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Philadelphia Authority For Industrial Development, Pennsylvania; Appropriations; Insured Liquidity

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Philadelphia Authority For Industrial Development, Pennsylvania; Appropriations; Insured Liquidity

Credit Profile		
Philadelphia Auth for Indl Dev fixed rate lse ser 2007A (FGIC)		
Unenhanced Rating	BBB(SPUR)/Stable	Rating Assigned
Philadelphia Auth for Indl Dev multi modal lse VRDB ser 2007B (FGIC)		
Unenhanced Rating	BBB(SPUR)/Stable	Rating Assigned

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services assigned its 'BBB' long-term rating and underlying rating (SPUR), with a stable outlook, to the Philadelphia Authority for Industrial Development's series 2007A fixed-rate lease revenue refunding bonds and series 2007B multimodal lease revenue refunding bonds.

The long-term rating reflects the security provided by an unconditional lease agreement by which the city will make annual rent payments sufficient to pay debt service on the bonds; therefore, the rating reflects Philadelphia's general obligation (GO) credit characteristics. We will release the rating pertaining to the letter of credit (LOC) portion shortly.

The long-term rating reflects the following weaknesses:

- The city's operating results have been historically erratic, although its financial position has improved over the past three years.
- The city continues to face cost increases related to health care and pensions, which, coupled with expiring union contracts and expected continued tax rate reductions, will pressure future financial operations.
- There are continuing longstanding fiscal problems at the Philadelphia School District and Philadelphia Gas Works (PGW), which in the past has required financial assistance from the city.
- The city's overall net debt burden is high, due in large part to previous pension bond issuance, a significant neighborhood revitalization program, and the issuance of general-fund-supported debt to finance the construction of two new stadiums. A large $3 billion pension bond issuance now being considered will increase debt even higher, but will be tempered by the city significantly increasing pension funding levels (to 95%) and reducing annual required pension contributions. Given that the current unfunded pension liability is factored into our debt analysis as a contingent liability, we view the additional debt incurred for the pension bond issuance as credit neutral.

Also reflected in the rating are the following credit strengths:

- The Pennsylvania Intergovernmental Cooperation Authority (PICA) provides continued fiscal oversight.
- The city is located in the center of a diverse regional economy that, despite the addition of several notable development projects, has experienced only modest growth over the past several years.

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The Philadelphia regional economy is highly diversified, with an emphasis on health care services, pharmaceutical manufacturing, education services, and tourism. However, out-migration from the city to the suburbs, relatively high business costs, a large number of poorly educated workers who live in Philadelphia, and high tax rates have served to constrain economic growth.

In an effort to stimulate growth, the city has, since 1995, cut wage and business privilege tax rates 13% and 27%, respectively, and expects to continue to do so through 2012 (an additional 6% and 3%, respectively). However, the combination of these cuts and an expected 11% decline in real estate transfer taxes are expected to limit future budgetary resources and flexibility.

Better-than-projected growth in wage, business privilege, and real estate transfer taxes have enabled the city to post positive financial operations over the past two years. On a GAAP basis, Philadelphia's unaudited, unreserved general fund balance at fiscal year-end 2007 was $153 million (4% of expenditures), up from $111 million the previous year and a negative $36 million at fiscal year-end 2005. On a legally enacted basis, which includes unearned business privilege tax receipts, the city had a $295 million balance.

Year-to-date fiscal 2008 operations project an $89 million operating deficit, better than originally budgeted. However, there is some uncertainty associated with the city's five-year financial plan (2009-2013), which incorporates $121 million of fund balance over the life of the plan to balance operations. The five-year plan also includes $78 million in casino revenue from two casinos that have yet to begin construction, as well as the repayment of the balance of a $43 million loan ($20.5 million still outstanding) by the financially challenged PGW. Also of note are the potential effects that the economic slowdown would have on revenues and expenditures. Realty transfer taxes are $8 million below budget and sales tax collections have flattened. While the city has budgeted conservatively for the slowdown, the length and depth of the recession and its effect on the five-year plan are yet to be determined.

We consider Philadelphia's management practices strong under our Standard & Poor's Financial Management Assessment (FMA). An FMA of strong indicates that practices are strong, well embedded, and likely sustainable. Concern over Philadelphia's financial condition is mitigated, to a degree, by the oversight provided by PICA, which requires the city to submit five-year financial plans. This, in turn, has resulted in a level of budgetary discipline and strong financial reporting. Nevertheless, the city's financial condition remains tenuous and will continue to be challenged by weak demographic trends, uneven revenue growth, policies of tax reductions to spur economic expansion, and items in the out-years of the financial plan that are not fully within the city's control.

Overall net debt burden is a high $4,952 per capita and roughly 18% of market value; this is especially high given household effective buying income, which is about 75% of the national average. Debt levels increased considerably in recent years as a result of debt issued for pension funding, urban renewal, and the construction of two sports stadiums. Carrying charges, inclusive of pension debt and debt secured by service agreements, are roughly 5% of general fund expenditures.

We have assigned Philadelphia a Standard & Poor's Debt Derivative Profile (DDP) overall score of '2' on a scale of '1' to '4', with '1' representing the lowest risk and '4' the highest. The overall score of '2' reflects our view that Philadelphia's general fund-related swap portfolio represents a neutral credit risk at this time.

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Outlook

The stable outlook reflects the combination of oversight from PICA and the expectation of continued prudent financial management, ensuring that future budgetary growth is appropriately matched to revenues. Standard & Poor's expects that as the economy continues to slow, the city's strong management practices will allow it to adjust to potential revenue shortfalls and rising operating costs without materially affecting results (as elaborated on in its five-year financial plan).

Economy

Philadelphia has a diversified economy, with notable strength in health care services, pharmaceutical manufacturing, education, and tourism. While buffering the Philadelphia economy from a more severe downturn, this diversity has also limited its expansion, as many of the sectors that form the region's economic base are growing slowly.

The city lost labor force (2.0%) and employment (2.2%) from 2001 through 2005 before posting modest gains in 2006. The city's 6.3% unemployment rate (2006) has edged off of peaks posted in 2002 and 2003; however, while in keeping with many urban centers, it remains well above the state and national rates. A long history of out-migration has fostered a large disparity in education and income levels between central city and suburban residents. Philadelphia's population declined 4.3% from 1990 to 2000; recent data suggests that this long-term trend is continuing, with a 4.6% decline from 2000 to 2006. However, the rate of decline has eased over the past couple of years.

Median household effective buying incomes within the city represent just 75% of the national benchmark.

Education and health services represent a large 28% of Philadelphia's jobs. Growth prospects are good for the metropolitan area's core of knowledge-based industries, which include health services, pharmaceuticals, education, and biotechnology, chiefly due to a highly educated work force drawn from suburban areas. With 45 hospitals and seven medical schools, the city is one of the largest health care centers in the world and is home to more than 80 degree-granting institutions of higher education.

Leading employers include several hospitals and health systems, numerous institutions of higher learning, the government sector, and Merck Pharmaceuticals. However, high-technology industries provide a relatively small portion of total employment.

Redevelopment of the city's Navy shipyard continues to provide an economic benefit, offsetting losses incurred upon the closure of several defense facilities (employing 20,000) in the 1990s. The Navy still maintains 2,500 personnel at the shipyard, which is also home to 60 companies employing a total of 4,500, including the shipbuilder Aker (formerly Kvaerner), which employs 1,300. Long-range plans for the shipyard are for mixed-use development and employment levels in the 15,000 to 20,000 range. Building on successes at the Navy yard, Philadelphia has launched redevelopment projects along the Delaware River waterfront. The project, covering 3,500 acres, seeks to convert dilapidated industrial properties to mixed use, and is expected to be the site of the city's newly approved casinos.

Limited new housing data is available, although management reports that sale prices are down about 1%. The commercial market, however, remains solid, with low 9% vacancy rates, despite the recent addition of the city's Cira and Comcast centers, netting nearly two million square feet of class A space.

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Tourism remains a key component of the city economy. The city expects the SugarHouse Casino and Foxwoods Casino Philadelphia to open in 2010. The city expects the creation of more than 1,000 construction and 9,000 permanent jobs. From a revenue standpoint, the city projects a $16 million increase in wage tax revenue and $20 million in annual "host fee" revenue generated from a 4% tax on the casinos' gross revenues. However, the casinos have not yet begun construction. If the projects are materially delayed, the city's five-year financial plan will require an offset to the $78 million in casino revenue in the current plan.

Several large-scale economic development projects have bolstered the city's tourism base over the past several years. Among these are the construction of new stadiums for the Philadelphia Eagles and Philadelphia Phillies (at a combined cost of $1 billion) as cornerstones of the city's sports district. Other large-scale projects include a performing arts center enhancing the city's "Avenue of the Arts", the completion of an attractions/museums building highlighting the city's historic past; the addition of 4,000 hotel rooms, and expansions at the Philadelphia Airport. Meanwhile, the city has plans to expand its convention center to 685,000 square feet from 440,000 square feet, making it the eighth largest in the nation. These projects should help enhance the city's efforts to expand tourism, already a key driver of Philadelphia's economy.

Finances

The city remains financially challenged, particularly in operating, with a thin (though improved) cushion of financial reserves, as pension and criminal justice cost growth is outpacing revenue growth, exacerbated by legally required and accelerating tax reductions.

Though these are challenges, the current five-year plan reasonably provides for them. However, uncertainties related to the PGW loan repayment and timing on casino receipts could negatively affect the city's five-year plan and projected financial operations.

Pension funding remains one of the city's largest cost pressures. The city expects to make minimum pension contributions required by the state. Funding has declined to 53% in fiscal 2008 from 64% in 2005. The city is making its minimum municipal obligation (MMO) pension payments, which totaled $400 million in 2007, and its funding is expected to rise to 92% by 2025. Philadelphia's MMO is projected to be more than $300 million higher than it was in 2003, rising to $451 million by fiscal 2012, up from $147 million for 2003. Pension obligations, which represented 6.7% of general fund revenue in fiscal 2003, are projected to reach 10.0% by 2012. Combined pension costs (including debt service on pension obligation bonds) plus other post-employment benefits, are expected to measure more than 20% of general fund revenue by fiscal 2012, up from 14% in fiscal 2003. A contemplated $3 billion pension bond issue, which would increase funding levels to 95%, would allow the city to lower annual required contributions.

Revenues

The city relies on a diverse stream of revenues for operations, which were pressured during the economic downturn. Taxes represent 70% of general fund revenue and property taxes make up 11% of general fund tax revenue. The city levies a 3.474% property tax on its $11.6 billion assessed base. An additional 4.79% is assessed for school district purposes. Wage and earnings taxes assessed on residents and nonresidents provide 31% of general fund revenue; inclusive of tax rate changes, receipts have grown at an anemic 2.4% average annual rate since 1993.

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Business privilege taxes make up 12% of general fund revenue. Assessed at 6.5% of net income and 0.154% on gross receipts, the latter rate has been reduced annually since 1995. This tax is very sensitive to economic cycles. The city also receives 4% of general fund revenue from a 1% sales tax, which produced moderate growth over the past few years, after being relatively stagnant over the previous three years. The city's real estate transfer tax (6% of general fund revenue) performed well over the past five years, providing better-than-expected growth, more than doubling from fiscal 2002 levels. The strong performance of this revenue source helped fuel increased general fund balances.

PICA Oversight

Standard & Poor's views the strong financial controls and PICA's oversight, which have been in place since the city encountered financial stress in the early 1990s, as credit strengths. Since 1992, the city has received financial oversight from PICA. In 1992 and 1993, PICA provided deficit financing by issuing special tax bonds on behalf of the city, of which $622 million are outstanding. Securing these bonds is a 1.5% income tax that was surrendered by the city and levied by PICA. While PICA no longer maintains the authority to issue additional new-money debt on behalf of the city, it does maintain oversight of the city's finances as long as PICA bonds remain outstanding. This oversight function includes the power to review and approve annual five-year financial plans and quarterly variance reports, and, if warranted, certify noncompliance by the city with the five-year plan, which could trigger the withholding of state aid by the commonwealth.

Financial Management Assessment: 'Strong'

We consider the city of Philadelphia's management practices strong under our Standard & Poor's FMA. An FMA of strong indicates that practices are strong, well embedded, and likely sustainable.

The city develops revenue and expenditure assumptions in consideration of past trends and adjusts them for internal and external forecasts. Budget officials use regional economic models for revenue forecasting; management consults with regional Federal Reserve Bank officials in developing estimates and reviews surveys of professional forecasters. Revenue is tracked on a daily basis, and expenditures are tracked on a monthly basis. Formal revenue reports are delivered to elected officials monthly. The city manager's quarterly report is comprehensive and is delivered to elected officials and to PICA, which has oversight responsibilities for the city. Budget officials meet quarterly with officials of each city department. Budgets are generally amended once each year, at the time of introduction of the next year's budget. However, city departments are given target budget reductions (roughly 1% to 3% of departmental budgets) that are held in reserve and can be swept out, if needed. In addition to the current-year budget, the city annually produces formal rolling five-year financial plans that are reviewed by elected officials and PICA. The five-year plan takes into account all known effects on revenue and expenditures. It factors in expected tax rate reductions, labor cost increases, and identifies risks to the plan. In cases where material challenges arise after the introduction of the five-year plan, PICA requires the city to submit a revised plan. Although the city does have a small structural budgetary imbalance, PICA legislation ensures that the five-year plan provides for surplus balances over the plan horizon. The city has a formal six-year capital plan (including the current budget year). The plan is updated annually, approved by the city council, and submitted for oversight to PICA, and funding sources are identified for each project. The city has a formal investment management policy, which was adopted through an ordinance by the city council. The policy, which was adopted in 1994 and revised in 2001, outlines permissible

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investments and forbids investment in certain derivatives such as inverse floaters, leveraged variable-rate debt, and interest-only or principal-only debt. The city is in the process of updating its formal and comprehensive debt management plan. Philadelphia's major weakness in financial management involves the absence of formal policies governing reserves and liquidity. The city has, in the past, had to do deficit financing and is under state oversight as a result.

Debt And Capital

The issuance of deficit bonds by PICA in the early 1990s, general capital and neighborhood revitalization funding, and the 1999 pension obligation financing have greatly increased debt burdens over the past decade. At June 30, 2007, the overall net debt burden was a high $4,952 per capita and approximately 12.7% of market value. Amortization is below average, with approximately 40% of GO and PICA bond principal to be retired over 10 years. Carrying charges, inclusive of debt service associated with pension obligation debt and debt secured by service agreements, is roughly 5% of general fund expenditures. The city's 2008-2012 capital plan calls for a modest $55 million annual tax supported debt issuance.

The city must balance its significant capital and debt plans within its general fund operating budget to ensure that debt service expenditures remain affordable. The significant capital needs of the Philadelphia School District could also increase the already-high overall net debt burden over the long term. Further debt/financial challenges may be presented by litigation related to environmental issues, such as toxic waste disposal and combined sewer overflows, although the city has several options for funding such costs at its disposal.

Debt Derivative Profile: '2'

We have assigned Philadelphia a Standard & Poor's DDP overall score of '2' on a scale of '1' to '4', with '1' representing the lowest risk and '4' the highest. The overall score of '2' reflects Standard & Poor's view that Philadelphia's general fund-related swap portfolio reflects a low credit risk at this time due to the following factors:

- A low degree of involuntary termination risk under the city's swap due to the ratings trigger spread;
- Above-average economic viability of the swap portfolio over stressful economic cycles; and
- Good management practices, with a formal swap management policy.

In conjunction with the 2007 bonds, Philadelphia entered into a fixed payer swap with Royal Bank of Canada (rated 'AA-'). The city previously entered into a general fund-related basis swap through the Philadelphia Authority for Industrial Development, in conjunction with the lease revenue bonds series 2001B (Phillies and Eagles stadium financing); the swap was with Merrill Lynch Capital Services (guaranteed by Merrill Lynch and Co., rated 'A+'). Due to the low degree of termination risk and the above-average economic viability of the swap, Standard & Poor's is not factoring in these values as contingent liabilities for the city at this time.

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