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RESEARCH

# Philadelphia Redevelopment Authority, Pennsylvania; Appropriation, General Obligation Equivalent Security; Tax Secured, General Obligation

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## Credit Profile

| | |
|---|---|
| US$146.995 mil taxable rev bnds & qualified redev rev bnds & rev bnds ser 2005 A-C due 10/15/2029 | BBB |
| Sale date: 23-FEB-2005 | |

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|---|---|
| **AFFIRMED** | |
| **Philadelphia Redev Auth, Pennsylvania** | |
| $18.520 mil. Philadelphia Redev Auth (City of Philadelphia Neighborhood Transformation Initiative) | AAA/BBB(SPUR) |
| $124.125 mil. Philadelphia Redev Auth rev bnds (City Of Philadelphia Neighborhood Transformation Initiative) ser 2002A dtd 04/15/2002 due 07/15/2026 | AAA/BBB(SPUR) |
| **Pennsylvania Conv Ctr Auth, Pennsylvania** | |
| Philadelphia, Pennsylvania | |
| $285.600 mil. Pennsylvania Conv Ctr Auth rfdg ser 94A | BBB |
| **Philadelphia, Pennsylvania** | |
| Philadelphia, Pennsylvania | |
| $639.488 mil. Philadelphia | BBB |
| $200.000 mil. Philadelphia ARS multi-modal go bnds ser 2003B-1&2 dtd 12/02/2003 due 02/15/2033 | AAA/BBB(SPUR) |
| $250.000 mil. Philadelphia GO bnds ser 1998 dtd 11/15/1998 due 03/15/2000-2018 2028 | AAA/BBB(SPUR) |
| $167.815 mil. Philadelphia GO rfdg bnds ser 1998 dtd 12/01/1998 due 05/15/2002-2016 2020 | AAA/BBB(SPUR) |
| $295.000 mil. Philadelphia go bnds ser 2001 dtd 01/01/2001 due 09/01/2002-2021 2025 2031 | AAA/BBB(SPUR) |
| $50.000 mil. Philadelphia go ltd tax serial bnds ser 2003A dtd 12/02/2003 due 02/15/2005-2015 | AAA/BBB(SPUR) |
| **Philadelphia Auth for Indl Dev, Pennsylvania** | |
| Philadelphia Auth for Indl Dev, Pennsylvania | |
| $225.000 mil. Philadelphia Auth for Indl Dev pension fdg bnds ser 1999C dtd 01/15/1999 due 10/15/2028 | AAA/BBB(SPUR) |
| $406.365 mil. Philadelphia Auth for Indl Dev pension fdg bnds ser 1999A dtd 01/15/1999 due 4/15/2000 2001 2003-2011 | AAA/BBB(SPUR) |
| $423.698 mil. Philadelphia Auth for Indl Dev pension fdg bnds ser 1999B dtd 01/15/1999 due 04/15/2012-2026 | AAA/BBB(SPUR) |
| **Philadelphia Pkg Auth, Pennsylvania** | |
| Philadelphia Pkg Auth, Pennsylvania | |
| $63.000 mil. Philadelphia Pkg Auth pkg rev bnds ser 1999 dtd 01/15/1999 due 02/01/2000-2016 2019 2021 2027 (SPUR) | AAA/BBB(SPUR) |
| **Philadelphia Redev Auth, Pennsylvania** | |
| Philadelphia, Pennsylvania | |
| $9.022 mil. Philadelphia Redev Auth (Philadelphia) ser 86 subser 2 | BBB |

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|---|---|
| **OUTLOOK:** | STABLE |

## Rationale

Standard & Poor's Ratings Services assigned its 'BBB' rating to Philadelphia Redevelopment Authority, Pa.'s taxable revenue bonds, qualified redevelopment revenue bonds, and revenue bonds, series 2005A, B, and C, respectively, as part of the city of Philadelphia's Neighborhood Transformation Initiative. The bonds are secured by a service agreement between the city and the authority; the rating, therefore, is based on the city's general credit characteristics.

Standard & Poor's also affirmed its 'BBB' rating and underlying rating (SPUR) on all GO and parity debt issued by, and on behalf of, the city of Philadelphia.

The ratings reflect the following credit weaknesses:

- The city's financial condition is weak, with fiscal 2004 deficit balances on both a GAAP basis ($148 million) and on a legally enacted budgetary basis ($46.8 million), with the former exacerbated by accounting changes (associated with the recognition of business privilege taxes and accounting for the difference in GAAP and budgetary balances) and the latter exacerbated by a $90 million delay in child welfare reimbursements from the state, which have been subsequently received.
- There are continuing long-standing fiscal problems at the Philadelphia School District and Philadelphia Gas Works (PGW), which could cause the city operating stress.
- Income levels are below average, with per capita effective buying income at about 91% of the national level.
- Overall net debt burden is high, due in large part to significant deficit financing related to fiscal distress during the early 1990s, a significant neighborhood revitalization program, and the issuance of general fund-supported debt to finance the construction of two new stadiums. Debt levels are even higher when pension obligation bonds, issued in 1999 to partially extinguish the city's unfunded pension liability, are factored in.

Also reflected in the rating are the following credit strengths:

- Continued fiscal oversight provided by the Pennsylvania Intergovernmental Cooperation Authority (PICA); and
- The city's location in the center of a diverse regional economy that, despite modest growth experienced over the past several years, has economic growth projected to lag the nation's growth rate over the next several years.

The 'BBB' rating on Philadelphia Municipal Authority's bonds, issued on behalf of the city, reflects the city's absolute and unconditional obligation to make lease rental payments, which are not subject to abatement, offset, or counterclaim. The 'BBB' SPUR on Philadelphia Authority for Industrial Development's bonds reflects the security provided by a service agreement with the city of Philadelphia, and is therefore based on the city's general credit characteristics.

Philadelphia has been assigned a Standard & Poor's Debt Derivative Profile (DDP) overall score of '2' on a scale of '1' to '5', with '1' representing the lowest risk and '5' the highest. The overall score of '2' reflects Standard & Poor's view that Philadelphia's general fund-related swap portfolio reflects a neutral credit risk at this time.

Philadelphia's financial condition is very weak. Concern 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, weak 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.

Philadelphia's financial operations have weakened over the past three years as the city posted general fund operating deficits of $91 million in fiscal 2002 and $48 million in fiscal 2003. The city's fiscal 2004 budget called for a $117 million operating deficit and negative $26 million year-end general fund balance. However, $62 million in positive revenue variances from budgeted levels were offset by delays in child welfare reimbursements from the commonwealth totaling $90 million, leaving the general fund balance at a deficit of $46.8 million (unaudited), or negative 1.5% of expenditures. These reimbursements were subsequently received in September. Had the state reimbursement funds been received on a timely basis, the fiscal 2004 balance would have been $45.1 million (1.5% of expenditures), which would still have represented a reduction from fiscal 2003 levels, but would also have been better than levels anticipated under the original budget.

The city's adopted five-year financial plan for fiscals 2005-2009 was revised late in 2004 to incorporate subsequent events related to police arbitration and other contractual settlements, higher baseline revenue growth, gaming revenue expected to be received commencing in fiscal 2007, and workforce reductions. Under the revised 2005-2009 plan, the city expected to eliminate its fiscal year-end 2004 legally enacted budgetary basis deficit and post a $1.6 million accumulated balance at fiscal year-end 2005.

Halfway through fiscal 2005, the city has introduced its financial plan for fiscals 2006-2010. Under the recently introduced plan, the city anticipates a $66.5 million operating surplus and a $19.7 million accumulated general fund balance (on a legally enacted budgetary basis) at fiscal year-end 2005 (roughly 0.5% of budget). The city anticipates largely balanced operations over the remainder of the planning horizon.

The Philadelphia regional economy is highly diversified, with an emphasis on health care services, pharmaceutical manufacturing, aerospace manufacturing, education services, and transportation services. 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. Nevertheless, the downturn in the Philadelphia economy has been mild relative to past recessions, and the unemployment rate is in keeping with many urban centers.

As of June 30, 2003, the overall net debt burden was high at approximately $4,500 per capita and roughly 16% of market value. Debt levels increased considerably in recent years as a result of debt issued for pension funding, urban renewal, and construction of two sports stadiums.

## Outlook

The stable outlook reflects the combination of oversight from PICA and the anticipation of continued prudent financial management, ensuring that future budgetary growth is appropriately matched to revenues. Should balances suffer substantive additional weakening, the rating could come under pressure.

## Economy

The Philadelphia regional economy is highly diversified, with an emphasis on health care services, pharmaceutical manufacturing, aerospace manufacturing, education services, and transportation services. While buffering the Philadelphia economy from 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 region's other weaknesses include out-migration from the center city, relatively high business costs, a large number of poorly educated workers that live in Philadelphia, and high tax rates.

Despite the recent downturn, the city's housing market has performed well--partly as a result of low interest rates and partly influenced by gains made under the city's Neighborhood Transformation Initiative. This has translated into property value growth and building activity, and, in turn, increased property tax and real estate transfer tax revenue.

The recent downturn in the Philadelphia economy has been mild relative to past recessions. After posting modest employment gains from 1998 to 2000 (the first gains in a decade), net job losses have been registered over the last three years, though at levels generally in keeping with national trends. The city's 7.5% unemployment rate has edged off of peaks posted in 2002 and 2003; as with many urban centers, however, it remains well above the state and national rates, which are both at 5.4% and 5.6%, respectively. 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 1990-2000; recent data suggest that this long-term trend is continuing. However, the rate of decline has eased, in part, due to economic development efforts amid the center city. Median household effective buying incomes within the city represent just 74% of the U.S. benchmark.

Education and health services comprise a large 18% of metropolitan area 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 workforce drawn from suburban areas. With 45 hospitals and seven medical schools, the area is one of the largest health care centers in the world and is home to more than 80 degree-granting institutions of higher education. Hospitals employ more than 110,000 workers, while private colleges and universities employ roughly 56,000. Leading employers in the metropolitan area include the University of Pennsylvania (roughly 25,000 employees), Jefferson Health System, Merck Pharmaceuticals, and Temple University Health Systems. However, high-technology industries provide a relatively small portion of total employment.

US Airways, which maintains connector hub operations at the Philadelphia Airport, recently re-filed for bankruptcy protection. The airline ranks among the area's largest employers, although expected layoffs, wage reductions, and service cuts will likely have only a modest effect on the local economy, as the overall diversity of the Philadelphia's base should help the city absorb such losses.

Redevelopment of the city's Navy shipyard continues to provide economic benefit, offsetting losses incurred upon the closure of several defense facilities (employing 20,000) in the 1990s. The Navy still maintains approximately 2,000 personnel at the shipyard, which is also home to 47 companies, employing roughly 3,500, including the shipbuilder Kvaerner (about 1,000 jobs). Long-range plans for the shipyard are for mixed-use development, with employment levels ranging from 15,000 to 20,000.

Several large-scale economic development projects have recently been completed, which should bolster the city's tourism base. 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 $225 million performing arts center (which opened in 2001), enhancing the city's "Avenue of the Arts" offerings; the completion of attractions and museums, building on the city's historic past; and the construction of more than 4,000 hotel rooms, leading up to the city's hosting of the 2000 Republican National Convention. Meanwhile, the city has plans to expand its 440,000-square-foot convention center to 685,000 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

### Financial risks.

The city remains financially challenged, particularly in operating without a cushion of financial reserves. The following risks could further pressure the city's finances and ratings:

- The potential for adverse contracts with remaining bargaining units and raises to non-covered employees,
- The potential failure of PGW repay its outstanding indebtedness to the city,
- Rising health care costs, and
- Mounting pension costs (associated with a defined benefit plan and aggressive investment return assumptions) in an investment environment that has yet to indicate strong performance.

Pension funding remains one of the city's largest cost pressures. The city expects to make minimum pension contributions required by the state. Funding, which stood at 62% in 2004, is expected to decline to 54% in fiscal 2007, before rising thereafter to 86% by 2025. The city estimates that its annual pension contribution will total $364 million by fiscal 2009, up from $167 million for 2004.

In addition to these risks, the city will continue to face several challenges associated with an economy in weak recovery; revenue performance dampened by continued tax cuts; limited budgetary flexibility resulting from high fixed costs associated with the debt financing of pension costs, two new stadiums, and neighborhood redevelopment; and limited debt-raising capacity, which could place additional stress on the city's operating budget.

### Overview of recent results.

Philadelphia's uneven record of financial performance continues. On a budgetary basis, fiscals 2002, 2003, and 2004 operations resulted in deficits of $91 million, $68 million, and $138 million, respectively. The operating losses, combined with GASB 33 accounting changes in 2001 and 2003, have depleted the city's GAAP-based unreserved general fund balances, which stood at negative $148 million, at fiscal year-end 2004.

The fiscal 2004 budget was predicated on a beginning budgetary-basis balance of $119 million, and incorporated drawing the balances down to $16 million. This expectation was subsequently lowered to reflect the actual beginning balance, which was adjusted downward by $28 million, to $91 million.

Fiscal 2004 operations were negatively influenced by a $90 million delay in reimbursements from the state for child welfare outlays, which have been subsequently received. Absent the delays, operations would have produced better than budgeted--but nevertheless deficit--results for the year.

Despite the recent operating history, including a large drawdown in fiscal 2004 (which was largely attributable to reimbursement delays), there are some positive signs:

- Economically sensitive wage and business privilege taxes increased 4.0% and 4.4%, respectively, in 2004, after producing declining-to-flat results in fiscals 2002 and 2003, while property tax receipts increased a robust 8% in 2004;
- Investment losses in the pension system abated after a weak stock market produced investment losses on pension assets of 6.0% and 5.2% in fiscals 2002 and 2003, respectively, although returns remain well below rather aggressive earnings assumptions (9%), thereby necessitating additional city contribution; and

- The city has settled contracts with two of its largest unions, reducing budgetary uncertainty.

The city relies on a diverse stream of revenues for operations, which were pressured during the economic downturn. Property taxes comprise 12% of general fund revenue. The city levies a 34.74-mill property tax on its $10.4 billion assessed base (more than $46 billion estimated market value). An additional 47.9 mills are assessed for school district purposes. Combined millage rates have been unchanged over the past 10 years, although the city transferred 2.71 mills of authority to the school district in 2003. Assessed value growth has been modest, averaging about 3% annually over the past five years. Wage and earnings taxes assessed on residents and non-residents provide 33% of general fund revenue; inclusive of tax rate changes, receipts and have grown at an anemic 1.5% average annual rate since 2000. Business privilege taxes comprise 9% of revenue. Assessed at 6.5% of net income and 2.10 mills on gross receipts, the latter rate has been reduced annually since 1995, when it measured 3.25 mills. This tax is very sensitive to economic cycles. The city also receives 4% of revenue from a 1% sales tax, which has been stagnant to declining over the past four years. On a positive note, however, revenue from the city's real estate transfer tax (4% of revenue) has provided better-than-anticipated growth, increasing 62% over 2001 levels. On the expenditure side, the city had 23,759 full-time general fund positions as of June 30, 2004. As part of its ongoing efforts to address revenue weakness during the current economic downturn, the city has continued its hiring freeze for certain departments, resulting in a drop in the city workforce of approximately 400 positions.

### PICA oversight.

Philadelphia's poor financial results follow a generally stable financial period that was, in part, attributable to improved economic conditions and financial oversight provided by PICA, which had provided the city with necessary deficit financing during the early 1990s. Standard & Poor's views the strong financial controls that have been in place since the city encountered financial stress in the early 1990s as a credit strength. 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 $770 million where outstanding at June 30, 2004. These bonds are secured by a 1.5% income tax that was surrendered by the city and levied by PICA. While PICA no longer maintains 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 non-compliance by the city with the five-year plan, which could trigger the withholding of state aid by the commonwealth.

### Philadelphia's financial plans.

As part of the act establishing PICA, the city is responsible for annually producing five-year financial plans. Under the 2004-2008 financial plan submitted to PICA, the city successfully addressed a large operating gap that threatened to total $834 million by 2008. However, the plan did not include any provision for wage increases for the city's four major unions, the contracts with which were set to expire in fiscal 2004.

The city submitted its 2005-2009 plan to PICA, but revised it late in 2004 to reflect subsequent events, including:

- Settlements with the Fraternal Order of Police (3%, 3%, 3%, and 4% raises, for a total cost of $171 million over five years), DC-47 ($750 onetime bonus for 2005, 2%, 3%, and 4% thereafter; total cost $32 million over four years), and provision for raises for other bargaining units and non-covered employees (totaling $174 million over the term of the plan);
- Expected gaming revenue from the commonwealth, commencing in 2007 ($12.5 million) and increasing to $25 million annually in 2009 and thereafter;
- The expected commonwealth takeover of the costs of the convention center, beginning in 2007 ($29 million in savings over three years, and requiring state action);
- A 1,300 reduction in general funded positions (producing $58 million in savings);
- State reimbursements for patrolling state highways (requiring state approval); and
- Roughly $30 million in asset sales.

Standard & Poor's views these actions to be largely achievable and, in general, the city has conservatively estimated their impact. Given the city's marginal financial position, this is essential in maintaining current ratings.

In January 2005, the city introduced its financial plan for fiscals 2006-2010. The new financial plan makes small revisions to the prior plan, reflective of a slight improvement in base taxes, increased DHS spending, decreased gaming revenues in 2007 (due to delayed implementation of gaming), reduced savings from delays in workforce reductions, and increased debt service costs related to an additional financing expected in fiscal 2008.

### Prior financial history.

As a result of its strong oversight and conservative budgetary practices, the city had recorded nine consecutive years of surplus operations through fiscal 2001. Fiscal 2001 operations posted a $152 million operating surplus. The city increased reservations for encumbrances and loans by $52 million (including $45 million to cover loans made to PGW). Net of the reservations, the city added $100 million to its unreserved balances, which represented the city's ninth consecutive operating surplus. The fiscal 2001 surplus included roughly $60 million in onetime tax revenue accruals required under GASB 33, which also caused a downward adjustment to opening balances. The city's general fund balances had totaled $295 million at fiscal year-end 2000, but were adjusted downward by $165.2 million to reflect implementation of accounting changes as required under GASB 33 regulations, which affects recognition of grant-related transactions. As such, the city's post-GASB 33 fiscal 2001 unreserved balance totaled $230 million, or 8.8% of general fund expenditures. Fiscal 2000 operations posted an $89 million surplus.

## Debt

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, 2003, the overall net debt burden was high at $4,500 per capita and approximately 16% of market value. Amortization is moderate, with approximately half of GO and PICA bond principal retired over 10 years. Carrying charges are manageable at about 6% of expenditures. The city's 2005-20010 capital plan calls for $321 million in new loans to be secured by tax-supported city funds.

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.

## DDP

Philadelphia has been assigned a Standard & Poor's DDP overall score of '2' on a scale of '1' to '5', with '1' representing the lowest risk and '5' the highest. The overall score of '2' reflects Standard & Poor's view that Philadelphia's general fund-related swap portfolio reflects a neutral 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.

This is offset by a moderate degree of counterparty risk due to the trigger spread between the counterparty's rating and a credit event, and the fact that the counterparty's first collateral posting isn't until below 'BBB-'.

Philadelphia had one general fund-related swap with a total notional amount of $298 million at June 30, 2004. The city's basis swap, through the Philadelphia Authority for Industrial Development, in conjunction with its lease revenue bonds series 2001 series B (Phillies and Eagles stadium financing), is for $298 million notional with Merrill Lynch Capital Services (guaranteed by Merrill Lynch and Co., rated 'A+'). The swap scored a '3' for counterparty risk due to the trigger spread between the counterparty's rating and a credit event, the fact that the first collateral posting isn't until below 'BBB-', and higher historical default rates for financial institutions than tax-backed issuers. However, due to the still-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.