide additional working capital. They are supported by an irrevocable letter of credit and a subordinated security interest in the Company's revenues.

A new Series E of the tax-exempt commercial paper program was instituted on January 18, 2006, concurrently with the expiration of Series D. Under the new credit agreement, the commitment amount was increased from $100,000,000 to $150,000,000. The credit agreement was further amended and restated as of May 22, 2007 to reflect a new term and rate structure. The expiration of the credit agreement was extended to May 29, 2010.

The notes outstanding at August 31, 2007 had an average interest rate of 3.95% and remaining time to maturity of four days. The principal amount outstanding at August 31, 2007 and 2006 was $51,600,000 and $55,000,000, respectively. The date of issuance for the $51,600,000 was August 31, 2007, maturing on September 4, 2007. PGW reissued the maturing commercial paper on September 4, 2007, and issued an additional $87,900,000 with all of the components maturing on October 4, 2007.

Commercial paper activity for the years ended August 31, 2007 and 2006 was as follows (thousands of dollars):

| | | Year ended August 31, 2007 | | |
|---|---|---|---|---|
| | Beginning balance | Additions | Deletions | Ending balance |
| Commercial paper | $ 55,000 | 94,900 | 98,300 | 51,600 |

| | | Year ended August 31, 2006 | | |
|---|---|---|---|---|
| | Beginning balance | Additions | Deletions | Ending balance |
| Commercial paper | $ 49,900 | 100,000 | 94,900 | 55,000 |

See note 8(e) for detail of the current amount due for the $43,000,000 Note Payable – City Loan.

## (7) GCR Tariff Reconciliation

During the fiscal years ended August 31, 2007, 2006, and 2005, the Company's actual gas costs were below its billed gas costs by approximately $24,904,000, $8,466,000, and $21,369,000, respectively.

***Natural Gas Pipeline Supplier Refund***

The Company received refunds including interest in FY 2007 in the amount of $648,000 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 GCR for FY 2007.

The Company received refunds including interest in FY 2006 in the amount of $849,000 related to FERC/Pipeline Rate Cases. This amount was utilized as a reduction in the cost of gas for reconciliation purposes in the calculation of the GCR for FY 2006.

## (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, 2007 and 2006 (thousands of dollars):

| | August 31, 2007 | | | August 31, 2006 | | |
|---|---|---|---|---|---|---|
| | Current portion | Long-term | Total | Current portion | Long-term | Total |
| Revenue bonds | $ 41,830 | 1,176,368 | 1,218,198 | 38,045 | 1,016,993 | 1,055,038 |
| Unamortized discount | (511) | (4,951) | (5,462) | (425) | (4,689) | (5,114) |
| Unamortized premium | 2,676 | 30,375 | 33,051 | 1,971 | 18,827 | 20,798 |
| Total revenue bonds | 43,995 | 1,201,792 | 1,245,787 | 39,591 | 1,031,131 | 1,070,722 |
| Note Payable – City Loan | 43,000 | — | 43,000 | — | 45,000 | 45,000 |
| Total | $ 86,995 | 1,201,792 | 1,288,787 | 39,591 | 1,076,131 | 1,115,722 |

The following is a summary of activity related to revenue bonds and other liabilities and deferred credits and the respective balances for the fiscal years ended August 31, 2007 and 2006 (thousands of dollars):

| | | Year ended August 31, 2007 | | |
|---|---|---|---|---|
| | Beginning balance | Additions | Reductions | Ending balance |
| Revenue bonds | $ 1,055,038 | 246,655 | (83,495) | 1,218,198 |
| Other liabilities and deferred credits: | | | | |
| Forward rate agreement | $ 9,056 | — | (625) | 8,431 |
| Claims and judgments | 3,899 | — | (788) | 3,111 |
| Environmental clean-up | 9,074 | 939 | — | 10,013 |
| Other postemployment benefits | — | 26,421 | — | 26,421 |
| Total other liabilities and deferred credits | $ 22,029 | 27,360 | (1,413) | 47,976 |

| | | Year ended August 31, 2006 | | |
|---|---|---|---|---|
| | Beginning balance | Additions | Reductions | Ending balance |
| Revenue bonds | $ 1,059,684 | 313,390 | (318,036) | 1,055,038 |
| Other liabilities and deferred credits: | | | | |
| Forward rate agreement | $ 9,680 | — | (624) | 9,056 |
| Claims and judgments | 4,990 | — | (1,091) | 3,899 |
| Environmental clean-up | 9,513 | — | (439) | 9,074 |
| Total other liabilities and deferred credits | $ 24,183 | — | (2,154) | 22,029 |

Liability amounts due within one year are reflected in the other current liabilities and deferred credits line of the balance sheet.


(Continued)

Principal maturities and scheduled interest payments for revenue bonds are as follows (thousands of dollars):

| | Revenue bonds | | | |
|---|---|---|---|---|
| | **Principal** | **Interest** | **Net swap amount** | **Total** |
| Fiscal year ending August 31: | | | | |
| 2008 | $ 41,830 | 54,590 | (863) | 95,557 |
| 2009 | 44,625 | 53,890 | (858) | 97,657 |
| 2010 | 46,365 | 51,622 | (853) | 97,134 |
| 2011 | 46,977 | 49,334 | (848) | 95,463 |
| 2012* | 40,386 | 47,572 | (842) | 87,116 |
| 2013 – 2017 | 228,755 | 207,052 | (3,938) | 431,869 |
| 2018 – 2022 | 238,005 | 151,547 | (3,063) | 386,489 |
| 2023 – 2027 | 245,900 | 95,683 | (1,761) | 339,822 |
| 2028 – 2031 | 172,685 | 46,306 | (292) | 218,699 |
| 2033 – 2037 | 100,130 | 13,950 | — | 114,080 |
| 2038 | 12,540 | 314 | — | 12,854 |
| Total | $ 1,218,198 | 771,860 | (13,318) | 1,976,740 |

Future debt service is calculated using rates in effect at August 31, 2007 for variable rate bonds. The net swap payment amounts were calculated by subtracting the future variable rate interest payments subject to swap agreements from the synthetic fixed-rate amount intended to be achieved by the swap amount.

* Tax Exempt Capital Accumulator (T.E.C.A.) accretions for the 11 "C" Series in the amount of $6,044,000 are not included in the principal amount in FY 2012.

***(a) Bond Issuances***

**1) 2007 Ordinances**

On March 21, 2007, the Mayor signed two bills into law authorizing the City to issue revenue bonds. The first bill signed by the Mayor constituted the Nineteenth Supplemental Ordinance to the General Gas Works Revenue Bond Ordinance of 1975 (the 1975 General Ordinance). This ordinance authorizes the City to issue revenue bonds for the following purposes: (a) the current refunding of a portion of the outstanding City of Philadelphia, Pennsylvania Gas Works Revenue Bonds, Fifteenth Series (1975 Refunded Bonds); (b) paying the costs of issuing the Nineteenth Series Bonds; and (c) paying any other Project Costs (as defined in the Act).

The second bill signed by the Mayor constituted the Eight Supplemental Ordinance to the General Gas Works Revenue Bond Ordinance of 1998 (the 1998 General Ordinance). This ordinance authorizes the City to issue revenue bonds for the following purposes: (a) providing funding for the capital projects included in the capital program of PGW as from time to time included in the capital budgets of PGW, as approved by City Council; (b) advance refunding of the 1998 Refunded Bonds, which were issued under the 1998 General Ordinance; (c) paying the costs of issuing the Seventh

Series Bonds and the required deposits to the 1998 Ordinance Sinking Fund Reserve; and (d) paying any other Project Costs (as defined in the Act).

*i) 1998 Ordinance Seventh Series Bonds*

On May 15, 2007, the Company issued $230,900,000 of Seventh Series Bonds for the purpose of providing funds for the financing of the capital projects included in the capital program of the Company, and for the purpose of redeeming and refunding, on a current basis, a portion of the outstanding Second Series B, Third Series and Fourth Series Bonds. The refunded par amounts of the Second Series B, Third Series and Fourth Series Bonds were: $7,500,000, $3,145,000, and $20,005,000, respectively. The Seventh Series Bonds contained new money debt issued in the amount of $200,000,000. This new debt was issued under the 1998 Ordinance. The interest rate on the $137,720,000 of Serial Bonds ranged from 4.0% to 5.0%. The interest rate on the $93,180,000 of Term Bonds was 5.0%. The bonds, consisting of Serial Bonds and Term Bonds, have maturity dates through 2037.

*ii) 1975 Ordinance Nineteenth Series Bonds*

On May 15, 2007, the Company issued $14,450,000 of Nineteenth Series Bonds for the purpose of redeeming and refunding, on a current basis, the outstanding Fifteenth Series Bonds previously issued under the 1975 Ordinance. This new debt was issued under the 1975 Ordinance. The interest rate on the Serial Bonds was 5.0%. The bonds, consisting of Serial Bonds, have maturity dates through 2023.

**2) 2006 Ordinances**

On December 22, 2005, the Mayor signed an ordinance into law authorizing the City to issue revenue bonds for the purpose of (a) refunding all or a portion of the following Series of Gas Works Revenue Bonds (the 1998 General Ordinance): First Series B, Second Series A, Third Series, Fourth Series, and Fifth Series; (b) paying the costs of issuing the bonds and making any required deposits to the Sinking Fund Reserve; and (c) paying any other Project Costs, which may include, without limitation, the repayment to any fund of the City or to accounts of the Company of amounts advanced for Project Costs.

*i) 1998 Ordinance Sixth Series Bonds*

On January 26, 2006, the Company issued $313,390,000 of Sixth Series Bonds, maturing at various dates through 2031, for the purpose of redeeming and refunding, on a current basis, all of the First Series B and a portion of the outstanding Second Series A, Third Series, and Fourth Series City of Philadelphia, Pennsylvania, Gas Works Revenue Bonds previously issued under the 1998 Ordinance. The refunded par amounts of the First Series B, Second Series A, Third Series, and Fourth Series Bonds were: $103,550,000, $79,355,000, $99,915,000, and $2,295,000, respectively. As of August 31, 2007, there were no Fifth Series Bonds refunded. The $313,390,000 of Serial Bonds have a variable rate set through weekly auction and are paid monthly.

The Bonds were issued on a parity with other Senior 1998 Ordinance Bonds issued under the 1998 General Ordinance, but are subordinated in right of payment and security to all bonds issued and outstanding under the General Gas Works Revenue Bond Ordinance of 1975, approved on May 30, 1975, Bill No. 1871, as amended and supplemented from time to time (the "1975 General Ordinance" and together with the 1998 General Ordinance). The Bonds were also issued on parity with the Obligations of the City to make periodic payments due under a Qualified Swap being entered into between the City and the counterparty in connection with the issuance of the bonds.

**3) 2004 Ordinances**

On May 27, 2004, two bills were introduced into City Council related to the authorization to sell Gas Works Revenue Bonds. The first bill, constituting the Sixth Supplemental Ordinance to the General Gas Works Revenue Bond Ordinance of 1998 (the 1998 Ordinance), authorizes the sale in an aggregate principal amount of up to $150,000,000 of Fifth Series A Gas Works Revenue Bonds (Fifth Series A Bonds) under the 1998 Ordinance. The Fifth Series A Bonds were issued for the purpose of providing funds for the capital projects of the Company. The first bill also authorizes the sale in an aggregate principal amount of up to $18,000,000 of Fifth Series B Gas Works Revenue Bonds (Fifth Series B Bonds) under the 1998 Ordinance. The Fifth Series B Bonds may be issued for the purpose of providing funds redeeming or refunding certain outstanding Gas Works Revenue Bonds and related project costs, but as of August 31, 2007, there were no Fifth Series B Bonds issued.

The second bill, constituting the Eighteenth Supplemental Ordinance to the General Gas Works Revenue Bond Ordinance of 1975 (the 1975 Ordinance), authorizes the sale in an aggregate principal amount of up to $75,000,000 of Gas Works Revenue Bonds under the 1975 Ordinance. The bonds were issued for the purpose of providing funds for the redeeming or refunding on a current basis of all or any portion of the outstanding Fifteenth Series Gas Works Revenue Bonds.

City Council approved the bills on June 21, 2004, and the Mayor signed the bills into law on July 1, 2004.

*i) 1998 Ordinance Fifth Series A 1*

On October 14, 2004, the Company issued $120,000,000 of new debt for the purpose of providing funds for the financing of the capital projects included in the capital program of the Company. This new debt was issued as the Fifth Series A 1 Bonds under the 1998 Ordinance. The interest rates on the $70,275,000 of Serial Bonds ranged from 4.0% to 5.25%. The interest rate on the $49,725,000 of Term Bonds was 5.0%. The bonds, consisting of Serial Bonds and Term Bonds, have maturity dates through 2033.

*ii) 1975 Ordinance Fifteenth Series*

On October 14, 2004, the Company issued $57,820,000 of new debt for the purpose of redeeming and refunding, on a current basis, a portion of the outstanding Fifteenth Series City of Philadelphia, Pennsylvania, Gas Works Revenue Bonds previously issued under the 1975

Ordinance. The par amount of the Fifteenth Series Bonds being redeemed and refunded was $58,995,000. This new debt was issued as the Eighteenth Series under the 1975 Ordinance. The interest rates on the $57,820,000 of Serial Bonds ranged from 3.0% to 5.25%. The bonds consisting of Serial Bonds have maturity dates through 2021.

*iii) 1998 Ordinance Fifth Series A 2*

On October 19, 2004, the Company issued $30,000,000 of new debt for the purpose of providing funds for the financing of the capital projects included in the capital program of the Company. This new debt was issued as the Fifth Series A 2 Bonds under the 1998 Ordinance. The interest rates on the $30,000,000 of Fifth Series A 2 Bonds will initially bear interest at a weekly auction rate and during such weekly mode interest will be payable on the first business day of each month commencing November 1, 2004. Thereafter, the City may designate a different rate mode for the Fifth Series A 2 Bonds. The bonds have maturity dates through 2034. The City has not designated a different rate mode.

Proceeds of all series of revenue bonds were applied to reduce capital improvement loans from the City that had been previously approved by the voters but for which bonds had not been issued, to fund future capital projects by deposits in the Capital Improvement Fund, or to refund bonds previously issued. The serial bonds are not subject to redemption prior to maturity while the term bonds are subject to redemption at the option of the City after a designated date, either in whole or in part, at varying redemption prices. In addition, the term bonds are subject to mandatory redemption after a designated date prior to maturity at a redemption price of 100% of principal amount and accrued interest. Funds deposited in a sinking fund may be used for this purpose.

***(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. The Company has satisfied the debt coverage requirements in FY 2007 and FY 2006.

Also provided by both general ordinances is the establishment of a sinking fund into which deposits are made sufficient to meet all principal and interest requirements of the bonds as they become due. Both general ordinances also provide that sinking fund reserves be maintained as part of the Sinking Fund, which have previously been funded from the proceeds of each series of bonds in an amount equal to the maximum annual debt service requirement on the bonds of each respective General Ordinance in any fiscal year.

Monies in the Sinking Fund reserves are to be applied to the payment of debt service if, for any reason, other monies 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 is reported as long-term debt.

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

In FY 2006, the City entered into an interest rate swap pursuant to an agreement with a counterparty in connection and concurrently with the issuance of the Sixth Series Bonds. The Sixth Series Swap agreement provides, in general, that the City will pay to a counterparty semiannually on every February 1 and August 1 a fixed-rate payment of 3.6745% on an initial notional amount equal to $313,390,000, amortizing in accordance with the principal amortization schedule of the Bonds, as set forth in the Sixth Series Swap Agreement, and that the counterparty will pay to the City on the first day of each calendar month a floating-rate payment equal to the lesser of the fixed payment to the counterparty and the Bond Market Association Municipal Swap Index (BMA), on the notional amount from time to time outstanding, to and including August 1, 2011, and thereafter a floating rate payment equal to 70% of one-month London Interbank Offered Rate (LIBOR), on the notional amount from time to time outstanding. As of August 31, 2007, the fair value of the unexercised portion of the swap was approximately $2,713,000.

*Objective of the swap*. In January 2006, the City entered into a swap to synthetically refund outstanding Bonds, which provided the City with present value savings of $14,667,000 or 5.144% of the Refunded Bonds. The swap structure was used as a means to increase the City's savings, when compared against fixed-rate bonds at the time of issuance. The intention of the swap was to effectively change the City's interest rate on the bonds to a fixed rate.

*Terms*. The swap, executed with the counterparty, commenced on January 26, 2006 and will mature on August 1, 2031. Under the swap, the City pays a fixed rate of 3.6745% and receives a variable rate computed as the BMA index until September 1, 2011 on which date the variable interest rate received will switch to 70.0% of the one month LIBOR until maturity. The swap has a notional amount of $313,390,000 and the associated variable rate bond has a $313,390,000 principal amount. The bonds' variable-rate coupons are not based on an index but on market conditions. As of August 31, 2007, rates were as follows:

| | **Rates** |
|---|---|
| Terms: | |
| *Interest rate swap* | |
| Fixed payment to counterparty | 3.6745% |
| Variable payment from counterparty (BMA) | (3.9500) |
| Net interest rate swap payments | (0.2755) |
| Variable rate bond coupon payments (auction rates) | 3.9500 |
| Synthetic interest rate on bonds | 3.6745% |

*Fair value*. As of August 31, 2007, the swap had a fair value of $2,713,000. Since the coupons on the City's variable rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value increase. The fair value on the swap was estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement of the swap.

*Credit risk*. The swap's fair value represents the City's credit exposure to the counterparty as of August 31, 2007. Should the counterparty fail to perform according to the terms of the swap, the City faces a maximum possible loss equivalent to the swap's $2,713,000 fair value. As of August 31, 2007, the counterparty was rated AA – by Standard & Poor's and Aa2 by Moody's Investors Service.

*Termination risk*. The swap uses the International Swap Dealers Association Master Agreement, which includes standard termination events. The Schedule to the master agreement includes an "additional termination event." That is, the swap may be terminated if the long-term debt rating of the counterparty falls below "A-" by Standard & Poor's Ratings Group or "A3" by Moody's Investors Service 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 to the schedule with the City, in form and substance acceptable to the City providing for the collateralization by the counterparty of its obligations under the swap. Also, if at the time of termination the swap has a negative fair value, the Authority would be liable to the counterparty for a payment equal to the swap's fair value.

The scheduled payments by the City are secured by an insurance policy provided from Financial Security Assurance Inc. (FSA). The swap may be terminated if (i) the associated bonds are rated below "BBB" by Standard & Poor's Ratings Group or below "Baa2" by Moody's Investors Service or (ii) the bonds are not rated by either Standard & Poor's Ratings Group or Moody's Investors Service, and the City has not provided a credit support provider acceptable to the counterparty whose obligations are pursuant to a credit support document reasonably acceptable to the counterparty.

*Basis risk.* After September 1, 2011, the City will be exposed to tax risk as reflected by the relationship between the rate paid on the outstanding bonds and 70.0% of one-month LIBOR, the rate received on the swap. Tax risk is a form of basis risk where the City is exposed to a potential additional interest cost in the event that changes in the structure of the federal tax system or in the marginal tax rates causes the rate paid on the outstanding bonds to be greater than the 70.0% of LIBOR received on the swap.

***(d) Forward Rate Agreement and Guaranteed Investment Contracts***

On August 23, 2002, the City entered into 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 $61,396,000 were invested in the GICs. In exchange for this investment, the Company received an up-front payment of $21,800,000 in lieu of receiving interest payments over the life of the GICs. The life of the Forward Rate Agreement is 18½ years, with 13½ years remaining at August 31, 2007.

The GICs are recorded at fair value in the Sinking Fund and had fair values of $49,504,000 and $53,597,000 at August 31, 2007 and 2006, respectively.

The Company also paid $1,650,000 to terminate an existing Forward Rate Agreement as part of this transaction. Of the remaining net proceeds of $20,150,000, $8,596,000 was allocated to the 1975 Sinking Fund Reserve and $11,554,000 was allocated to the 1998 Sinking Fund Reserve, respectively. For debt service coverage purposes, the $20,150,000 was considered "project revenues" in FY 2002. For financial statement purposes, the $8,596,000 was recorded as revenue in FY 2002 in the category of interest and other income. This amount is nonrefundable and was granted to the Company by the City.

Under the 1998 Ordinance, the Company is entitled to the earnings on the portion of the Sinking Fund allocated to bonds issued under the 1998 Ordinance. Therefore, the $11,554,000 received under the 1998 ordinance was deferred and is being amortized on a straight-line basis over the life of the agreement. The unamortized balance of the proceeds was $8,431,000 and $9,056,000 at August 31, 2007 and 2006, respectively.

### *(e) Note Payable – City Loan*

On November 15, 2000, the Mayor signed an ordinance authorizing the City to advance in whole or in part, up to $45,000,000 to the Company, in order to enable the Company to operate through the winter of 2000-2001. The loan was subject to the Company submitting a Five-Year Financial and Management Plan. This plan was accepted by City Council in January 2001. The loan from the City carries no interest. The loan originally had to be repaid in full within 24 months following the first draw under the loan agreement, but no later than January 2003. On May 15, 2002, the Mayor signed an ordinance authorizing the extension of the repayment period of the City loan. The repayment period for the $45,000,000 temporary advance was extended from a date no later than June 30, 2003, to a date no later than August 29, 2006. On December 22, 2005, the Mayor signed an ordinance extending the repayment date of the loan from August 2006 to August 2008. All of the other terms of the loan remain unchanged.

The loan from the City is subordinate to the Company's other repayment obligations on its revenue bonds and commercial paper program. The outstanding balance of the City loan was $43,000,000 and $45,000,000 at August 31, 2007 and 2006 respectively. The outstanding $43,000,000 balance of the City loan is due in FY 2008; therefore, the City loan is being classified under the current portion of long-term debt as of August 31, 2007.

## (9) Defeased Debt

Defeased debt of the Company (bonds issued by the Company payable from the proceeds of irrevocably pledged assets) at August 31, 2007 was as follows:

| | Latest date maturing to | Interest rate | Bonds outstanding |
|---|---|---|---|
| 7th Series | 3/15/13 | 6.00% | $ 10,675,000 |
| 12th Series B | 5/15/20 | 7.00 | 50,415,000 |
| 1st Series | 7/1/28 | 5.35 | 103,550,000 |
| 2nd Series | 7/1/29 | 5.00 | 84,640,000 |
| 3rd Series | 8/1/31 | 5.50 | 99,445,000 |
| 4th Series | 8/1/32 | 5.25 | 20,005,000 |

PGW issued $230,900,000 of Seventh Series Bonds during FY 2007. The proceeds of $30,900,000 from the sale were utilized to refund a portion of the Second Series B, Third Series, and Fourth Series Bonds, in the amounts of $7,500,000, $3,145,000, and $20,005,000, respectively. The refunding of this existing debt resulted in an accounting loss of $2,218,000. This loss is being deferred and amortized as interest expense over the life of the new bonds. The refunding generated a present value savings of $2,146,000.

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 $386,582,000 at August 31, 2007, bearing interest on face value from 4.30% to 7.76%.

## (10) Pension Costs

### *(a) Plan Description*

The Company sponsors a public employee retirement system (PERS), a single-employer defined-benefit plan, to provide pension benefits for all of its employees, whose annual covered payroll (which was substantially equal to total payroll) was $106,018,000 and $102,544,000 at August 31, 2007 and 2006, respectively.

At September 1, 2005, 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 | 2,187 |
| Current employees: | |
| Vested | 1,338 |
| Nonvested | 363 |
| Total current employees | 1,701 |
| Total membership | 3,888 |

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% of the highest annual earnings during the last 10 years of credited service, or
- 2% 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 ten 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.

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 Director of Finance of the City.

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

| | | Normal cost | Amortization of the underfunded balance | Contributions |
|---|---|---|---|---|
| Fiscal year: | | | | |
| 2007 | $ | 7,693,000 | 7,524,000 | 15,217,000 |
| 2006 | | 7,617,000 | 9,946,000 | 17,563,000 |
| 2005 | | 7,015,000 | 7,687,000 | 14,702,000 |

Withdrawals from pension assets of $16,776,000 and $13,863,000 in FY 2007 and FY 2006, respectively, were utilized to meet beneficiary payment obligations.

The Company's annual pension cost is equal to its annual required contribution. The annual required contributions 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 8.25% per year compounded annually; projected salary increases of 3% of the salary at the beginning of the next three years, then 4.25% of the salary at the beginning of the fourth and subsequent year; and retirements that are assumed to occur prior to age 62, at a rate of 10% at ages 55 to 61 and 100% 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 10 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 Pension Plan had an actuarial value of assets of $411,886,000 and an actuarial accrued liability of $474,250,000 resulting in a funded ratio of 86.84% based on a biennial actuarial valuation of the pension fund as of September 1, 2005 updated for the plan year September 1, 2006 through August 31, 2007. The resulting unfunded actuarial accrued liability of $62,364,000 was 58.82% of covered payroll of $106,018,000.



(Continued)

### *(c) Historical Trend Information (unaudited)*

Historical trend information reflecting funding progress and contributions made by the Company is presented in the supplemental schedule of pension funding progress (unaudited).

## (11) Other Postemployment Benefits

### *(a) Plan Description*

The Company sponsors a single employer defined benefit healthcare plan and provides postemployment healthcare and life insurance benefits to approximately 1,935 and 1,929 participating retirees and their beneficiaries and dependents for FY 2007 and FY 2006, respectively, in accordance with their retiree medical program. The Company also provides such benefits to approximately 1,720 and 1,749 active employees and their dependents for FY 2007 and FY 2006, respectively, by charging the annual insurance premiums to expense. The annual covered payroll (which was substantially equal to total payroll) was $106,018,000 and $102,544,000 at August 31, 2007 and 2006, respectively.

The Company pays 100.0% of premiums for basic medical, hospitalization, and prescription drugs incurred by retirees and their dependents. The Company also pays a portion of the premium for life insurance for each eligible retiree. 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 amounted to $36,111,000 and $35,076,000 in FY 2007 and FY 2006, respectively, of which approximately 48.1% and 52.0%, respectively, represents payments on behalf of retired employees and their dependents. Employees and retirees contributed $1,470,000 and $1,391,000 in FY 2007 and FY 2006, respectively, towards their healthcare. These contributions represent the additional cost of healthcare plans chosen by employees and retirees above the basic plan offered by the Company. Total premiums for group life insurance were $2,080,000 and $2,075,000 in FY 2007 and FY 2006, respectively. The amount attributed to retirees was approximately 76.3% in FY 2007 and FY 2006. The contribution requirements of nonunion plan members are established by management and may be amended. The contribution requirements for union plan members are subject to collective bargaining.

The Plan does not issue a stand-alone report and therefore the Company has included the schedule of employer contributions as a supplemental schedule (unaudited).

### *(b) Actuarial Valuation and Assumptions*

The Company engaged an actuarial consulting firm to provide an actuarial valuation of the Company’s OPEB obligations as of August 31, 2007. The actuarial valuations involve estimates of the value of reported amounts and the assumptions about the probability of events far into the future. Actuarially determined amounts are subject to continual revision, as actual results are compared to past expectations, and new estimates are made about the future. The calculations were based on the types of benefits provided under the terms of the substantive plan at the time of the valuation.

The projected unit cost method was utilized in the valuation to develop the actuarial accrued liability and normal cost. Under the projected unit cost method, the present value of benefits is allocated uniformly over the employee's expected working lifetime. The actuarial accrued liability is that portion of the present value of projected benefits, which has been accrued during the employee's working lifetime from hire to valuation date. The normal cost represents the amount charged for services earned during the current reporting period. The normal cost is calculated by dividing the present value of projected benefits for an employee by the total service.

The valuation was prepared utilizing certain assumptions, including the following:

- Economic assumptions – the discount rate and health care cost trend rates

  The report utilized a 5.0% discount rate for purposes of developing the liabilities and ARC on the basis that the Plan would not be funded. This rate is based on the investment return expected on the Company's general investments, because the Company has not funded the Plan for FY 2007.

| | Healthcare Cost Trend Rates | | |
|---|---|---|---|
| | **Medical** | **Prescription** | **Dental** |
| Year: | | | |
| 1 | 10.0% | 10.0% | 4.5% |
| 2 | 9.0 | 9.0 | 4.5 |
| 3 | 8.0 | 8.0 | 4.5 |
| 4 | 7.0 | 7.0 | 4.5 |
| 5 | 6.0 | 6.0 | 4.5 |
| 6 | 5.0 | 5.0 | 4.5 |
| 7 and beyond | 4.5 | 4.5 | 4.5 |

- Benefit assumptions – the initial per capita cost rates for medical coverage, and the face amount of Company-paid life insurance

- Demographic assumptions – including the probabilities of retiring, dying, terminating (without a benefit), becoming disabled, recovery from disability, election (participation rates), and coverage levels

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

The ARC for FY 2007 is estimated to be $45,237,000 which is also the annual OPEB cost. The amount paid by the Company for retiree benefits in FY 2007 was $18,816,000, consisting of $17,360,000 of healthcare expenses and $1,456,000 of life insurance expenses, respectively. The difference between the ARC and the expenses paid results in an OPEB liability of $26,421,000. This amount has been recorded in other liabilities and deferred credits and has been expensed in FY 2007.

As of August 31, 2007, the actuarial accrued liability for benefits was $573,734,000, all of which was unfunded and the ratio of the unfunded actuarial accrued liability to the covered payroll was 541.0%. Historical trend information reflecting funding progress and contributions made by the

Company is presented in the supplemental schedule of postemployment benefit funding progress (unaudited).

### *(d) Other Coverage Information*

Also, the Company has entered into several one-year contracts to provide health care for both active and retired employees that are experience rated, and premiums are adjusted annually; in addition, the Company has in place approximately $161,320,000 of group life insurance coverage for both active and retired employees, which is retrospectively rated on a monthly basis. The Company also has in place approximately $120,807,000 of accidental death and dismemberment insurance coverage for active employees.

## (12) 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 $250,000,000, subject to a $500,000 per accident deductible at the Richmond and Passyunk Plants and a $100,000 deductible per accident 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 boiler and machinery, blanket crime, and other forms of property insurance.

The Company maintained $210,000,000 in Liability (including terrorism) Coverage, insuring against the risk of damage or injury to the public with a per occurrence self insured retention of $500,000; however, effective September 1, 2007, the self insured retention was increased to $1,000,000.

The Company maintains statutory limits for Workers' Compensation (including terrorism) with a $500,000 per occurrence self insured retention.

The Company maintains a $10,000,000 Public Officials Liability (Directors and Officers Liability) policy with a $500,000 retention.

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

| | | Beginning of year reserve | Current year claims and adjustments | Claims settled | End of year reserve | Current liability amount |
|---|---|---|---|---|---|---|
| Fiscal year ended August 31: | | | | | | |
| 2005 | $ | 7,366 | 3,859 | (2,715) | 8,510 | 3,521 |
| 2006 | | 8,510 | 2,808 | (3,259) | 8,059 | 4,159 |
| 2007 | | 8,059 | 3,367 | (2,958) | 8,468 | 5,357 |

## (13) Commitments and Contingencies

Commitments for major construction and maintenance contracts were approximately $9,694,000 as of August 31, 2007.

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

| | | |
|---|---|---|
| Fiscal year ending August 31: | | |
| 2008 | $ | 492 |
| 2009 | | 195 |
| 2010 | | 67 |
| 2011 | | 36 |

Rent expense for the fiscal years ended August 31, 2007 and 2006 amounted to $932,000 and $884,000, respectively.

The Company, in the normal course of conducting business, has entered into long-term contracts for the supply of natural gas and firm transportation and long-term firm gas storage service. The Company's cumulative obligations for demand charges for all of these services are approximately $5,100,000 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, 2007 through March 31, 2008.

The Company's operations and facilities are subject to federal, state, and local environmental requirements, including the need to obtain certain permits and approvals. Because these requirements are subject to change, additional or different requirements may be imposed upon the Company in the future. No assurances can be given that the Company would be able to comply with any such changed or new requirements, or that compliance with such requirements would not materially increase the Company's capital or operating costs, or have a material adverse effect on its financial position.

Like many providers of utility services throughout the northeastern United States, the Company has been in operation for more than 100 years, and many of its facilities were built decades ago. As a result of preliminary internal environmental evaluations of its facilities, the Company believes that several of its facilities that had been used in gas manufacturing contain contaminants from those operations or from other sources, and that certain equipment and processes that the Company removed from service years ago may no longer comply with current environmental requirements. In order to address these issues, the Company and the City voluntarily approached the Pennsylvania Department of Environmental Protection (PADEP), and proposed to resolve these issues under PADEP's Land Recycling Program. The Company intends to reach an agreement with PADEP on a comprehensive program pursuant to which the Company will address identified environmental issues.


(Continued)

At this time, the Company is unable to determine the full extent to which it may be necessary to remediate environmental conditions impacting its facilities, or the final costs of any such remedial work. The Company's pending agreement with PADEP provides that PADEP will cooperate with the Company to develop a schedule for any necessary work. The Company expects that this will allow for the proper allocation of resources in a manner calculated to avoid any material adverse effect on the Company's cash flows. Nevertheless, until a definitive schedule is finalized with PADEP, it is not possible to determine with quantifiable certainty many of the costs of potential site remediation and whether such costs would have a material adverse effect on the Company's financial position, results of operations, or cash flows.

The Company has received from its engineering firm and forwarded to PADEP Phase 1 and 2 site assessments on relevant properties. PADEP has approved these final reports, and the Company is moving forward on a series of remedial projects that will meet clean-up standards as set in PADEP's Act 2 Program. The Company estimates such expenditures to be approximately $13,349,000 over the next six years. These estimates are subject to substantial revision. The Company has recorded $3,337,000 in other current liabilities and $10,012,000 in other liabilities for estimated future environmental costs. The Company is also pursuing further recovery for remediation against environmental insurance policies.

The Company's FY 2008 Capital Budget was approved by City Council in the amount of $70,648,000. Within this approval, funding is provided to continue the implementation of an 18-mile Cast Iron Main Replacement Program. Main replacement cost for this program in FY 2008 is $15,023,000. The total six-year cost of the Cast Iron Main Replacement Program is forecasted to be approximately $97,413,000.

The FY 2008 Capital Budget also includes $4,083,000 for the purchase of replacement Automatic Meter Reading (AMR) units. The total six-year cost of this program to replace AMR units is approximately $17,096,000.

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

Required Supplementary Information (Unaudited)
Schedule of Pension Funding Progress

(Thousands of dollars)

| Actuarial valuation date | | (a) Actuarial value of assets | (b) Actuarial accrued liability (AAL) | (b)-(a) Unfunded (overfunded) AAL (UAAL [OAAL]) | (a/b) Funded ratio | | Covered payroll | UAAL (OAAL) as a percent of covered payroll |
|---|---|---|---|---|---|---|---|---|
| September 1, 2002* | $ | 370,019 | 424,670 | 54,651 | 87.13 | $ | 98,300 | 55.60% |
| September 1, 2003** | | 356,000 | 427,006 | 71,006 | 83.37 | | 101,200 | 70.16 |
| September 1, 2004+ | | 366,783 | 436,255 | 69,472 | 84.08 | | 102,500 | 67.78 |
| September 1, 2005++ | | 383,517 | 450,866 | 67,349 | 85.06 | | 102,544 | 65.68 |
| September 1, 2006+++ | | 411,886 | 474,250 | 62,364 | 86.85 | | 106,018 | 58.82 |

* The required supplementary information is based on a biennial actuarial valuation of the pension fund as updated for the plan year September 1, 2002 through August 31, 2003.

** The required supplementary information is based on a biennial actuarial valuation of the pension fund for the plan year September 1, 2003 through August 31, 2004.

+ The required supplementary information is based on a biennial actuarial valuation of the pension fund as updated for the plan year September 1, 2004 through August 31, 2005.

++ The required supplementary information is based on a biennial actuarial valuation of the pension fund for the plan year September 1, 2005 through August 31, 2006.

+++ The required supplementary information is based on a biennial actuarial valuation of the pension fund as updated for the plan year September 1, 2006 through August 31, 2007.

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 dollars)

| Actuarial valuation date | (a) Actuarial value of assets | (b) Actuarial accrued liability (AAL) | (b)-(a) Unfunded (overfunded) AAL (UAAL [OAAL]) | (a/b) Funded ratio | Covered payroll | UAAL (OAAL) as a percent of covered payroll |
|---|---|---|---|---|---|---|
| August 31, 2007 | — | $ 573,734 | 573,734 | — | 106,018 | 541.00% |

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 Employer Contributions

(Thousands of dollars)

| Year-end | Annual required contribution | Percentage contributed |
| --- | --- | --- |
| August 31, 2007 | $45,237 | 41.60% |

See accompanying independent auditors' report.

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

Supplemental Statements of Net Assets (City Format)

August 31, 2007 and 2006

(Thousands of dollars)

| | | 2007 | 2006 |
|---|---|---|---|
| Assets: | | | |
| Cash on deposit and on hold | $ | 51,692 | 6,611 |
| Equity in pooled cash and investments | | — | — |
| Equity in treasurer's account | | — | — |
| Investments | | — | — |
| Internal balances | | — | — |
| Amounts held by fiscal agent | | 6 | 86 |
| Notes receivable | | 48 | 106 |
| Taxes receivable | | — | — |
| Accounts receivable | | 221,635 | 243,143 |
| Allowance for doubtful accounts | | (150,231) | (168,889) |
| Interest and dividends receivable | | — | — |
| Due from other governments | | — | — |
| Restricted assets | | 277,139 | 135,625 |
| Inventories | | 147,770 | 149,438 |
| Unamortized loss and discount | | 58,818 | 60,972 |
| Other assets | | 55,982 | 76,383 |
| Property, plant, and equipment | | 1,681,313 | 1,620,791 |
| Accumulated depreciation | | (640,940) | (613,143) |
| Total assets | $ | 1,703,232 | 1,511,123 |
| Liabilities: | | | |
| Notes payable | $ | 94,600 | 100,000 |
| Vouchers and accounts payable | | 43,449 | 40,316 |
| Salaries and wages payable | | 2,797 | 4,771 |
| Accrued expenses | | 67,425 | 37,981 |
| Funds held in escrow | | — | — |
| Due to other governments | | — | — |
| Deferred revenue | | 20,411 | 12,815 |
| Current portion of long-term obligations | | 41,830 | 38,045 |
| Noncurrent portion of long-term obligations | | 1,176,368 | 1,016,993 |
| Unamortized gain and premium | | 33,051 | 20,797 |
| Total liabilities | $ | 1,479,931 | 1,271,718 |
| Net assets: | | | |
| Invested in capital assets, net of related debt | $ | (5,690) | (7,754) |
| Restricted for: | | | |
| Capital projects | | — | — |
| Debt service | | 105,005 | 95,989 |
| Community development projects | | — | — |
| Behavioral health programs | | — | — |
| Intergovernmental financing | | — | — |
| Emergency phone system | | — | — |
| Rate stabilization | | — | — |
| Unrestricted | | 123,986 | 151,170 |
| Total net assets | $ | 223,301 | 239,405 |

See accompanying independent auditors' report.

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

Supplemental Statements of Activities (City Format)

Years ended August 31, 2007 and 2006

(Thousands of dollars)

| | August 31, 2007 | | | | |
|---|---|---|---|---|---|
| | **Expenses** | **Charges for services** | **Operating grants and contributions** | **Capital grants and contributions** | **Total** |
| Gas services | $ (773,581) | 849,503 | 22,921* | — | 98,843 |
| Interest on debt | (52,146) | — | — | — | (52,146) |
| Unallocated depreciation | (36,380) | — | — | — | (36,380) |
| Other postemployment benefits | (26,421) | — | — | — | (26,421) |
| Total | $ (888,528) | 849,503 | 22,921* | — | (16,104) |

* Includes $13,073 of interest and other income and $9,848 of other operating revenues.

| | August 31, 2006 | | | | |
|---|---|---|---|---|---|
| | **Expenses** | **Charges for services** | **Operating grants and contributions** | **Capital grants and contributions** | **Total** |
| Gas services | $ (861,042) | 940,443 | 23,882* | — | 103,283 |
| Interest on debt | (51,799) | — | — | — | (51,799) |
| Unallocated depreciation | (34,725) | — | — | — | (34,725) |
| Total | $ (947,566) | 940,443 | 23,882* | — | 16,759 |

* Includes $8,518 of interest and other income and $13,525 of other operating revenues.

See accompanying independent auditors' report.

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

Supplemental Statements of Revenues, Expenses, and Changes in Fund Net Assets (City Format)

Years ended August 31, 2007 and 2006

(Thousands of dollars)

| | | 2007 | 2006 |
|---|---|---|---|
| Operating revenues: | | | |
| Charges for goods and services | $ | 840,105 | 929,961 |
| Sales of land and improvements | | — | — |
| Rentals and concessions | | — | — |
| Miscellaneous operating revenues | | 19,246 | 24,007 |
| Total operating revenues | | 859,351 | 953,968 |
| Operating expenses: | | | |
| Personal services | | 74,054 | 73,647 |
| Purchase of services | | 76,299 | 75,865 |
| Material and supplies | | 4,290 | 4,524 |
| Employee benefits | | 41,863 | 16,540 |
| Indemnities and taxes | | — | — |
| Depreciation and amortization | | 39,708 | 37,955 |
| Cost of goods sold | | 539,300 | 625,093 |
| Other | | — | — |
| Total operating expenses | | 775,514 | 833,624 |
| Operating income | | 83,837 | 120,344 |
| Nonoperating revenues (expenses): | | | |
| Operating grants | | — | — |
| Passenger facility charges | | — | — |
| Other income | | 1,262 | 1,203 |
| Interest income | | 11,811 | 7,316 |
| Debt service – interest | | (52,146) | (51,799) |
| Other expenses | | (60,868) | (60,305) |
| Total nonoperating expenses | | (99,941) | (103,585) |
| Income (loss) before transfers | | (16,104) | 16,759 |
| Transfer in | | 18,000 | 18,000 |
| Transfer out | | (18,000) | (18,000) |
| Capital contributions | | — | — |
| Change in net assets | | (16,104) | 16,759 |
| Net assets – beginning of period | | 239,405 | 222,646 |
| Net assets – end of period | $ | 223,301 | 239,405 |

See accompanying independent auditors’ report.

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

Supplemental Schedule of Interfund Transfers

Year ended August 31, 2007

(Thousands of dollars)

| | | |
|---|---|---|
| Due to the City, September 1, 2006 | $ | 3,000 |
| Accrued distributions | | 18,000 |
| Payments to the City | | (18,000) |
| Due to the City, August 31, 2007 | $ | 3,000 |

See accompanying independent auditors' report.