FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Philadelphia's (PA) IDR to 'A' from 'A-'; Outlook Stable

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Fitch Ratings - New York - 06 Jul 2022: Fitch Ratings has upgraded the following Philadelphia (PA) ratings to 'A' from 'A-':

--Issuer Default Rating (IDR);

--Outstanding unlimited tax general obligation (GO) bonds;

--Philadelphia Municipal Authority (PMA) bonds;

--Philadelphia Authority for Industrial Development (PAID) bonds;

--Philadelphia Redevelopment Authority (PRA) bonds;

--Philadelphia Parking Authority (PPA) parking system revenue bonds, series 1999A.

The Rating Outlook is Stable.

SECURITY

The GO bonds are backed by the city's full faith and credit and are payable from an ad valorem tax without limitation as to rate or amount. The outstanding obligations of PAID, PMA, PRA, and PPA are payable from annual service fee or lease rental payments by the city under non-cancellable agreements from any lawfully available source. The city's obligation to make payments is absolute and unconditional. State law and the city charter obligate the city council to appropriate annual payments through final maturity. Fitch rates these on par with the city's GO bonds and IDR given the lack of optionality.

ANALYTICAL CONCLUSION

The IDR and bond ratings upgrade to 'A' from 'A-' reflects the city's materially improved operating performance due to a robust tax revenue rebound and management's proactive budgetary actions.

The 'A' ratings reflect the city's fundamentally sound economic base including healthy growth in assessed values, broad legal control over key revenue items and a moderate long-term liability burden. These strengths are offset by the city's workforce-related expenditure constraints and historically constrained, but improved gap-closing capacity, even throughout the pandemic.

Economic Resource Base

Philadelphia is the sixth largest city in the U.S., with a stable employment base weighted toward higher education, healthcare and professional and business services. The 2020 Census population was 1.6 million, up 5% since 2010, and incorporates low-income levels and high poverty rates persist among city residents.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Wage, property and business income, PICA and receipts (BIRT) taxes together make up about 60% of total general fund revenues. Fitch expects them to resume growth in excess of its expectations for long-term inflation, as public health and economic conditions stabilize. The city retains essentially unlimited independent legal ability to raise revenues.

Expenditure Framework: 'a'

Spending increases will likely exceed revenue growth, requiring continued proactive budgeting. The city has just adequate expenditure flexibility notwithstanding moderate fixed costs given a highly unionized workforce and a statutorily-defined collective bargaining framework.

Long-Term Liability Burden: 'aa'

Long-term liabilities are expected to remain moderate relative to Philadelphia's broad and diverse economic resource base.

Operating Performance: 'a'

Reserves have strengthened with the city's prudent management through the pandemic-driven downturn and subsequent economic and tax revenue recovery. Despite anticipated drawdowns through Philadelphia's five-year financial plan, Fitch believes the city will continue its trend of prudent and conservative budget management, preserving strong gap-closing capacity to weather a moderate economic downturn.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--The city's ability to maintain reserves at or above the current projected level for fiscal 2022 (approximately 9% of budgetary basis spending) as federal aid is spent down.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--An increased gap between spending and revenue growth trends due to use of non-recurring funds to increase ongoing spending, other spending pressures or weaker than expected revenue recovery;

--Deeper draws on reserves than the currently projected in the city's five-year plan, potentially due to slower than anticipated economic and local revenue recovery, that erodes the city's improved gap closing ability and could delay a return to structural balance beyond 2025.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CURRENT DEVELOPMENTS

The city entered the pandemic-related economic downturn better prepared for economic weakness than it had been in many years, and operating performance has consistently exceeded budget through the pandemic. The city had built up available general fund reserves to $448 million on a GAAP basis, 9.7% of spending by fiscal 2019, or $439 million (9.1%) on the city's five-year financial plan basis. In fiscal 2020, tax revenues declined modestly and spending increased by 8% as the city responded to the pandemic. The budgetary pressures resulted in a draw on reserves including a $34.3 million use of the budget stabilization fund in 2020, to end the year with $414.5 million in unrestricted general fund reserves on a GAAP basis; a solid 8.4% of spending.

In June 2021, the city's five-year financial plan projected the city would end fiscal 2021 with a more than $200 million general fund deficit and less than $80 million in ending fund balance. Actual fiscal 2021 results reported in the June 2022 five-year financial plan indicate Philadelphia ended with a $7.8 million general fund surplus, increasing available unrestricted reserves to $298.5 million, 6.3% of general fund spending. On a GAAP basis, fiscal 2021 ended with a $442.7 million unrestricted fund balance, 9.3% of general fund spending including transfers. The GAAP basis includes reserves including the budget stabilization fund and unearned revenues not reflected in the city's five-year financial plan.

The positive results were driven by tax revenue collections that exceeded budget by $139.8 million and federal aid used to reimburse the general fund for pandemic related expenditures. The city's expenses were below the final budget by $230 million due in large part to spending cuts, including reduced debt service for restructured pension obligation bonds.

Estimated results for fiscal 2022 per the city's June 2022 five-year financial plan (reflecting the adopted fiscal 2023 budget) indicate a solid revenue recovery with approximately 15% yoy growth in local tax revenues driven in part by strong growth in wage (up 5%) and real estate transfer taxes (up 77%). The city also utilized $250 million in ARPA funds as revenue replacement and anticipates ending fiscal 2022 with a $194 million projected general fund surplus, ending the year with unrestricted general fund reserves of $492.4 million, roughly 9% of general fund spending.

Final results for fiscal 2022 may exceed projections as revenues have been trending higher. Through May, PICA reports y-o-y tax revenue growth of 17.8% versus the 15% estimate in the most recent five-year financial plan.

The fiscal 2023 adopted general fund budget incorporates roughly 3.8% in increase total general fund revenues including a 13.8% increase in property taxes and 5.6% increase in wage taxes compared to estimated fiscal 2022 revenues, and allocated $335 million in ARPA funds. The adopted budget projects that the year-end general fund balance on a budgetary basis will be $372 million or 6.3% of general fund spending, excluding a projected $40 million budget stabilization fund contribution and a $32 million recession and reopening contingency reserve. Collectively, estimated reserves at the end of fiscal 2023 may total $444 million, or 7.6% of projected spending.

The city saw a significant increase in taxable assessed values and projected property tax revenues, which provided an opportunity to lower the wage and BIRT tax rates. In April, the city released its new property valuation assessments, which reflected a 31% increase in residential property values since 2020, which is expected to yield an additional $93 million in fiscal 2023 ($460 million from 2023 to 2027), adjusted for projected tax appeals and collection losses. The adopted budget holds the tax rate level at 14 mills (for city and schools), but includes property tax relief programs to minimize the effect of the increase in property values including the Longtime Owner Occupation Program, rental assistance and a senior tax freeze program.

Slow reductions in the wage tax rate were planned prior to the pandemic but in fiscal 2021 the resident tax rate was held constant and the non-resident rate was increased temporarily. The adopted fiscal 2023 budget reduces the city's wage tax to 3.79% from 3.83% for residents; 3.44% from 3.448% for non-residents; and the net income portion of the business income and receipts tax (BIRT) to 5.99% from 6.2%. The 2023 adopted budget assumes that wage and BIRT tax collections will grow by 6.9%, reflecting a healthy economic recovery.

Five-Year Plan Assumes Recovery

The city's June 2022 five-year financial plan (fiscal 2023-2027) assumes a solid revenue recovery with 3.9% average annual growth throughout the plan, reflecting anticipated growth in the local economy. Wage tax revenues are projected to surpass pre-pandemic levels in fiscal 2023 despite the expected long-term decline in the number of non-residents commuting to the city and slight tax rate declines. The city anticipates a structurally balanced budget for 2025, after all ARPA funds are expended.

The city plans to add roughly $165 million to the budget stabilization reserve throughout the five-year plan. Additionally, the city has established a recession/pandemic reserve and a labor reserve for future labor contracts, appropriating $32 million and $10.6 million, respectively, in fiscal 2023. Management plans to direct unused balances at year-end to general fund reserves. Fitch views the plan to grow reserves as prudent; nevertheless, out-year shortfalls may widen if revenues fall short of management's expectations.

The city expects to continue gradually increasing its contribution to the Philadelphia School District (PSD; BB+/Stable) including a budgeted a 5.4% increase in fiscal 2023. The city's annual contributions to SDP are expected to increase each year, reaching $288 million by fiscal 2025. The city also provides Southeastern Pennsylvania Transportation Authority (SEPTA; AA/Stable) a $100.7 million subsidy, a 10% increase over fiscal 2022's contribution.

CREDIT PROFILE

The city's trend of solid economic, jobs and tax revenue growth, was disrupted by the coronavirus pandemic. During the pandemic, company mandates directing employees to work remotely for health and safety reasons led to increased job losses and unemployment, with rates that exceeded the state and national averages. There is a lingering impact on the city's wage and earnings tax revenues given that 40% of wage taxes (13% of general fund revenues) were generated from workers who reside outside of the city and the total number of commuters is expected to decline. The city anticipates that to the nonresident wage tax will decline by 25% because a large portion of the commuter population will continue to work remotely given the shifts in work requirements.

Revenue Framework

Philadelphia has a diverse revenue base, with a wage tax, business income and receipts taxes, and a property tax and a sales tax each generating a significant portion of local revenues. The wage and earnings tax (essentially an individual income tax without a capital gains component and often referred to as the wage tax) typically accounts for approximately one-third of general fund revenues. A tax on net profits of businesses within the city generates a much smaller share of revenues and is often reported with the wage tax.

The city also receives transfers from the Pennsylvania Intergovernmental Cooperation Authority (PICA), a state-appointed oversight board, of a 1.5% tax on wages, earnings and net profits, net of deductions for debt service on PICA revenue bonds. Including the PICA transfer, the total revenues derived from wage, earnings and net profits taxes make up approximately 40% of general fund revenues.

Fitch anticipates solid general fund revenue growth prospects, absent future policy actions. Historical general fund revenue growth, after adjusting for a significant accounting change including rate increases and decreases over the years, has been robust. The city has a history of making tax policy changes including the slowly reducing the wage tax rate (except for three years around the Great Recession, and in the fiscal 2021 adopted budget when the city held rates steady), restructuring of the business income and receipts tax, and sales tax rate changes authorized by the commonwealth.

Philadelphia maintains ample independent legal authority to adjust revenues, other than the sales tax, under provisions of Pennsylvania's Sterling Act. The city has regularly utilized that ability to adjust wage, business income and receipts, and property taxes to improve Philadelphia's economic competitiveness or provide additional budgetary flexibility

Expenditure Framework

Philadelphia pays for a wide range of public services, including public safety which represents about one-half of spending, as with many local governments. The city does not directly pay for education but supports the coterminous SDP with direct appropriations and other policy measures such as statutory allocations of specific taxes. A fixed portion of a 1% local sales tax is directed to the school district, with any excess allocated to the city's pension system

Spending growth absent policy actions will likely exceed projected natural revenue growth due to a high demand for services (particularly given the city's low wealth levels), moderating yet persistent growth in pension and other labor costs, and expectations for increased support for SDP.

Philadelphia has adequate expenditure flexibility with a moderate carrying cost burden for debt service and post-retirement benefit costs (approximately 14% of governmental funds expenditures in fiscal 2021) but a constraining workforce environment. The vast majority of city employees are unionized (80%) and labor relations have been somewhat contentious, with multiple recent public safety contract negotiations ending in binding arbitration. Management retains very limited ability to alter contracts.

Pension Funding is a Fiscal Priority

The city consistently directs otherwise unallocated revenues to the pension fund in addition to making its standard annual contribution discussed further below. Since fiscal 2018, calculation of the city's annual pension contributions utilizes a revenue recognition policy (RRP) that leads to contributions above the statutorily required minimum municipal obligation (MMO), which is essentially the actuarially determined contribution (ADC).

The RRP excludes the sales tax contributions and certain recently collectively-bargained increases in employee contributions when calculating the city's annual pension contributions. Therefore, instead of reducing annual contributions, those additional revenues are used exclusively to pay down the pension liability. The fiscal 2023 RRR estimated contribution reflects an almost 5% increase and 6.2% increase in the sales tax contribution compared to fiscal 2022 contributions.

Substantial City Investment in School District Will Continue

Philadelphia's commitment to the school district represents an additional expenditure pressure. SDP faces its own significant challenges and relies heavily on the city for fiscal support. In addition to the school district's share of the property tax, which is the district's largest source of local funding, Philadelphia has historically contributed to the school district primarily via direct appropriations, sometimes supported by the levying of new taxes or allocations of existing taxes.

In the fiscal 2023 budget, the city's contribution to SDP is $270 million, approximately 4.6% of the city's general fund budget. The city's annual contributions to SDP are expected to increase each year until the total reaches $288 million by fiscal 2025. SDP's fiscal position has improved but the district remains challenged. The district relies primarily on partnerships with the commonwealth and city, its primary external stakeholders, to provide its funding.

Long-Term Liability Burden

Philadelphia's long-term liability burden of approximately 15% of 2020 personal income is in the moderate range relative to the city's resource base. Fitch views the city's capital needs as moderate and unlikely to affect the burden significantly. Direct and overlapping (mostly Philadelphia School District) debt are each about one-fourth of the total liability, with NPL representing the other half.

The city utilizes a closed 30-year pension amortization schedule (ending in 2038). When the amortization was reset to this schedule, the city also shifted to the more conservative level-dollar amortization method from the level percentage of payroll method. The city's revenue contributions above the ADC noted above could moderate the burden over time if actuarial assumptions are met, but Fitch anticipates the burden will remain sizable.

Operating Performance

Philadelphia's reserves have remained strong throughout the pandemic, exceeding the pre-Great Recession peak both in nominal terms and as a percentage of spending. Based on the June 2022 five-year financial plan, Fitch anticipates Philadelphia will have some level of operating deficits over the next several years as it adjusts its budget to the expiration of federal aid. But the city's high inherent budget flexibility will support maintenance of strong gap-closing capacity. The city plans to add $165 million to its budget stabilization fund in the five-year plan through fiscal 2027 to provide cushion against ongoing economic pressures.

Philadelphia has an extensive statutory and policy-based framework for timely and proactive budget management throughout the economic cycle, revolving around PICA's reporting and certification requirements, which has been in place for many years. The city's effort to maintain its financial flexibility during periods of economic recovery are key to the city's ability to address the fiscal stresses in economic downturns. A demonstrated ability of the city to maintain its higher reserve balances over the next few years could lead to a positive rating outcome.

Close monitoring of fiscal performance by the Pennsylvania Intergovernmental Cooperation Authority (PICA), a fiscal oversight entity, reinforces the city's efforts to address the imbalances as they arise. The mayor submits annual five-year financial plans and quarterly intra-year updates to PICA. PICA must certify whether the plans resolve any projected deficits.

If PICA certifies non-compliance, the city forfeits a portion of the 1.5% additional PICA wage tax providing strong incentive for the city to maintain fiscal balance. The PICA revenues are used first to pay debt service and administrative costs, then remitted the remainder to the city for operations. The 2023 adopted budget estimates that $561.3 million will be available in fiscal 2023, approximately 10% of general fund revenues.

The final payment in fiscal 2023 of debt service on PICA bonds issued on the city's behalf contributes a small amount to the anticipated increase in the net wage tax. Without further action PICA will sunset upon debt maturity. However, the city intends to retain PICA to provide monitoring and oversight. Legislation, which recently passed in the PA senate to extend the oversight period to 2047 has been sent to the governor for final approval

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Philadelphia (PA) [General Government] has an ESG Relevance Score of '4' for Labor Relations & Practices due to the impact collective bargaining has on the city's expenditure flexibility which has a negative impact on the credit profile, and is relevant to the rating[s] in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Philadelphia (PA) [General Government]	LT IDR	A Rating Outlook Stable	Upgrade	A- Rating Outlook Stable
Philadelphia (PA) /General Fund Contractual Obligations - Lease and Service Agreements/1 LT	LT	A Rating Outlook Stable	Upgrade	A- Rating Outlook Stable
Philadelphia (PA) /General Fund Contractual Obligations - Parking Authority/1 LT	LT	A Rating Outlook Stable	Upgrade	A- Rating Outlook Stable
Philadelphia (PA) /General Obligation - Unlimited Tax/1 LT	LT	A Rating Outlook Stable	Upgrade	A- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 04 May 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Philadelphia Parking Authority (PA)	EU Endorsed, UK Endorsed

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