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Fitch: Philadelphia School District Takeover Presents Risks and Opportunity.

Fitch Ratings-New York-09 November 2017: Philadelphia's plan to take direct control over its school district could provide needed fiscal certainty for the school district, but also could pressure the city's expenditure framework and operating performance, according to Fitch Ratings. Last week, Philadelphia's (IDR of A-/Stable) mayor announced a proposal to take back direct control over the city's coterminous school district (IDR of BB-/Stable) from a state-controlled board, and provide significant additional funding from local sources. A strong public education system could be important for the city's long-term economic growth prospects and the mayor's proposal will give Philadelphia more direct control over this key local service. The school district's financial position has stabilized in the past several years, but remains somewhat precarious as the most recent published estimates project cumulative operating deficits over the next five years totalling over $1 billion. By fiscal 2022, the projected $300 million annual deficit would be nearly 9% of spending. With no independent revenue raising ability, the district is entirely reliant on support from the city and the commonwealth of Pennsylvania (IDR of AA-/Rating Watch Negative).

Fitch has previously noted that both the commonwealth and city have stepped up their support in recent years and provided additional resources to the district on a one-time and recurring basis. In the most recent move, the newly enacted commonwealth budget includes provisions that appear to resolve nearly $300 million of the projected deficit through an adjustment in the property value assessment formula that affects the commonwealth's reimbursement of the district's pension expenses.

The mayor's announcement did not include specifics on how the school district would address its remaining substantial projected operating deficit, but he did indicate that additional city resources would be the key avenue. The mayor and city council have raised taxes on behalf of the school district several times over the past few years. Fitch anticipates additional support from the commonwealth will be extremely limited, beyond modest growth in statewide K-12 basic education aid.

Currently, the school district is an independent legal entity with its own assets and liabilities, including debt and pension obligations, but entirely reliant on external stakeholders for operating revenues. Fitch's commentaries on Philadelphia have noted the city's commitment to the school district as an ongoing expenditure pressure point, and closer integration could challenge Philadelphia's expenditure framework and operating performance assessments under Fitch's "U.S. Public Finance Tax-Supported Rating Criteria". Increased spending for schools could alter the trajectory of expenditure growth and limit the city's ability to maintain or grow already limited reserves. To assess rating implications for both the city and the district, Fitch will evaluate the terms of the city's proposed takeover of the school district once they are made clearer. We will focus on how the city finds the resources to address the district's significant fiscal needs, and whether the district retains some legal independence and distinct responsibility for its pension obligations. School district debt is already factored into Fitch's analysis for the city as overlapping debt.

Fitch anticipates the state board overseeing the schools, the School Reform Commission, will vote to dissolve itself at its next meeting scheduled for Nov. 16. The commonwealth's education commissioner, appointed by the Governor who has expressed support for reverting the district back to local control, must certify the commission's decision by Dec. 31, in order for the SRC to dissolve on June 30, 2018.

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