STANDARD & POOR'S

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Philadelphia Municipal Authority; Philadelphia; Appropriations

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Credit Profile		
US$94.2 mil lse rev bnds (Philadelphia) ser 2009 due 04/01/2039		
Long Term Rating	BBB/Stable	New

Rationale

Standard & Poor's Rating Services has assigned its 'BBB' rating to Philadelphia Municipal Authority's lease rental bonds series 2009. The outlook is stable.

The 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 and therefore the rating is based on Philadelphia's general obligation (GO) credit characteristics. Bond proceeds will be used to finance construction of a youth center detention facility.

The ratings reflect our opinion of the following weaknesses:

- The city's operating results have been historically erratic, and although its financial position has improved between fiscals 2005-2007, reserves have since declined and are not projected to rebound until fiscal 2010;
- The city continues to face cost increases related to health care and pensions that, coupled with diminished revenues caused by the effects of the recession, are pressuring financial operations;
- Continuing long-standing fiscal challenges at the Philadelphia School District and Philadelphia Gas Works, the latter of which has in the past required financial assistance from the city; and
- A high overall net debt burden due in large part to significant deficit financing related to fiscal distress in the early 1990s, pension bond issuance, a significant neighborhood revitalization program, and general-fund-supported debt to finance the construction of two new stadiums.

Also reflected in the rating are what Standard & Poor's views as the following credit strengths:

- Continued fiscal oversight provided by the Pennsylvania Intergovernmental Cooperation Authority (PICA);
- The city's location in the center of a major regional economy that while experiencing the effects of the national recession, has been diversifying into more growth-oriented sectors such as health care, higher education, and services, which should position the city for growth once the recovery ensues; and
- A proactive administration that has taken action to rebalance operations in the face of repeated revenue shortfalls.

As is the case with most U.S. cities, Philadelphia is struggling with the effects of the severe recession. Following a period from fiscals 2005-2007 when fund balance levels were rising (from a negative $10.4 million in fiscal 2004 to $348 million in fiscal 2007), reserves have been declining due in large part to the economic slowdown. Fiscal 2008 ended with a $119.5 million ending unreserved general fund balance (3% of general fund expenditures) and further drawdowns caused by slowing revenues (in particular declines in the real estate transfer and business privilege taxes) could result in tax revenues falling $179 million below budget. The city has been taking corrective actions to offset a portion of the revenue loss including savings of nearly $78 million. However, city officials now project the fiscal 2009 unreserved general fund balance to be a negative $60 million.

The administration has been taking actions to address the budget gap. Driven by projected revenue shortfalls, between November 2008 and March 2009 Mayor Nutter's administration has had to offset a $2.4 billion operating deficit over its current five-year (fiscal 2009-2013) approximately $20.0 billion financial plan. Actions to balance the budget included elimination of 800 full-time and 2,000 part-time and seasonal positions, reduction in overtime costs, curtailment of certain non-essential services, suspension of further city-funded annual business privilege, and wage tax reductions until fiscal 2015), and the closing of many of the city's pools. The city has also eliminated its reserve for wage increases, and is seeking to temporarily increase (for five years) the sales tax from 7% to 8% (generates $106 million in fiscal 2010 and $115 million-$120 million annually per year thereafter), defer for two years $235 million of pension payments to the pension fund; and extend the amortization of the unfunded pension liability from 20 to 30 years. The sales tax increase and changes in pension payments and amortization of the unfunded liability require state legislative approval.

Standard & Poor's believes that while the administration has taken significant steps to rebalance, there are some elements of risk involved in the recovery plan. Critical to the recovery plan is required state approval for raising the sales tax and the change in the pension amortization schedule. Failure to receive state approval of these actions would require further actions by the city, whether it be additional revenue raising options, service cuts, or a combination of both. In addition, given the uncertainty about the length and depth of the recession, additional actions might be warranted to further balance the financial plan.

At $4,952 per capita, Standard & Poor's views Philadelphia's overall net debt burden as moderate but considered high (18%) when measured against market value. Debt levels increased considerably in the past 12-15 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 much more manageable at about 5% of general fund expenditures.

Philadelphia's management practices are considered "strong" under Standard & Poor's Financial Management Assessment (FMA) methodology. 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 PICA provides, which requires the city to submit five-year financial plans. This, in turn, has led to a level of budgetary discipline and strong financial reporting. Nevertheless, in our opinion the city's financial condition remains tenuous and will remain challenged by weak demographic trends, uneven revenue growth, policies of tax reductions to spur economic expansion, and items in the financial plan that are not fully within the city's control.

Outlook

The stable outlook reflects our view that, with the combination of oversight from PICA and the expectation of continued prudent financial management, the city will likely ensure that future budgetary growth is appropriately matched to revenues. Standard & Poor's expects that if the recession persists, Philadelphia's strong management practices will allow it to continue taking necessary actions to address imbalances and balance its five-year financial plan

The Philadelphia Municipal Authority

The Philadelphia Municipal Authority (formerly The Equipment Leasing Authority of Philadelphia) was originally established for the purpose of buying equipment and vehicles to be leased to the city. PMA's powers have been expanded to include construction and leasing of municipal solid waste disposal facilities, correctional facilities, and other municipal buildings.

City of Philadelphia Finances

As is the case with most U.S. cities, Philadelphia is struggling with the effects of the severe national recession. Following a period from fiscals 2005-2007 when fund balance levels were climbing (rising from a negative $10.4 million in fiscal 2004 to $298 million in fiscal 2007), fiscal 2008 ended with a $119.5 million ending general fund balance (3.0% of expenditures). The decrease was in part due to one-time settlements to the city's four unions, along with the early signs of the economic slowdown, evidenced by reductions in the business privilege and real estate transfer tax collections, which fell $39.4 million below budget. While the fiscal 2009 budget projected an ending fund balance of $62.5 million (1.6% of expenditures), current estimates indicate declines in the real estate transfer and business privilege taxes ($152 million) could result in tax revenues falling $179 million below budget. The city has been taking corrective actions including savings of nearly $78 million. However, it now projects the fiscal 2009 fund balance to be a negative $60 million.

Fiscal 2008 results

The city ended fiscal 2008 with a $119.5 million fund balance (on a $3.9 billion budget). The fund balance was $35.1 million higher than estimated in the adopted budget, but a decrease of $178.4 million from the fiscal 2007 ending fund balance. The decrease was caused in large part by one-time payments to the city's four unions as part of collective bargaining agreement settlements and reduction in business privilege and real estate transfer tax collections. This increase from the estimate in the adopted budget is largely due to the fact that the fiscal 2007 fund balance was $126 million higher than anticipated when the budget was adopted. The estimate is also $54 million lower than the fiscal 2008 fund balance estimated in the approved five-year plan. This decrease is mainly the result of the lower-than-expected business privilege tax receipts and lower state reimbursements.

Fiscal 2009 projected

For the current fiscal year, the city's adopted budget projected an ending fund balance of $62.5 million (on a $4.03 billion budget). Management now projects tax revenues to be $179 million below budget levels. The real estate transfer tax and business privilege tax account for more than $152 million of the reduction. Management projects total general fund revenue to be $138.5 million below budget. Due to strong efforts by the administration at controlling the budget, spending is now projected to be $78.4 million below budgeted levels. The cityprojects the fiscal 2009 general fund balance to be a negative $60 million.

Fiscal 2010 budget

The city's fiscal 2010 budget was presented to City Council on March 19, 2009 and approved by City Council on May 21, 2009. The budget projects estimated revenues of $3.815 billion, obligations of $3.694 billion, and an ending fund balance of $85.3 million after discharging the fiscal 2009 fund balance deficit. The budget includes a 1% city sales tax increase. The city sales tax increase and several of the assumed changes to the pension system will require approval of the Pennsylvania General Assembly. The administration is developing alternate budget balancing scenarios in the event that approval of the Pennsylvania General Assembly does not occur.

Strong Oversight (PICA)

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 the early 1990s, PICA provided deficit and capital financing by issuing special tax bonds on behalf of the city, of which $572 million in debt remains outstanding. 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 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.

The Philadelphia Economy

Encompassing 130 square miles, Philadelphia is the fifth-largest city in the nation, with an estimated 2007 population of 1.45 million. The greater nine-county metropolitan population is much larger, estimated at 5.1 million. The Philadelphia regional economy is highly diversified in our view, with an emphasis on health care services, pharmaceutical manufacturing, aerospace manufacturing, education services, and transportation services. This diversity has buffered the Philadelphia economy from a more severe downturn, but has also limited its expansion, as many of the sectors that form the region's core economic base were growing slowly in the last economic expansion. While the city enjoys a moderate cost of living compared with many other large metropolitan areas, its relatively high business costs, large number of poorly educated workers, and high tax rates have inhibited growth. A trend of out-migration has fostered a large disparity in education and income levels between central city and suburban residents. Effective buying incomes within the city represent just 81% of the national benchmark, while per capita incomes for the metropolitan area represent what we consider a strong 117% of the national average.

According to IHS Global Insight Inc., Philadelphia, while clearly in a significant recession, has been experiencing a more moderate downturn than the nation, but has been affected less by the real estate boom and bust. This is because the city did not experience the significant growth and speculation in real estate in the past decade to the extent that many other U.S. cities did. Global Insight estimates that after experiencing a modest decline in employment (0.1%) in 2008, as with the rest of the nation, Philadelphia's employment will decline more rapidly in 2009 (2.9%). Global Insight projects 55,000 jobs will be lost this year and unemployment will reach 8.6%. Employment loses will slow in 2010, with a projected (0.3%) decline, before positive job growth occurs in 2011.

Health services account for a large 10.5% of metropolitan area jobs. We consider growth prospects 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. Significant sectoral presence is attributable to numerous hospitals, employing more than 100,000 workers, while private colleges and universities employ more than 50,000. However, high-technology industries provide a relatively low number of jobs and represent about 5% of total employment. Manufacturing continues its weak performance and nondurable manufacturing employment continues to outpace that of durables.

Abhishek Ahuja of CRISIL contributed to this article.

Related Research

USPF Criteria: "GO Debt," Oct. 12, 2006