S&P Global Ratings

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Summary:

Philadelphia Philadelphia Redevelopment Authority; General Obligation

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Credit Profile		
US$89.225 mil city service agreement rev bnds (taxable social bnds) (Philadelphia) ser 2021A due 09/01/2041		
Long Term Rating	A/Stable	New
US$8.695 mil city service agreement rev bnds (tax-exempt social bnds) (Philadelphia) ser 2021B due 09/01/2032		
Long Term Rating	A/Stable	New

Rating Action

S&P Global Ratings assigned its 'A' rating to the Philadelphia Redevelopment Authority's (PRA) approximately $89.225 million series 2021A city service agreement revenue bonds (federally taxable social bonds) and approximately $8.695 million series 2021B city service agreement revenue bonds (tax-exempt social bonds) issued for the city of Philadelphia. The outlook is stable.

Proceeds of the series 2021A and B bonds will finance certain costs related to the city's Neighborhood Preservation Initiative (NPI) program, which includes investments in affordable housing, neighborhood corridors, and neighborhood infrastructure.

The bonds are secured by service fee payments payable by Philadelphia to PRA under a service agreement. The city's service fee is payable solely from current revenues and is unconditional and absolute. The city council is required by the city charter to appropriate to pay the service fee in each fiscal year. We rate the bonds at the same level as our view of the city's general creditworthiness, reflecting the lack of appropriation risk and that there are no significant limitations on the fungibility of resources.

Credit overview

Philadelphia is allocated to receive $1.4 billion of American Rescue Plan (ARP) funding, which is expected to substantially mitigate the city's revenue losses stemming from the COVID-19 pandemic. Because of its significant declines in revenue, which are not anticipated to return to fiscal 2020 levels until 2023, management plans to categorize all the ARP funding as revenue replacement rather than submitting specific qualifying expenditures for reimbursement. The city's current five-year forecast shows it using $575 million in fiscal 2022, then $425 million, $250 million, and $149 million in fiscal years 2023 through 2025, respectively. Management plans to use the funding as a glide path to structural balance by the end of its five-year forecast (fiscal 2026). The city recently reached tentative three-year agreements with two of its largest unions, and an arbitration panel issued a three-year award covering the police union. As a result, it will submit a revised five-year plan to its oversight body, the Pennsylvania Intergovernmental Cooperation Authority (PICA), to incorporate expenditures related to those agreements, likely in late-October. If we begin to see expenditure growth outstripping revenue, requiring a faster draw on ARP funds, and creating a fiscal cliff in 2026, we could see downward rating pressure.

On a budgetary basis, the city estimates that fiscal 2021 year-end general fund balance fell to just $78.7 million, or 1.7% of revenue, only slightly higher than previous projections. The ARP funds will be held in the city's grants revenue fund until they are transferred to the general fund in accordance with their planned drawdown schedule. As a result, the city's general fund balance is expected to increase only marginally in 2022. However, the 2022 budget includes $75 million in reopening and recession reserve, which could pad the fund balance, if unused.

The stable outlook reflects our expectation that ARP funds will provide significant cushion while revenues recover, allowing the city to regain structural balance and rebuild its general fund balance before the ARP spending time horizon closes in December 2024. Our outlook horizon is up to two years, and over that time, we will be watching for how quickly revenues return to pre-pandemic levels and if expenditure growth outstrips current projections. Strong economic growth has underpinned much of the city's financial improvement in prior years. We see downside risk if revenues underperform or if expenditures outpace management's assumptions, requiring the city to draw down the ARP funding more quickly than projected, and leaving a large structural imbalance at the end of the drawdown period.

Over the long term, we believe that challenges persist for the city as it has grappled with improving pension funding levels and addressing its pockets of poverty. Changes in commuter behavior could also be a longer-term drag on city revenue. Philadelphia's revenues are highly concentrated in wage and earnings tax, roughly 40% of which is derived from noncity residents. Its ability to navigate through this period while maintaining pension funding discipline, school district support, and sufficient operational flexibility are key to supporting the current rating.

The 'A' rating reflects our assessment of the city's:

- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA), that benefited from recent years of growth but still has pockets of poverty;
- Strong management, with good financial policies and practices that will be necessary for navigating the return to structural balance post-pandemic;
- Very weak budgetary performance, with operating results that we expect will deteriorate in the near term relative to fiscal 2020, which closed with an operating deficit in the general fund and a slight operating deficit at the total governmental fund level;
- Budgetary flexibility that we expect will weaken further in 2021 from 5.8% of operating expenditures in 2020 and which we view as very weak overall due to high fixed costs and potentially limited capacity to raise revenues in outgoing years;
- Very strong liquidity, with total government available cash (including liquid investments) above 30% of total governmental fund expenditures and above 8.0x governmental debt service based on the 2020 audit; cash flow was also facilitated by a $300 million intrayear tax revenue anticipation note (TRAN) issued in fiscal 2021 but which will not be necessary in 2022;
- Weak debt and contingent liability position, with debt service carrying charges at 3.8% of expenditures and net direct debt that is 55.3% of total governmental fund revenue, as well as a large pension and other postemployment benefit (OPEB) obligation with low funded levels despite reforms and contributions above the required amounts;

and

- Very strong institutional framework. In our view, PICA provides additional oversight that we view as a credit positive.

Environmental, social, and governance factors

While health and safety social risks stemming from the pandemic are abating, our rating incorporates our view that they remain somewhat elevated for Philadelphia and have weakened many of the city's revenue sources, including income taxes generated by commuters. The city has given $95 million in refunds to commuters in 2021 due to work-from-home requirements. It is still unclear how work patterns will change after the pandemic, but the city has assumed that 15% of nonresident salaries will be permanently lost as commuter behavior changes. Notably, the commuter tax still applies to nonresidents if work from home is considered an optional benefit rather than a requirement, which we believe may mitigate some of the future losses. Furthermore, the pandemic affected the city's financial performance by the need to focus expenditures on addressing the health and safety of the community. Social capital risks reflected in its relatively weaker sociodemographic profile, including higher-than-average unemployment and poverty, could inhibit its ability to raise or collect revenue and also create a greater demand for services. While poverty rates in the city had decreased over the last few years, we do not yet have data post-pandemic, which likely exacerbated economic conditions for the most vulnerable. We analyzed Philadelphia's environmental and governance risks relative to its economy, management, financial measures, and debt and liability profile, and determined that all are in line with our view of the sector standard.

Stable Outlook

Downside scenario

If we no longer view the city's path to structural balance by the end of its five-year forecast as credible due to weaker revenue growth or rising expenditures and evidenced by faster-than-projected draws on ARP funding, we could lower the rating. Furthermore, we could also do so if the city is unable to continue to fund its pensions in line with its revenue recognition policy (RRP), resulting in deterioration of plan funding.

Upside scenario

If general fund reserves were to be restored to 2019 levels and if there was evidence of structural balance in which the city's recurring revenues were keeping pace with expenditures, we could raise the rating.

Credit Opinion

Adequate economy

We consider Philadelphia's economy adequate. The city, with an estimated population of 1.6 million, is in Philadelphia County in the Philadelphia-Camden-Wilmington MSA, which we consider to be broad and diverse. It has a projected per capita effective buying income (EBI) of 75.8% of the national level and per capita market value of $107,481. Overall, market value grew by 0.6% over the past year to $171.0 billion in 2022.

Philadelphia is gradually recovering from the COVID-19 pandemic-related decline in economic activity. The city lifted the last of its COVID-19 restrictions on June 11, 2021, and roughly 69% of Philadelphians were fully vaccinated through Sept. 26, 2021, which we believe will allow for further economic recovery in fiscal 2022. The city benefits from the strength of the entire MSA as commuter income taxes are a significant revenue stream. Commuter income taxes have been curtailed somewhat due to increased working from home during the pandemic, and the city has issued approximately $85 million in refunds for taxes filed in 2021. We view the return to more normal work patterns as key to near-term improvement in city revenue. The most recent economic forecast from S&P Global Economics indicates that the national economic outlook has cooled somewhat but remains resilient (see "Economic Outlook U.S. Q4 2021: The Rocket Is Leveling Off," published Sept. 23, 2021, on RatingsDirect).

Lower-income workers, who are more likely to live within the city than the wealthier surrounding suburbs, were disproportionately affected by the COVID-19 recession. The city's labor force participation has historically been weaker than peers, and this was exacerbated by COVID-19. The county unemployment rate was 12.4% in 2020, which we consider high and a negative credit factor. As of July 2021, it was 9.4%, which is still higher than the state (6.5%) and national (5.4%) rates. With the further easing of restrictions and children returning to in-person school in the fall, we anticipate the unemployment rate will decline. Still, we note that the city's population has long held pockets of deep poverty, and we believe it has both short- and long-term demands for service levels given its comparatively low per capita EBI. These statistics feed into our view of both the service-level needs and the ability to tap into the population for additional revenues.

Strong management

We view the city's management as strong, with good financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

Management practices include the following:

- Management develops revenue and expenditure assumptions during budget preparation based on an evaluation of past trends, adjusted for internal and external forecasts.
- Officials use regional economic models and IHS information for revenue forecasting and consult with regional Federal Reserve Bank officials. The city submits quarterly budget-to-actual and cash-flow reports to elected officials and PICA.
- Philadelphia annually produces robust rolling five-year financial plans that elected officials review and PICA approves. In cases where material challenges occur after the five-year plan's introduction, PICA requires the city to submit a revised plan.
- Management updates its six-year capital improvement program annually and identifies funding sources for each project.
- The city's formal investment policy requires monthly monitoring and reporting of holdings to the treasurer's office, coupled with quarterly meetings to evaluate performance.
- The city's debt policy includes various quantitative targets including: level debt service; 50% of tax-supported principal amortized in 10 years; net direct debt less than 3.5% of total assessed value (AV); 6% of general fund expenditures for tax-supported debt (excluding pension obligation bonds [POBs]); 7% of general fund expenditures for tax-supported debt service plus other fixed payments; and 20% of general fund expenditures for tax-supported

debt, other fixed costs, and pension costs combined.

- Philadelphia's home-rule charter calls for a budget stabilization reserve. Additionally, the city targets maintaining a general fund balance between 6% and 8% of revenue. However, reserves were lower than its policy in 2020 (5.8%) and are expected to fall well below it in 2021 (1.7%).
- While PICA was originally expected to terminate in 2023, the city is exploring options for a potential continued role for the authority. The oversight remains a strength, in our view.

Very weak budgetary performance

Philadelphia's budgetary performance is very weak, in our opinion. The city had deficit operating results in the general fund of 4.0% of expenditures, and slight deficit results across all governmental funds 0.9% in fiscal 2020. We base our assessment of performance on our view that Philadelphia's performance will weaken compared to its performance in 2020.

Current estimates for 2021 show that total general fund revenue was down 4.5% from 2020, due primarily to the pandemic-induced slowdown in the economy. Expenditures were also lower, but only 2.3% relative to 2020. As a result, the city estimates that fiscal 2021 closed with $212 million (4.3% of expenditures) decrease in general fund reserves. The structural budget gap was larger, but the city achieved about $75 million of general fund savings through a debt restructuring in the spring of 2021. It made some structural adjustments through increased parking taxes, a small increase in the nonresident wage tax rate, and maintaining other tax rates that were slated to decline, but these were relatively small adjustments.

The adopted 2022 budget contains $5.26 billion of revenue (including $575 million of ARP funds) and $5.27 billion of spending, a 5% increase over 2021 spending. The city's largest general fund revenue is its wage and earnings tax (45% of budgeted 2022 revenue) which is derived from city residents (approximately 60% of taxable income) and noncity residents (40%). Philadelphia lowered both its resident wage tax rate (3.8398% from 3.8712%) and its nonresident tax rate (3.4201% from 3.5019%) for fiscal 2022 and expects to continue to gradually lower them over the course of its five-year plan to make Philadelphia a more competitive place to live and work. Despite the reduced rate, the budget assumes 8.11% growth in its wage tax from fiscal years 2021 to 2022, as the economy recovers. If wage and earnings taxes do not rebound due to a lagging economy or a more significant and lasting change in commuter behavior, we would likely see downward credit pressure. The city expects real property taxes (20%) to remain flat in 2022. Business income and receipts tax (BIRT, 13%), real property transfer taxes (9%), and sales taxes (6%) are projected to change positive 0.86%, negative 1.49%, and positive 2.03%, respectively. Approximately half of the increased spending in 2022 is related to increased pension contributions as the city continues to fund its pensions in line with its RRP. It has also included $75 million as a reopening and recession reserve. All Philadelphia's labor contracts expired at the close of fiscal 2021, and the city recently reached agreements with its three largest unions for fiscal years 2022 through 2024. It estimates that the new agreements will increase expenditures above current projections by $318 million over the three years. The city included a $200 million labor reserve in its five-year forecast, which will partially cover the increase. It is in the process of identifying ways to offset the increased expenditures and will update its five-year plan to submit to PICA, likely in mid-October.

The city's financial statements are audited according to generally accepted accounting principles (GAAP), but management also reports results on a budgetary basis due to the significant amount of BIRT payments received in advance of being earned. Philadelphia prepares its five-year financial plan for PICA on a budgetary basis. We adjust the city's GAAP results to reflect the budgetary basis to recognize BIRT receipts in the fiscal year in which they are collected, and we view the budgetary basis as representative of the city's revenue profile.

As the potential termination of PICA nears (the existing law terminates PICA and the related city wage tax when the bonds are paid off in 2023), we will be watching for how the city responds to reduced oversight, as well as how it adjusts its revenue, if at all. To date, the surplus PICA revenue flows to the city. Management is exploring how the revenue and oversight could change at the planned expiration date and what other revenue-raising options it has. State involvement is necessary with respect to PICA's role and revenue, but should the city decide to raise revenues independently of PICA's role, it would only need to address the city council.

Very weak budgetary flexibility

Philadelphia's budgetary flexibility is very weak, in our view, with an available fund balance that we expect could decrease in the near term from its fiscal 2020 level of 5.8% of operating expenditures, or $290.7 million. Impairing budgetary flexibility, in our view, is limited capacity to reduce expenditures and limited capacity to raise revenues due to consistent and ongoing political resistance.

Management estimates that general fund reserves fell to just $78.7 million, or 1.7% of expenditures on a budgetary basis in fiscal 2021. Reserves are anticipated to improve modestly over the city's five-year forecast, but only if Philadelphia does not have to tap into its budgeted reopening and recession reserve will it make real headway improving its reserve levels. If it does not use the reopening and recession reserve, fund balance would increase to just over 3% in 2022, 5.45% in 2023, 5.74% in 2024, and just over its target of 6% by the end of 2025.

We view Philadelphia's overall budgetary flexibility as very weak given the city's relatively limited ability to raise revenue. We also view the city to have a limited capacity to reduce expenditures due to its high service needs and fixed costs, which for pensions alone are budgeted to be 15% of 2022 general fund expenditures. While it has the statutory authority to raise additional revenues, it has been focused on how to reduce various tax rates to lower the cost of business.

Very strong liquidity

In our opinion, Philadelphia's liquidity is very strong, with total government available cash at 30.7% of total governmental fund expenditures and 8.0x governmental debt service in 2020. In our view, the city has exceptional access to external liquidity if necessary.

We do not believe the various liquidity facility agreements supporting service and lease-agreement debt expose the city to nonremote contingent liability risk. With certain limited exceptions, service agreements expressly prohibit the acceleration of service fees supporting debt service on the related obligations or credit facility payments. The exception is debt issued to fund the city's stadium projects; in those cases, agreements allow for term but not principal acceleration.

Furthermore, we do not believe the city's swaps create a nonremote contingent liability risk due to the wide margin between its rating and the 'BBB-' rating trigger. Nor does it have any collateral posting obligations to its counterparties for the swaps.

Weak debt and contingent liability profile

In our view, Philadelphia's debt and contingent liability profile is weak. Total governmental fund debt service is 3.8% of total governmental fund expenditures, and net direct debt is 55.3% of total governmental fund revenue.

We view Philadelphia as having a weak debt and contingent liability position, reflecting our view of its low funded ratio for its pensions. The city's net direct debt is moderate. Approximately, 69% of general fund-supported debt is scheduled to be repaid in ten years; however, amortization of the city's total direct debt (including revenue debt) is slower, with approximately 53% repaid in ten years. The city's general fund-supported debt service payments are scheduled to decrease significantly in 2030, which could provide some additional flexibility in its budget for capital or operations.

Pension and other postemployment benefits:

- The crux of our assessment of the city's liability profile is its large pension obligation. And although the city's plan for funding has evolved through pension plan reforms and higher contribution rates, the low funded level remains a concern.
- The city has reformed its pension plan, lowered its discount rate, and contributed above its required contributions in recent years, but progress remains slow given the size of the liability.
- While the city provides OPEBs and only funds them on a pay-as-you-go basis, which does leave it somewhat vulnerable to rises in health care costs, it has a fixed five-year provision window, which somewhat mitigates these risks, in our view.

Philadelphia participates in the following plans (information as of June 30, 2020):

- City of Philadelphia Municipal Pension Fund: 51.9% funded, with a net pension liability of $6.2 billion.
- City of Philadelphia single-employer OPEB plan: 0% funded, with total OPEB liability of $1.9 billion.

The city's weak pension plan funding levels remain a credit pressure despite continued reforms and higher contributions. It made contributions in line with its RRP in 2020, which was in excess of our guideline for minimal funding progress, as well as static funding. It has made contributions above the RRP in prior years, but due to COVID-19-related financial pressures, it did not contribute above its RRP in 2020 or after.

As of the July 1, 2020 actuarial analysis, plan funding improved to 51.9%, using a 7.50% discount rate assumption. Under current assumptions, the plan is expected to be 80% funded by 2029 and 100% by 2033; however, we view some of these assumptions to be aggressive and that notable improvement in plan funding will likely require more time to come to fruition. The city has gradually lowered its discount rate over the past few years, and lowered it again to 7.50% from 7.55%, effective July 1, 2021. However, 7.50% is still high relative to S&P Global Ratings' guideline of 6.0%, which we consider a rate that mitigates contribution volatility, so in a market downturn, the city could be pressured to increase its pension contributions. The plan is amortized for a closed period and mortality rates have been updated, which we believe are stronger planning components. We believe that one of the keys to Philadelphia reaching its funding goal will be continued strong, above-MMO contribution levels, which help mitigate the potential for market-rate fluctuations and the lower-than-targeted investment returns.

The city funds OPEBs on a pay-as-you-go basis. The plan is a self-administered, single-employer, defined-benefit plan and the benefits are to provide health care for five years subsequent to separation for its eligible retirees. Some union-represented members might be able to defer their benefits. Nevertheless, the amount Philadelphia pays will be fixed at the amount the member would have paid at the separation date.

Very strong institutional framework

The institutional framework score for Philadelphia is very strong. (For more information on our view of institutional frameworks, see our "2020 Update Of Institutional Framework For U.S. Local Governments," published Nov. 10, 2020.)

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020