

# **Bond Case Briefs**

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## **Fitch Rates Philadelphia, PA's GOs 'A-'; Outlook Revised to Positive.**

Fitch Ratings-New York-19 April 2019: Fitch Ratings has assigned an 'A-' rating to the city of Philadelphia, Pennsylvania's \$179.69 million general obligation (GO) refunding bonds, series 2019A.

The bonds are expected to sell through a negotiated sale on or about April 30, 2019. Proceeds will refund certain outstanding GO bonds of the city.

Fitch has also affirmed the following ratings at 'A-':

- \$157.6 million Philadelphia Municipal Authority (PMA) bonds;
- \$1.9 billion Philadelphia Authority for Industrial Development (PAID) bonds;
- \$206.5 million Philadelphia Redevelopment Authority (PRA) bonds;
- \$10.9 million Philadelphia Parking Authority (PPA) parking system revenue bonds, series 1999A;
- Philadelphia's Issuer Default Rating (IDR);
- \$1.5 billion Philadelphia GO bonds.

The Rating Outlook is revised to Positive from Stable.

### **SECURITY**

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 bonds issued by PMA, PAID, PRA, and PPA are payable from annual service fee or lease rental payments by the city under non-cancellable agreements. 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, and Fitch rates these on par with the city's GO bonds and IDR given the lack of optionality.

### **ANALYTICAL CONCLUSION**

The Outlook revision to Positive reflects gains in Philadelphia's operating performance and overall flexibility, which could support a higher rating if the city is able to consolidate those improvements as spending pressure ramps up, including for pension costs, new labor contracts, and the school district.

Philadelphia's 'A-' IDR reflects its strong economic base and solid revenue growth prospects, offset by expenditure constraints and reserves which had been fairly modest until very recently. The long-term liability burden is somewhat elevated but well within the capacity of the city's resource base. A comparatively constrained expenditure framework pressures the budget, but solid economic and revenue growth and careful budget monitoring should support spending demands. Long-term forecasting, active fiscal management, and close oversight from a state board provide important support for the city's financial resilience.

The 'A-' ratings on lease and service fee agreement bonds issued by various authorities for the city, as well as the PPA series 1999A parking system revenue bonds, reflect the lack of optionality for appropriation embedded in these commitments by city ordinance, the city's charter and state law.

#### Economic Resource Base

Philadelphia serves as a regional economic center in the Northeast, with a stable employment base weighted toward the higher education and healthcare sectors. Jobs expansion since the Great Recession has been steady and strong, but comparatively low wealth levels and modest population increases persist, limiting growth prospects. The population is approximately 1.6 million.

#### KEY RATING DRIVERS

##### Revenue Framework: 'aa'

The income, property and sales taxes that are Philadelphia's primary revenue sources will likely grow ahead of inflation but below national GDP given economic prospects, absent policy action. Philadelphia retains essentially unlimited independent legal ability to raise revenues.

##### Expenditure Framework: 'a'

Philadelphia's recent expenditure growth has been measured, reflecting ongoing budgetary control efforts. The city faces persistent fixed-cost growth pressures with limited flexibility regarding labor expenses given a highly unionized workforce and a statutorily-defined collective bargaining framework. The future trajectory of spending growth will likely exceed baseline revenue growth, requiring continued proactive budgeting.

##### Long-Term Liability Burden: 'a'

Long-term liabilities are somewhat elevated but still in the moderate range relative to Philadelphia's resource base.

##### Operating Performance: 'bbb'

Recent gains in the city's ability to respond to changing fiscal circumstances, including higher reserves, reflect improved budgetary management practices and robust revenue growth. In the event of a downturn, Fitch anticipates the city would address fiscal stress with its available tools, including some use of reserves, and continue its demonstrated ability to gradually recover financial flexibility.

#### RATING SENSITIVITIES

**SUSTAINED IMPROVEMENT IN FINANCIAL FLEXIBILITY:** The city has made recent progress in enhancing fiscal resilience and its budgetary management, benefiting from a long economic expansion and strong tax revenue growth. Indications that these gains reflect sustainable improvements in the city's fundamental financial flexibility, such as achieving projected reserve levels over the next one to two years and maintaining the federal funding reserve cushion, would support an upgrade. Our view of the city's current operating performance is tempered by Philadelphia's significant budgetary stress following the Great Recession and somewhat inconsistent progress in restoring financial flexibility since then.

**MANAGEMENT OF EXPENDITURE PRESSURES:** One potential hurdle for the city will be expenditure challenges. Philadelphia faces notable expenditure pressures over the next several years including for contracts for a mostly unionized workforce which expire at the end of fiscal 2020, demands for increased funding for the school district that is now under city control, and retirement benefit costs. The city has taken steps to mitigate these risks including a labor reserve, a multi-year commitment to increase appropriations to the school district and supplemental pension contributions, all of which are built into the city's five-year financial plans. An upgrade will be

contingent on the city's ability to manage that growth while consolidating the recent improvements in overall financial flexibility.

## CREDIT PROFILE

### Revenue Framework

Philadelphia has a diverse revenue base, with a wage tax, business income and receipts taxes, 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) accounts for more than 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 and earnings tax.

The city also receives transfers from the Pennsylvania Intergovernmental Cooperation Authority (PICA) 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 one-half of general fund revenues. The other key revenue sources make up another one-third of general fund revenues.

Historically, the wage and earnings tax (also referred to as the wage tax) has proven relatively resilient with limited declines. For well over a decade, the city has been gradually reducing rates to enhance the city's economic competitiveness. The wage tax is levied on both residents and non-residents working within Philadelphia (and on residents working outside the city), thereby capturing higher wealth levels in surrounding suburbs and offsetting Philadelphia's high poverty rate.

Property taxes have shown little volatility throughout economic cycles as well, with more robust growth in recent years attributable to the strong real estate market and the city's continued position as a regional economic center. Other tax revenues have been more volatile, due mainly to policy changes at the city and commonwealth levels.

Historical general fund revenue growth, after adjusting for a significant accounting change, has been robust. However, the growth also reflects tax policy changes including both rate increases and decreases. The city shifted certain federal and commonwealth grants from the general fund to the grants revenue fund beginning in fiscal 2012; these grants averaged \$469 million between fiscal years 1999 and 2011, or roughly 10% to 15% of general fund revenues. Management provided Fitch with detailed breakouts of the revenues from prior years, which allowed Fitch to adjust general fund revenues to a like-for-like basis by removing the affected revenues in earlier years.

Fitch anticipates solid general fund revenue growth, absent future policy actions, ahead of inflation but somewhat below national economic growth. Significant policy changes implemented by the city include small but regular rate reductions in the wage tax (except for three years around the Great Recession, 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.

The Philadelphia beverage tax (PBT) is levied on the distribution of certain beverages at 1.5 cents per ounce. Proceeds are funding specific policy initiatives, including expanded pre-kindergarten. PBT revenue has fallen short of expectations. The city continues to moderate spending on related initiatives to reflect lower receipts. Fiscal 2018 collections were just under \$80 million, or a modest

approximately 2% of general fund revenues.

#### Expenditure Framework

Philadelphia pays for a wide range of public services, but public safety represents the largest expenditure category (about one-half of spending), as with many local governments. The city does not directly pay for education but does support the coterminous School District of Philadelphia (SDP, IDR BB-/Stable) with direct appropriations and through other policy measures such as statutory allocations of specific taxes.

In recent years, the city issued short-term bonds to finance an SDP operating deficit, and the commonwealth Legislature permanently redirected part of an increase in the city's local sales tax levy to the district. The commonwealth originally authorized the increased levy (to 2% from 1%) effective in fiscal 2010 as a temporary measure and directed it to the city's pension contributions. Effective in fiscal 2015, the commonwealth made the increase permanent and designated a fixed portion for the school district and any excess 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 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% in fiscal 2018) but a constraining workforce environment. Pension costs have escalated sharply in recent years due partially to actuarial adjustments to revise down the investment return assumption (to a still somewhat aggressive 7.55% for the fiscal year 2020 contribution calculation) and apply findings from the 2016 actuarial experience study. The pension board has lowered the investment return assumption steadily from 8.75% for the fiscal 2008 contribution and intends to continue reducing the rate in future years.

Pension contributions growth remains a pressure point. To help mitigate this, the city consistently directs any new and otherwise unallocated revenues to the pension fund. For fiscal 2019, a statutorily-required (at the commonwealth) allocation from the city's sales tax to pay down the pension liability increases by approximately \$15 million as debt service on the short-term bonds for SDP rolls off with bond maturity, rising to \$45.2 million. The city also allocated \$74.4 million from the fiscal 2018 ending general fund balance, which was \$140 million higher than budgeted, to the pension system.

In addition, since fiscal 2018, the city is contributing using 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 pension system's actuary estimates the RRP will exceed the MMO by \$30 million in fiscal 2020. If these practices continue, and if actuarial assumptions including the still-aggressive investment return assumptions are met, the city could stabilize or reduce its long-term liability burden and carrying cost over time.

The vast majority of city employees are unionized with most work terms established in multiyear contracts. Historically, labor relations have been somewhat contentious, with multiple recent contract negotiations ending in binding arbitration. Management retains very limited ability to alter contracts, but current wage and benefit terms are not a short-term threat to fiscal stability.

The current set of labor contracts reflects the challenges and the city's somewhat constrained flexibility. A 2016 agreement with the largest blue-collar union (AFSCME DC 33) included salary increases well within the city's fiscal capacity and a stacked hybrid pension plan that is mandatory for new hires and could reduce costs over the long term. More recent arbitration awards to the Fraternal Order of Police (FOP) and International Association of Fire Fighters (IAFF) included slightly more robust wage increases through fiscal 2020 and they do not reduce pension benefits for new employees. The awards do include increased employee pension contributions.

Contracts for essentially all of the city's unionized workforce and the school district's contract with the teachers union, expire at the end of fiscal 2020. The city's 27th five-year financial plan approved by PICA in 2018 includes a reserve for increased labor costs but Fitch anticipates actual needs could exceed the dedicated reserve, driving higher spending in future years. In its review of the five-year financial plan, PICA estimated new labor contracts with 2% wage increase assumptions could exhaust the reserve by 2022. Annual wage increases under the current contracts range from 2.5% to 3.75%.

Philadelphia's commitment to the school district represents an additional expenditure challenge point, particularly given the city's resumption of school district oversight in 2018 from the commonwealth's now-dissolved School Reform Commission. SDP faces its own significant challenges and relies heavily on the city for fiscal support. Philadelphia has historically contributed to the school district primarily via direct appropriations, sometimes supported by the imposition of new taxes or allocations of existing taxes.

Actions taken in the city's enacted fiscal 2019 budget illustrate the city's ongoing commitment to supporting SDP, and the implications for the city's fiscal flexibility. In fiscal 2019, the city's contribution to SDP increases approximately \$77 million, or 73%, to \$181 million. This contribution represents 4% of the city's general fund budget. While future increases are more modest (18% in fiscal 2020, 14% in fiscal 2021, 5.8% in fiscal 2022, and 1.2% in fiscal 2023) and SDP's fiscal position has improved, the district remains challenged. The pending expiration of the teachers' contract next fiscal year will add further pressure and could require additional city support. Unlike all other Pennsylvania school districts, SDP has no ability to set its own local tax policy and relies entirely on the commonwealth and city to approve its tax rates.

#### Long-Term Liability Burden

Philadelphia's long-term liability burden of approximately 20% of 2017 personal income is somewhat elevated but still in the moderate range relative to the city's resource base. Philadelphia has similar levels of debt (approximately \$7 billion, including direct debt and overlapping debt of SDP) and Fitch-adjusted net pension liabilities (approximately \$8 billion) for its primary single employer plan. The city maintains a separate single employer plan for Philadelphia Gas Works (PGW), an independently operated enterprise unit (revenue bonds BBB+/Stable) that Fitch does not include in our calculation of the city's long-term liability burden. At July 1, 2018, PGW reported an unfunded actuarial liability of approximately \$215 million, or less than 1% of the city's 2017 personal income.

For the city's pension fund, the primary contributors to growth in the reported net pension liability in recent years were market underperformance (below actuarial assumptions) and recent actuarial changes to revise down the return assumption and implement findings from an experience study. The city's ongoing contribution of revenues above the actuarially determined contribution (ADC) could moderate the burden over the long term if actuarial assumptions are met, but Fitch anticipates the burden will remain sizable.

The city has contributed at least the ADC for many years, although Philadelphia did defer (and repay within five years as required when the commonwealth authorized the deferral) a portion of the

statutorily required MMO in fiscal years 2010 and 2011. The pension liability was re-amortized several years ago over a closed 30-year term (ending in 2039), which reduced the annual cost. The re-amortization also included a shift to the more conservative level-dollar amortization method from the prior level percentage of payroll method.

Long-term debt has been managed very closely in recent years. Fitch's calculations for the city's outstanding debt includes Philadelphia's estimate for \$15 million in annual capital lease payments and a \$200 million projected bond issuance in 2026 for its police headquarters renovation project at 400 N. Broad Street.

The city does have variable-rate debt and swap exposure amounting to approximately 10% of its outstanding direct debt, but Fitch does not view it as a material rating concern.

#### Operating Performance

Philadelphia's reserves have increased notably in recent years, reaching levels not achieved since the Great Recession. While likely to decline somewhat over the next several years, the city projects reserves will remain at levels supportive of strong gap-closing capacity. The city's proposed 28th five-year plan included with the Mayor's executive budget for fiscal 2020, indicates the ending general fund balance portion of reserves will be drawn on over the next several years as the city addresses spending pressures including continued growth in pension contributions, labor costs in current contracts and in the next set of contracts, and growth in SDP contributions agreed to last year.

The projected fund balance draws also include the city's first contributions to a dedicated budget stabilization reserve (BSR, or rainy day fund) this year (\$20 million) and next (\$34 million) with another \$38 million contribution projected for fiscal 2024. The reserve, established via city charter amendment in 2011, has never been funded. Charter restrictions limit its use to fiscal emergencies as declared by the city's finance director. The five-year plan also incorporates approximately \$55 to \$58 million annually as a "federal funding reserve" to offset potential losses in federal revenues. The city began including the reserve with its fiscal 2018 budget. To date, the city has not been required to tap into that annual budget allocation.

If the city is able to maintain overall reserves (available general fund balance and BSR) at or near currently projected levels and continue the enhanced budgetary management practices discussed further below, despite the spending pressures noted earlier, then Fitch could raise its assessment of the city's operating performance. Generally, in the event of a downturn, Fitch anticipates the city would draw on its reserves and also utilize its high budget flexibility with possible measures including halting currently planned reductions in wage and business income and receipts tax rates, headcount reductions and furloughs. Philadelphia took such steps during the Great Recession.

Close monitoring of fiscal performance by PICA, the state-appointed oversight board, provides further assurance the city would quickly address potential imbalances caused by economic downturns. 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 the PICA portion of the wage tax (more than \$400 million in fiscal 2018 or approximately 10% of general fund revenues), providing strong incentive for the city to maintain long-term fiscal balance.

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. The city's efforts to rebuild flexibility during periods of economic recovery remain somewhat inconsistent but have improved recently. Fund balances grew in the years following the

Great Recession, then became more volatile in recent years, before strong increases of \$74 million and \$170 million in fiscal years 2017 and 2018.

The federal funding reserve included in the 2018 budget contributed to the sizable increase that year, as did robust tax revenue growth discussed below. Inclusion of the federal funding reserve in the five-year financial plans provides a modest annual budgetary cushion, and the BSR contributions in 2019, 2020, and 2024 would establish the city's first dedicated rainy day fund. Other steps include the one-time and ongoing supplemental pension contributions above the ADC noted above. Together, these measures indicate some improvement in the city's budgetary management and could support an improved assessment of the city's operating performance if they are maintained.

Philadelphia's liquidity improved considerably in fiscal 2018 with government-wide days cash reaching 76 days, from below 60 days in the past several years, reflecting the improvement in general fund ending balance. Fitch anticipates liquidity levels could weaken somewhat with the projected declines in general fund balance, we expect they will remain adequate for the city's fiscal needs given its high level of budget flexibility and close monitoring from PICA. Philadelphia has demonstrated clear and consistent market access, having issued tax and revenue anticipation notes virtually every year since fiscal 1972.

## CURRENT DEVELOPMENTS

Philadelphia ended fiscal 2018 with a second consecutive general fund annual surplus on a GAAP basis (\$211 million, or 5% of general fund spending) and on a budgetary basis (\$153 million, or 3% of spending). This well exceeds the enacted budget estimate of \$75.5 million. Philadelphia's fiscal 2018 GAAP-basis, available general fund balance of \$322 million represented 7% of general fund spending. The city reported a higher available general fund balance of \$369 million (8% of general fund spending) on a budgetary basis.

The reported general fund balance is net of a \$74.4 million supplemental pension contribution and additional funding for pay as you go capital spending. The lower GAAP basis number reflects an accounting change implemented by the city in fiscal 2002 regarding the business income and receipts tax. PICA and the city both utilize the budgetary basis for the certified five-year financial plans.

Strong tax revenue growth primarily drove performance in fiscal 2018. On a combined basis, the wage tax and the real estate transfer tax exceeded initial budget estimates by more than \$160 million in fiscal 2018. Wage tax collections were up an estimated 6% to \$1.5 billion versus a roughly 3% budgeted growth rate from fiscal 2017. The more volatile real estate transfer tax was even stronger, coming in at more than 26% growth to \$313 million while the initial budget only anticipated \$243 million. The city attributes the gains primarily to a growing economy, but notes that some of the growth may reflect one-time activity. For example, Comcast, one of the larger local private employers, distributed one-time bonuses to employees following enactment of the recent federal tax changes.

## FISCAL 2019 REFLECTS ADDITIONAL SUPPORT TO SCHOOL DISTRICT

The enacted fiscal 2019 budget includes a significant package of approximately \$600 million in increased funding for the coterminous SDP over the next five years. Enacted revenue measures to support the \$600 million increase include a slower pace in planned reduction of the wage tax rate, an increase in the real estate transfer tax rate, and an increase in direct city grants to the school district. Even if the revenue measures fell short of expectations, Fitch anticipates the city would fulfill its additional commitments to SDP.

The tax increase and slow-down in the planned reduction in the wage tax rate somewhat limits the city's practical future revenue-raising flexibility. But education remains a key policy priority for the mayor and the new funding allows the school district to make significant progress in addressing a fund balance deficit estimated at \$900 million over the next five years before the city's contributions. Stabilizing the fiscal position of the school district is likely to yield long-term positive economic and budgetary implications for the city.

## PROJECTIONS INDICATE IMPROVED FISCAL RESILIENCE, AND FISCAL RISKS

In March, the Mayor released a fiscal 2020 executive budget and proposed 28th five-year financial plan through fiscal 2024. The plan incorporates higher spending for SDP as noted above, growth in pension costs, and reserves for new collective bargaining agreements and federal funding. The federal funding reserve level is consistent with prior years, and Fitch believes it provides valuable annual budgetary flexibility. In contrast, the labor reserve is likely to be inadequate to meet increased costs for new collective bargaining agreements, requiring proactive budgeting for the city to maintain projected reserve levels.

## LEASE AND SERVICE FEE AGREEMENT OVERVIEW

Fitch considers the credit quality of Philadelphia's lease and service fee agreement bonds equivalent to the city's general credit quality as expressed in the IDR, given the lack of optionality for the city to annually appropriate for payments used for debt service. Prior to the issuance of each series of bonds, the city enters into a non-cancellable agreement with the issuing authority that has been approved by the City Council by ordinance. The agreements, all substantially similar in legal terms, require the city to appropriate annual lease rental or service fee payments from current revenues.

The City Council ordinance approving the agreements also requires the council to budget and appropriate these payments annually. The city's charter explicitly allows the council to authorize service agreements that extend beyond one year, and they are valid and binding commitments of the city. Commonwealth law also authorizes the city to make contracts for more than one year and states that it is "the duty of [city] council to make subsequent appropriations from year to year as required for the purposes of such contracts."

Fitch views the combination of the commonwealth statutory language, the city charter provision authorizing multiyear commitments, and the non-cancellable nature of the absolute and unconditional obligations set forth in the agreement approved by local ordinance as eliminating any optionality on the part of the city to appropriate required annual payments.

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

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