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Pittsburgh Rebirth Tainted as Pension Fuels Deficit: Muni Credit.

The fiscal rebound of Pittsburgh, the former steel-city capital that shed a Rust-Belt fate by rebuilding its economy around universities and hospitals, has struck an obstacle that's bedeviling municipalities nationwide.

Pennsylvania's second-most-populous city faces an operating deficit next year for the first time since 2005, partly because of higher pension contributions after officials lowered assumptions for the retirement system's investment returns.

Pittsburgh faces a month-end deadline to approve a plan to plug the shortfall, illustrating how even municipalities that have dodged bankruptcy struggle with pension burdens. The city, which teetered on the brink of insolvency a decade ago, earned its highest rating ever from Standard & Poor's in February.

"We've come a long way; we see the light at the end of the tunnel," said Michael Lamb, the city's controller. "We have put more money in pensions than we're required to, but we're still not doing enough."

Lower Target

In December, Pittsburgh decided to lower its pension-return target — adding $8 million to annual costs — to fall in line with national trends, according to consultants hired by the state to oversee the city's recovery. The average assumed return rate last year for 150 U.S. public plans was 7.66 percent, compared with 8.08 percent in 2001, according to the Center for Retirement Research at Boston College.

More municipalities will lower targets as rating companies factor retirement liabilities into credit assessments, said Howard Cure, head of municipal research in New York at Evercore Wealth Management LLC, which oversees about $5.2 billion.

Pittsburgh has evolved from its industrial past, when plants producing coke used in steel-making would shower parked cars with ash. As manufacturing dwindled amid global competition, residents left. About 306,000 people live in the city at the confluence of the Ohio, Allegheny and Monongahela rivers, compared with about 604,000 in 1960.

By 2003, Pittsburgh was in crisis. It cut about 13 percent of its workforce that year, firing 446 employees, including almost 100 police officers. It also earned the dubious distinction of having the lowest credit rating of any major U.S. city. Pennsylvania officials placed it in the Act 47 program for distressed communities in December 2003, giving the state oversight over its finances and requiring recovery plans.

Turnaround Time

Since then, city officials have turned around Pittsburgh's finances through steps such as taxing companies' payrolls and temporarily freezing wages, said Dean Kaplan, a managing director at Public Financial Management Inc., one of the state-appointed consultants.

In a sign of the diversifying economy, U.S. Steel Corp. (X), which has been based in Pittsburgh since 1937, no longer ranks among the top 10 employers. The biggest is the University of Pittsburgh Medical Center, and the city is also home to companies such as PNC Financial Services Group (PNC) and H.J. Heinz Co.

In November 2012, the state's consultants said Pittsburgh was ready to exit the distressed program. Revenue had exceeded operating expenses every year since 2005, although transfers to pay debt and pensions in 2008 and 2010 generated shortfalls approved by the city's fiscal overseers. State officials rejected the consultants' recommendation in March, saying legacy costs such as pensions jeopardize the budget.

Deficit Ahead

That caution was borne out in the recovery plan consultants released last month in response to the state's denial. The city faces a projected $14 million operating deficit in the year beginning in January and may use up its reserves by 2018, the report said.

The city's change in how it levies real estate taxes curbed revenue, Kaplan said. At the same time, minimum pension contributions will jump to $43 million next year, or 8.6 percent of the general-fund budget, from $31 million, or 6.5 percent of this year's plan. The swelling costs resulted from adjusting actuarial assumptions to reflect recipients' longer life expectancy, and from lowering the target investment return on pension assets to 7.5 percent from 8 percent, Kaplan said.

Pay Up

The state's consultants said the city should pay even more than required amounts over the next five years to sustain its pension system, which serves about 7,500 people and is about 58 percent funded. The average state and local plan had about 72 percent of the money needed to meet retirement obligations last year, the Center for Retirement Research said. In 2010, the city avoided a state takeover of its pensions by dedicating parking revenue through 2041 to the system.

The five-year road map recommends raising real-estate taxes and parking rates. Mayor Bill Peduto, a Democrat, wants to avoid the increases, and to do so, "all options are on the table," said a spokesman, Tim McNulty, who declined to offer specifics. Officials have planned a public hearing on the consultants' proposal for June 16, he said.

Kaplan said the city, which last sold municipal bonds in 2012, must also invest in roads and bridges. The consultants' blueprint calls for selling $50 million of bonds in 2015 and again in 2017 for infrastructure.

Officials "are not going to have a hard time placing it" because of the city's progress during the past decade, said Dennis Derby, who helps manage munis, including Pittsburgh debt, at Wells Capital Management in Menomonee Falls, Wisconsin.

S&P raised Pittsburgh's rating in February to A+, its fifth-highest level, citing its diverse economy.

Pittsburgh general-obligation bonds maturing in September 2021 traded June 6 at an average yield of 2.4 percent, the lowest in 14 months and 0.52 percentage point above benchmark munis, data compiled by Bloomberg show.

By Romy Varghese Jun 12, 2014

To contact the reporter on this story: Romy Varghese in Philadelphia at rvarghese8@bloomberg.net

To contact the editors responsible for this story: Stephen Merelman at smerelman@bloomberg.net
Mark Tannenbaum, Alan Goldstein