Moody's Investors Service

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New Issue: Philadelphia Municipal Authority, PA

MOODY'S AFFIRMS THE CITY OF PHILADELPHIA'S (PA) Baa1 RATING AND REVISES OUTLOOK TO NEGATIVE; $4.3 BILLION IN OUTSTANDING GO AND PARITY DEBT AFFECTED

Baa1 RATING ASSIGNED TO PHILADELPHIA MUNICIPAL AUTHORITY'S (PA) $94.22 MILLION BONDS BASED ON UNCONDITIONAL PLEDGE OF CITY TO PAY DEBT SERVICE

Municipality
PA

Moody's Rating

ISSUE	RATING
Lease Revenue Bonds, Series 2009	Baa1

Sale Amount	$94,220,000
Expected Sale Date	06/15/09
Rating Description	Lease Rental Bonds

Opinion

NEW YORK, Jun 12, 2009 -- Moody's Investors Service has assigned an underlying Baa1 rating with a negative outlook to the Philadelphia Municipal Authority's (PA) $94.22 million Lease Revenue Refunding Bonds, Series 2009. The bonds are secured by unconditional General Fund payments made by the City of Philadelphia under a Prime Lease with the authority, whose payments represent the ultimate security for the bonds. Concurrently, Moody's has affirmed the Baa1 rating on the City of Philadelphia's $1.32 billion in general obligation debt and $3.0 billion in other unconditional General Fund obligations and revised the outlook to negative.

The negative outlook reflects continued weakening of the city's finances, which had improved from 2005 to 2007, but weakened in fiscal 2008 and are projected to further deteriorate in fiscal 2009. Like other major cities, Philadelphia faces ongoing financial challenges in its fiscal 2010 budget and beyond, driven by the current economic downturn. In response, city officials have created a fiscal recovery plan that includes a sales tax increase and delays both short- and long-term pension contributions. However, the plan requires approval by the Commonwealth of Pennsylvania legislature, which may occur after the start of the fiscal year. Moody's believes that without timely legislative approval Philadelphia will face considerably more difficult challenges closing at least its fiscal 2010 budget gap and may be precluded from enacting certain contingencies, including increasing taxes. The Baa1 rating also reflects the recessionary economy, 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.

FINANCES CONTINUE TO DETERIORATE IN FISCAL 2009; PLAN TO BALANCE FISCAL 2010 AND BEYOND BALANCED NEEDS COMMONWEALTH APPROVAL

After three years of surplus operations that increased reserves to satisfactory levels, the city returned to deficit operations in fiscal 2008 and is expected to run an additional operating deficit in fiscal 2009. The 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 temporarily ceased the wage tax reductions, delaying them until 2015.

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 response to recent fiscal challenges, the city has forecasted revenue cautiously, added modest contingency reserves, and included other smaller layers of cushion in its annual budgets.

In fiscal 2007, the city experienced its third year of surplus operations of approximately $180 million (on a GAAP basis), increasing 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 the 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 the current 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 expects to run a deficit in fiscal 2009 of approximately $180 million, reducing budgetary General Fund balance to -$60 million (-1.5% of General Fund revenues).

The fiscal 2010 budget approved by the City Council builds on expenditure savings and efficiencies from the plan developed earlier in fiscal 2009. The new fiscal recovery plan adds additional gap-closing measures, including further staff reductions, increases in certain fees, savings in the employee pension and health benefit areas, and other, mostly expenditure-side adjustments. Two changes that will significantly close the gap in fiscal 2010 and over the five-year plan require approval of the Pennsylvania legislature. One is a temporary increase in the city's sales tax by 1% for five years, which is projected to generate $106 million in additional revenue in fiscal 2010 and $581 million in total across the five-year plan. The second involves several changes to pension fund assumptions, including a proposed lowering of assumed return on pension investments by 0.5%, smoothing losses over ten years as opposed to five, and extending the amortization of the city's unfunded liability to 30 years from 20. Also, the city is requesting a two-year payment deferral of part of its required payments in fiscal 2010 and 2011, which will generate $150 million in savings for 2010 and $80 million in fiscal 2011. The city expects to repay the deferred pension payments with the additional revenue from the increased sales tax. With these enhancements, the fiscal 2010 budgeted surplus is approximately $145 million, increasing budgetary General Fund balance to $85 million (a narrow, but positive 2.3% of General Fund revenues); General Fund balance through the life of the plan would remain positive, falling to a low of $36.5 million in fiscal 2013.

Unless the commonwealth approves those two changes, the city will face a fiscal 2010 budget gap of $111 million. Given that a decision is not expected to be made prior to the beginning of the fiscal year, an increase in the property tax would not be possible in fiscal 2010, limiting Philadelphia's options for further budget balancing in fiscal 2010. Moody's expects the city to be significantly challenged to find additional expenditure cuts and revenue enhancements to balance fiscal 2010 should approval not be forthcoming, and the negative outlook reflects that expectation.

WEAK LONG-TERM DEMOGRAPHIC AND ECONOMIC TRENDS EXACERBATED BY RECESSION

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 slowdown in the national economy, modest employment increases resumed, with growth of about 1.1% in 2005, 0.9% in 2006, and 0.7% in 2007. Although employment continued to grow for 2008 (overall annual growth was 0.2%), employment growth halted in October and turned negative in every month from November through April, which is showing a preliminary year-over-year loss of employment of 2.7%, following 1.8% and 2.2% drops in February and March respectively. Unemployment has risen to 9.7% (March, 2009) above state (8.2%) and national (9.0%) medians. Moody's Economy.com projects Philadelphia's economic recovery to be slow, with job growth returning only in the latter half of 2010 and full employment not returning until 2012. Even prior to the current recession, manufacturing continued to decline in importance, and as of 2005, diversified services accounted 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 1.45 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 Philadelphia'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 2.8% growth annually since 2002. The approximately $60 billion tax base does benefit from significant diversity, with the 10 largest tax payers comprising less than 5% of total valuation.

SIGNIFICANT DEBT BURDEN; SOME VARIABLE RATE EXPOSURE

Including this issue, Philadelphia's total tax-supported debt is approximately $7.6 billion, inclusive of overlapping school district debt. The ratio of debt to full property value is high at 12.4%, 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, 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, there will likely be continued use of non-G.O. debt structures going forward.

The city has variable rate exposure representing approximately 13.0% of its total general obligation and unconditional General Fund debt. In conjunction with the Series 2007B bonds, the city entered into a fixed payer swap with Royal Bank of Canada (RBC - Issuer Rating of Aaa) for a notional amount equal to the Series B issuance amount. The city is 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. (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 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. 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 2006, approximately $105 million of the swap was converted so that the city receives payments based on 63% of five-year LIBOR.

In the case of all of the swaps, regularly scheduled payments are parity with the general obligation debt 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. Total potential termination payments are currently assessed at $47 million for the city. A termination payment by the city would be subordinate to the general obligation debt service payments. The city is currently planning a refunding of the Series 2007B bonds with a combination of fixed and variable rate debt, and terminating a portion of the swap, which will mitigate the city's exposure.

BONDS SECURED BY UNCONDITIONAL CITY PAYMENTS

The bonds are limited obligations of the authority, ultimately secured by lease rental payments from the city which include provision for debt service payment when due. Pursuant to the Prime Lease, the city has covenanted to budget and appropriate each fiscal year for all rental payments, including the portions representing debt service, when due and payable, without suspension or abatement of any nature. Failure to appropriate is an event of default under the Prime Lease. This legal obligation is similar to those associated with approximately $2.9 billion of other outstanding debt obligations of the city, including its pension, neighborhood transformation and stadium obligations. In view of the non-contingent nature of the pledge, as well as the city's strong financial oversight, these obligations have all been rated at the same level as the city's unlimited tax G.O. bonds. The city is required to balance its budget each year and to raise taxes if necessary to achieve such balance.

MOST RECENT REPORT AND PRINCIPAL METHODOLOGY

The last rating action was on December 1, 2008 when the general obligation rating of the City of Philadelphia was affirmed at Baa1.

The principal methodology used in the rating this issue was "Local Government General Obligation and Related Ratings," 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, projected negative General Fund balance, and need for legislative approval for aspects of its recovery plan. Moody's will continue to monitor the city's recovery efforts, including the assessment of any contingency plans the city develops should it not receive the necessary approval from the commonwealth.

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

- Successful development and implementation of a comprehensive recovery plan that strengthens financial operations and results in fund balance improvement.

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

- Further financial deterioration in fiscal 2010 due to failure of budget-balancing strategies

KEY STATISTICS

2007 estimated population: 1.45 million

2008 full value: $60.8 billion

Full value per capita: $41,989

1999 Per capita income as % of state: 79.1%

1999 Median family income as % of state: 75.3%

Direct debt burden: 8.1%

Total debt burden: 12.4%

Payout of principal (10 years): 39.2%

FY2008 General Fund balance: $234 million (6.5% of General Fund revenues)

FY2008 Unreserved General Fund balance: -$24million (-0.7% of General Fund revenues)

FY2008 General Fund balance (budget basis): $119 million (3.0% of General Fund revenues)

Projected FY2009 General Fund balance (budget basis): -$60 million (-1.5% of General Fund revenues)

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