Pennsylvania Intergovernmental Cooperation Authority

Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 2003 - Fiscal Year 2007

June 18, 2002

PENNSYLVANIA INTERGOVERNMENTAL COOPERATION AUTHORITY

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SECTION I:

INTRODUCTION

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EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

The City of Philadelphia (City) submitted its *Five-Year Financial Plan, Fiscal Year 2003-Fiscal Year 2007* (the Plan) to the Pennsylvania Intergovernmental Cooperation Authority (PICA) on May 31, 2002. This Plan continues to increase its focus on overall strategic goals for the City as well as better use of performance measures throughout. PICA Staff applauds the changes and hopes that the City will continue to incorporate performance measures as part of its planning process.

Expenditures and revenues are projected utilizing realistic assumptions. The Plan presents a reasonable prospect for balanced budgets over the life of the Plan, and anticipates ending FY2007 with a surplus of nearly $5 million.

As in the past, there are a number of risks, both quantifiable and qualitative, which threaten the fiscal health of the City over the life of the Plan. Many of these risks are ongoing issues previously documented by PICA Staff. These risks are dependent on a variety of circumstances, some of which are beyond the City's control. While the Plan often acknowledges these risks, few precautionary strategies are offered.

PICA Staff is pleased to note that several of the risks identified in previous years have been addressed. While the School District remains a risk, the City's financial requirements have been identified and are contained in the Plan. Philadelphia weathered the long-predicted recession well. Unfortunately, the City was unable to create a Rainy Day Fund, a safeguard that PICA Staff has long advocated.

The Plan confronts five significant risks, two of which are quantifiable. These risks include:

- Inclusion of unidentified "Future Government Efficiencies" in each of the final four years of the Plan ($178 million risk).

- Loss of Philadelphia Gas Work's annual $18 million payment to the City as well as possible failure to repay a loan to the City ($153 million).

- No explicit funding in the Plan for any costs associated with new labor contracts for uniformed employees after FY2002 and non-uniformed employees after FY2004.

- Additional City contributions to the Pension Fund if lower than expected rates of return continue.

- An increase in the percentage of locally generated dollars that are subject to long-term commitments and the City's fast approach to its allowable debt limit, which jeopardizes the infrastructure maintenance goals of the overall Capital Program.

Report Summary

As in recent years, this report focuses primarily on significant risks to the Plan, with discussion of some department-specific and other issues that have a direct relationship to maintaining fiscal stability. A Chart of Quantifiable Risks to the FY2003-FY2007 Plan appears at the end of this Executive Summary. PICA Staff continues to track departmental progress in numerous areas and will report on those areas as significant issues arise, as well as continuing to produce White Papers to provoke discussion on areas of concern to the fiscal health of the City.

City's Revenue Assumptions

Other than the specific risks to the revenue side (PGW) discussed in detail below, PICA Staff found the assumptions underlying the City's revenue projections to be reasonable. In addition to the PICA Staff review, PICA convened a group of regional economists to comment on the revenue assumptions. The group's consensus was that the estimates used in the Plan were reasonable in light of the current economic outlook.

Quantifiable Risks

As mentioned earlier, the Plan confronts five significant risks to its successful implementation. The first two of those risks are quantifiable and are included in the Chart of Quantifiable Risks at the end of this Executive Summary.

The Plan anticipates a cumulative total of $178 million in unspecified expenditure reductions over its final four years resulting from future government efficiencies. Though this figure is significantly higher than the previous assumption of savings related to the Target Budget process, PICA Staff agreed to these figures in discussions related to the implementation of new wage tax cuts. As the Chart of Quantifiable Risks demonstrates, this risk is offset by the opportunity for the Administration and City Council to rescind the previously agreed upon tax cuts should these savings not be realized.

Despite making some significant strides during the past fiscal year, PGW continues to pose a significant threat to the fiscal health of the City's General Fund. PGW's financial situation continues to be predicated on a number of optimistic scenarios. PGW's ability to continue making its annual $18 million payment to the City's General Fund as well as repay the $45 million loan it received from that Fund may be considered uncertain. Also, PGW's large outstanding debt situation is a significant negative element in the City's overall financial well being.

Other Significant Risks

The largest unknown variable in the Plan is personnel costs. The collective bargaining agreements between the City and its Police and Fire employees expire at the end of FY2002; the other municipal employee contracts expire at the end of FY2004. As is standard procedure, the Plan assumes no increases in wages or benefit costs after these expiration dates. Personnel costs account for 56 percent of the FY2002 budget; thus even a minimal increase in wages and benefit costs will have a significant impact on the City's expenditures throughout the life of the Plan.

Over the first few years of the Plan, the City will increase the percentage of locally generated dollars that are subject to long-term commitments. The risk inherent in these long-term commitments is compounded by the City's fast approach to its legal debt limit, which jeopardizes the infrastructure maintenance goals of the overall Capital Program.

As a result of worse than projected performance by the City's Pension Fund last year, the City increased its projected payments into the Pension Plan over the life of the Plan. If Pension Fund returns continue to fall below the assumed nine percent rate of return, the City may be required to make up the difference out of the General Fund. However, the projected impact of the Deferred Retirement Option Program (DROP) as well as an easily obtainable waiver in funding requirements lessen the threat to the General Fund considerably.

Other General Fund Concerns

The agreement reached between the Commonwealth of Pennsylvania and the City regarding management of the School District of Philadelphia (SDP) has dramatically changed the fiscal risk posed to the City's General Fund. The City's new financial contributions to the SDP have been quantified and are included in the Plan. Preliminary budget estimates by the newly created administrative body, the School Reform Commission (SRC) continues to project deficits, albeit smaller than one-year ago. However, these rosier budget projections are predicated on the Commonwealth living up to its agreement and providing an additional $75 million per year to the SDP. Even with greater financial stability, the onus remains on the SRC to solve the problems of the District which is currently unable to provide a qualified workforce for attracting business, and contributes to the erosion of the tax-base of the City.

According to the National Bureau of Economic Research, the longest economic expansion in U.S. history abruptly ended in March 2001, ten years to the month after it commenced. Unlike past recessions, the City's economy has weathered the most recent short-lived recession relatively well. Recent data released by the Bureau of Labor Statistics (BLS) indicates that the number of jobs in Philadelphia has decreased by 4,600 from February 2001 to February 2002. Following the tragic attacks of September 11, 2001, the hospitality and service sectors have stabilized, fueled by certain one-time events and a targeted advertising campaign.

The Neighborhood Transformation Initiative (NTI) was designed by the Administration to end suburban flight and stabilize the City's neighborhoods. While applauding the City for under-taking a much needed project, PICA Staff has concerns regarding the lack of specificity surrounding a project which is expected to add nearly $300 million to the City's debt obligations, particularly the lack of performance measures and the slow pace of elements of the NTI program.

The City continues to show dramatic improvement in the development of useful performance measures and the collection of data. These improvements have not been as prevalent in some of the current Administration's newer initiatives. Despite the improved focus on outcome measurement, there remains a disconnect between new initiatives outlined in the Plan and projected measures related to these initiatives.

The Department of Human Services has successfully and significantly increased its State and Federal funding over the past nine years. This increased "outside" funding has allowed the City to enhance service levels, while simultaneously reducing net City costs. As programmatic and funding challenges threaten to increase net City costs in the future, the City must continue working diligently with other governments to protect the funding it currently receives from them and to identify new funding streams.

There are a number of issues that either fall outside the duration of the Plan or are not addressed by the proposed Plan. The Plan makes no mention of funding an expansion of the Convention Center. The Plan makes no mention of new revenues from the decrease in PICA debt service and the increase in Real Estate tax revenue as previous property tax abatements expire. The Plan makes no effort to address the problem of annual structural deficits.

Staff Recommendation

The identified potential risks to the General Fund in the FY2003-FY2007 Plan constitute a real threat to the fiscal health of the City. However, the Plan is also predicated on a continuation of the previous Administration's program of small and steady cuts to the Wage and Business Privilege taxes. PICA Staff will continue to closely monitor the City's fiscal situation throughout the coming year, paying particular attention to the threat posed by PGW. PICA Staff is further encouraged by the stable performance of the City's economy despite the recession. With these caveats in mind, the FY2003-FY2007 Plan presents a reasonable prospect for balanced budgets in each year of its term.

PICA Staff recommends that the Pennsylvania Intergovernmental Cooperation Authority approve the Plan as submitted to the Authority on May 31, 2002.

Chart of Quantifiable Risks to the FY2003-FY2007 Plan

($ in thousands; totals may vary slightly due to rounding)

	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	TOTALS
Quantifiable Risks							
Future Government Efficiencies			(40,000)	(42,000)	(48,000)	(48,000)	(178,000)
Annual PGW Payment	(18,000)	(18,000)	(18,000)	(18,000)	(18,000)	(18,000)	(108,000)
PGW Loan Repayment						(45,000)	(45,000)
Other Significant Risks							
School District of Philadelphia							
Labor Contracts							
Long-Term Debt							
Welfare Reform							
Total Risks	(18,000)	(18,000)	(58,000)	(60,000)	(66,000)	(111,000)	(331,000)
Cumulative Total Risks	(18,000)	(36,000)	(94,000)	(154,000)	(220,000)	(331,000)	
City's Projections as of December 31, 2001							
Total Revenue	2,926,496	3,023,723	3,082,081	3,123,247	3,189,810	3,297,780	
Total Obligations	2,997,117	3,085,485	3,171,127	3,195,463	3,263,139	3,347,845	
Prior Year Adjustments	32,000	(129,628)	133,628	62,000	47,000	47,000	
Prior Year Fund Balance	230,011	191,390	0	44,582	34,366	8,037	
Plan Projected Fund Balance	191,390	0	44,582	34,366	8,037	4,972	
Fund Balance if All Risks Realized	173,390	(36,000)	(49,418)	(119,634)	(211,963)	(326,028)	
Value of Wage Tax Rate Reductions		11,162	11,162	23,047	35,822	50,069	
Value of Business Tax Reductions		4,837	5,627	6,632	7,164	7,941	
Net Fund Balance if All Risks Realized Without Making Cuts in Tax Rates (cumulative)		(20,001)	(16,630)	(57,167)	(106,510)	(162,565)	

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SECTION II:

QUANTIFIABLE RISKS

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PHILADELPHIA GAS WORKS

Despite making some significant strides during the past fiscal year, the Philadelphia Gas Works (PGW) continues to pose a significant threat to the fiscal health of the City's General Fund. PGW's financial situation continues to be predicated on a number of optimistic scenarios. PGW's ability to continue making its annual $18 million payment to the City's General Fund as well as repay the $45 million loan it received from that Fund may be considered uncertain. Also, PGW's large outstanding debt situation is a significant negative element in the City's overall financial well being.

The current management team deserves credit for dramatically improving its operations, while continuing to be burdened by the City's requirements that it also serve as a social service delivery operation. PGW has also strengthened its working relationship with the Pennsylvania Public Utility Commission (PUC) which now oversees PGW. Whether the City is willing to sell PGW is unclear. The probability that PGW can remain an economically viable entity in a competitive environment is subject to serious question.

PGW's Fiscal Condition

Due to past mild winters, mismanagement, and rising fuel costs, PGW has experienced five years of below average revenues and poor cash flow. PGW has maintained a positive cash balance only through the use of short-term debt, a $45 million loan from the City, and a delay in making its annual $18 million payment to the City. Debt service costs, as well as the high cost of continued short-term debt strategies, further strain PGW's finances. PGW has also seen its bond rating lowered, limiting its ability to make use of the capital markets.

On April 11, 2002, the PUC approved $36 million in extraordinary rate relief, the most pressing of the numerous rate increases requested by PGW over the past six months. This rate relief should bring PGW some respite from the dire straits it currently faces, but will not solve all of the fiscal problems PGW faces.

PGW's long-term planning process continues to be based on highly optimistic projections. PGW's plan assumes that costs will drop over the life of their plan, despite a record of steady expense increases. Undeterred by falling collection rates, PGW's five-year financial plan assumes steady revenue increases after years of continued revenue decrease. If PGW's long term financial plan were subject to PICA supervision, PICA Staff would recommend disapproval as it continues to be based more on hope than on fact.

Short-term Risk: The $18 million Payment to the City's General Fund; $45 million Loan Repayment by FY2007

PGW's current leadership team has verbally committed to PICA Staff that it will meet the utility's financial obligation to the City's General Fund. It remains uncertain whether PGW can make the payment, and how keeping that commitment would affect the utility's financial stability and credit rating.

As it did from FY1999-FY2001, PGW anticipates it will be making the $18 million FY2002 payment later than stipulated by the Agreement for the Management of PGW. In accordance with that Agreement, previous late payments have included interest. No commitment has as yet been made to include interest with the FY2002 late payment. Even more disturbing is a verbal commitment by the City's Finance Director that some or all of the $18 million payment will be available to PGW as a "give-back" next fiscal year. This "give-back" provision marks another dangerous precedent in the City's dealings with PGW.

The possible negative impact on the City is further increased by the $45 million loan approved by City Council last year. The loan exists as a revolving credit that PGW can draw on as it needs help with cash flow issues. PICA Staff's concern is heightened by the constantly evolving claim by the Administration as to when the loan will be paid back. The loan was originally expected to be paid back by February 2003. This date was pushed back to August 2003 in the preliminary Plan presented, still within the same fiscal year period for accounting purposes. However, PGW informed PICA Staff during its meetings that the loan period had been extended for up to 36 months, with final repayment not due until the end of FY2006. The City later extended the loan period to 48 months, with final repayment at the end of FY2007, the last year of the current Plan. PICA Staff's confidence in the repayment of this loan continues to dwindle with every extension.

The combination of the loan and the annual payments constitute a possible net negative impact of $153 million dollars over the life of the Plan.[1] Given the overall state of PGW's financial situation, as well as the difficulties detailed in this section, the future of these payments to the City is considered questionable. The only factor preventing PICA Staff from discounting this money altogether is PGW's past record of making such payments as well as the assurances of PGW's CEO and the City's Finance Director that the payments will be made. PICA Staff believes that there is a strong likelihood that City revenues will be short up to the $153 million over the five years covered in the Plan.

[1] $45 million loan, plus FY2002 $18 million payment "give-back," plus FY2003–2007 $18 million annual payments, totals $153 million.

PGW Operations: Noticeable Improvements and the Burdens of a Social Services Organization

PGW management can rightly take credit for a vast improvement in many of the operational problems discussed in this section one year ago. The billing system is working and customers now wait a few minutes on the phone as opposed to a few hours. PGW management has also indicated that many of the employee attendance and performance issues have been dealt with, although no meaningful performance and productivity measures were provided.

The new management information system has passed the transitional stage and is beginning to be utilized. PGW's delinquency shut-off program began with much fanfare in April 2002, supported by newly reliable data. Based on the cash receipts for April and May, the program appears to be having positive effects. PICA Staff looks forward to continued improvement resulting from utilization of the management information systems.

Concerns continue regarding the high labor costs for PGW. Although improvements were achieved in the most recent labor agreements, employee work rules continue to impact PGW's ability to work efficiently. The benefits package for PGW employees is singular in its munificence, and ultimately fiscally untenable.

PGW continues to be hampered by City Council imposed requirements that it function as a social services agency as well as a public utility. These requirements include significant discount programs for the elderly and the indigent, as well as regulations preventing winter shut-offs. These rules, often abused by customers, hamper PGW's efforts to run as an efficient business. Many customers, despite having the means to do so, simply don't pay their bills during the winter because they know their gas cannot be shut off.

With the advent of improved information systems, the time has come for changes in these programs in order to prevent abuse. Discount programs for the elderly should have some kind of means-testing to prevent the very wealthy from paying a discounted rate. Senior citizen landlords should not be able to obtain the discounted rates on behalf of their tenants. Accounts which demonstrate an ability to pay gas bills must be considered eligible for winter shut-offs. To date, there has been no indication from the Administration or City Council of any willingness to amend these rules.

Long-term Risk: The City's Liability for PGW Bonds

There are significant capital expenditures looming for PGW, particularly in regard to its Liquified Natural Gas Plant. PGW is in the process of prioritizing its limited capital dollars, but numerous infrastructure improvement requirements have reached the critical stage. PGW currently has well over $900 million in outstanding debt. It is conceivable that the combination of increasing capital demands combined with the continued loss in revenue could render PGW unable to meet its debt obligations.

According to the City, there has been no official legal opinion on whether the City is contractually liable for repayment of PGW's debt should PGW be unable to meet those obligations. However, considering that nearly all Philadelphia commercial and residential gas users are served by PGW, and given the City's history of coming to the aid of its citizenry even when not legally liable, the likelihood of the City assuming such responsibility is strong.

Competition in the Natural Gas Industry

Since July 2000, PGW's operations have been regulated by the PUC. The General Assembly is still considering a number of proposals for allowing customers to choose a natural gas supplier. Although PGW, with a legally limited service area, expects to avoid full-fledged competition, it is likely to be included in some way in the movement toward natural gas deregulation.

PICA Staff has previously reported on the challenges PGW would face in a competitive environment, particularly as a result of its high debt load, City Council-mandated discount programs, and significant number of delinquent accounts. Significant uncertainty remains about how the industry, and how PGW itself, will look in the future. PGW's current leadership team has promised to keep PICA Staff informed as it explores options for the utility, including privatization of certain operations.

Administration Plans for PGW: Selling or ?

In his last two budget addresses, Mayor Street forcefully raised the notion of selling PGW. Over the past year-and-a-half however, the Administration has continued to release ambiguous statements regarding future plans for PGW. Options have included selling the utility to the first serious bidder; improving the utility to make it more attractive to prospective buyers; or, improving the utility and maintaining City control. The City commissioned a study to look at the feasibility of selling PGW originally due to be released in December 2001. The initial study was found to be incorrect however, and was sent back for revisions; no date has been set for release of the new study. Until a clear goal is established, PICA Staff cannot evaluate the impact of selling PGW.

PICA Staff also finds it important to note that despite the continued claims that PGW is a priority for this Administration, its actions are inconsistent. When pressed on the issues surrounding the potential sale of PGW, the Chief of Staff indicated that PGW was on a back burner while the Administration dealt with the Schools and NTI. Most disturbing is that more than two years after taking office, the Mayor has not filled his appointments to the Gas Commission. This failure reinforces the impression that PGW remains a "back burner" issue.

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SECTION III:

OTHER SIGNIFICANT RISKS

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LABOR CONTRACTS AND THE MUNICIPAL WORKFORCE

During the course of the FY2003-2007 Five-Year Plan, all of the collective bargaining agreements between the City and its unionized workers will expire; it is impossible to assess the effect of any future wage and benefit related cost increases over the life of the Plan. However, past practices project a significant impact on the Plan.

The onset of the Deferred Retirement Option Program (DROP) will provide an opportunity for rightsizing the City's workforce, but may also threaten the delivery of some City services. While the City is making good use of the opportunities presented by the DROP, the First Judicial District of Pennsylvania (FJDP) has made no indication that it will follow suit. PICA Staff's concerns also include the significant increase in the number of employees in the Mayor's Office and Independently Elected Officials offices, and the lack of a comprehensive human resource information system.

Municipal Union Contracts

The largest unknown variable in the Plan is personnel costs. The collective bargaining agreements between the City and its Police and Fire employees expire at the end of FY2002; the other municipal employee contracts expire at the end of FY2004. As is standard procedure, the Plan assumes no increases in wages or benefit costs after these expiration dates. Personnel costs account for 57 percent of the FY2002 budget; thus even a minimal increase in wages and benefit costs will have a significant impact on the City's expenditures throughout the life of the Plan.

Given the past history of wage increases, PICA Staff has great concern regarding the long-term effects of the contracts currently being negotiated. From FY1997–FY2001, represented employees average annual wage increase was over 3.5 percent, while over the same period inflation averaged just over 2.5 percent, private industry gains averaged just under 4 percent, and the State and Local government average was 3.1 percent. While the Philadelphia municipal average seems only slightly higher than the norm, it does not take into account automatic step and longevity pay increases included in municipal employee contracts which can add anywhere from 2 to 9 percent to the annual base salary of an employee.

It should also be noted that during this past year's mild recession, while the City's labor force shrunk by several thousand jobs, no City employee was laid off. It is plausible to suggest that municipal employee job security during such tumultuous times is a priceless employee benefit.

DROP

Since the DROP began in October 1999, nearly 3,000 employees, or 12 percent of the workforce, have enrolled in the program. The City has taken important steps to make use of the opportunities afforded by the DROP. PICA Staff applauds the stated goal of filling only two of every three non-uniform jobs affected by the DROP. The use of an outside consultant to aid departmental reorganization and reassess workflow is vital to the continued rightsizing of the City's workforce. The DROP has also highlighted the need for better succession planning within City Departments, an effort that should continue beyond preparing for the DROP.

The City estimates that it will save approximately $55 million over the life of the Plan as a result of the DROP. PICA Staff believes that if the City is able to meet its stated goals, the net savings over the life of the Plan, including salary, benefits, and pensions could net over $90 million in savings.

The DROP does present some service related challenges for the City. The Police Department is of greatest concern as the Police force is slated to lose more than 750 uniformed personnel, including the Commissioner and many senior commanders, as a result of the DROP. Commissioner Johnson has done an excellent job of preparing for the significant succession issues and loss of institutional knowledge with an aggressive promotions program. However, PICA Staff is skeptical that the Department will be able to meet its stated goal of filling four classes of 125 recruits for each of the next two years. In light of this need, it is extremely puzzling that the one-year pre-residency requirement has not been waived for Police recruits.

Unfortunately, not all City funded entities are taking advantage of the DROP to realign their workforce. The FJDP, which has over 230 employees enrolled in the DROP, has given no indication that it will mirror the City's efforts. If the FJDP were to fill two out of every three jobs impacted by DROP, the FJDP could realize savings of over $4.5 million per year, which could be passed along to the City. Alternatively, if the FJDP were to continue its zero growth budget arrangement with the City, these funds could be used by the FJDP for additional attorney's fees or other improvements to help speed up the processing of cases. PICA Staff will continue to monitor DROP related efforts of the FJDP.

Unnecessary Increases in Personnel and Salaries

While much has been made about an increase in the size of the City's workforce, it is important to note where those increases have occurred. Since the beginning of the current Administration, there has been a net increase of 85 General Fund positions. The largest growth has been in the direct service delivery areas – Human Services, Police, Fire and the Free Library while internal services Departments have been reduced – Fleet, Public Property and Revenue.

There is a disturbing growth trend in a few areas. The Mayor's Office has grown from 43 positions to a projected 70 positions by the end of FY2002. The independently elected officials have grown even more dramatically in both staff complement and salaries. This group is led by City Council, which went from 181 positions and a budget of $9.6 million at the end of FY1999 to a projected 226 positions and a $13.4 million budget by the end of FY2002. These figures represent a 25 percent growth in staff, and a nearly 40 percent increase in the budget for City Council in just three years.

The most egregious example of seemingly unnecessary dramatic growth is the two-year history of the City Commissioner's Office. In FY2001, the City Commissioner had a staff complement of 75. In FY2002, the Office is projected to increase 12 percent to 84 positions, and in FY2003 is expected to grow an additional 20 percent to 101 positions. This represents a total growth in staff of **35 percent in just two years**. This despite the introduction of new electronic polling machines which were purchased in order to **reduce** the manpower required to oversee elections.

Although the independently elected officials are not subject to the City's normal budget process, they should be required to explain and justify their dramatic growth to the taxpayers of Philadelphia. PICA Staff has yet to be so informed.

Human Resource Information System is Needed

Despite the City's enormous personnel costs, the Personnel Office functions without a comprehensive Human Resource Information System (HRIS). The absence of such a system results in significant costs through non-automated paper processing, duplication of effort, and an inability to properly manage personnel needs throughout the City. Unusual personnel initiatives such as DROP and the recent hiring freeze only increase the need for a HRIS.

According to a City Personnel Department report, the City employs 160 clerks to complete and route over 70 paper forms used to establish and maintain employee status. At an estimate of $33,000 per employee (salary and benefits), the City pays $5 million every year to support this function. Updates on employee status take an average of 27 days resulting in delays in information availability and hampering City Departmental management of personnel.

The Personnel Department estimates that a comprehensive system would cost $5-7 million. Obvious savings generated would include the reduction in staff support by half. The system would be largely paperless, reducing staff time currently spent filing documents in the operating departments and in Central Personnel. Personnel related time delays would be eliminated with the advent of real-time information updates allowing for better human resource management.

A HRIS system also provides new tools for programs such as employee development and training, and compensation support. It can provide logistical support for running training programs, such as automatically posting employees to class lists, generating notices and tracking attendance. Data on employee performance can be collected and used to support performance-based pay initiatives. In short, to best manage the largest piece of its budget, the City needs to strongly examine the implementation of a HRIS.

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INCREASING DEBT SERVICE COSTS

The City again anticipates increasing the percentage of locally generated dollars that are subject to long-term debt commitments and continues to approach its allowable debt limit. As stated in the Plan, this jeopardizes the infrastructure maintenance goals of the overall Capital Program. These risks are further heightened by the issuance of debt related to the implementation of the Neighborhood Transformation Initiative (NTI) and any future borrowing to fund the proposed expansion of the Pennsylvania Convention Center. While the debt associated with these is exempt from the City's allowable debt limit, nonetheless, these projects add to the City's annual debt burdens on the local taxpayers.

Increasing Reliance on Long-Term Debt

During the last few years of the prior Administration, the City was able to slowly reduce the percentage of locally generated dollars that were devoted to long-term debt costs. As the chart below details, the current Administration's Plan reverses that trend. In fact, by the first year of the Plan, this percentage will be above 13 percent, higher than in FY1995.

Fiscal Year	Locally Generated Dollars[1]	Total Fixed Costs[2]	Fixed costs as a % of Locally Generated
1995	1,998,355,000	256,919,307	12.86%
1996	2,048,305,000	259,989,423	12.69%
1997	2,099,164,000	258,893,561	12.33%
1998	2,149,455,248	253,322,174	11.79%
1999	2,267,505,000	254,263,652	11.21%
2000	2,334169,000	263,588,374	11.29%
2001	2,379,233,000	280,208,100	11.70%
2002 (Target/ Revised Estimate)	2,343,346,000	294,812,900	12.60%
2003	2,369,955,000	326,017,800	13.80%

[1] Locally Generated Dollars includes City Tax Revenues, PICA Tax Revenues, Locally Generated Non-Tax Revenues, and Revenue from Other Funds of the City.
[2] Total Fixed Costs includes Debt Service payments, PICA Debt payments, Long Term Leases, and the Convention Center Subsidy.

The increasing reliance on long-term debt is a concern in light of the other risks highlighted within the Plan and in this report. The cost of long-term obligations are dedicated monies that cannot be rebudgeted. Should there be another national economic downturn, revenues will not increase as projected; should welfare reform lead to an increased need for services, additional monies will be required in the appropriate service agencies; if revenues fall short of projections, or if other unbudgeted costs arise, the City will be forced to reallocate from among a smaller pool of funds.

It is a generally accepted sound budgeting axiom that the time for a municipality to pay down debt is when that municipality has surplus funds. This Plan takes the opposite approach by increasing the City's reliance on long-term debt during a period of relative fiscal health. Following nine straight years of balanced budgets and another significant surplus, the City should be using this opportunity to put its financial house in order, reduce its long-term obligations, and attain the fiscal flexibility needed to meet unforeseen challenges.

The City is Quickly Approaching its Legal Debt Limit

At the end of FY2001, the City's general obligation debt borrowing capacity was down to $134.8 million. As a result, the City's Capital Budget for FY2007 is expected to be under $52 million, about one-third of the average Capital Program from FY1993-FY2001. This shrinking of the Capital Program places at risk the routine construction and renovation necessary to maintain the City's buildings, facilities, and infrastructure. Additionally, much of the State and Federal construction monies that the City receives is dependent on the local matching of funds. Without the availability of capital fund dollars to provide these matching funds, the City risks losing tens of millions of dollars in State and Federal funds for SEPTA infrastructure, highway repair, etc. The City will also be unable to make commitments to long-term projects (City Hall, the Art Museum, etc.), commitments which are often used to gain private funding to complete a project.

Although the Plan acknowledges the approaching debt limit constraint, there is no defined approach to solving the problem. While the Plan presents a series of measures for evading the debt limit, there are no plans for fixing the problem. The City has not even updated its own Debt Policy Statement, published most recently in December 1997. As an example, a stated policy is that the Debt Service on Net Direct Debt of the City of Philadelphia will not exceed 6.9 percent of the total General Fund obligations of the City. Yet, in the very first year of the policy, FY1997, this ratio was seven percent.

PICA Staff does agree with the City that the formula for determining the City's debt limit is not equitable with other municipalities in the State. However, before seeking redress from the State Legislature, or even putting itself within danger of reaching the current debt limit, the City should observe the directive found in the introduction to the most recent Debt Policy Statement: "This Debt Policy is intended to be a dynamic, not a static document. Therefore it should be annually reviewed and updated."

RISING PENSION FUND CONTRIBUTIONS

As a result of worse than projected performance by the City's Pension Fund last year, the City increased its projected payments into the Pension Plan over the life of the Plan. If Pension Fund returns continue to fall below the assumed nine percent rate of return, the City may be required to make up the difference out of the General Fund. However, the projected impact of the DROP as well as an easily obtainable waiver in funding requirements lessen the threat to the General Fund.

Weak National Economy Reduces Pension Fund Returns; Poses Ongoing Risk

Last year's recession had a dramatic impact on the investment returns for the City's Pension Fund. When calculating its funding requirements, the Pension Fund assumes a nine percent rate of return; these calculations help determine the amount of the annual contribution from the City to the Pension Fund. In the years immediately prior to 2001, Pension Fund rates of return were well above ten percent. Like many pension funds nationally however, returns for the City's Pension Fund were negative for 2001.

The City's Pension Fund is governed in part by the Pennsylvania Pension Plan Act that dictates mandatory actuarial funding standards and the minimum annual contributions which the City must make in order to amortize the unfunded liability. Because of the poor returns, the City faced additional payments into the fund of over $115 million over the Plan. By spreading those payments over a longer period, the City was able to reduce the impact on the Plan to approximately $55 million.

Should the national economy continue to recover slowly, as has been the case in the first half of the year, it is possible that the Pension Fund will continue to fall below its expected nine percent rate of return. According to some estimates, each percentage point below the expected rate of return would require an additional $10 to 15 million City contribution.

Risk Mitigated by DROP and Funding Waiver

The actuarial analyses prepared for the Pension Fund cannot take into account some of the benefits the City will realize from the DROP. If the City achieves its goals, nearly five hundred positions will not be replaced. Additionally, the other DROP positions will be replaced by employees with shorter City tenures (and therefore fewer accrued pension benefits) and lower salaries. Once these factors can be included in the actuarial analyses, the City's pension funding requirements should lower.

Another option open to the City is a funding waiver. Once a pension plan is over seventy percent funded, it is considered "full" from an actuarial perspective. At that level it is possible to request a waiver from the Commonwealth, and reduce the minimum annual contributions required under the Pension Plan Act, as the City of Pittsburgh did several years ago. Philadelphia's Pension Plan is currently about seventy-eight percent funded, and could be expected to obtain a waiver should it be requested. At the same time, PICA Staff does note that utilizing such a waiver could result in higher City payments in future years. While the City's Finance Director has chosen not to pursue such a waiver at this time, PICA Staff believes that the availability of this tool lessens the risk presented by lower Pension Fund returns.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2003-FY2007 FIVE-YEAR FINANCIAL PLAN

SECTION IV:

OTHER GENERAL FUND CONCERNS

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SCHOOL DISTRICT OF PHILADELPHIA

The agreement reached between the Commonwealth and the City regarding management of the School District of Philadelphia (SDP) has dramatically changed the fiscal risk posed to the fiscal health of the City's General Fund. The City's new financial contributions to the SDP have been quantified and are included in the City's Five-Year Financial Plan for FY2003-FY2007 (Plan).

Preliminary budget estimates by the newly created administrative body, the School Reform Commission (SRC), continue to project deficits, albeit smaller than one-year ago. However, these rosier budget projections are predicated on the Commonwealth living up to its agreement and providing an additional $75 million per year to the SDP. As of this writing, those monies remain questionable.

Even with greater financial stability, the onus remains on the SRC to solve the problems of the district which is unable to provide a qualified workforce for attracting business, and contributes to the erosion of the tax-base of the City.

Background

Due to a variety of factors including (though not limited to) the City's limited Real Estate tax base, education spending caps by the Commonwealth, increased SDP costs, and the high-needs student population, the SDP has faced significant deficits over the past few years. With all sides focused on annual debates about funding, insufficient attention was given to improving the situation.

A Smaller but Challenging Deficit

The $1.7 billion budget passed by the SRC on May 29, 2002, projects a deficit of $28 million for the 2002-2003 academic year. This is a vast improvement over the previous year's projection of a nearly $250 million deficit. Most of the deficit reductions are due to increased funding from the City ($45 million) and the Commonwealth ($75 million) coupled with expenditure cuts authorized by the SRC. Nearly half of the City's increased contribution is expected to finance a bond issuance that will close the existing budget deficit, and cover annual operating deficits through 2006.

While this situation is more manageable than that which faced the SDP one year ago, the SDP has not addressed how it will cover operating deficits beyond 2006. Further, with the City already dedicating significant additional funds to pay for the bond issuance, there will be no new money to cover deficits in 2007 and beyond. The SRC must present a plan for achieving structural balance in its annual operating budget.

Additional Funding Provided by the City and the Commonwealth

The City's increased contribution will consist of $20 million in a cash transfer, and $25 million through a shift in the millage rates on property. While there will be no resultant tax increase, the School District will gain approximately $25 million more in property tax receipts beginning in FY2003. Providing the additional funds in this manner accomplishes two important goals: first, the defined revenue stream allows the SDP to secure the aforementioned deficit reduction bonds; and second, as the property tax base grows (projected annual two percent growth rate through the life of the Plan) the value of the City's contribution will increase.

As of this writing, the Commonwealth's additional funding is uncertain. No budget has been passed, and there has been a significant number of state lawmakers who have expressed unhappiness with giving the SDP an additional $75 million while their school districts would average a one percent increase in state funding.

The recent surprising decision by the SRC to certify additional charter schools in Philadelphia may provide an opening to give the appearance of $75 million in new monies to the SDP. However, since the budget that was passed assumed the $75 million in new funds but did not include the additional costs required for the new charter schools, the SDP would be facing immediate operating budget deficits.

Indirect Fiscal Impact

Ultimately, a stable financial situation is only the first step to solving the SDP's problems. The SDP continues to serve a population comprised of more than fifty percent low-income households. Drop-out rates are estimated as high as twenty percent, and some of those students who do graduate are unable to meet the skill set required by employers. Buildings are in disrepair, textbooks are not only out-dated but in short supply, and the existing contract with the Philadelphia Federation of Teachers continues to both micro-manage the teacher's workday and reward teacher longevity over performance.

Unless the SRC is able to utilize this projected period of relative fiscal stability to address the performance of the SDP, the long-term fiscal and social health of the City will remain at risk. Poor public schools are one of the key reasons the City's population (and tax-base) continues to erode. Businesses are less likely to relocate to, or stay in, Philadelphia without the hope of a qualified workforce to meet operational needs. In short, while the fiscal situation has improved dramatically in just one year, the long-term problems have yet to be addressed.

ANALYSIS OF THE CITY'S ECONOMY

According to the National Bureau of Economic Research, the longest economic expansion in U. S. history abruptly ended in March 2001, ten years to the month after it commenced. Unlike past recessions, the City's economy has weathered the most recent short-lived recession relatively well. The City's decreased reliance on manufacturing, and a relatively small high tech industry, enabled the City to alter the historical economic trends.

Recent data released by the Bureau of Labor Statistics (BLS) indicates the number of jobs in Philadelphia has decreased by 4,600 from February 2001 to February 2002. The 2000 Census figures indicate that the City continues to suffer significant population losses, though not as bad as originally feared. Concurrently, the City can boast of a stabilized property tax assessment base, and a FY2001 General Fund balance of $230 million.

Following the tragic attacks of September 11, 2001, the hospitality and service sectors have rebounded, fueled by certain one-time events and a targeted advertising campaign.

The City cautiously projects flattening post recession employment growth, while appropriately estimating moderate growth in property assessments. These assumptions seem to be a reasonable short-term forecast for the City's economy, with (as must be expected) greater uncertainty over the last three years of the Plan.

Impact of the 2001 Recession on Philadelphia

Historically during national economic downturns, the City's economy can be described as "first in and last out". The City's history of leading the region into periods of economic downtown and lagging the region in rebounding from such slowdowns is notable. On the contrary, during this most recent recession, the Philadelphia economy escaped the national decline and remained relatively stable.[2] A number of reasons can be attributed to this unusual event:

The City's economy has diversified over the last twenty years, moving away from its heavy reliance on the manufacturing sector.

The recession was primarily concentrated in the information technology and manufacturing sectors, which do not play a large role in the City's overall economy.

The City's major industries such as financial services, educational services and the healthcare industry have remained stable during the downturn.

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[2] *2002 Mid-Year Economic and Financial Report,* Office of the City Controller, City of Philadelphia, p.8

Large-scale publicly funded projects such as the Eagles and Phillies stadia, the National Constitution Center and the new International Terminal at the airport have maintained construction employment at high levels.[3]

While the City's economy has weathered the latest recession, the City did experience employment loss. For the first time since October 1997, employment was lower on a year-over-year basis.[4]

Post September 11th effects on Philadelphia's Economy

In the immediate aftermath of the tragic events of September 11th, the City incurred a number of unanticipated expenditures resulting from increased security activity. The City expects to incur an additional $15,100 per day in costs to the Aviation and General Funds for the rest of FY2002. Augmented police presence, activation of the 24-hour Emergency Operations Center, deployment of Rapid Assessment Teams and extra security at the airport are just some of the examples that the City implemented as a result of the terrorist attacks. The extent of future homeland security costs borne by the City remains uncertain.[5]

The City's hospitality and tourism industry was adversely affected by the attacks. The Greater Philadelphia Tourism and Marketing Cooperation estimated that within the first seven weeks of the attacks, tourism revenues fell by $47 million.[6] In part due to one-time events such as the National Basketball Association All-Star game and a collaborative marketing effort to increase the number of over night visitors, the initial shock of reduced revenues has been alleviated.

As the nation wages war abroad and with ongoing security concerns at home, it is uncertain what the effects of September 11th will have on the City's economy. If anti-terrorism expenditures are sustained for many years, these expenditures could possibly affect and/or curb the City services. Without an equitable reimbursement of homeland security costs by the federal government, PICA Staff is concerned about the City's ability to fund such contingencies over a long period of time.

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[3] *2002 Mid-Year Economic and Financial Report*, Office of the City Controller, City of Philadelphia, p.10
[4] *Five Year Financial Plan, Fiscal year 2003 –Fiscal year 2007, p. 2*
[5] *Five Year Financial Plan, Fiscal year 2003 –Fiscal year 2007, p.xiii*
[6] *Five Year Financial Plan, Fiscal year 2003 –Fiscal year 2007, p.xii*

The City's Revenue Projections

Philadelphia's tax base grew from FY1991 to FY2001 at an average annual rate of 3.6 percent. During this same period the average rate of inflation was 2.6 percent. Due to the impact of the recent recession, the Plan assumes the tax base will no longer grow more quickly than inflation, averaging 2.4 percent compared to an average inflation rate of 2.5 percent.

Estimates for the Real Property Tax are important since property tax is the second largest source of City revenue, approximately 20 percent of the General Fund tax revenue. The tax is levied on behalf of both the School District and the City at a combined rate of 8.264 percent of assessed value of residential and commercial property. Historically, the General Fund's share was 3.745 percent and the School District's share was 4.519 percent.

Commencing in FY2003, the Plan proposes to shift additional 2.7 mills to the School District to provide an additional $25 million in funding. The mileage shift would increase the School District portion of the tax from 4.519 to 4.79 percent and to decrease the City's portion from 3.745 to 3.474 percent.

Real estate tax assessments for commercial, industrial and residential properties have grown for each respective year since 1997. This is due to a strong residential and commercial real estate market and improved assessment techniques.

The pattern of slight but consistent growth in real property assessments can be expected to continue. The Philadelphia real estate market continues to be healthy, despite the recent recession. Vacancy for office space in the Central Business District was 10.1 percent in the third quarter, well below the peak of 18 percent during the last economic slowdown.[7]

The City projects that commercial assessments will grow by 1.7 percent annually and residential assessments will grow by 2.2 percent annually through 2007.[8] Based on the past four years of property assessment growth and property tax revenue, and after discussions with regional economists, the Board of Revision of Taxes, and local real estate industry leaders, PICA Staff feels that the City's projections throughout the life of the Plan are justified.

Looking to the Future

According to most economists, the recent recession was one of the mildest and shortest on record. Signs point toward a recovery and a resumption of economic growth to resume in mid 2002. The growth in the next expansion, according to the Federal Reserve Bank of

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[7] *Five Year Financial Plan, Fiscal year 2003–Fiscal year 2007, p.21*
[8] *Five-Year Plan, Fiscal Year 2003-Fiscal Year 2007,* p. 21

Philadelphia, will be in financial and business services, pharmaceuticals and hospitality and tourism, industries that are currently stable if not growing in the City.[9]

While recovery is foreseen on the horizon, there are risks for the City's economic future. Economists predict that Philadelphia is likely to remain one of the nation's slower growing metropolitan regions. Data from the 2000 Census point to an ongoing loss of middle income population, leaving behind a population that is proportionately poorer, less able to contribute to the tax base and more in need of City services.[10]

Another risk to the City's economy is the unresolved question of expansion of the Pennsylvania Convention Center. Hospitality and tourism growth in the City during the last decade parallels the building and completion of the Convention Center. In order for Philadelphia to compete with other East Coast convention destinations, expanding the Center to 2.4 million square feet has been proposed. Approximate costs to complete the expansion are upwards of $460 million, with no funding proposed in the Plan. PICA Staff is concerned with the negative impact of higher than average labor costs and lower than average rebooking rates on the Convention Center's operations.

[9] Fernandez, Bob, "Fed Economist Sees Regional Growth Resumption by June", The Philadelphia Inquirer, January 2, 2002
[10] *Five-Year Plan, Fiscal Year 2003-Fiscal Year 2007,* p. 9

NEIGHBORHOOD TRANSFORMATION AND BLIGHT ELIMINATION

Since 1950, the City's population has declined by approximately 25 percent. The Neighborhood Transformation Initiative (NTI) was designed by the current Administration to end suburban flight and stabilize the City's neighborhoods. The issuance of nearly $300 million of Blight Remediation Bonds to fund NTI services is the major component of the project.

While applauding the City for undertaking efforts of this magnitude, PICA Staff has major concerns regarding the details of NTI particularly the lack of performance measures and the slow pace of elements of the NTI program.

Background and First Stages of NTI

In order to stem the tide of the City's physical decline and in an attempt to reverse its fifty-year decline in population, the Administration created the Office of Neighborhood Transformation. This office is responsible for developing and implementing the Neighborhood Transformation Initiative. NTI is an unprecedented, multifaceted, multi-agency project that is the most ambitious urban-renewal program in the City's history.

Over the past year, the Office of Neighborhood Transformation has refined the goals of NTI, utilizing the data gathered about the various census tracts in the City of Philadelphia. As a result, the restated framework goals of NTI include:

- Neighborhood Planning
- Blight Elimination
- Blight Prevention
- Assembling Land for Development
- Neighborhood Investments
- Leveraging Resources

This spring, the City issued the first series of NTI related bonds in order to begin the first stages of demolitions as well as community-building in designated areas of the City. During meetings with PICA Staff, the NTI team demonstrated the enormous amount of data gathered on the status of every block in the City. The tremendous amount of information was a positive sign as to the due diligence undertaken by the NTI team in understanding the problems presented by the deterioration of Philadelphia's neighborhoods. The data will make an excellent starting point for devising accurate strategies for working with the wide-variety of City neighborhoods.

Fiscal Elements of NTI

As of this writing the implementation and financial strategies have not been detailed in the Plan. According to the Plan, the City, through the RDA, is anticipating issuing two different types of bonds.

Over a period of five years, approximately $245 million of governmental purpose (tax-exempt) bonds will be issued to fund the demolition of abandoned residential and commercial buildings, encapsulate vacant homes and improve streetscapes. An estimated $50 million of private activity (taxable) bonds will be issued to finance nontraditional neighborhood investment programs and thus avoid being hamstrung by federal regulations.

According to the Plan, the City has budgeted just under $20 million annually to pay the debt service on the NTI bonds over the life of the Plan.

PICA Staff Concerns

As part of its review of NTI, PICA Staff reviewed similar (though smaller) efforts undertaken by other communities across the country. Although the details differed, a few key elements were identified as being indicative of a successful effort. These included: comprehensive data; strong political support; clear, measurable goals; and, "organized momentum."

As mentioned above, the depth and quality of the data assembled by the NTI team is astounding. The base information for moving forward with the project has been assembled. Similarly regarding political support, the Mayor has made NTI a focal point of his Administration at every stage of implementation. It is the remaining two areas which greatly concern PICA Staff.

Perhaps the most troubling is the overall lack of accountability and performance standards (not presently evident in the Plan or any documents distributed by the NTI team). Despite a fairly long planning process, NTI has few specific outcome measures, and little beyond broad policy goals. In meetings with PICA Staff, the NTI team conceded that there has been little focus on developing such measures to date. PICA Staff has great concern about the ongoing evaluation of the success of NTI beyond counting the number of buildings demolished and lots cleared.

"Organized momentum" was described to PICA Staff as the community feeling that the project is moving forward in a non-chaotic fashion. While it could be expected that the fiscal and contract elements of NTI would move slowly, it is disappointing that other elements of the project have dragged along. Nearly two-and-a-half years after NTI was first broached, many of the easier to achieve components of NTI have yet to be achieved, including:

- NTI requires the coordination and consolidation of City departments and agencies related to housing. Although some plans have been designed, no consolidation effort has taken place.

- NTI requires changes in local and state laws that will ease condemnation and code compliance efforts. Few, if any, of these legislative changes have even been proposed.

- The establishment of a City-wide landbank has yet to occur.

- NTI assumes the development of market-rate housing despite building costs in Philadelphia that are unnecessarily inflated. No efforts have been made to find ways to control these costs.

Each of these elements are central to NTI and each are already lagging in momentum.

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PERFORMANCE MEASUREMENT

The City continues to show dramatic improvement in the development of useful performance measures and the collection of data. These improvements have not been as prevalent in some of the current Administration's newer initiatives. Despite the improved focus on outcome measurement, there remains a disconnect between new initiatives outlined in the Plan and projected measures related to these initiatives.

Development of Useful Measures and Reliable Data Continues to Improve

For a true performance measurement system to work, it must have outcome-based measures which relate directly to the service mission of the department. In many City Departments, the ongoing emphasis on useful performance measures spearheaded by the Office of Budget and Program Evaluation has dramatically improved the quality of measures developed. The focus is shifting to true outcomes – how is the Department performing relative to its mission, rather than what the Department is doing.

Some Departments are further along the process than others. The Social Services Departments have begun to capture data on key measures that relate closely to Department-wide objectives. While this data alone will not give a complete picture of Departmental activities, it should give some indication of progress toward achieving goals, as well as highlighting activities which are not achieving success. PICA Staff hopes to begin seeing this data reported beginning next fiscal year.

The reliability of data remains a concern of PICA Staff. While the Police Department was revealed to have the most egregious misrepresentation of performance statistics, a few other Departments have some similar issues. Dramatic publicity lead to more accurate reporting of Police measures; other departments should not require similar prodding. PICA Staff is encouraged by indications that improved technology will enhance data reliability.

New Initiatives Lack Clear Performance Measures

One of the difficulties with instituting a performance measurement system is the natural resistance to applying new techniques to existing programs. The reverse is usually true as well, so that newly instituted programs which incorporate performance measures into their formation will work well. Unfortunately, many initiatives of the current Administration have failed to follow this model.

The most disappointing of these failures is the Neighborhood Transformation Initiative (NTI). Other than a few broad goals (demolish a certain number of buildings, clear a certain number of vacant lots) there is very little detail regarding ongoing performance measures. This shortcoming will make assessing the impact of the nearly $300 million in NTI funds nearly impossible. Administration officials acknowledged the lack of specific measures, but gave no timetable for developing measures.

While NTI is a complex initiative, relatively simple initiatives have also ignored performance measures. For example, the introduction of a Secretary of Boards, Agencies and Commissions included clear goals: reductions in the number of vacancies, shorter time periods with new vacancies unfilled, and greater diversity among appointees to these positions. To date, there has been no tracking of data regarding the percentage of vacancies that go unfilled, how long they remain unfilled, or even a diversity assessment.

Plan Initiatives are not Reflected in Performance Goals

While reviewing the Plan and during meetings with Departments, PICA Staff continued to be disappointed by the lack of relationship between objectives stated in the Plan and performance goals. In several Plan chapters, specific initiatives were described with specific aims. Yet, performance measures were either not provided in the Plan or the projected measures showed no impact from the initiatives.

Many of the Social Service Departments described new emphases on prevention programs in the new Plan. However, many measures for client services displayed little or no change following these new initiatives. Similarly, crime statistics should have better reflected initiatives like Operation Safe Streets which would have initially increased arrests but should reduce criminal activity over time.

When questioned, many Departments indicated that their projections are based on trends and do not incorporate the initiatives described in the Plan. This approach hinders any attempt to tie desired service goals with programs to achieve those goals. Ideally, projected measures should be set where Departments want their level of achievement to reach; where we want to be as opposed to where we are headed.

DEPARTMENT OF HUMAN SERVICES

The Division of Social Services (DSS) was created in FY2001 to improve the planning, integration, coordination and delivery of social services to the residents of Philadelphia. The Department of Human Services (DHS), whose mission is to protect children from abuse, neglect and to strengthen families is a component of the new service delivery structure.

Over the last decade, DHS has significantly and consistently increased its "outside" funding levels. This has allowed the City to increase service levels, while simultaneously reducing net City costs to provide these services. While the City should be congratulated for increasing state and federal funding levels, challenges that could negatively affect net City costs still remain. In light of the recent economic downturn, which has negatively impacted both the state and federal budgets, it is imperative that the City continues to be vigilant in maintaining external funding to serve the ever-increasing needs of its population.

Increase in State and Federal Funding Levels

In the early 1990's the City started to aggressively pursue additional funding opportunities for human service functions. When meeting with PICA Staff, DHS staff provided a historical analysis of the City share of these costs by fiscal year.

Analysis of City Share of Department of Human Services Costs
(numbers in thousands)

Fiscal Year	City Costs	State/Federal	Total	City % of Costs
'93	61.5	180.9	242.4	25%
'94	64.6	195.1	259.7	24%
'95	48.5	235.5	284.0	17%
'96	38.5	256.7	295.2	13%
'97	44.7	263.2	307.9	14%
'98	48.2	288.7	336.9	14%
'99	45.7	318.3	364.0	12%
'00	39.2	368.7	407.9	9%
'01	51.8	392.0	443.8	11%
'02	44.8	433.1	477.9	9%

As the above information illustrates, the City share of DHS service costs decreased from 25 percent in FY1993 to 9 percent in FY2002, while simultaneously the total costs of the department services rose from $242.4 million in FY93 to $477.9 million in FY2002. Throughout the life of the Plan, the City share of costs is projected to remain remarkably consistent at eight percent.[11] Given the changes at the national and state levels, and anticipated budget deficits, PICA Staff has concerns about the likelihood of maintaining these funding levels.

[11] *Five Year Financial Plan, Fiscal Year 2003-Fiscal Year 2007, p. 152-161*

Projected City Share of Department of Human Services Costs

(numbers in thousands)

Fiscal Year	**City Costs**	**State/Federal**	**Total**	**City % of Costs**
‘03	42.1	487.7	530.4	8%
‘04	47.4	521.9	569.1	8%
‘05	49.6	535.3	584.3	8%
‘06	51.8	548.9	599.7	8%
‘07	54.1	563.0	616.0	8%

Needs-Based Budgeting

Simultaneously to the City’s pursuit of additional funding, the Commonwealth instituted a Need Based Budgeting System to determine the appropriate levels of funding. This system continues to hamper the efforts of the Department to effectively plan and allocate expenditures. PICA Staff remains concerned about the absence of a clear and equitable reimbursement process. The criteria utilized by the Commonwealth to determine county-funding allocations continues to remain confusing and more importantly at odds with the realities that face human service departments across the State.

Various demographic factors are also not taken into consideration when the Commonwealth determines funding levels for DHS. According to the 1999 publication of the *State of the Child in Pennsylvania*, the rate of children living in poverty in the City is 37.4 percent. The average for the rest of the Commonwealth is 17.3 percent.[12] The 2000 census reports that a single parent heads 51% of families in Philadelphia.[13] In general, there is a high correlation between the incidence of child poverty and the incidence of children raised in single parent households.[14] The City’s welfare population represents nearly 50 percent of Pennsylvania’s total welfare caseload, whereas the City’s population compromises only 12 percent of the state’s population.[15]

[12] *Five Year Financial Plan, Fiscal Year 2003-Fiscal Year 2007, p. 159*

[13] *The Bottom Line is….Children, Philadelphia Citizens for Children and Youth 2001, p.25*

[14] *The Bottom Line is….Children, Philadelphia Citizens for Children and Youth 2001, p.24*

[15] *Recommendations to Strengthen TANF: A State Briefing Paper, The Stoneleigh Roundtable, Nov. 2001,* p. *4*

DHS takes issue with the following tenets regarding the funding process that the Department of Public Welfare utilizes:

1. Uniform, Statewide caps on rates of increases for costs of purchased services without regard to actual costs or differences in costs among counties;

2. Uniform Statewide caps for salaries and benefits which ignore the cost of living differences among counties;

3. "Certified" funding amounts from the previous year rather than actual costs or mid-year estimates;

4. Cap on administrative costs and exclusion of certain services from reimbursement.

While the current utilization of the Needs-Based Budgeting process has not yet hampered the City's ability to obtain and even increase its fair share of funding for human services, PICA Staff believes that the funding inequities listed above pose a potential risk.

Welfare Reform and Five–Year Lifetime Limit

Since Pennsylvania's welfare reform law, titled Act 35, was enacted in March 1997, welfare caseloads across the state have been reduced by more than 50 percent.[16] Modeled after federal legislation, the Personal Responsibility and Work Opportunity Reconciliation Act, Act 35 imposes a five-year limit on a recipient's ability to collect benefits under the Temporary Assistance to Needy Families (TANF). Currently the Pennsylvania Department of Public Welfare (DPW) is in the process of finalizing regulations that would extend eligibility for TANF benefits to all adults reaching their sixtieth month if certain conditions are met.

PICA Staff is concerned because the TANF regulations regarding extensions have not yet been finalized. This would affect an estimated 20,000 parents and children in Philadelphia, who will reach their lifetime limit between March 2002 and July 2002. Moreover, this estimate does not include those recipients who will reach their lifetime limit after July 2002.[17]

Improvements Resulting from the New DSS Structure

Since the implementation of the DSS in FY2001, PICA Staff has continued to monitor the efforts to streamline services, eliminate duplication of effort, and enhance performance measures (see "performance measurement" section). The holistic look at City service

[16] *Pennsylvania Department of Public Welfare*

[17] *Recommendations to Strengthen TANF: A State Briefing Paper, The Stoneleigh Roundtable, Nov. 2001, p. 3*

delivery, combined with efforts like the *Children's Report Card*, allow for a more comprehensive approach to meeting the needs of DHS customers.

The development of an integrated case management system will allow DHS staff members to access relevant data from all city systems insuring that all customer needs can be met at one point of contact. Additionally, the anticipated implementation of performance-based contracting will ensure that contractors are providing the services that meet the City's standards.

As DSS moves past its nascent stage, PICA Staff anticipates more tangible results. With projected State and federal deficits for the foreseeable future, the continuous improvement projects and improved client services should also result in measurable cost savings for DHS and other social service delivery units of the City.

Conclusion

The consistent, annual increase in non-City funding for DHS services has been exceptional over the last decade. This has allowed the Department to increase service levels for its needy clients while also beginning to implement systemic reform based on accountability, accessibility, and prevention. Expansion and enhancement of after-school services such as the Beacon Schools and the Family Centers are prime examples of systemic reform. In order to continue the past successes, the City must be proactive in working collaboratively with its State and federal partners and it must also be vigilant in identifying new funding sources to serve the City's neediest residents.

OUTSIDE THE FIVE-YEAR PLAN

There are a number of issues that either fall outside the duration of the Plan or are not addressed by the proposed Plan. The Plan makes no mention of funding an expansion of the Convention Center. The Plan makes no mention of new revenues from the decrease in PICA debt service and the increase in Real Estate tax revenue as previous property tax abatements expire. The Plan makes no effort to address the problem of annual structural deficits.

Convention Center Expansion

In the Mayor's budget address on January 29, 2002, expansion of the Pennsylvania Convention Center was deemed a priority. Hospitality and tourism growth in the City during the last decade parallels the building and completion of the Convention Center. In order for Philadelphia to compete with other East Coast convention destinations, expanding the Center to 2.4 million square feet has been proposed. Approximate costs to complete the expansion are upwards of $460 million. Even if this cost were to be shared with the Commonwealth, not one cent has been proposed in the Plan for expansion.

The greater concern however is the viability of expansion given the higher than average labor costs and lower than average rebooking rate at the current Convention Center. Little discussion in the Plan centers on concerns that this economic engine has a rebooking rate of just 15 percent. Labor disagreements and costs are continually cited as problems by Convention Center customers, not the size of the facility.

The ideal would be a well-managed large Convention Center that would continue to drive the City and State economy. The reality today is a smaller, unevenly-managed Convention Center which drives customers away. If the likely result is a large, poorly-managed Convention Center, than the City should save taxpayers millions of dollars in debt, and refrain from expanding the Convention Center.

New Revenue Streams

Beginning in FY2007, two "new" revenue streams will begin to impact the Plan, in small but steady ways. In FY2007, PICA debt service will be just over $86 million, down slightly from FY2006. After FY2007, the debt service begins dropping every year, reaching $61 million by FY2010. Since the difference between PICA tax dollars received and debt service is returned to the City, this drop should result in additional funds for the City, totaling over $21 million in FY2010 alone.

In the mid-1990's, the City began a series of tax abatement programs to spur new development in the City. These programs were very successful and supported the recent building growth in Philadelphia. Most of these tax abatements were for limited periods of time (3, 5, 10 or 12 years), and will begin to "return" to the tax rolls in significant numbers in FY2007. PICA Staff estimates that in FY2007 the City should realize over $3 million from previously untaxed entities. By FY2010, this annual number will be over $4.1 million. When combined with the PICA surplus described above, the City should expect to see $25 million in "new" revenues annually by FY2010, a number that although a small percentage of the overall budget, will continue to grow.

Annual Structural Deficits

PICA's mandate has always been to determine whether or not the City's proposed Plan presents a reasonable projection for a balanced spending plan over the ensuing five-year period. In effect, do the City's projected revenues and fund balance equal or better the proposed spending over five years? However, as the dwindling fund balance at the end of the Plan demonstrates, PICA Staff makes no attempt to address the issue of annual structural deficits.

Every year of the current Plan assumes an annual operating deficit, ranging from $50 million to nearly $90 million. It would be logical to assume that if the Plan extended to FY2008, even with the increased revenue streams mentioned above, the City would be faced with a negative fund balance. PICA Staff believes the City needs to begin striving for projected annual Operating Fund balance in order to achieve true fiscal stability.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT
ON
FY2003-FY2007
FIVE-YEAR FINANCIAL PLAN

SECTION V:

APPENDICES

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APPENDIX A

Statutory Background, Plan Review Methodology and Summary of Events

Overview

The General Assembly created PICA in June of 1991 by its approval of The Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class (Act of June 5, 1991, P.L. 9, No. 6). As in previous PICA Staff reports concerning the City's prior five-year financial plans, rather than re-state in the body of this Staff Report the principal provisions of the PICA Act and the Intergovernmental Cooperation Agreement, PICA Staff has included such information in this Appendix.

A brief summary of events to date including comments as to PICA's future focus, a summary of PICA Staff's Plan review methodology and a compilation of required future City reporting to PICA is also included herein.

Statutory Basis -- The PICA Act

The mission of the Authority, as stated in the PICA Act (Section 102), is as follows:

> Policy.--It is hereby declared to be a public policy of the Commonwealth to exercise its retained sovereign powers with regard to taxation, debt issuance and matters of Statewide concern in a manner calculated to foster the fiscal integrity of cities of the first class to assure that these cities provide for the health, safety and welfare of their citizens; pay principal and interest owed on their debt obligations when due; meet financial obligations to their employees, vendors and suppliers; and provide for proper financial planning procedures and budgeting practices. The inability of a city of the first class to provide essential services to its citizens as a result of a fiscal emergency is hereby determined to affect adversely the health, safety and welfare not only of the citizens of that municipality but also of other citizens in this Commonwealth.
>
> Legislative intent.--
>
> (1) It is the intent of the General Assembly to:
>
> (i) provide cities of the first class with the legal tools with which such cities can eliminate budget deficits that render them unable to perform essential municipal services;

(ii) create an authority that will enable cities of the first class to access capital markets for deficit elimination and seasonal borrowings to avoid default on existing obligations and chronic cash shortages that will disrupt the delivery of municipal services;

(iii) foster sound financial planning and budgetary practices that will address the underlying problems which result in such deficits for cities of the first class, which city shall be charged with the responsibility to exercise efficient and accountable fiscal practices, such as:

(A) increased managerial accountability;

(B) consolidation or elimination of inefficient city programs;

(C) recertification of tax-exempt properties;

(D) increased collection of existing tax revenues;

(E) privatization of appropriate city services;

(F) sale of city assets as appropriate;

(G) improvement of procurement practices including competitive bidding procedures;

(H) review of compensation and benefits of city employees; and

(iv) exercise its powers consistent with the rights of citizens to home rule and self government.

(2) The General Assembly further declares that this legislation is intended to remedy the fiscal emergency confronting cities of the first class through the implementation of sovereign powers of the Commonwealth with respect to taxation, indebtedness and matters of Statewide concern. To safeguard the rights of the citizens to the electoral process and home rule, the General Assembly intends to exercise its power in an appropriate manner with the elected officers of cities of the first class.

(3) The General Assembly further declares that this legislation is intended to authorize the imposition of a tax or taxes to provide a source of funding for an intergovernmental cooperation authority to enable it to assist cities of the first class and to incur debt of such authority for such purposes; however, the General Assembly intends that such debt shall not be a debt or liability of the Commonwealth or a city of the first class

nor shall debt of the authority payable from and secured by such source of funding create a charge directly or indirectly against revenues of the Commonwealth or city of the first class.

The PICA Act establishes requirements for the content of a five year financial plan, and Sections 209 (b)-(d) of the statute and the Cooperation Agreement provide:

(b) Elements of plan. -- The financial plan shall include:

(1) Projected revenues and expenditures of the principal operating fund or funds of the city for five fiscal years consisting of the current fiscal year and the next four fiscal years.

(2) Plan components that will:

(i) eliminate any projected deficit for the current fiscal year and for subsequent years;

(ii) restore to special fund accounts money from those accounts used for purposes other than those specifically authorized;

(iii) balance the current fiscal year budget and subsequent budgets in the financial plan through sound budgetary practices, including, but not limited to, reductions in expenditures, improvements in productivity, increases in revenues, or a combination of these steps;

(iv) provide procedures to avoid a fiscal emergency condition in the future; and

(v) enhance the ability of the city to regain access to the short-term and long-term credit markets.

(c) Standards for formulation of plan:

(1) All projections of revenues and expenditures in a financial plan shall be based on reasonable and appropriate assumptions and methods of estimation, all such assumptions and methods to be consistently applied.

(2) All revenue and appropriation estimates shall be on a modified accrual basis in accordance with generally accepted standards. Revenue estimates shall recognize revenues in the accounting period in which they become both measurable and available. Estimates of city-generated revenues shall be based on current or proposed tax rates, historical collection patterns, and generally recognized econometric models. Estimates of revenues to

be received from the state government shall be based on historical patterns, currently available levels, or on levels proposed in a budget by the governor. Estimates of revenues to be received from the federal government shall be based on historical patterns, currently available levels, or on levels proposed in a budget by the president or in a congressional budget resolution. Non-tax revenues shall be based on current or proposed rates, charges or fees, historical patterns and generally recognized econometric models. Appropriation estimates shall include, at a minimum, all obligations incurred during the fiscal years and estimated to be payable during the fiscal year or in the 24-month period following the close of the current fiscal year, and all obligations of prior fiscal years not covered by encumbered funds from prior fiscal years. Any deviations from these standards of estimating revenues and appropriations proposed to be used by a city shall be specifically disclosed and shall be approved by a qualified majority of the board.

(3) All cash flow projections shall be based upon reasonable and appropriate assumptions as to sources and uses of cash, including, but not limited to, reasonable and appropriate assumptions as to the timing of receipt and expenditure thereof and shall provide for operations of the assisted city to be conducted within the resources so projected. All estimates shall take due account of the past and anticipated collection, expenditure and service demand experience of the assisted city and of current and projected economic conditions.

(d) Form of plan. -- Each financial plan shall, consistent with the requirements of an assisted city's home rule charter or optional plan of government:

(1) be in such form and shall contain:

(i) for each of the first two fiscal years covered by the financial plan such information as shall reflect an assisted city's total expenditures by fund and by lump sum amount for each board, commission, department or office of an assisted city; and

(ii) for the remaining three fiscal years of the financial plan such information as shall reflect an assisted city's total expenditures by fund and by lump sum amount for major object classification;

(2) include projections of all revenues and expenditures for five fiscal years, including, but not limited to, projected capital expenditures and short-

term and long-term debt incurrence and cash flow forecasts by fund for the first year of the financial plan;

(3) include a schedule of projected capital commitments of the assisted city and proposed sources of funding for such commitments; and

(4) be accompanied by a statement describing, in reasonable detail, the significant assumptions and methods of estimation used in arriving at the projections contained in such plan.

The Cooperation Agreement (at Section 4.04(a)-(h)), and similar provisions of the PICA Act, also require the following as supporting data for the Plan:

(a) a schedule of debt service payments due or projected to become due in respect of all indebtedness of the City and all indebtedness of others supported in any manner by the City (by guaranty, lease, service agreement, or otherwise) during each fiscal year of the City until the final scheduled maturity of such indebtedness, such schedule to set forth such debt service payments separately according to the general categories of direct general obligation debt, direct revenue debt, lease obligations, service agreement obligations and guaranty obligations.

(b) a schedule of payments for legally mandated services included in the Financial Plan and due or projected to be due during the fiscal years of the City covered by the Financial Plan;

(c) a statement describing, in reasonable detail, the significant assumptions and methods of estimation used in arriving at the projections contained in the Financial Plan;

(d) the Mayor's proposed operating budget and capital budget for each of the Covered Funds for the next (or in the case of the initial Financial Plan, the current) fiscal year of the City, which budgets shall be consistent with the first year of the Financial Plan and which budgets shall be prepared in accordance with the Home Rule Charter;

(e) a statement by the Mayor that the budgets described in section 4.04(d) hereof:

(i) are consistent with the Financial Plan;

(ii) contain funding adequate for debt service payments, legally mandated services and lease payments securing bonds of other government agencies or of any other entities; and

(iii) are based on reasonable and appropriate assumptions and methods of estimation.

(f) a cash flow forecast for the City's consolidated cash account for the first fiscal year of the City covered by the Financial Plan;

(g) an opinion or certification of the City Controller, prepared in accordance with generally accepted auditing standards, with respect to the reasonableness of the assumptions and estimates in the Financial Plan; and

(h) a schedule setting forth the number of authorized employee positions (filled and unfilled) for the first year covered by such Financial Plan for each board, commission, department or office of the City, and an estimate of this information for the later years covered by the Financial Plan. The schedule required under this paragraph (h) shall be accompanied by a report setting forth the City's estimates of wage and benefit levels for various groups of employees, such information to be presented in a manner which will allow the Authority to understand and effectively review the portions of the Financial Plan which reflect the results of the City's labor agreements with its employees, and an analysis of the financial effect on the City and its employees of changes in compensation and benefits, in collective bargaining agreements, and in other terms and conditions of employment, which changes may be appropriate in light of the City's current and forecast financial condition. The parties agree to cooperate such that the form of the report required under this paragraph (h), and the subjects covered, are reasonably satisfactory to the Authority.

City Reporting and Variances

The PICA Act (Section 209) and the Cooperation Agreement (Section 409(b)) require submission of quarterly reports by the City on its compliance with the Plan within 45 days of the end of a fiscal quarter. If a quarterly report indicates that the City is unable to project a balanced Plan and budget for its current fiscal year, the Authority may by the vote of four of its five appointed members declare the occurrence of a "variance", which is defined in Section 4.10 of the Cooperation Agreement as follows:

(i) a net adverse change in the fund balance of a Covered Fund of more than one percent of the revenues budgeted for such Covered Fund for that fiscal year is reasonably projected to occur, such projection to be calculated from the beginning of the fiscal year for the entire fiscal year, or (ii) the actual net cash flows of the City for a Covered Fund are reasonably projected to be less than ninety-five percent (95%) of the net cash flows of the City for such Covered Fund for that fiscal year originally forecast at the time of adoption of the budget, such projection to be calculated from the beginning of the fiscal year for the entire fiscal year.

As defined in Section 1.01 of the Cooperation Agreement, the City's "Covered Funds" are the General Fund, General Capital Fund, Grants Revenue Fund and any other principal operating funds of the City which become part of the City's Consolidated Cash Account.

The statute mandates the submission of monthly reports to PICA by the City after determination by the Authority of the occurrence of a variance.

As provided in Section 210(e) of the PICA Act, there are legal consequences flowing from a determination by the Authority that a variance exists, and in addition to the City's additional reporting responsibilities, it also is required to develop revisions to the Plan necessary to cure the variance. The remedies which PICA has available to it to deal with a continuing uncorrected variance are to direct the withholding of both specific Commonwealth funds due the City, and that portion of the 1.5 percent tax levied on the wages and income of residents of the City in excess of the amounts necessary to pay debt correction of the variance.

Plan Review Methodology

Staff Report - The Plan, as approved by City Council on May 2, 2002, was submitted to PICA by the Mayor on May 31, 2002 and the PICA Act provides a 30 day period for review which expires June 30, 2002. Authority Staff has consulted with the City, both on the departmental level and otherwise, since the Plan was initially submitted to City Council by the Mayor on January 29, 2002 and has referred to material presented to City Council and the Controller's Office, as well as information included in reports submitted by the City to PICA and other data developed by PICA Staff. This report includes reference to materials received by the Authority through June 10, 2002.

Under Section 5.07 of the Cooperation Agreement, PICA agreed not to disclose information provided to it in confidence by the City with respect to negotiation of collective bargaining agreements and ongoing arbitration proceedings, and the Authority has consistently followed that requirement.

Relationship to Future Plan Revisions - The City is obligated under both the Cooperation Agreement and the PICA Act to submit a revised Plan in the event it enters into a collective bargaining agreement, or receives a labor arbitration award, at variance with that which was assumed in the Plan. The Cooperation Agreement anticipates that the Plan must be revised to deal with such matters within 45 days after declaration of a "variance" by PICA.

Apart from labor-related revisions, or those required by declaration by PICA of a variance in the Plan in the future, the Plan is subject to mandatory revision on March 22, 2003 (100 days prior to the end of FY2003). At that time, the City is required to add its Fiscal Year 2008 to the Plan and make any other alterations necessary to reflect changed circumstances. Under the PICA Act, the City may determine to revise the Plan at any time and submit the revision to the Authority for its review.

Accounting Concerns

The PICA Act requires that a modified accrual accounting system be used in preparation and administration of the Plan, in accordance with generally accepted accounting standards. Specifically, the Cooperation Agreement (at Sections 4.02(a) and (b)) provides:

> Estimates of revenues shall recognize revenues in the accounting period in which they become both measurable and available….
>
> Appropriation estimates shall include, at a minimum, all obligations incurred during the fiscal year and estimated to be payable during the fiscal year or in the twenty-four (24) month period following the close of the current fiscal year….

The Plan as submitted meets the requirements of the PICA Act and Cooperation Agreement.

Summary of Events to Date/Future Focus

PICA's creation was an action taken by the Commonwealth of Pennsylvania in direct reaction to Philadelphia's financial crisis. Accordingly, PICA's primary focus during its initial years of existence has been to assist the City to avoid insolvency; to provide the funds directly required for that purpose and for essential capital programs; and to oversee the City's efforts to lay a sound foundation for its return to fiscal stability. The negotiation of the Cooperation Agreement to set out the basic terms of the City-PICA relationship, the PICA sponsored effort resulting in the establishing of the format and content of the Five-Year Financial Plan process, and the issuance of bonds to provide funds to assist the City to stabilize its finances were all major accomplishments. Successful defense against challenges to the constitutionality of the PICA Act was another vital PICA process component. PICA's annual assessment of Plan progress, successful challenges to overgenerous prior Plan revenue estimates and suspect methodologies, evaluations of City reporting, and analysis of City practices and programs have assisted in the ongoing City improvement as envisioned by the PICA Act.

PICA also provides continuing oversight as to the encumbrance by the City of PICA provided capital funds for capital projects deemed required to rectify emergency conditions or necessary for Plan operational success.

PICA has provided in excess of $1,128 million in funding to assist the City, allocated to the following purposes:

Purpose	Amount (thousands)
Deficit Elimination/Indemnities Funding	$ 256,200
Productivity Bank	20,000
Capital Projects	471,129
Retirement of Certain High Interest City Debt	381,300
TOTAL	**$1,128,629**

PICA's authority to issue new money debt has expired. PICA anticipates that its future activities with respect to the City will focus more closely on oversight on the City's efforts to maintain financial balance, further institutionalize management reforms (both those initiated to date and those still to be made) and to implement ongoing operations changes in accordance with the City Strategic Plan.

The City had taken full advantage of the tools PICA made available to it. It is anticipated that the PICA/City relationship will continue to be a catalyst for further City operational improvements.

Whether PICA will also become involved in the financial oversight of the School District of the City Philadelphia is a matter that presently is in the hands of the Appellate Courts of the Commonwealth.

Future City Reporting to PICA

Absent the occurrence of a variance, receipt of an arbitration award which is at variance with the Plan or a determination by the City that further revisions to the Plan are necessary, the City will not submit a revised Plan to the Authority until March 2003. During future months, the Authority will receive quarterly reports on the City's performance under the Plan, together with other data.

The reporting system established in the Cooperation Agreement and the PICA Act anticipates a regular flow of data to PICA, and the reporting system which has been established by agreement between the City and PICA under the provisions of the PICA Act is divided into several groups, which are described below:

> Quarterly Plan Reports. The Authority receives reports from the City on a quarterly basis (45 days after the end of each fiscal quarter) concerning the

status of compliance with the Plan and associated achievement of initiatives. The remaining quarterly reporting deadline for FY2002 is August 15, 2002. Quarterly reporting deadlines for FY2003 are November 15, 2002, February 17, 2003, May 15, 2003 and August 15, 2003. The Cooperation Agreement also requires that the City provide reports to PICA concerning Supplemental Funds (*i.e.*, the Water and Aviation Funds) on a quarterly basis.

Grants Revenue Fund Contingency Account Report. The Cooperation Agreement provides that a report on the Grants Revenue Fund Contingency Account be prepared and submitted, by department, not later than 20 days after the close of each fiscal quarter, and still to be received relating to FY2002 is the report due June 20, 2002. For FY2003, the reporting dates are October 21, 2002, January 21, 2003, April 21, 2003 and July 21, 2003. Commonwealth funds by the City, as well as the eligibility for fund withholding by the Commonwealth at PICA's direction in the event the City cannot balance the Plan after an extended period of intensive reporting and PICA review of proposed corrective efforts.

Prospective Debt Service Requirements Reports. The Cooperation Agreement requires submission of a report detailing prospective debt service payments by the City, as well as lease payments, 60 days prior to the beginning of a fiscal quarter. The dates for submission of such reports for FY2003 are August 1, 2002, November 1, 2002, January 31, 2003 and May 2, 2003.

APPENDIX B

Schedule of Findings, Office of the City Controller

In accordance with Section 4.04(g) of the Intergovernmental Cooperation Agreement between PICA and the City, the City Controller's Office submitted to PICA its report upon the Forecasted Statements of General Fund Revenues, Obligations and Changes in Fund Balance for the Fiscal Years Ending June 30, 2003 and June 30, 2004, included in the Plan. That report included the Controller's Office opinion that the underlying assumptions provide a reasonable basis for City management's forecast. At the request of the PICA Board, the City Controller's Office also prepared a report upon the results of agreed upon procedures with respect to the Plan. PICA Staff is grateful for the assistance provided by the Controller's Staff in evaluating this Plan.

The Schedule of Findings of the Controller's Office resulting from its work with respect to the Plan, formally reported to PICA May 31, 2002 (as a component of the Controller's report upon the performance of agreed upon procedures) is reproduced in this Appendix. Certain findings have been previously discussed in this report from a PICA Staff perspective. PICA Staff believes the reader will gain added value from a review of the Office of the Controller's perspective on such matters.

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CITY CONTROLLER'S OFFICE
FIVE-YEAR FINANCIAL PLAN - Schedule of Findings
FOR THE FISCAL YEARS 2005 THROUGH 2007

Economic and General Fund Revenue Forecasts

The Controller's comparative economic and General Fund revenue forecasts appear to be consistent with the Plan's estimates. The key underlying assumptions for both projections include (1) continuation of Wage Tax cuts and acceleration of Gross Receipts Tax reductions proposed from the second year of the Plan, and (2) refreshed growth in the national economy. It has been assumed that the city will regain a relatively stable economic base throughout the life of the Plan.

Wage and Earnings Tax
Forces such as the city's tax policies, the city's economic development programs, local industry restructuring, and welfare reform will shape City payroll employment. Although the city's non-farm payroll employment decreased by 1.0 percent in 2001, favorable socioeconomic conditions will help to regain momentum. Incremental tax cuts led to incremental job growth over the last few years. But Philadelphia also reaped the benefits of a strong national economy. Regardless, the local pressure resulting from population loss and middle-class tax base erosion will continue to hamper Philadelphia's economic health over the life of the Plan. As there is little evidence that the city's onerous tax structure will be significantly changed, the relatively conservative revenue estimates in the Plan are reasonable. Wage rates that increase faster than employment will continue to drive revenue growth that should outpace inflation.

Real Property Tax
The Controller's Office assumes that the commercial and industrial real estate markets will continue to be shaped by two patterns. First, industry restructuring and technological improvements in the labor and capital markets will continue to reduce the demand for space. However, this may be somewhat mitigated by a recent trend showing a rebounding appreciation for the amenities and central location provided by an urban location, and a new 10-year tax abatement on qualified improvements. Second, favorable prices, especially in comparison to increasingly expensive suburban space, may induce some modest improvement in the market for commercial office space. Recent conjecture about the construction of one or more new office towers and the success of several new apartment buildings and condominiums supports this reasoning. To remain conservative, and because historically the city's Real Property Tax assessments have been slow to keep pace with increasing property values, we believe that the demand reduction and favorable price patterns will offset each other, leaving sub-inflation level growth in Real Property Tax revenue, as projected in the Plan.

Business Privilege Tax
By nature, the Business Privilege Tax (BPT), which comprises the gross receipts and net income components, is volatile and contingent upon economic conditions. As the city continues to reduce the gross receipts portion of the tax, the proportion of BPT revenue derived from net income is likely to continue to increase. While the decreased rate makes Philadelphia more competitive, especially to new companies and small companies working with low profit margins, the higher dependence on the net income portion makes overall BPT revenue increasingly more sensitive to trends in profitability. By reflecting this trend and taking the current economic rebound into consideration, the Plan's conservative BPT revenue estimates appear reasonable.

Revenue from Other Governments
Department of Human Services (DHS)
DHS receives a considerable amount of State and Federal funding, especially from Federal program Title IV-E and State program Act 148. The Plan assumes a 2.9-percent average annual growth rate for Title IV-E and a 3.7-percent average annual growth rate for Act 148. Assuming continued State and Federal surpluses, these funding levels appear reasonable. DHS also receives significant funding from the federal TANF program. For FY 2003, the Plan assumes a 21.8-percent increase over FY 2002 funding and then continued funding at the new level for the remaining years, resulting in an assumed average annual growth rate of 4.4 percent. This may be conservative.

Philadelphia Gas Works (PGW)
PGW still faces financial difficulties. The relative warm winter caused reduced sales and thus reduced coverage of the operating costs. PGW now seeks a rate increase to pass uncovered costs onto the consumers. Consequently, the already fragile collection rate is likely to erode further, compromising PGW's recovery options. With wholesale prices expected to remain at current levels, few real structural changes, and the possibility of a sale, the city may not receive the $18 million annual dividend payments or the $45 million loan repayment now scheduled for FY 2007.

Locally Generated Non-Tax
Stadium
The Plan shows approximately $16.6 million dollars in annual Veterans Stadium related revenue for FY 2003 with a drop to $4.4 million in FY 2004 and negligible revenues for the remainder of the Plan. This reasonably reflects the revenue impacts of the newly negotiated stadium agreements with the Phillies and the Eagles.

GENERAL FUND OBLIGATIONS

Base Methodology

The city's General Fund Obligation growth assumptions as presented in Appendix V – Base Methodology of the Five-Year Plan – appear to be deficient and may be misleading. The projected General Fund obligations as presented in Appendix III of the Plan are at variance with the obligation growth rates shown in Appendix V.

In particular, the projected growth rates for Class 500 (Contributions and Indemnities), and Class 800 (Payments to Other Funds), are inconsistent. The base methodology shows zero percentage growth in Class 500 obligations annually over the life of the Plan. However, Appendix III shows these obligations decreasing by 1.30 percent over the life of the Plan. Additionally, the base methodology in Appendix V shows zero percentage growth in Class 800 obligations annually over the life of the Plan; Appendix III shows the Class 800 obligations to decrease by approximately 13.9 percent on average over the life of the plan.

Payroll

Uniformed unionized employee contracts expire on June 30, 2002. However, the Plan makes no provision for salary increases for uniformed employees. The Street administration continues to state that the unionized work force deserves fair contracts. Given that the non-uniformed employees have a negotiated contract through FY 2004 calling for 3.0-percent increases in each of the last two years, it is likely that the uniformed forces will receive some salary increase beginning in FY 2003. Additionally, there is no provision in the Plan for any salary increases beyond FY 2004 for any organized labor group. Again, it seems highly unlikely that unionized employees will forego wage increases in FY 2005 or FY 2006. While we are not able to predict the outcome of the future labor negotiations, any salary increases for employees will have significant financial impact on the city's budget over the life of the Plan.

Operation Safe Streets

There is no provision for overtime costs associated with this initiative in any year of the Plan. Administration sources state that overtime for Police will cost about $1.5 million per month or $18 million per year. Over the life of the Plan this amounts to $90 million. The Mayor has stated publicly that he will not end this initiative. He has even mentioned possibly petitioning the State or Federal government for financial assistance. To date no non-city funding source for *Operation Safe Streets* has been identified.

Debt Service

Based upon our review of the current General Fund General Obligation Bond maturity registers and related debt service schedules, the General Fund Debt Service Obligations may be over-estimated throughout the life of the Plan.

Debt Service obligations include principal and interest payments for General Obligations Bonds issued in each year of the Plan. While it is possible that the Administration will authorize and sell General Obligation (GO) bonds during the life of this Plan, it is highly unlikely that they will sell GO bonds each year. We believe that the amounts budgeted may exceed the actual costs.

The Plan includes commitment fees and arbitrage payments of $1.25 million and $850,000, respectively, over the next five years. The city has not utilized any type of credit enhancement for the last four short-term note sales. It appears the city will not need, or use, any credit enhancement for its short-term borrowings in the future. Furthermore, it is unlikely the city will be subject to any arbitrage payments over the life of the Plan. In addition, the Plan budgets on average approximately $4.5 million per year for Sinking Fund Reserve Payments. The majority of this funding is for Philadelphia Parking Authority (PPA) bonds for garages that have yet to be built. According to prior service agreements between the city and PPA, the city is responsible for any debt service shortfall the Parking Authority incurs during or after construction. Until these garages are built and generating sufficient revenues, the city will continue to be responsible for subsidizing any shortfall.

Future Government Efficiencies

The Street Administration included $178 million in unspecified future government efficiencies over the life of the Plan. However, the Plan makes no mention of how or where these cuts will be made. Failure to attain these cuts will put the city's budget at a risk equal to the amount of the cuts.

CAPITAL PLAN

Capital Budget

We reviewed the FY 2003 Capital Budget included in Appendix VI of the city's Five-Year Plan. Our review consisted of agreeing the Plan amounts to the City Planning Commission's six-year funding schedule for FY 2003-2008 and verifying the mathematical accuracy of both. In addition, we reviewed all projects in the FY 2003 Capital Budget to determine whether they were capital in nature.

Included in our review was a computation of the current and future legal debt capacity. We also compared potential debt service costs associated with the Capital Plan with projected debt service costs shown in the General Fund section of the Plan. Again, as stated in the Debt Servicesection of this schedule, it appears that debt service obligations are over-budgeted throughout the life of the Plan.

The city is fast approaching its legal debt limit. As FY 2002 draws to a close, the city has slightly less than $60 million in debt capacity remaining. At a time when the city is struggling to stay within its legal debt margin, the Plan offers no solution to how the city will combat this problem. The FY 2003 and FY 2004 capital budgets are seeking funding of $89.9 million and $81.6 million, respectively. With the Capital Plan burgeoning in the first two years, and dwindling to $37 million in FY 2005, the city is at risk of being unable to match state and federal dollars available for projects in the out years. As a result, millions of dollars for capital improvements from outside agencies may be lost.

OTHER FUNDS

Aviation Fund

Based upon the assurances from Aviation Fund officials, it appears unlikely the city will be required to make a General Fund subsidy payment for the Outside Terminal Area (OTA) and the International Gates.

The Division of Aviation continues to achieve surpluses from the OTA. These surpluses are carried in the Aviation Fund Unrestricted Cash Account. Division of Aviation representatives stated that these holdings plus any interest earned, may be sufficient to prevent the General Fund from contributing to the Aviation Fund over the life of the Plan.

Water Fund

Water Department officials continue to assure PICA officials that there is minimal risk that the General Fund will not receive the annual transfer of approximately $4 million. The Water Department continues to cut costs at both their wastewater treatment and biosolids recycling center. In addition, the Water Department realized significant cost savings in its energy bill through successful implementation of multiple energy savings initiatives. As a result of these cost cutting measures, energy initiatives, and increased delinquent collections through the enforcement of the Utility Services Tenant's Rights Act, Water Department management believes that the $4 million annual transfer to the General Fund will continue over the life of the Plan.

CASH FLOWS

The cash flows presented in Appendix IV of the Plan for FY 2002 and FY 2003 agreed with the estimates for General Fund revenues and obligations as presented in Appendix III of the Plan. The forecast for the monthly distribution of revenues and obligations were materially consistent with historical patterns.

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