MOODY'S
INVESTORS SERVICE

New Issue: **MOODY'S DOWNGRADES THE CITY OF PHILADELPHIA (PA) TO A2 FROM A1, AFFECTING $3.85 BILLION IN OUTSTANDING GO AND PARITY DEBT; OUTLOOK IS STABLE**

Global Credit Research - 17 Nov 2010

A2 RATING ASSIGNED TO SERIES 2010A AND B BONDS

Municipality
PA

Moody's Rating

ISSUE		RATING
General Obligation Bonds, Series 2010B (Federally Taxable - Issuer Subsidy - Build America Bonds)		A2
Sale Amount	$69,000,000	
Expected Sale Date	11/22/10	
Rating Description	General Obligation	
General Obligation Bonds, Series 2010A (Tax-Exempt)		NA
Sale Amount	$199,000,000	
Expected Sale Date	11/22/10	
Rating Description	General Obligation	

Opinion

NEW YORK, Nov 17, 2010 -- Moody's Investors Service has downgraded to A2 from A1 the rating on City of Philadelphia's $3.8 billion in general obligation bonds and unconditional General Fund debt obligations. At this time, Moody's has also assigned an A2 rating to the city's $199 million General Obligation Bonds, Series 2010A and $69 million General Obligation Bonds, Series 2010B (Federally Taxable - Issuer Subsidy - Build America Bonds). Approximately $135.3 million of the Series A bonds will be used to refund portions of the city's Series 1998 and 2001 bonds for a net present value savings of 6.5% of refunded principal. The remaining $63.65 million and the Series B bonds will be used to finance the city's ongoing capital improvement plan.

RATINGS RATIONALE

The downgrade to A2 reflects continued weakness of the city's finances, which had improved from 2005 to 2007, but deteriorated in fiscal 2008 and 2009, and improved in 2010, but continue to face challenges in the coming few years. Although fiscal 2010 results are favorable, General Fund balance remains negative, both on a budgetary and GAAP basis, and we believe the city has little budgetary margin over its five-year plan which includes significant repayment of deferred pension contributions in 2013 and 2014. In response to the significant financial stresses that began in fiscal 2008, city officials created a fiscal recovery plan that included a temporary sales tax increase and the pension deferral in fiscal 2010 and 2011; the plan gained the required approval from the Commonwealth of Pennsylvania legislature at the end of September 2009, allowing for the sales tax increase to begin at the beginning of October. Additional revenue and expenditure reductions in fiscal 2010 resulted in surplus operations, although these were diminished from previous forecasts due to a late state aid payment of approximately $70 million; much of that revenue has since been received.

The fiscal 2011 budget, which includes a property tax increase and the full-year effect of the sales tax increase, projects an additional surplus in fiscal 2011 with the expectation that the city will return to a positive, albeit low, General Fund balance position. Throughout the plan, financial flexibility remains relatively weak, providing little cushion for contingencies. Moody's believes that growth in the local economy will remain weak, affecting wage tax collections and the potential for mid-year cuts in aid from the Commonwealth of Pennsylvania (G.O. rated Aa1 with a negative outlook).

The A2 rating also reflects the city's ongoing economic challenges, weak demographics and high unemployment, modest property value growth, and a heavy burden of tax-supported debt. Moody's believes the city's weak credit characteristics are mitigated by the fact that it is subject to a state oversight board, with well-established five-year planning and quarterly monitoring procedures in place.

SURPLUS OPERATIONS IN FISCAL 2010 AFTER COMMONWEALTH APPROVES CITY'S RECOVERY PLAN; GENERAL FUND BALANCE EXPECTED TO RETURN TO POSITIVE BY THE END OF FY 2011

After three years of surplus operations that increased reserves to satisfactory levels, the city returned to deficit operations in fiscal 2008 and fiscal 2009, and has returned to surplus operations again in fiscal 2010. The previous surpluses occurred despite a program of gradual reduction in the city's wage tax rate in place since 1995, which was intended to enhance Philadelphia's competitive position. Through fiscal 2009, the rate had been reduced by approximately 16%. Given the current financial challenges, the city is delaying the city-funded wage tax reductions until 2014.

Philadelphia's responsibility for both city and county government services, a trend of loss of middle-class residents, high tax rates and sluggish tax base growth have historically combined to present significant challenges to the maintenance of balanced financial operations. The city's finances are subject to oversight by a state body, the Pennsylvania Intergovernmental Cooperation Authority (PICA - special tax rating of Aa2 with a stable outlook), with well-established five-year planning and quarterly monitoring procedures in place. State oversight will continue until long-term bonds issued by PICA to finance the city's early 1990's accumulated operating and capital deficits are fully retired (scheduled final maturity is in 2023).

In fiscal 2007, the city experienced its third year of surplus operations of approximately $180 million (on a GAAP basis), increasing the total General Fund balance to $488 million (a healthy 14.8% of General Fund revenues) and unreserved General Fund balance to $153 million (a narrow 3.9% of General Fund revenues) on a GAAP basis; on a budgetary basis, General Fund balance grew to $297 million (8.0% of General Fund revenues). While real estate transfer taxes were lower than the previous year, they were still ahead of budget, and business privilege and wage taxes remained strong in fiscal 2007. Although most other revenues were close to or greater than budget in fiscal 2008, business privilege tax revenues were below budgeted figures by nearly $40 million. Additionally, state reimbursements were approximately $10 million below budget and another $23 million was received after the end of the fiscal year accrual period. The city also experienced increased employee costs related to health care collective bargaining agreement settlements. Although the city budgeted to use approximately $87 million of General Fund balance, by fiscal year-end it had drawn down $178 million, reducing the budgetary basis General Fund balance to $119 million (a narrow 3.0% of General Fund revenues). On a GAAP basis, total General Fund balance fell to $234 million (an adequate 6.3% of General Fund revenues) and unreserved General Fund balance fell to -$24 million (-0.7% of General Fund balance).

The city's fiscal 2009 adopted budget, developed in conjunction with its 2009-2013 five-year plan, anticipated using $136 million of General Fund balance, under the assumption that fiscal 2008 would end with General Fund balance at $182 million, reducing reserves to $62.5 million (a narrow 1.6% of budgeted General Fund revenues). The budget assumed moderate growth in the business privilege tax. Soon into the fiscal year, the city revised its revenue forecasts downward, and outlined anticipated increases in the pension contributions due to dramatic decline in pension assets amid poor investment performance. The city outlined a $1 billion shortfall in its five-year plan and developed a plan to reduce the budget gap, which included the delay in scheduled city-funded wage tax reductions until 2014 as well as various expenditure cuts, such as a reduction in force, employee furloughs, a hiring freeze, reduced overtime, and the reduction of hours at libraries and the closure of pools, although most were reopened with private funding. At the time, the city still expected reserves to fall to approximately $41 million by the end of fiscal 2009. In January 2009, as revenues continued to deteriorate and the pension fund's investment performance further weakened, the city announced a shortfall of an additional $1 billion across the five-year plan. The city projected the fiscal 2009 deficit to reach $180 million, reducing budgetary General Fund balance to -$60 million (-1.5% of General Fund revenues). The city ended the year with a budget deficit $257 million, reducing General Fund balance to approximately -$138 million (-3.5% of General Fund revenues), on a budgetary basis, including a late state aid payment $55 million that was remitted in fiscal 2010. On a GAAP basis, total General Fund balance fell to -$76 million (-2.1% of General Fund revenues) and unreserved General Fund balance fell to -$275 million (-7.6% of General Fund revenues).

The fiscal 2010 budget built on expenditure savings and efficiencies from the plan developed in fiscal 2009. The new plan included gap-closing measures such as additional staff reductions, increases in certain fees, savings in the employee pension and health benefit areas, and other, mostly expenditure-side adjustments. The plan also included two changes that helped to close the gap in fiscal 2010 and over the five-year plan, both of which received the approval of the Pennsylvania legislature in September 2010. One was a temporary increase in the city's sales tax by 1% for five years, the second involved several changes to pension fund assumptions, which extend the amortization of the city's unfunded liability to 30 years from 20. The city also deferred a portion of its required pension payments in fiscal 2010 and 2011, generating $150 million in savings for 2010 and $80 million in fiscal 2011. The city expects to repay the deferred pension payments in fiscal 2013 and 2014, as shown in the five-year plan. These enhancements contributed to a fiscal 2010 budget surplus that was projected to be of $86 million earlier in the year, but was reduced to $23 million due to a $70 million late state aid payment, much of which the city did receive in October, too late to accrue into fiscal 2010. At the end of fiscal 2010, the General Fund balance was -$114 million (-3.1% of revenues) on a budgetary basis; on a GAAP basis, total General Fund balance was -$133 million (-3.75 of revenues) and undesignated fund balance was -$252 million (-6.9% of revenues).

The fiscal 2011 budget includes a property tax increase of 10% (inclusive of the portion that goes to the Philadelphia School District - G.O. underlying rating of Ba1/stable) that is projected to net the city approximately $100 million in additional revenues. The city will also benefit from a full year of the increased sales tax, and a variety of other revenue and expenditure enhancements that is projected to result in another surplus of $144 million (including the late state aid payment), increasing budgetary General Fund balance to a projected $29.6million, positive for the first time since fiscal 2008. General Fund balance is projected to remain positive through the 5-year plan, although fund balance levels will remain narrow, never going above $70 million, which will leave little margin for the city to deal with contingencies. The city has also no payroll increases (other than pension and benefit costs) budgeted after fiscal 2012, but has budgeted for moderate growth in revenues.

LARGE, DIVERSE ECONOMY; WEAK LONG-TERM DEMOGRAPHIC AND ECONOMIC TRENDS

Philadelphia is an economic center for a large, multi-state region, with a diverse, significantly-sized tax base of over $60 billion, with a stabilizing health care and higher education presence. The city has experienced a long trend of industry and population loss since 1950, with a particularly sharp economic retreat hitting in the late 1980's and early 1990's. The late 1990's saw a resumption of growth, with employment up 5.7% between 1998 and 2001. After a decline between 2001 and 2003, reflecting the last slowdown in the national economy, modest growth in employment resumed, with growth of about 1.1% in 2005, 0.9% in 2006, 0.7% in 2007 and 0.2% in 2008. In 2009, annual employment growth reversed sharply, with a 3.3% drop in employment levels for the year. Year-over-year employment losses continued through September, although the magnitude of job losses seem to be leveling off, and in September, Philadelphia had a preliminary 0.4% reduction in employment, the smallest loss in employment since December 2008. Unemployment rates have remained high (11.8% in September 2010), however. Manufacturing has continued to decline in importance, and as of 2005, diversified services account for 54% of total employment (or more than 60% including the finance/insurance/real estate sector). Population loss during the 1990's was just over 4%, although this was only about half the loss that had been estimated prior to the 2000 census count. With an estimated 1.54 million residents, the city is the nation's sixth most populous.

Resident wealth indicators are low, with per capita and median family incomes only about 77% and 74% of the national median, respectively, and 23% of residents below the poverty level. A relatively large portion of the city's job base is in low-paying sectors, with healthcare, social services, and state and local government accounting for about 30% of total jobs (a large share of which are likely held by city residents, as opposed to commuters). The city's taxable base has grown modestly over the past decade, averaging 3.2% growth annually since 2004. The $61 billion tax base does benefit from significant diversity, with the 10 largest tax payers comprising less than 5% of total valuation.

SIGNIFICANT DEBT BURDEN; MODERATE VARIABLE RATE EXPOSURE

Philadelphia's total tax-supported debt is approximately $7.2 billion, inclusive of overlapping school district debt. The ratio of direct debt to full property value is high at 7.2%, climbing to 11.8% when overlapping debt is included, one of the highest ratios among the nation's 10 largest cities. The city's high debt burden reflects its dual city and county responsibilities, special efforts to promote economic development (e.g. stadiums, cultural assets, convention center and blight remediation), the PICA deficit-funding bonds, and a $1.3 billion pension bond issued ten years ago. Additionally, the school district has faced significant capital needs associated with its aging facilities. With city G.O. bond issuance tightly constrained by a debt cap in the Pennsylvania Constitution, we expect there to be continued use of non-G.O. debt structures going forward.

The city has variable rate exposure representing approximately 10% of its total general obligation and unconditional General Fund debt. In conjunction with the Series 2007B variable rate bonds, the city entered into a fixed payer swap with Royal Bank of Canada (RBC - Long-term Issuer Rating of Aaa, on watch for downgrade) for a notional amount equal to the original Series B issuance amount. Last year, the city refunded the Series 2007B bonds, issuing $100 million as variable rate and the remaining portion as fixed rate debt. A portion of the RBC swap was terminated and the notional amount reduced to $100 million, equal to the new variable rate principal. The city entered into two fixed payer interest rate swaps in conjunction with the Philadelphia Authority for Industrial Development's (PAID) Series 2007B bonds, one with JP Morgan Chase Bank, N.A. (Senior Unsecured rating of Aa3 with a negative outlook) for a notional amount of $217.3 million and one with Merrill Lynch Capital Services, Inc. (MLCS) for a notional amount of $72.4 million, which combined equals the PAID 2007B issuance amount. In all cases, the city (either directly or through PAID) makes semi-annual payments based on a fixed rate and the counterparties make monthly payments based on the SIFMA Municipal Swap Index. The city is also a party to a basis swap, through PAID, with MLCS originally for a notional amount of $298 million, now currently outstanding with a notional amount of $194 million. Under the swap, the city makes payments based on SIFMA and receives payments based on 67% of one-month LIBOR plus 20 basis points.

In the case of all of the swaps, regularly scheduled payments are General Fund obligations of the city. Early termination is optional for the city only. Termination events include deterioration of either the city or the counterparty's rating falling below Baa3. Any termination payment by the city would be subordinate to the general obligation debt service payments.

The principal methodology used in this rating was General Obligation Bonds Issued by U.S. Local Governments published in October 2009.

REGULATORY DISCLOSURES

Information sources used to prepare the credit rating are the following: parties involved in the ratings, parties not involved in the ratings, public information, confidential and proprietary Moody's Investors Service information, and confidential and proprietary Moody's Analytics information.

Moody's Investors Service considers the quality of information available on the credit satisfactory for the purposes of assigning a credit rating.

Outlook

Moody's rating outlook for Philadelphia is stable, reflecting indications of financial stability at weaker reserve levels, projected return to positive fund balance levels, and oversight by a state-appointed entity , including 5-year forecasting.

What could make the G.O. rating go UP:

- Continued implementation of the recovery plan that results in financial operations and fund balance improvement well above the current levels

- Ability to navigate significant additional pension contributions and reduce unfunded pension liablity

What could make the G.O. rating go DOWN:

-A return to deficit operations in fiscal 2011 or in subsequent years

- Stagnant or further weakened reserve levels

KEY STATISTICS

2008 estimated population: 1.54 million

2009 full value: $61.0 billion

Full value per capita: $42,165

1999 Per capita income as % of state: 79.1%

1999 Median family income as % of state: 75.3%

Direct debt burden: 7.2%

Total debt burden: 11.8%

Payout of principal (10 years): 37.6%

FY2010 General Fund balance: -$133 million (-3.7% of General Fund revenues)

FY2010 Unreserved General Fund balance: -$251 million (-6.9% of General Fund revenues)

FY2010 General Fund balance (budget basis): -$114 million (-3.1% of General Fund revenues)

Post-sale parity debt outstanding: $3.8 billion

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