MOODY'S INVESTORS SERVICE

New Issue: **MOODY'S ASSIGNS MIG 1 RATING TO CITY OF PHILADELPHIA'S (PA) $285 MILLION TRANS**

Global Credit Research - 13 Jul 2010

AFFIRMS A1 LONG-TERM RATING AND NEGATIVE OUTLOOK ON APPROXIMATELY $4.6 BILLION OF G.O.-BACKED DEBT OUTSTANDING

Municipality
PA

Moody's Rating

ISSUE	RATING
Tax and Revenue Anticipation Notes, Series A of 2010-2011	MIG 1

Sale Amount	$285,000,000
Expected Sale Date	07/19/10
Rating Description	Tax and Revenue Anticipation Notes

Opinion

NEW YORK, Jul 13, 2010 -- Moody's Investors Service has assigned a MIG 1 rating to the City of Philadelphia's $285 million Tax and Revenue Anticipation Notes, Series A of 2010-2011, which mature on June 30, 2011. Issued to fund temporary cash flow imbalances in the city's General Fund during the upcoming fiscal year, the notes are secured by a pledge of taxes and revenues to be received by the General Fund during fiscal 2011 (ending June 30). The city has covenanted to make deposits into a dedicated repayment fund held by the note trustee on May 27, 2011 (full principal amount) and June 28, 2011 (full interest requirement). Concurrently, we have affirmed the A1 rating and negative outlook assigned to the city's $4.6 billion of general obligation bonds and unconditional General Fund debt obligations.

The best-quality short-term note rating reflects (i) the city's historically strong financial management practices and state-board oversight, despite weakened financial operations in fiscal 2008 and 2009, (ii) its long and successful track record as an issuer of short-term notes, (iii) improvement in cash flows in fiscal 2010; and (iv) cash flow projections for fiscal 2011 that indicate an ending cash balance of a narrow $72 million in the General Fund after note repayment, but an additional $238 million of cash projected to be available in the Capital Improvement Fund, Grants Revenue Fund and other funds outside the General Fund.

The A1 rating and negative outlook reflect ongoing weakness of the city's finances, which had improved from 2005 to 2007, but weakened in fiscal 2008 continued to deteriorate in fiscal 2009. In response to these financial challenges, city officials created a fiscal recovery plan that includes a temporary sales tax increase and delays a portion of two years of pension contributions, which required approval by the Commonwealth of Pennsylvania legislature. The approval was granted 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, and 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. Despite these improvements, Moody's believes risks to the city's financial stability remain, given continued weakness in the labor market which could affect wage tax collections and the potential for mid-year cuts in aid from the Commonwealth of Pennsylvania (G.O. rated Aa1/negative outlook). The A1 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.

NEGATIVE GENERAL FUND CASH BALANCES IN JUNE 2010 SUPPLEMENTED BY SUFFICIENT CASH IN ALTERNATE FUNDS

The city is a regular issuer of temporary cash flow notes, reflecting its essentially level monthly expenditure patterns and uneven revenue collections. For example, the majority of receipts from the property tax and business privilege tax are collected in the second half of the fiscal year. In addition, state aid reimbursements for human services programs normally delay cash flow receipts to the city. The city typically issues between $275 million and $375 million in tax and revenue anticipation notes, but is borrowing slightly less this year, as it did in fiscal 2008 ($200 million) and fiscal 2009 ($275 million) when the city's cash balances had been higher. The city ended fiscal 2010 with cash balances that were negative in the General Fund, with cash in its other funds providing liquidity. The General Fund cash balance at the end of the year was -$30.6 million, or -0.8% of General Fund cash receipts. City officials have indicated that this was due to late aid payments from the commonwealth due to issues related to new systems for billing the commonwealth for aid. City management has indicated that they are making billing for aid a priority and expect to avoid similar problems in the future.

The city's fiscal 2011 cash flow projections indicate an expected ending General Fund cash balance in June 2011, after note repayment, of $72 million, a considerable improvement from the negative opening balance. The ending balance represents a narrow 1.8% of General Fund cash receipts anticipated during the year after note repayment, a narrow cushion to absorb risks in the revenue and expenditure forecasts. Prior to fiscal 2008, the city's cash forecasts have been fairly reliable, reflecting strong budgetary practices, final cash balances for fiscal years 2008 through 2010 were significantly below original projections, reflective of ongoing weakness in local revenues in fiscal 2008 and 2009 due to the economic downturn, and the aforementioned delay in commonwealth aid in fiscal 2010. There is additional risk to the city's projections for fiscal 2011 commonwealth aid given that Pennsylvania budgeted for an extension of the portion of the federal stimulus that provided Medicaid matching funds (FMAP) although this has not yet occurred.

CASH IN OTHER FUNDS PROVIDES ADEQUATE CUSHION

The city projects an additional $238 million of cash to be available in other funds as of the end of June 2011. Thus, on a consolidated cash basis, the city projects an ending balance at June, 2011, after note repayment, of $309 million, which represents a satisfactory 8.0% of total anticipated receipts for the year. The majority of the additional cash ($164.4 million) is projected be in the Capital Improvement Fund. The balance of the projected additional cash resides in a variety of other funds, including a Grants Revenue Fund, which is projected to have $40 million at the end of the year, although that fund has typically been above projections in past years.

RETURN TO SURPLUS OPERATIONS IN FISCAL 2010 AFTER COMMONWEALTH APPROVES CITY'S RECOVERY PLAN; PROJECTED ADDITIONAL SURPLUS IN FISCAL 2011

After three years of surplus operations that increased reserves to satisfactory levels, the city returned to deficit operations in fiscal 2008 and ran another operating deficit in fiscal 2009. 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 has delayed the 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), 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 2015 as well as various expenditure cuts, such as a reduction in force, employee furloughs, a hiring freeze, reduced overtime, and closure of libraries and pools. At the time, the city still expected reserves to fall to approximately $41 million by the end of fiscal 2009. In January, 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 required the approval of the Pennsylvania legislature, and which were received in September 2010. One is a temporary increase in the city's sales tax by 1% for five years, which generated approximately $77 million in additional revenue in fiscal 2010 and $550 million across the five-year plan. The second involves several changes to pension fund assumptions, which are extending the amortization of the city's unfunded liability to 30 years from 20. Also, the city is deferring 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 with the additional revenue from the increased sales tax. These enhancements contributed to a projected fiscal 2010 budget surplus of $86 million, increasing General Fund balance to -$52 million (-1.4% of General Fund 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 will 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 $88 million, increasing budgetary General Fund balance to $36 million, 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 $75 million.

WEAK LONG-TERM DEMOGRAPHIC AND ECONOMIC TRENDS, SOME IMPROVEMENT INDICATED

Philadelphia 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 May, although the magnitude of job losses seem to be leveling off, and in May, Philadelphia had a preliminary 0.9% reduction in employment, the smallest loss in employment since December 2008. Unemployment rates have continued to grow (11.3% in March 2010 vs. 9.4% in March 2009), 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 $7.4 billion, inclusive of overlapping school district debt. The ratio of debt to full property value is high at 12.1%, 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 sold in the early 1990's (subsequently refunded), 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 8% 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) 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. (Long-term Issuer Rating of Aa1) 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.

MOST RECENT RATING ACTION AND PRINCIPAL METHODOLOGY

The last rating action was on October 20, 2009 when a MIG 1 was assigned to Philadelphia's Tax and Revenue Anticipation Notes, Series B of 2009-2010.

The principal methodology used in the rating the City of Philadelphia's TRAN issue was "Short-term Cash Flow Notes," which can be found at www.moodys.com in the Credit Policy & Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Credit Policy & Methodologies directory.

Outlook

Moody's rating outlook for Philadelphia is negative, reflecting two years of operating deficits, negative General Fund balance, and continued weak financial operations. Moody's will continue to monitor the city's recovery efforts through fiscal 2011 and beyond.

What could make the G.O. rating go UP (removal of the negative outlook):

- Continued implementation of the recovery plan that results in strengthened financial operations and fund balance improvement

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

- Financial deterioration in fiscal 2011 resulting in a reversal of positive results in fiscal 2010

KEY STATISTICS

2007 estimated population: 1.45 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: 7.5%

Total debt burden: 12.1%

Payout of principal (10 years): 42.1%

FY2009 General Fund balance: $234 million (6.3% of General Fund revenues)

FY2009 Unreserved General Fund balance: -$274.6 million (-7.6% of General Fund revenues)

FY2009 General Fund balance (budget basis): -$138 million (-3.6% of General Fund revenues)

Post-sale parity debt outstanding: $4.6 billion

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