Tax Supported
New Issue

Philadelphia, Pennsylvania

Ratings

New Issue

Tax and Revenue Anticipation Notes, Series A of 2007–2008 .... F1+

Outstanding Debt

General Obligation Bonds .... BBB+

Rating Outlook .... Stable

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New Issue Details

Approximately $200,000,000 Tax and Revenue Anticipation Notes (TRANS), Series A of 2007–2008, are scheduled for negotiated sale on Aug. 1 via a syndicate led by PNC Bank. **Security:** The notes are secured by a pledge of, security interest in, and lien and charge on the taxes, revenues, or both to be received by the general fund of the city in fiscal 2008. **Purpose:** TRAN proceeds will be used to assist the city's cash flow during fiscal 2008.

■ Outlook

The assignment of Fitch's highest short-term rating to the TRANs reflects the strong note repayment structure and legal protections afforded noteholders, adequate coverage of both note repayment set-asides, and the availability of borrowable resources within the city's consolidated cash account. The set-aside structure requires 100% of principal to be deposited in an irrevocable trustee-held note fund by the end of May 2008, one full month in advance of note maturity. Interest is payable on June 27, 2008, three days before the June 30, 2008 maturity date.

In accordance with the Pennsylvania Intergovernmental Cooperation Authority (PICA) Act (the Act), the notes are secured by a pledge of, security interest in, and a lien and charge on the taxes, revenues, or both to be received by the general fund of the city. The trustee will perfect the security interest through a filing of financing statements as required by the state's Uniform Commercial Code (UCC). The security interest extends only to pledged receipts during fiscal 2008. However, the Act also requires the notes to be GOs of the city, meaning that any deficiencies must be made up in the subsequent year budget, which must be approved by PICA.

■ Rating Considerations

The 'BBB+' rating on the GO debt is based on the city's improved financial condition following deterioration at the beginning of the decade, which was the result of stagnant growth in recurring revenue sources that was outpaced by an escalating fixed-cost burden related to employee benefit and health care costs. The 'BBB+' rating also reflects the city's high debt levels and underfunded pension position, which is exacerbated by its policy of funding the minimum municipal obligation (MMO), which is less than the actuarially required contribution. Although the 8.75% assumed rate of investment return assumption is high, it was lowered from 9% effective fiscal 2007.

Fitch notes that the city performed better than its financial multiyear plan (MYP) projections from fiscal years 2005–2007, providing a level of confidence that plan assumptions are sufficiently conservative. However, much of the gains in revenues have been realized in the economically sensitive business privilege tax and real estate transfer tax. Several tax sources performed at above-budget levels in fiscal years 2005–2007, leading to an increase in reserve levels, although financial flexibility remains limited. Fitch remains concerned about vulnerabilities in the city's financial position, namely the continuation of a legislatively mandated schedule of tax cuts that will significantly reduce recurring revenues in coming years. The city will be required to cut expenditures or identify additional sources of funding to offset the impact of these cuts.

Economic indicators have recently shown improvement. Between May 2006 and 2007, the city's unemployment rate declined to 5.9% from 6.3%, although it remained above the respective state and national May 2007 rates of 5.3% and 4.3%. The employment base is heavily weighted toward education and health services jobs, with the University of Pennsylvania being the city's largest employer. Commercial and residential development projects, occurring mostly in the downtown area, including the construction of the Comcast Center, which is scheduled to open in fall 2008, will add 1.25 million square feet of office space and 32,000 square feet of retail space to the downtown market.

Philadelphia has borrowed for cash flow purposes since 1972. Short-term borrowing is necessary because a larger proportion of general fund revenues is received in the second half of the year while expenditures are weighted toward the first half of the year. The largest revenue sources include the wage tax at 31% of expected fiscal 2008 receipts and intergovernmental funds at 17%. For fiscal 2008, TRAN proceeds are budgeted at 5.2% of general fund receipts, the lowest level in at least 13 years and well below the 8.5% of receipts represented by the city's fiscal 2007 TRAN issuance, indicative of the city's improved liquidity position. Coverage of the May 30, 2008 principal impoundment by general fund receipts is projected to be a strong 3.3 times (x). Coverage of the interest-only payment is projected to be 44.2x.

Strengths

- Noteholders benefit from a first perfected security interest in all general fund taxes and revenues.
- Transparent and rigorous financial reporting and monitoring, both internally and by oversight officials.
- Solid coverage on note repayment dates.
- Demonstrated ability to meet financial projections has improved liquidity and reserve levels in recent years.

Risks

- Tightly balanced financial plan with limited flexibility.
- High debt levels and underfunded pension position.

Note Structure and Coverage

The notes are secured by a pledge of, security interest in, and lien and charge on the taxes, revenues, or both to be received by the general fund of the city. The trustee will perfect the security interest through a filing of financing statements, as required by the state's UCC. The security interest extends only to pledged receipts during fiscal 2008. However, the act also requires the notes to be GOs of the city, meaning that any deficiencies must be made up in the subsequent year's budget, which must be approved by PICA.

The note trust agreement, as well as commonwealth law, requires the trustee to notify the city of any deficiency in the note fund on a required deposit date. The set-aside structure requires 100% of principal to be deposited in an irrevocable trustee-held note fund by May 30, 2008, one full month in advance of note maturity. Interest is due on June 27, 2007, three days before maturity. General fund receipts are held in the city concentration account; pursuant to the trust agreement, the city has directed that the concentration account bank transfer the funds from the account directly to the trustee on the principal and interest impoundment dates.

If the city does not make up the deficiency by 10:00 a.m. on the following day, the trustee is required to take action to enforce the security interest. The most important of these actions is the requirement that the trustee must notify all government officials holding any amounts payable to the city's general fund. This would include any local revenues in the city's bank accounts, as well as any aid payable to the city by the commonwealth. Revenues of the school district and PICA, collected by the city's revenue department, are not available.

The loan authorization permitting issuance of these notes also allows for up to $50 million of additional notes to be issued in fiscal 2008. The additional notes would be on parity with the current offering as to the pledge of taxes and revenues but have no recourse against the note fund held by the trustee. If offered, the additional notes would marginally improve cash flow and coverage of the series A notes.

Philadelphia has borrowed for cash flow purposes since 1972. Short-term borrowing is necessary because a larger proportion of general fund revenues is received in the second half of the fiscal year, while expenditures are weighted toward the first half. The city pays the majority of its municipal pension contribution in July, the first month of the fiscal year. Wage, earnings, and net profit taxes on residents and nonresidents are the city's largest revenue source, constituting about 31% of projected receipts, and collections are evenly dispersed throughout the fiscal year. Intergovernmental aid, which is the second largest revenue source and accounts for about 17% of receipts, is received early and late in the fiscal year. The largest share of property and business privilege taxes, together making up 21% of cash flow, is received from February through May. The fiscal 2008 cash flow is based on the adopted budget.

The notes are budgeted at 5.2% of expected general fund revenues in fiscal 2008, the lowest level in at least the past 14 years and well below the 8.5% of receipts represented by TRANs in fiscal 2007. The reduction in the amount of the TRAN issuance reflects the city's improved liquidity position. The amount of the note issuance as a percentage of budget peaked at 17.8% in fiscal 1995. General fund receipts are projected to cover the May 30 principal payment by a strong 3.3x. Coverage on the June 27 interest payment date is projected to be 44.2x.

Pennsylvania statutes permit interfund borrowing between operating and capital funds. Philadelphia periodically advances cash to the capital fund and borrows from it to meet cash flow needs. All subsequent receipts of a borrowing fund are applied to repayment of any advance. The statutes also permit carryover of interfund loans from one fiscal year to the next, meaning the city could temporarily borrow from the capital fund to make its note set-aside requirements and repay the loan with a subsequent TRAN borrowing.

General Credit Characteristics

Debt

The city's debt burden is high, but debt-carrying charges are affordable, as amortization is slow. Philadelphia's approximately $6.7 billion of overall tax-supported debt creates per capita and debt-to-market value ratios that are among the highest in the urban U.S. These figures include overlapping debt of the coterminous school district and PICA bonds payable from a dedicated portion of the wage tax. Overall debt is $4,650 per capita and 17.5% of market value. Deducting $1.25 billion of outstanding pension obligation bonds (POBs) sold in the late 1990s reduces these ratios to $3,787 and 14.3%, respectively.

The fiscal years 2008–2013 capital improvement plan (CIP) totals $7.0 billion, $2.0 billion of which is to be funded by commonwealth and federal sources and the remainder by the city; $370 million of new tax-supported borrowing is anticipated over the life of the CIP. Given statutory tax-supported GO debt limitations, the city has only $210 million available GO debt capacity, indicating that it would need to issue through its authorities for additional general government needs.

Debt Statistics
($000)

Outstanding Debt	3,368,000
Less: Self Supporting Debt	18,800
Direct Debt	3,349,200
Overlapping Debt	3,385,890
Total Overall Debt	6,735,090
Debt Ratios	
Direct Debt per Capita ($)*	2,312
As % of Market Value**	8.7
Overall Debt per Capita ($)*	4,650
As % of Market Value**	17.5

*Population: 1,448,394 (2005 estimate).
**Market value: $38,501,000,000 (fiscal 2006).

The city's municipal pension system is now in a weaker funding ratio position than it was immediately after the sale of $1.3 billion of POBs in 1999. Proceeds from that bond sale boosted the actuarial funding level to 70% from nearly 50%. The funding level had dropped to 53% based on the most recent actuarial valuation completed for the close of fiscal 2005. Fitch considers funded ratios below 70% to be an indicator of fiscal stress.

The drop in the funded level is directly related to the city's policy of funding the MMO), which is less than the actuarially required contribution (ARC). The city had been contributing well above the MMO but dropped to that level beginning in fiscal 2004 as a result of budgetary strain. In fiscal 2007, the MMO payment was $400.5 million, about $84 million below the ARC. Pension funding requirements have continued to rise dramatically despite the change in the funding methodology to the MMO. City officials project that pension obligations will be $300 million greater in fiscal 2012 than in fiscal 2003, representing a jump to 10% from 7% of total obligations over that period.

On a positive note, beginning in fiscal 2007, the city reduced its investment return assumption to 8.75% from 9%. This rate is still well above the national norm of about 8%; the city is considering further reduction of the rate in future years. This change increased the city's fiscal 2007 pension payment by $19 million.

Finances

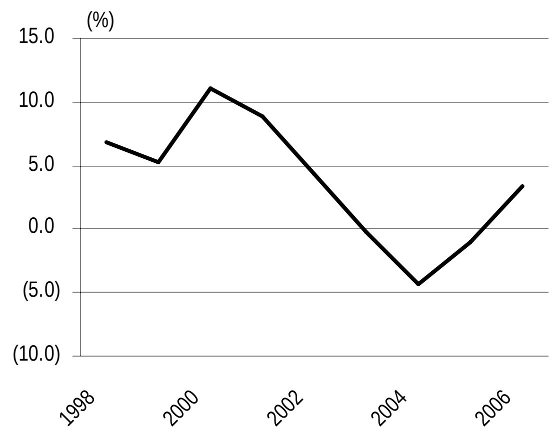
Philadelphia experienced extreme fiscal pressures in the early 1990s, partly from protracted population and job losses that began to accelerate in the late 1980s. PICA was established to oversee the city's financial recovery and issue deficit-financing bonds. With state oversight and assistance, the city made rapid and sustained improvements to its fiscal condition, including a decade of consecutive operating surpluses. The unreserved general fund balance peaked in fiscal 2000 at $295 million, nearly 11% of expenditures and transfers out.

Results between fiscal years 2000 and 2004 showed steady declines, partly because of weak revenue growth related to the recession, as well as tax cuts and spending that exceeded recurring revenues. The anticipated economic benefits and corresponding positive impact on recurring revenues of scheduled wage and business privilege tax reductions have lagged expectations. This softening of revenues, coupled with a growing fixed-cost burden, led to a structural imbalance requiring an increased use of reserves for normal operations and a significant deferral of pension expense. Philadelphia posted its second consecutive accumulated GAAP deficit in fiscal 2004. The elimination of a financial cushion also strained liquidity.

Financial results improved in fiscal years 2005–2007, as several tax revenue sources performed better than budgeted levels. The fiscal years 2007–2012 MYP projected an $84 million budgetary basis general fund balance at the close of fiscal 2007; officials now anticipate that the actual fund balance will be approximately $215 million. This represents a drawdown from the $254 million budget basis fund balance recorded in fiscal 2006; however, fiscal 2007 results reflect an unbudgeted transfer of $30 million of operating funds to the capital budget. Better than budgeted results in fiscal years 2005–2007 were mainly due to positive variance in wage, business privilege, and real estate transfer tax receipts. Audited results for fiscal 2006 showed a positive GAAP basis general fund unreserved fund balance for the first time since fiscal 2002.

Fitch notes that the city's ability to outperform MYP projections in fiscal years 2005–2007 provides a level of confidence that MYP revenue projections are sufficiently conservative. However, the positive performance was mostly related to above-budget results in economically sensitive and highly volatility tax revenue sources, leading to concern regarding whether the positive variances are sustainable. Given that, Fitch believes the 2008–2012 MYP contains less speculative revenue items than in past years, which somewhat offsets concerns related to the potential for decline in the real estate transfer and other economically sensitive tax revenue sources. The fiscal years 2008–2012 MYP calls for a budget basis fund balance of $46.6 million at the close of fiscal 2012, which represents a slight amount of financial flexibility; appropriations are projected to be $3.8 billion in fiscal 2012.

Unreserved Fund Balance as % of Spending and Transfers Out
(Audited Fiscal Years Ended June 30)



Over the longer term, there is concern about the city's ability to identify expenditure reductions or increase recurring revenues to offset the planned schedule of wage and business privilege tax cuts, including a wage tax credit program for low-income citizens. At issue is whether these tax cuts, which will have an escalating negative impact on recurring revenues, are financially sustainable for the city, which has already made significant reductions in its expenditure base to offset previous cuts. The impact of the tax cuts was $25 million in fiscal 2007 and is expected to escalate to $50 million in fiscal 2011.

Future vulnerabilities in the MYP include risk related to labor costs. Contracts with the police and fire unions expired at the close of fiscal 2007. The city is currently involved in litigation regarding the arbitration settlements awarded to the unions related to city contributions for health insurance costs in fiscal 2007. Contracts with two additional large municipal employee unions expire at the close of fiscal 2008. The MYP does not reflect wage increases beyond those included in current labor contracts and, as such, does not include wage increases in fiscal years 2009–2012. In fiscal 2006, personnel costs accounted for 58% of general fund appropriations.

In the past, the city has provided significant financial support for the city-owned Philadelphia Gas Works (PGW). In recent years, PGW's constrained financial position called into question MYP assumptions that PGW will be able to repay a $45 million loan made by the city or to recommence making its $18 million return on investment payment. The MYP currently contemplates that PGW will pay back the loan in August 2008 and recommence making the $18 million payment in fiscal 2011.

Fitch believes that the financial condition of the utility has improved in recent years, largely due to improvements in management practices and favorable regulatory actions that have led to an increase in historically low collection rates. In December 2006, PGW filed for a $100 million base rate increase with the Public Utility Commission, which will rule on the rate increase by September 2007. The funds provided by this increase in base rates would be used to establish an adequate level of working capital and enable the utility to repay the city loan on schedule.

■ Economy

Philadelphia and its suburbs are the center of the commonwealth's economy. The city has lost population to its suburbs over the past 40 years but remains an important center for business, finance, health care, higher education, and culture in the Northeast.

City job growth continues to falter, with total employment down 2.2% between 2001 and 2006; however, wage tax receipts grew by 2.4% annually between 2003 and 2007, with the strongest growth occurring in the construction, telecommunications, professional services, real estate, and financial services sectors. Unemployment rates remain above state and national levels but declined year over year between May 2006 and 2007, to 5.9% from 6.3%. Income levels are slightly below average; per capita personal income in 2005 was 78% of that of the commonwealth and 77% of the national figure.

The recent passage of casino gaming legislation by the commonwealth presents additional tourism opportunities and other benefits to the city. The city will be host to two casino gaming operations. In addition, the state is funding a significant expansion of the city's convention center.