# Pennsylvania Intergovernmental Cooperation Authority

**Staff Report**
**on the**
**City of Philadelphia's**
**Five-Year Financial Plan**
**for**
**Fiscal Year 2009 - Fiscal Year 2013**

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**June 17, 2008**

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**STAFF REPORT ON FY2009-FY2013 FIVE-YEAR FINANCIAL PLAN**

# SECTION I:

# EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

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## EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

The FY09-13 Five-Year Financial Plan (Plan) reorients government spending initiatives around specific goals and attempts to address some of the City's long-term fiscal challenges. However, several outstanding unquantifiable risks, as well as the reliance on a somewhat uncertain Pension Obligation Bond (POB) issuance, leave many question marks as PICA Staff considers the Plan.

During the course of discussions with City Council and PICA prior to completion of the submitted Plan, the City took several steps to bring the Plan into balance, and for the first time in several years has taken steps to create a structural balance between recurring expenditures and recurring revenues as the projected fund balance in the last four years of the Plan fluctuates only $5 million. Another positive development was that for the first time in several years, City Council approved the entire Five-Year Plan as opposed to just approving the first year's budget.

As recommended in several previous PICA reports, the new Administration has proposed several first steps in addressing the long-term fiscal challenges faced by the City, though the success of key initiatives will not be known until the end of the calendar year once labor contracts and the POB issuance are completed.

Under the PICA Act, the Board is charged with determining whether: "the financial plan projects balanced budgets, based upon reasonable assumptions…for each year of the Plan." The Plan the Board is now considering meets that test.

### Report Summary

The report focuses primarily on four areas:

1. **Speculative items included in the Plan:** While the City addressed many of PICA's concerns, there are still some items in the Plan that PICA Staff does not believe are realistic. PICA Staff believes that the Plan is balanced despite the inclusion of these items.

2. **Substantial risks in the Plan above and beyond the Plan's speculative items:** These are items for which a strong possibility exists that the City will not meet its projections, or the potential impacts are unquantifiable, but the risk of the City's missing those projections is not so large that it is unreasonable for the City to include them in the Plan.

3. **Tax revenue projections included in the Plan:** The tax collection projections are a key determinant of the level of expenditures that can be included in the Plan.

4. **The long-term financial risks that face the City:** The City faces an array of issues that must be addressed to secure the City's long-term fiscal health, but that do not pose a threat to the City's ability to achieve balanced budgets over the next five years.

## Speculative Items Included in the Plan

**Casino-Related Revenues and the Absence of any Costs:** The Plan assumes that the City will begin receiving fees from casinos in FY11, but the longer that the start of construction is delayed, the less likely it is that those revenues will be received in accordance with Plan estimates. Further, the Plan does not assume that the opening of those casinos will result in any social, police or infrastructure costs to the City's general fund, beyond the payment amounts pledged by the casino operators.

**Skybox Payment from the Philadelphia Eagles:** Each year since FY04 the City has assumed that it will receive $8 million in sky box rental payments from the Philadelphia Eagles. The City has asserted that the Eagles have owed those payments since they played at Veterans' Stadium, but those payments have not been made. Until an agreement has been reached with the Eagles on the timing and amount of these payments, there will continue to be a substantial risk that the City either will not receive the $8 million that the budget includes or will receive a much smaller amount.

PICA Staff is recommending that the Plan be approved even though it contains both of these speculative items because the Plan never projects a fund balance that is below the $8 million that represents the rental payments from the Eagles, and recent court rulings continue to come down in favor of the building of casinos in the City.

## Substantial risks in the Plan above and beyond the Plan's speculative items

Among the Plan's largest risks are:

**Labor Costs.** For the first time, the Plan includes a line-item for increases in wages and benefits – over $400 million during the life of the Plan. While the identification of available funds is a positive step, it remains uncertain whether that amount will be sufficient to cover the cost of the new contracts, all of which expire at the beginning of this Plan. **Any contracts which increase General Fund costs beyond the City's ability to pay will require a revision to the Plan. This revision must demonstrate that there are sufficient funds to cover these costs.**

**Pension Obligation Bonds:** The Plan assumes that the City will issue about $3 billion worth of Pension Obligation Bonds (POBs) prior to the end of calendar year 2008. The resulting savings to the City's annual pension costs are expected to allow the General Fund to recognize a savings of $50 million a year in each of the last four years of the Plan. Issuing POBs of this magnitude is somewhat complex and will require the approval of City Council and others. If the City is unable to issue the POBs, the Plan will be short $200 million. Further, even though the POBs are being issued in part to address the City's most serious long-term fiscal threat, failure to realign pension fund contributions with pension benefits will ultimately leave the City's pension fund in a precarious state.

**Weak National Economy:** While the City has generally avoided significant losses in its revenue streams, ongoing uncertainty in the national economy poses significant risks to the Plan. Real Estate Transfer tax revenues were down about 15 percent for the current year (which is reflected in the Plan) but other revenues have remained stable or even grown slightly. If continuing increases in food and fuel costs, as well as uncertainty in the housing market continue to erode consumer spending and business activity, City revenues would be likely to fall in the next few years.

**The School District of Philadelphia:** In April, the School District announced that it was facing a $39 million FY08 deficit unless additional corrective actions were taken. While the City did not include any additional funds in its Plan and the School District did not include any additional funds from the City in its budget, operating deficits remain a concern. If Governor Rendell's plan to increase school funding state-wide is enacted, the School District will be fiscally more stable. However, if the plan is not enacted, the School District will remain in need of additional funds or program cuts to close future budget gaps, and the District may again turn to the City for more funding.

**Prison Costs:** Though the Administration is focusing on addressing the various Prisons concerns that PICA has continually brought in the forefront, the Plan seems to include overly optimistic cost figures. While the Plan projects a 3 percent increase in the average daily inmate census to 9,371 in FY09, the introduction of the Crime Fighting Plan has seen admission numbers skyrocket. Additionally, the census grew by over five percent in FY07 and has not grown by less than 3.5 percent in any of the last three years. While the Plan does project a 5 percent increase in contracts costs each year, PICA Staff remains concerned that this projection may be too low given recent history.

**Philadelphia Gas Works (PGW):** While the rate increase granted by the Public Utility Commission last year will enable PGW to repay the $45 million loan from the City, it was insufficient to allow the utility to emerge from its overall precarious fiscal status. Unless the utility is able to gain additional rate relief, or find other means to generate revenues, PGW's large debt load and narrow operating margins leave it susceptible to fiscal distress.

**Costs Related to the New 3-1-1 System:** One of the new Administration's main focuses has been to significantly improve operations, achieve government efficiency and lead a result-driven, customer-service oriented operation. In order to bring all these steps together, the Managing Director's office has implemented PhillyStat and is already setting up to bring a 3-1-1 system in Philadelphia. While 3-1-1 is a critical tool needed to achieve a high performing government and improve customer service, PICA staff is concerned that the upfront costs needed to set-up the 3-1-1 system are not reflected in the Five Year Plan. Currently there is $1.5 million in FY09 for contract costs geared towards putting together this structure; however, other cities have reported spending between $6 and $10 million in upfront costs.

## Tax Revenue Projections

As mentioned in the National Economy paragraph above, most revenues have remained steady other than the Real Estate Transfer Tax. It is also too soon to tell the impact of the economy on Business Privilege Tax receipts. Tax revenues will continue to be looked at closely to determine if any weakness emerges.

## Long Term Financial Risks

Among the long-term financial risks facing the City, this Plan does strive to make progress in some areas. The issuance of Pension Obligation Bonds is a dramatic attempt to gain control of the Pension Fund Liability of nearly $3.8 billion, though it is too soon to know if the new contracts will allow the City to begin addressing the imbalance between Pension Fund contributions and pension benefits. A new parking tax will provide a steady stream of pay-as-you-go capital funds, allowing for an increase in necessary infrastructure spending without impacting the City's significant long-term obligations. The Plan proposes additional means for making the tax structure more competitive, which has also been helped by gaming revenues from the Commonwealth. It is unknown at this time whether new contracts will allow for gaining control of health-care costs, though the City does intend to provide better oversight of health benefit programs. There are no plans to establish a Rainy Day Fund.

### *City Controller's Opinion*

As in past years, and per the PICA enabling legislation, PICA Staff requested of the City Controller an opinion or certification prepared in accordance with generally accepted auditing standards, with respect to the reasonableness of the assumptions and estimates in the City's proposed FY09-FY13 Five-Year Plan. The Controller's Office has declined to offer an opinion at this time.

### *Staff Recommendation*

Unlike the most recent Plans submitted to PICA, this Plan makes a concerted effort to address some of the City's long-term fiscal challenges and does not rely on large amounts of speculative revenues. However, the Plan does have two significant unquantifiable risks: labor contracts and the issuance of Pension Obligation Bonds. Each of these risks has the potential to leave the Plan short several hundred million dollars. In the case of the Pension Obligation Bonds, failure to achieve a better alignment of fund contributions and pension benefits will prevent the Pension Fund from achieving true fiscal stability.

Despite these risks, and given that new contract costs which significantly exceed the $400 million allotted in the Plan will require the submission of a revised Plan, PICA Staff recommends that the Board of the Pennsylvania Intergovernmental Cooperation Authority approve the revised Plan as submitted to the Authority on June 2, 2008.

**Pennsylvania Intergovernmental Cooperation Authority**

**STAFF REPORT ON FY2009-FY2013 FIVE-YEAR FINANCIAL PLAN**

# SECTION II:

# SPECULATIVE ITEMS

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## OVERVIEW

This section will discuss items that are so speculative that they are almost certain to make the fund balance lower than the amounts included in the Plan. PICA Staff is recommending that the Plan be approved even though it contains both of these speculative items because the Plan never projects a fund balance that is below the $8 million that represents the rental payments from the Eagles, and recent court rulings continue to come down in favor of the building of casinos in the City.

## GAMING REVENUES AND COSTS

Due to the continued delay in the start of construction of casinos in the City, the City pushed back the expected start date for receipt of hosting fees until the middle of FY11, which total $70 million over the life of the Plan. As was the case in the FY08-FY12 Plan, there are no City costs attributed to the opening of the two casinos in the City of Philadelphia in the FY09-FY13 Plan. Given that the Administration continues to fight the construction of the Casinos, these projected revenues, or at the very least their start date, must be considered somewhat speculative.

Gross slots revenues across Pennsylvania last year totaled $1.04 billion, which exceeded estimates for the initial year of operation. State gaming funds totaling $86.5 million will result in a reduction in the City's wage tax which is almost equal to the City's Wage Tax reductions since 1995.

*Host Fees*

The ongoing battles over construction of the two casinos in Philadelphia have forced the City to push back its expected receipt of hosting fees. The original Plan presented in February assumed that host fees would begin in the middle of FY10; that estimate has been pushed back to the middle of FY11. The total amount of host fees assumed over the life of the Plan is $70 million. Based on the success of the casinos already functioning throughout the Commonwealth, these estimates remain reasonable once the casinos are in fact up and running.

Although recent Court decisions continue to favor the casinos, construction has not begun at either site, and legislation to reopen site selection has been introduced in Harrisburg. The Administration has made numerous attempts to block construction of the casinos at the currently approved sites. Should initial construction be further delayed, the City will have to further delay the expected revenues, or remove them from the Plan altogether.

*Costs of Additional Law Enforcement*

Police Department officials estimate it would cost nearly $18 million in start up costs for a new officer unit to patrol around the casinos. After the first year officials estimate that the annual cost to run the unit would be $12.8 million. The administration has stated that police costs are not part of the five-year financial plan and the mayor has, "no particular interest" in paying for them.[1]

[1] Brennan, Chris, "Mayor vents over Foxwoods", The Philadelphia Daily News, April 7, 2008

The City had reached tentative agreements with the casino operators regarding payments to offset these costs, however the details of these commitments have not been made available. It is unknown if they will be sufficient to offset the Police costs, or other direct costs the City will incur.

PICA Staff noted last year that the Plan does not isolate secondary costs associated with the opening of casinos in Philadelphia. Experts say the costs are real, but the range of estimated costs is so great, that it is effectively unquantifiable. If and when the casinos are in fact operational in Philadelphia, it will be incumbent on the City to try and quantify any resulting secondary revenues and costs.

**THE EAGLES LUXURY BOX PAYMENT**

The FY09 budget projects that the City will receive $8 million from the Eagles in payment of rent for luxury boxes in Veterans Stadium. It is the fifth straight budget in which the City has made that assumption and it will be the fifth straight budget in which that assumption has been wrong.

The City has been wrong in assuming that it will receive the $8 million payment because the Eagles and the City have disagreed about the amount that the Eagles owe the City and the Eagles have claimed that the City owes them money for a separate claim. The matter has ended up in court and has yet to be resolved.

Until the matter is resolved and the timing and amount of the payment from the Eagles to the City is known, it is not reasonable for the City to assume that it will receive this revenue.

**Pennsylvania Intergovernmental Cooperation Authority**

**STAFF REPORT ON FY2009-FY2013 FIVE-YEAR FINANCIAL PLAN**

# SECTION III:

# ADDITIONAL RISKS TO THE PLAN

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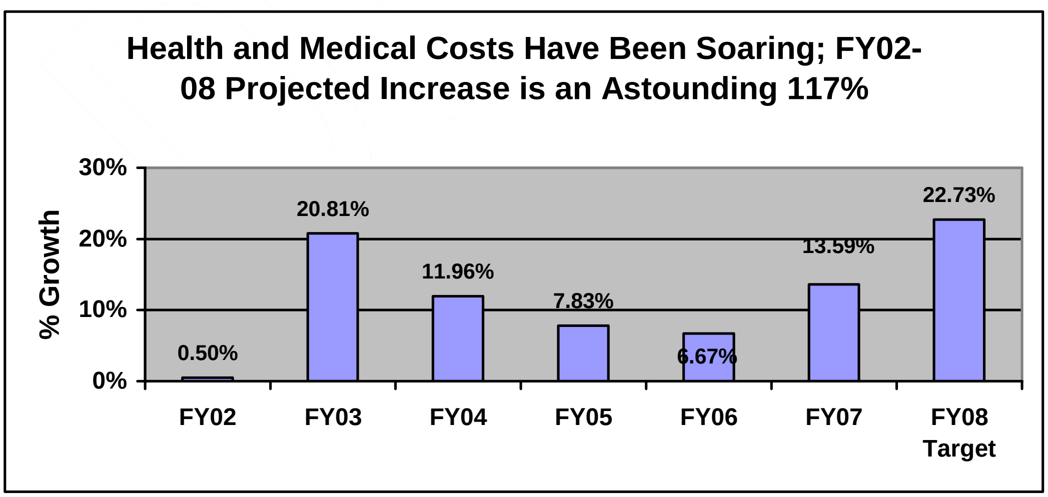
**OVERVIEW**
In addition to the speculative items listed above, there are a number of other areas of substantial risk for the Plan.

- Labor Contracts and the Municipal Workforce
- Pension Obligation Bonds
- Weak National Economy
- The Finances of the School District of Philadelphia
- Growth in the Number of Inmates in the City's Prison System
- Philadelphia Gas Works (PGW)
- Costs for the New 311 System

**LABOR CONTRACTS AND THE MUNICIPAL WORK FORCE**
By far the City's largest general fund cost is for personnel. For the current fiscal year, projections show that of every dollar City government spends, 60 cents goes to labor costs. Changes in labor costs can, as a result, have a major impact on the City's finances.

All four labor contracts are set to expire in June 30, 2008. While the City has already entered negotiations with the unions, it is unlikely that any of them will be settled prior to July and as such poses an unquantifiable risk. The current Five-Year Plan includes nearly $403 million to cover the cost of the contracts over the life of the Plan. While this is a significant improvement over prior Plans, there are still great concerns. Historically, Health and Medical costs have seen soaring increases from year to year. Last September, Commonwealth Court upheld the arbitration panel's decision that the City's monthly dollar contribution to the Firefighters' Health and Welfare Fun would increase per eligible participant each month by 11.3 percent on July 1, 2005; 14.1 percent on July 1, 2006 and 14 percent on July 1, 2007.




Given recent awards, and quotes from union leaders that increases of 2.1 percent are viewed as a "starting point," it is unclear that the $403 million would be sufficient to cover significant wage and benefit increases, especially if there are no other savings for the City in the new contracts.

**Any contracts that increase General Fund costs above the amounts included in the Plan will require a revision to the Plan that demonstrates sufficient revenues to cover the increased costs.**

## PENSION OBLIGATION BONDS

The Plan assumes that the City will issue nearly $3 billion in Pension Obligation Bonds (POBs) as a means for trying to control the nearly $3.8 billion unfunded liability in the Pension Fund. Short of tax increases or dramatic service cuts, the City cannot keep up with the annual Pension Fund payments and also increase the health of the Pension Fund. POBs alone will not solve the problems in the Pension Fund – failure to realign fund contributions with fund benefits will continue to leave the Pension Fund at risk.

*Status of the Pension Fund*

Currently, the City faces a Pension Fund which is only 54 percent funded according to the most recent actuarial analysis (April 2008). The Fund should have $8.2 billion; its current funding level is $4.4 billion, leaving an unfunded liability of $3.78 billion. While this figure represented an increase from the previous year's 52 percent funding level, the slight improvement in funding level resulted from a very good investment year, with the Pension Fund earning over 18 percent. It is improbable that the Fund will be able to sustain that level over time; because the actuarial analysis assumes that the fund will earn 8.75 percent annually, the City is effectively carrying this liability at that assumed earnings rate in its accounts.

As a result of the liability and the outstanding 1999 Pension Obligation Bonds (POBs), the City is projected to make payments toward its Pension Fund in FY09 totaling $456.1 million ($359.5 million to meet the Minimum Municipal Obligation payment; $96.6 million toward debt service on the 1999 Bonds). These annual payments have been rising steadily and dramatically for some time – in FY2001 Pension costs totaled $194 million – placing increasing pressure on the City's General Fund. The problems in the fund are exacerbated by generous pension benefits and a relatively low contribution rate for the City and its employees.

*Will Pension Obligation Bonds Help*

While certain details regarding the exact financing structure remain to be established, the overall structure of the current proposal includes:

- A $3 billion issuance
- Bringing the Pension Fund to a 90 percent funding level
- Level debt service payments over the life of the repayment schedule
- Creation of a Reserve Fund which could be used to mitigate against poor earnings in the Pension Fund or provide for early defeasement of the POBs
- Maintaining a call option on as many of the POBs as is practicable in the taxable bond market

- Annual savings to the General Fund of between $50 – 60 million

Effectively, the City would be trading a liability it currently carries at 8.75 percent for a liability at approximately 6.5 percent. Since the City already pays the MMO, it is essentially replacing one fixed cost for a new fixed cost at a lower rate. The Reserve Fund would be restricted to prevent future raids on the fund for non-Pension uses.

The POBs will not make the Pension Fund problem go away however – they essentially buy time for the City and its employees to realign the fundamental underpinnings of the City's pension system. As was pointed out in the PICA Issues Paper "An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund,"[2] the Philadelphia Pension Fund has relatively high benefits while requiring relatively low contribution rates of its employees. Coupled with the City's decision during the last Administration to fund at the MMO, there is an imbalance between contributions and benefits.

The PICA paper recommends corrective measures, including moving to a defined contribution pension system; changing benefit determination factors; and, increasing employee contributions (non-uniformed employees contribute less than 2 percent of salary – in some municipalities' contribution levels are 5 percent, and Commonwealth employees contribute 6.5 percent of salary).The employees also assume no direct risk from fund performance – when the Pension Fund outperforms its earnings assumption, a portion of the excess is used to increase benefits; when it underperforms, the Pension Fund must absorb the loss. A lowering of the earnings assumption would also significantly improve the long-term health of the Pension Fund.

*Conclusion*

There is no doubt that a Pension Obligation Bond issuance, particularly of this magnitude, does come with significant risks. However, the risks of doing nothing are even greater. The Pension Fund liability is severe and is continually listed by rating agencies, PICA, the Pew Charitable Trust, and others as the most significant long-term fiscal challenge facing the City.

To paraphrase Winston Churchill's comment on democracy – Pension Obligation Bonds are the worst solution for such a severe problem, except for all of the others. Short of draconian budget cuts or dramatic tax increases, there is no other reasonable way to raise the funds to fix this problem. The City has an opportunity to sharply reduce a $3.78 billion liability which it is carrying at an assumed rate of 8.75 percent, assume lower net fixed costs at an interest rate that is projected to be more than 2 percentage points below the current rate, and make improvements to the structure of its Pension system. The City is structuring this issuance in line with most of the best practices recommended by the GFOA and other financial experts, and has creatively designed a reserve fund to provide maximum financial maneuverability to allow responses to changes in the market over time.

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[2] This report can be found on the PICA website at www.picapa.org

However, it should be noted that failure to make changes in the existing Pension Fund benefits, or employee contribution rates, or expected rate of return is tantamount to half of a solution. If changes are not made during the current employee contract negotiations, then the City has failed to properly mitigate the risks in the Pension Plan. The results of those negotiations should be known prior to the City going to market with the POBs, and should be taken into consideration, along with prevalent market conditions, when the City makes a final determination about going ahead with the issuance.

With the caveat of the need for fundamental changes in the pension system, the proposed Pension Obligation Bonds make the most fiscal sense for the City at this time.

**IMPACT OF NATIONAL ECONOMY**

As national economic indicators such as jobless claims, real estate prices, sales revenues, stock prices, consumer borrowing, etc, paint an ominous picture, Philadelphia seems to be fairly resilient to the general recessionary path. Though Real Property Transfer Tax has taken a large hit with fiscal year-end adjusted projections almost 15 percent lower than FY07, other major taxes seem to be doing surprisingly well. Despite an increase in the national unemployment rate, Philadelphia wage tax collections remain strong and are projected to meet projections. The region's main industries, education, healthcare and tourism, are the main drivers, as they are the three industries that have not been affected by the shrinking economy. In fact, recent reports indicate that employment has increased in education and healthcare.

Nonetheless, Business Privilege Tax collections continue to pose a question mark as revenues remain at lower than anticipated levels through May. Amidst gloomy national reports for sales down up to 20 percent from the prior year, sales tax collections in Philadelphia are surpassing prior years' levels and are on track to meet projections. Strong collections also continue in other taxes such as real property taxes, amusement and parking.

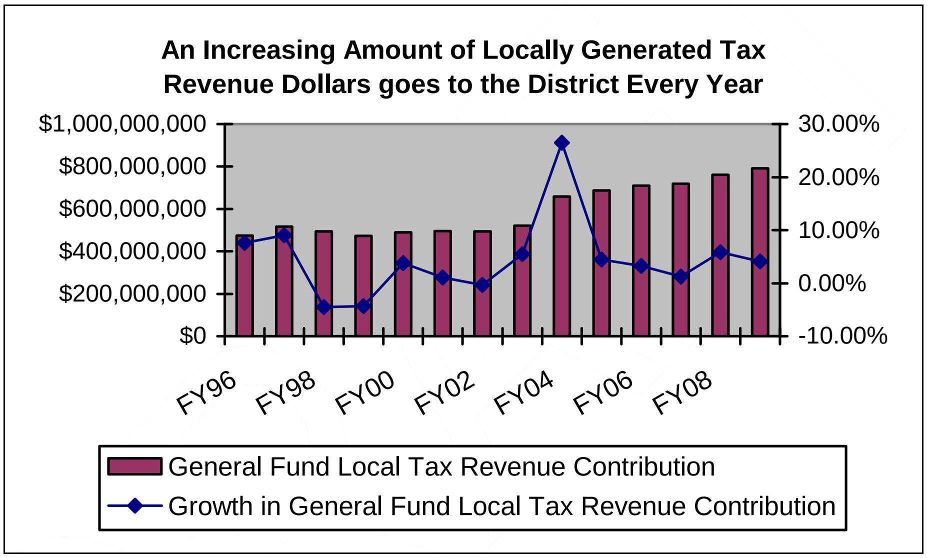
While the signs are generally positive, it is clear that Philadelphia is the exception and not the rule. The question thus remains whether this resilience is sustainable or whether FY09 will see a greater impact in revenue collections, much like what is projected in other cities. Luckily, the region's economy is based on the three aforementioned industries which have remained strong. Additionally, not only Philadelphia's home-price drop is smaller than the 20 metropolitan areas tracked by the Standard & Poor's Case-Shiller Index, but because the assessed value is about 30% of the full taxable value and 60 percent of property tax revenues go to the School District, a relatively low percentage of the City's general fund revenue is derived from property taxes compared to other major cities. However, as inflation rates escalate, gas-prices continue to rise and jobless claim projections are on the rise, there is great concern as to how Philadelphia will fare during this general downturn.

**SCHOOL DISTRICT OF PHILADELPHIA**

In FY08, the City provided financial relief to the School District by shifting approximately $18 million in real estate millage from the General Fund, increasing the city grant by $2 million and assuming $8 million in contracts. In FY09, the City contribution is projected at $31.3 million more than FY08, a 3.9 percent increase.

*Background*

The City has been increasing its local funding commitment to the District incrementally over the past few years to address the District's mounting financial problems. In FY02, the City committed $45 million in additional funding by increasing the General Fund grant from $15 million to $35 million and shifting approximately $25 million in real estate millage. Last year, the City further increased its contribution by an additional $27.6 million, for a total projected City-support of $805.




Despite the increasing levels of State and City funding, the District has been incurring deficits. The main contributors have been charter schools and debt service. In FY04, the School District had been spending $152.9 million for charter schools and had $168.9 million in debt expense. In FY08, those figures are projected at $275.7 and $224.3 respectively, which represent an increase of 80.3 and 32.8 percent in merely 4 years.

These increases were driven by a 29.8 percent increase in charter schools from FY04 to FY08 and by an aggressive capital program which borrowed more than $1.1 billion since FY04 to build new facilities and refurbish existing ones.

*The Deficit Reduction and Gap Closing Plans*

The development of a plan became an urgent need with the District facing projected fund deficits of over $181 million in FY08. In addition to the increased contributions from the Commonwealth and the City, the District, through the Deficit Reduction Plan, has achieved $69.6 million in savings by implementing cuts in administrative positions, academic programs, contracted services, and medical premium cost reduction and overtime control measures, among others. The District ultimately passed a balanced budget which relies on a series of steps to close a projected $39 million deficit in FY09. The District's Gap Closing Plan includes savings of $38.9 million in FY09, followed by $19.5 million annually for all subsequent years until FY13. Including these savings, the current District FY09-13 Plan projects surpluses for FY10-12 followed by a deficit of $49.1 million in FY13, mainly as a result of major increases in employer funding requirements stateside for the Pennsylvania Public School employees' Retirement System.

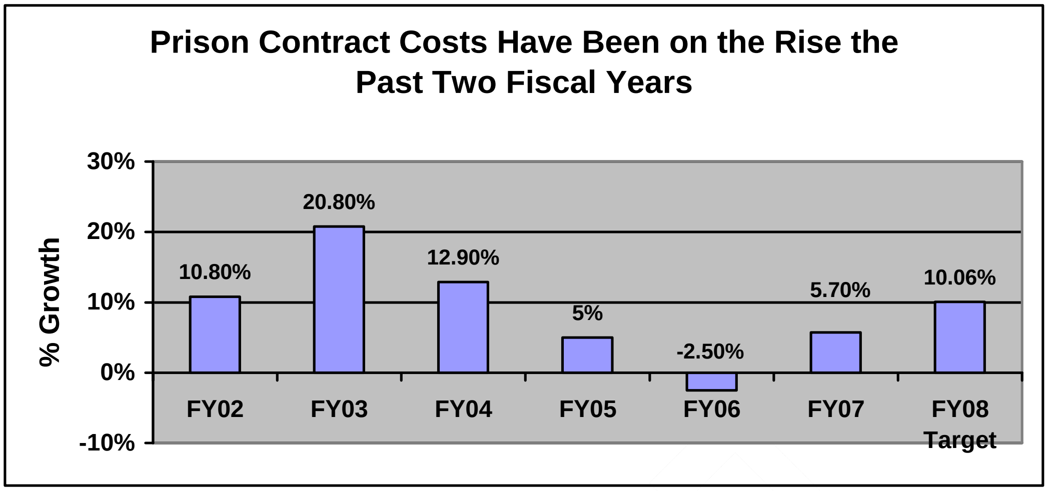
While it is encouraging that the District is engaging in crucial structural changes, there are risks that threaten the fiscal stability of this Plan. The District is assuming an $85 million increase in basic education subsidy from the Commonwealth. This represents a 9.6 percent increase from the prior year. The average increase has been 4.4 percent and while the Governor has committed to aggressively assisting school districts across the Commonwealth, this remains a risky assumption. The plan also assumes continuation of the General Assembly's $14 million appropriation for the Alternative Education Demonstration Grant in FY09 and all other years. Among the structural risks, the most significant ones involve the growth of charter schools, debt service, and employee salaries and benefits. If any of these risky assumptions do indeed fall through, they will jeopardize the Plan and as such can put more pressure on the City to contribute higher levels of funding to assist the ailing system.

**GROWTH IN THE NUMBER OF INMATES IN THE CITY'S PRISON SYSTEM**

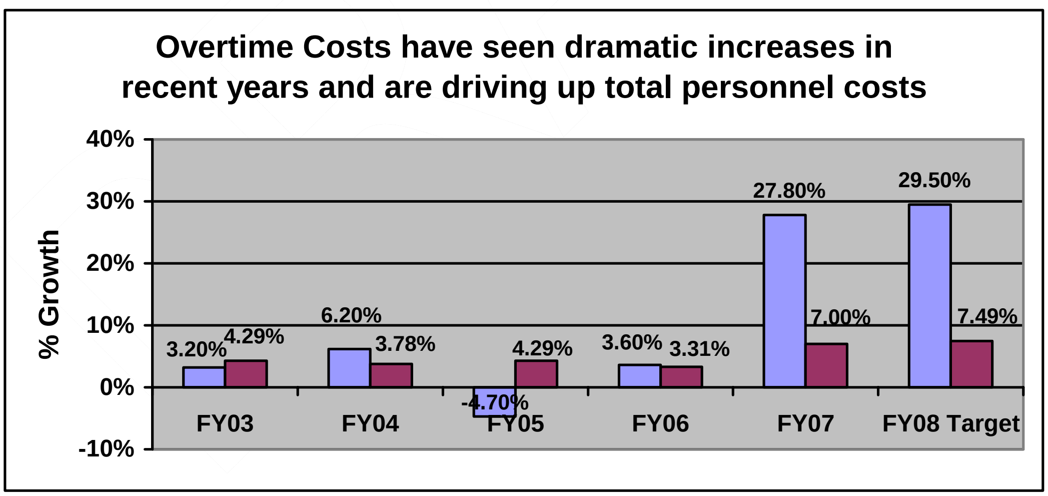
Though the Administration is focusing on addressing the various Prisons concerns that PICA has continually brought in the forefront, the Plan seems to include overly optimistic figures.

The Plan projects a 3 percent increase in the average daily inmate census to 9,371 in FY09. Since the introduction of the Crime Fighting Plan, the department has seen admission numbers skyrocket, reaching 800 admissions per week, up from about 500, with no expectation for those figures to go down. The month of April, in particular, saw a record high of 9,334 inmates. Additionally, recent census trends indicate that 3.00 percent growth is likely an optimistic figure since the census grew by over five percent in FY07 and has not grown by less than 3.5 percent in any of the last three years. In fact, in May 2008 the Prisons department projected an average daily census of 9400-9800.

While the Plan does project a 5 percent increase in contracts costs each year, PICA Staff remains concerned that this projection may be too low given recent history. The trend of diminished growth in contract costs from FY03 to FY06 has seen a reversal, with the past 2 fiscal years seeing increases of 5.70 and 10.06 percent respectively. As the overcrowding in the City facilities worsens and legal pressures increase, the department continues to seek outside inmate housing which can push costs higher. Moreover, the inmate health contract is up for re-bidding in the current year, which adds further uncertainty in contracts costs. Further, the ever increasing inflationary figures in food and beverages will place additional pressure to the department's food costs.




The increase in the prison population has also had an impact on personnel costs and in particular overtime. Overtime costs went up 27.8 percent in FY07 and are projected to increase by an additional 29.5 percent by the end of FY08, amounting to 18.6 percent of total personnel costs. To further exacerbate the situation, the department's sick leave jumped to 8.5 percent in the first three quarters of FY08, higher than the city's median of 5.4 percent and higher than the department's FY01-07 average of 5.7 percent. Total personnel costs had been steadily increasing by an average of 3.92 percent in FY03-FY06 but saw a jump of 7 percent in FY07 and are projected to further increase by 7.49 percent in FY08.




There is hope that the department will overcome its difficulty in increasing the number of correctional officers through the residency waiver and will thus be able to better control overtime costs. This could free up funds for the department that can be allocated towards providing services in the Prison system or be reallocated in the General Fund.

*Prisons Census and Cost Control Measures*
The City is hopeful that the number of initiatives they are implementing will provide some relief in the soaring costs and census of the Prisons department. Some of the initiatives include:

- Aggressive re-entry assistance measures from the Mayor's Office for Re-Entry Services to reduce recidivism, including establishment of Criminal Justice Advisory Board and $10,000 tax-incentive offered to local business for hiring ex-offenders
- Follow-up on inmates' chronic care
- Identification of inmates who are eligible for Medicaid or have private insurance
- Application for federal funds for pharmaceuticals
- Cost-effective contracting for 450 beds to house inmates outside the Philadelphia Prison System. This can free up personnel in PPS facilities and help reduce the $1.2 million overtime cost per pay period
- Aggressive efforts to increase enrollment in Vocational Training and Job Assignments
- Partnership with the Police Department to increase joint home visits with parole and probation
- Allowance of non-violent, non-sex offenders to avoid jail by reporting daily to authorities

While each of these initiatives is a step to the right direction, some provide longer-term systematic changes whose results will not be immediate. Moreover, the department is not an autonomous entity but rather part of a system that includes the Police Department, the District Attorney's Office, the Courts, etc. As such, prison population control needs to be part of a global effort. While these departments work together to address this alarming trend, PICA Staff remains skeptical that the cost and census projections may be too low.

**Philadelphia Gas Works (PGW)**

*Overview*
PGW continues to present an enormous risk for the City and the entire region. While PGW received sufficient rate relief from the Public Utility Commission to ensure repayment of the $45 million loan to the City in FY09, the decision was not enough to enable PGW to gain a firm financial footing. There remains a real possibility that future fiscal crises at PGW will require additional city subsidies and could even damage the entire region's economy.

*PGW's Fiscal Condition*
PGW continued to maintain a positive status quo in its operational finances. Collection rates continued to increase to a level consistent with those of other public and private utilities. While the utility now has a narrow positive annual operating balance, the nearly $1 billion debt load and other fiscal constraints make it unlikely it will ever be able to gain a true fiscal stability. As the utility's capital demands continue to increase, even

greater pressure will be exacted on the slender amount of funds available. Effectively, PGW is treading water financially until serious plans for its future can be determined.

*PGW's Plan for Recovery*
As in the last several years, PGW has established a series of initiatives aimed at gaining fiscal security. However, as in the past, many of these initiatives remain unlikely. The utility is likely to recognize some savings from restructuring and utilizing some available programs for infrastructure charges and the sale of unused capacity. Unfortunately, the key to PGW's Improvement Plan relies on additional rate relief from the PUC.

PICA Staff continues to believe that PGW has a compelling case to make in a rate request. Over the last several years cost increases and the loss of its customer base have diminished its operating margins. The utility also continually operates with dangerously low cash balances necessitating extensive use of short-term borrowings.

However, as PICA Staff correctly predicted last year, it is doubtful that PGW will receive the full rate increase it is seeking. While it is true that the PUC regards each rate increase case on an individual basis, there are trends which do not bode well. Of the last fifteen rate cases decided by the PUC, the average award was just over 63 percent of the total rate increase requested. While some utilities did receive over 90 percent of the rate increase requested, several received barely a quarter of their request. PGW received a quarter of its rate request last year.

*Long-term Risk: The City's Exposure to PGW's Debt*
PGW has restructured its capital program to meet pressing needs despite having over $900 million in outstanding debt. The combination of increasing capital demands and a loss in revenue could render PGW unable to meet its debt obligations, forcing the City to either further subsidize the utility or allow it to default on its obligations. Either scenario would have dramatic implications on the fiscal stability of the City.

According to the City, there has been no official legal opinion on whether the City is contractually liable to repay PGW's debt should PGW be unable to meet those obligations. However, considering that PGW serves nearly all of Philadelphia's commercial and residential gas users, the City would be forced to deal with the aftermath of a PGW default.

*Long-term Risk: Potential for Regional Impact*
Unlike many of the risks highlighted in this Staff Report, the impact of a PGW collapse could be both sudden and dramatic. An abrupt failure would be beyond the City's fiscal capability, and would require help from other governments, putting additional strain on surrounding state and local authorities. Regional businesses and employees who are dependent on the City's economy would be vulnerable, as the main economic driver for the Commonwealth was disrupted. In short, a PGW failure would have consequences far beyond the City's fiscal stability.

## PERFORMANCE MANAGEMENT SYSTEM; 3-1-1 AND PHILLYSTAT

One of the new Administration's main focuses has been to significantly improve operations, achieve government efficiency and lead a result-driven, customer-service oriented operation. The need for this is a key component for the City to achieve the goals it has set in the six strategic areas it has identified: public safety, education, jobs and economic development, healthy and sustainable communities, ethics and customer service and a high performing government. The proposed Five Year Plan already sets the tone, as the City has put together a budget that is focused on results. However, this is only one step in the multi-step process the Administration is implementing. Performance monitoring and reporting, cross-departmental collaboration, citizen and employee feedback are among the various steps needed to achieve the set goals. In order to bring all these steps together, the Managing Director's office has implemented PhillyStat and is already setting up to bring a 3-1-1 system in Philadelphia.

3-1-1 is a citizen call center for any non-emergency calls or needs. It is a one-stop-shop used as a customer-service tool that is geared towards increasing customer satisfaction and improving delivery of City services. It is also a means for collection of data or service requests for each department. PhillyStat involves data-driven management discussions, enhanced with visual aids such as maps, charts, photos. The goal is to closely monitor the operations of each department, increase accountability and focus on outcome measures.

While both systems are critical tools needed to achieve a high performing government and improve customer service, PICA staff is concerned that the upfront costs needed to set-up the 3-1-1 system are not reflected in the Five Year Plan. Currently there is $1.5 million in FY09 for contract costs geared towards putting together this structure. The total cost is not yet specified as the City is going through the RFP process to identify vendors to set-up the system; however, other cities have reported spending between $6 and $10 million in upfront costs. While this program will help the city realize efficiencies over time, there is concern that the Plan does not include adequate funding for set-up and implementation.

**Pennsylvania Intergovernmental Cooperation Authority**

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# SECTION IV:

# TAX REVENUE PROJECTIONS

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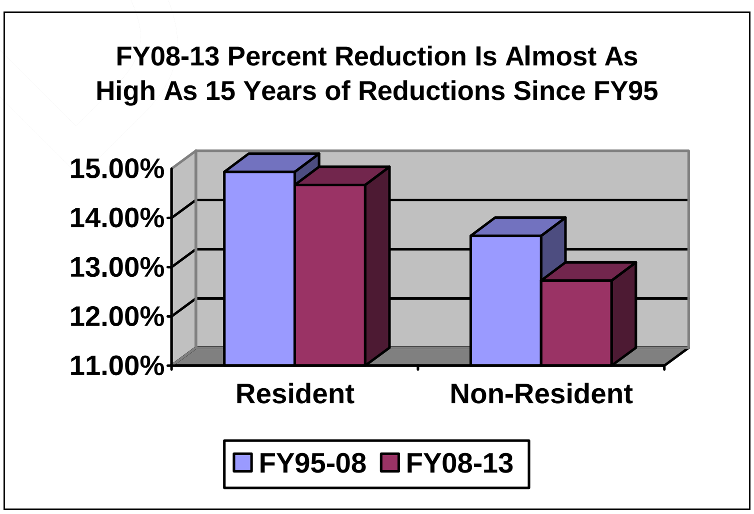
**OVERVIEW**
Taxes are by far the largest source of revenue for the City. As a result, the reasonableness of tax projections is perhaps the single most important item in determining whether a Plan is balanced. Overly aggressive tax projections substantially heighten the likelihood that the City will incur deficits. Appropriately conservative projections, on the other hand, make it more likely that the City will meet its projections – even over a multi-year period that is likely to include both strong and weak economic years.

**WAGE TAX**
The wage tax is the single largest source of revenue for the City, accounting for almost half of tax collections. Consequently, it is critical to maintain reasonable projections. Over the last few years, however, wage tax projections have become more aggressive.

This year's Plan has capped the base growth assumptions to address the concerns that PICA has expressed over the past few years. Specifically, the Administration projects a 3.5 percent base growth for FY09, followed by a 4 percent base growth in each of the subsequent years. Given collections in the past five years, 4 percent seems to be about the average base growth rate. The modest anticipated growth in the tax base in FY09 addresses concerns over the potential impact of the weakening national economy.

The current Plan includes a milestone in Philadelphia history. On July 1, 2008 the resident wage tax will be reset to 3.98 percent; this is the first time the resident wage tax will fall below 4 percent in over 30 years. The Commonwealth has certified slightly over $86.5 million dollars of wage tax relief for the City of Philadelphia from gaming revenues. In addition to these revenues, the current Administration has committed to continuing the wage tax reduction that started in 1995 and reaching a rate of 3.600 percent for residents and 3.250 percent for non-residents in FY13. The proposed reductions in FY08-13 are almost as steep as the reductions in the 13 years from FY95-FY08.



## PROPERTY TAX

Real Estate Tax Revenues for the current fiscal year have come in strong, despite the undoubtedly weakened market. Property tax collections through May have exceeded the projected FY08 year-end balance of $394.5 million by about $4.5 million. It thus seems that the FY08 base is going to be about $6-8 million higher than anticipated. This provides a cushion for FY09, which assumed a 6 percent base growth. The current Plan has an average growth assumption of 5.4 percent, which essentially continues the aggressive growth assumptions included in last year's Plan. While some of the projected growth will come from the end of some abatements and the City's expectation that the BRT will continue with more accurate assessments as part of their goal to equalize values across the City, concerns arise due to the overall downward direction of the market.

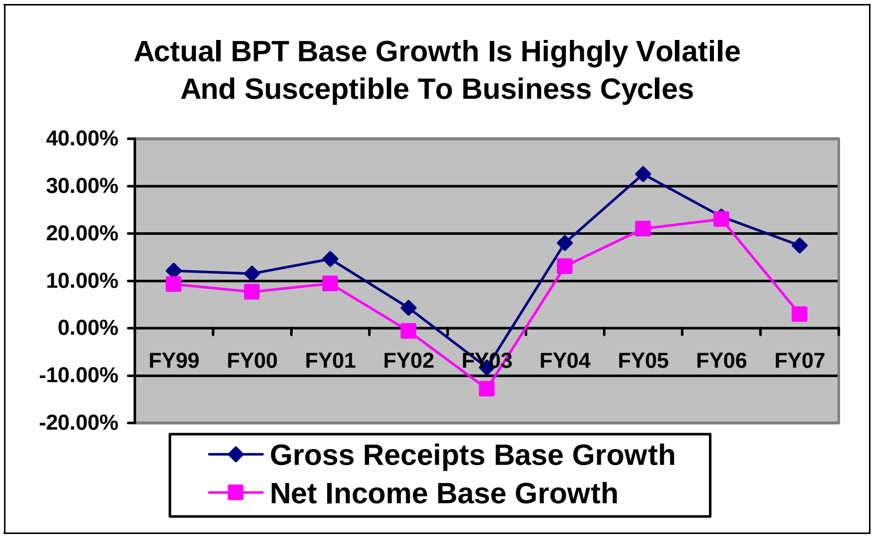
Philadelphia house prices declined citywide by an average of 4.4 percent. Additionally, the volume of sales declined by 6,590 properties in FY08 through March compared to the same period in FY07. Another indication of the general decline is the dramatic decrease in real estate transfer tax collections, which are projected to come in at almost 15 percent below last year's estimates.

Currently the assessed value is about 30 percent of the full taxable value which provides a relative buffer for the City. However, as the BRT moves towards a full value assessment, this relative ratio will change. Additionally, even though the impact of a full value assessment is assumed to be revenue neutral, there will indeed be an impact in the City's growth assumptions, which, as mentioned above, are relatively aggressive. Finally, there is no guarantee that Philadelphia's relative resilience to the nationwide average price decline of 7.7 percent will continue.

## BUSINESS PRIVILEGE TAX

The BPT is the second largest tax revenue source. Of all other taxes, it is the most volatile and difficult to predict. It is received late in the year and is a composite tax on both net income and gross receipts. Just over 70 percent of collections come from the net income component which is inherently volatile. Additionally, an accurate projection of each fiscal year's results is not possible until the beginning of May. As such, BPT projections have historically been conservative.

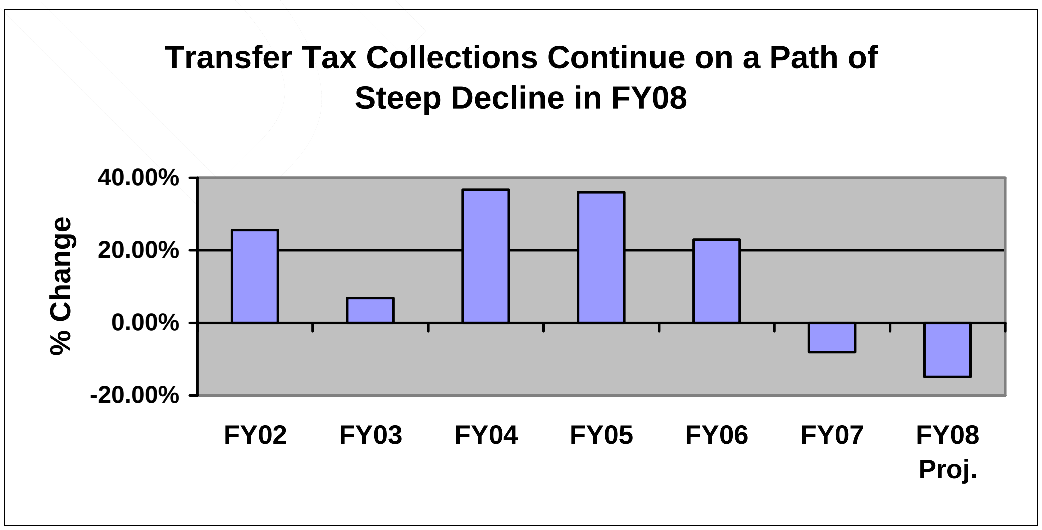
In FY06, the City collected more than $27 million over the prior Plan's expectations. In FY07 that figure was more than $28 million for total collections of $436.4 million. The current FY08 projections are at $438.2 million. Concerns are starting to arise as to whether the City will meet this target since collections are falling short of expectations even through the end of May. While this is not completely unexpected given the national downturn in the economy (despite signs of resilience on a local level), it raises further questions about the Plan's future projections. In fact, collections falling short of projections might be particularly worrisome given that growth assumptions were particularly modest for FY08, at 4 percent for Gross Receipts and 2 percent for Net Income.




The proposed Plan assumes a 4 percent base growth in both Gross Receipts and Net Income for all five years. While historically this is a conservative estimate, years of negative growth are not unprecedented. Despite encouraging figures in other tax collections such as wage, real estate, sales, advertising, etc, BPT's susceptibility to economic downturns creates realistic odds that collections in FY09 might in fact decrease.

**REAL ESTATE TRANSFER TAX**

Transfer Tax collections indeed continued on a declining path as anticipated. While the approved FY08-12 Plan projected a decline of about 5.7 percent from FY07 receipts, recent trends put collections at a Fiscal Year End balance of $185 million, a whopping 14.9 percent decline from the prior Fiscal Year. This figure is in fact lower than FY05's actual collections.

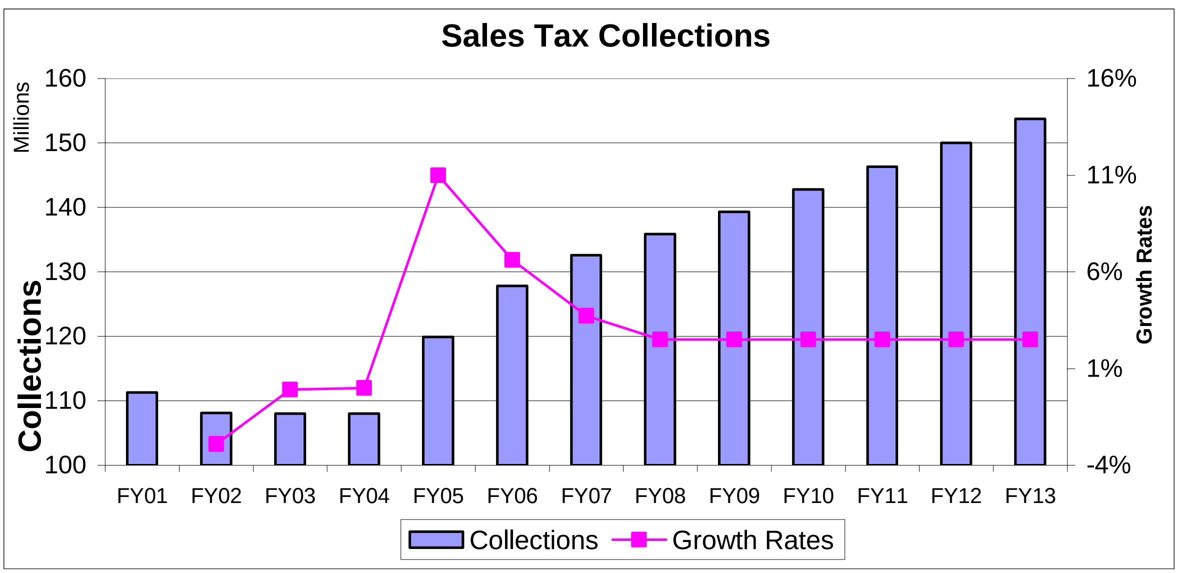


The cooling off of the housing market, paired with crises in sub-prime mortgages, a credit crunch and an overall weakened economy, has taken a huge toll on transfer tax collections. In FY08, the Plan reduced the base to $185 million, a further adjustment from the original estimate in the first version of the proposed Plan. The Plan projects a 1 percent increase in FY09, followed by increases of about 2.5 percent annually in the out years.

While the projections are relatively conservative, there is reason for concern. Data indicates that not only has the number of records declined compared to the prior year, but also the price of each transaction is lower, with the exception of Center City Residential properties which seem to have taken a significantly smaller hit. This raises concerns for the future because unless prices rebound significantly, we shall be dealing with a base that is valued lower than in the past few years which in turn can affect revenue collections. Moreover, not only is this tax unable to provide the cushion it did in the past but it also adds to the list of areas the City has to continuously monitor, increasing the need for controlling costs.

**SALES TAX**

After being relatively stagnant from FY01 through FY04, the sales tax grew about 11 percent in FY05, 6.6 percent in FY06, 3.72 percent in FY07 and is projected to grow by 2.5 percent in FY08. The Plan projects that the sales tax will grow 2.5 percent annually through FY13.




While this is a relatively conservative projection, there are great concerns given the economic downturn. Fuel prices are soaring, inflation is on the rise, jobless rates are up and consequently people have lower levels of disposable income. There are numerous reports on a nationwide cooling of retail sales; the region so far seems resilient according to current collection levels. However, given the 2-month lag period between collection and reporting of the sales tax and the continuous onerous economic reports, it is not unrealistic to expect stagnant growth.

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**STAFF REPORT ON FY2009-FY2013 FIVE-YEAR FINANCIAL PLAN**

# SECTION V:

# THE LONG-TERM FINANCIAL ISSUES FACING THE CITY

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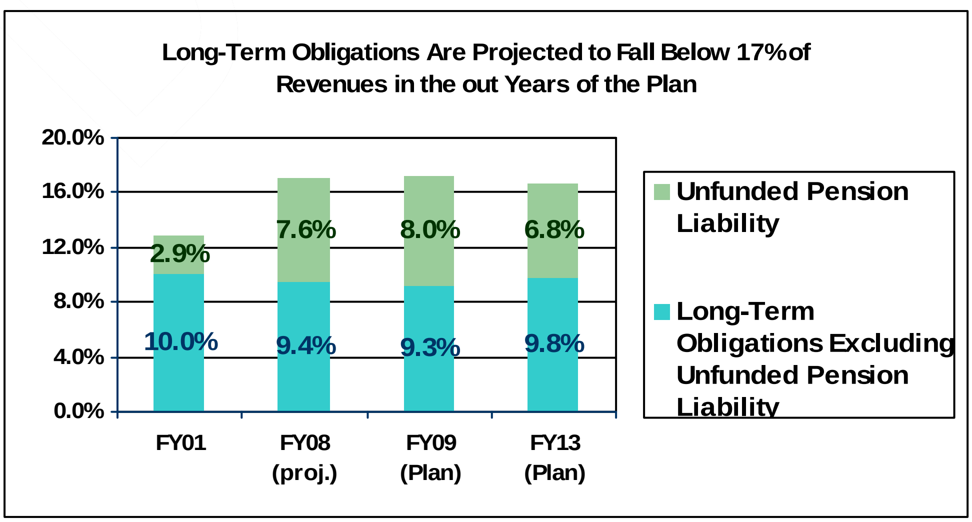
## OVERVIEW

Over the past several years, PICA has identified the key long-term financial issues which could have the greatest impact on the fiscal health of the City. In large measure, the goal was to make sure that current City leaders were fully aware of these issues looming on the horizon – the earlier these problems were addressed, the lighter the impact on current government. Unfortunately, most of these issues were not addressed in any form, and some were made worse over the past several years. Some, like the unfunded Pension Fund liability have already begun to impact current budgets; other issues remain in the not too distant horizon. Below we update the status of each of these issues, and the proposals to address these issues, or ignore them.

## LONG-TERM OBLIGATIONS

Keeping track of the City's long-term obligations is crucial; as these increase, the City's financial flexibility decreases and its credit strength weakens. The need for monitoring has become particularly urgent in recent years, as the City has seen its fixed costs rise dramatically; in FY08 the City is projected to spend about $265 million *more* on fixed costs than it did in FY01. That accounts for a whopping 69.4 percent increase, while General Fund obligations for the same period increased by 36 percent. In other words, fixed-cost increases far outpaced total cost increases, which translates in fewer dollars spent in services.

Another way of interpreting the City's position is looking at long-term obligations as a percentage of total revenues. When fixed costs become too high a percentage of total revenues, the City is limited in reacting to unforeseen contingencies. Examples from rating agencies and other cities suggest that it is advisable that long-term obligations do not exceed 15 percent of revenues in the short term. While the City projects a diminishing level of fixed costs as a percentage of revenues over the life of the plan, concerns remain because that percentage hovers between 16.5 and 17.2 percent. The issuance of the Pension Obligation Bonds should further reduce the long-term obligations as a percentage of total revenues; a revised figure will be arrived at once the details of the proposed POBs are known.



The City has taken steps in the right direction to address and monitor its ballooning liabilities, including:

- Formulating a comprehensive debt management policy: this year is the first time since 1997 that the City has updated its debt management policy and has set-forth fiscally prudent guidelines.
- Shifting $934,000 in payroll costs from capital to operating budget.
- Using more pay-as-you-go capital spending: the City has included $10 million in the Streets Department budget from pay-as-you-go financing.
- Reducing the number of facilities it maintains: the City has indicated that the department of Public Property along with the Capital Office have launched a more aggressive evaluation and feasibility study of the cost-effectiveness of each of the City's facilities in order to identify the ones that the City can close, sell or outsource.
- Issuing Pension Obligation Bonds to attempt to gain control over the unfunded Pension Fund liability (discussed elsewhere in this report).

**RAINY DAY FUND**

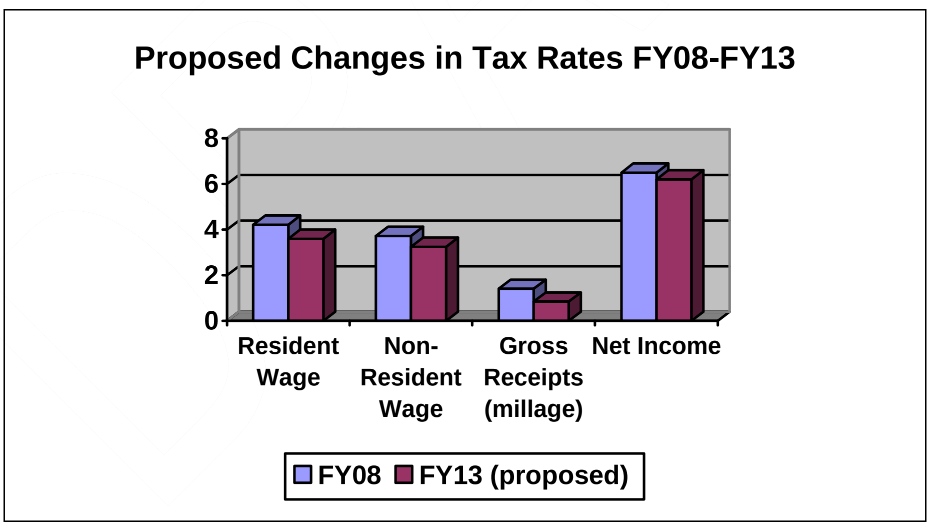
The establishment of a budget stabilization fund, also known as a rainy day fund, remains an important goal for the City. A rainy day fund would enable the City to cover budget shortfalls in case of unexpected emergencies and/or economic downturns. Also important, rating agencies use the existence and structure of a rainy day fund in deciding cities' bond ratings. By establishing a fund, the City would be able to reduce its borrowing costs, creating cost savings in the long run. According to a paper published in 2004 in the *National Tax Journal*, government entities can expect a ten basis point reduction in bond yields after the creation of a reserve fund.

While there is no specific mention of the fund in the Plan, the Pension Obligation Bonds proposal does establish a reserve fund within the Pension Fund. While this is not the hoped for fund, the City's attempts to address other long-term fiscal challenges does temper the need for a rainy day fund – it is somewhat accurate that it is impractical to start a rainy day fund when it is already raining. The City should continue to identify resources to establish a Rainy Day Fund.

## THE CITY'S TAX STRUCTURE

Philadelphia's burdensome tax structure has been the topic of numerous reports. Historically, the high levels of the wage tax and the BPT, especially the gross receipts portion, have discouraged businesses from entering the Philadelphia market, or driven away existing businesses. In order to address this competitive disadvantage relative to other major cities and to boost economic growth, the City has been reducing its wage and gross receipts tax rates since FY95. Last year, however, the FY08-12 Plan included the end of reductions in the gross receipts portion of the BPT after FY09. PICA had cautioned that this measure would only save $12 million while at the same time send a discouraging message to businesses.

The current Plan, with the assistance of gaming revenues, includes dramatic cuts in the wage tax. On July 1, 2008, the resident wage tax will go from 4.219 percent down to 3.980 percent and then further down to 3.930 percent on January 1, 2009. It will be the first time in 30 years that this tax will fall below 4 percent. This reduction presents a 20.8 percent cut from the FY95 rate of 4.960 percent. The Plan also proposes to further reduce the rate to 3.60 percent for residents and 3.250 percent for non-residents by FY13. Equally importantly, the proposed FY09-13 Plan eliminates the freeze in the gross receipt tax reductions. The Plan continues the reductions from the current level of 1.415 mills, proposes to drop the rate down to 1 mill in FY13 and completely eliminate it in FY17. Additionally, for the first time in history, the City is proposing to cut the Net Income tax portion of the BPT from 6.50 percent to 6.45 in FY09 and continue reducing it to 6.25 percent for the final year of the Plan, with a goal to take it down to 6.00 percent in FY17.




In order to balance out revenues and promote sustainable activities, the City is raising the Parking Tax from 15 to 20 percent. This effectively raises the tax on a $20 parking rate from $3 to $4.

While these measures address tax issues that have put up barriers to the City's economic growth, it is important to reinforce this tax restructuring with programs that provide sustainable economic development and make Philadelphia an overall attractive location for job creation.

## UNFUNDED PENSION LIABILITY

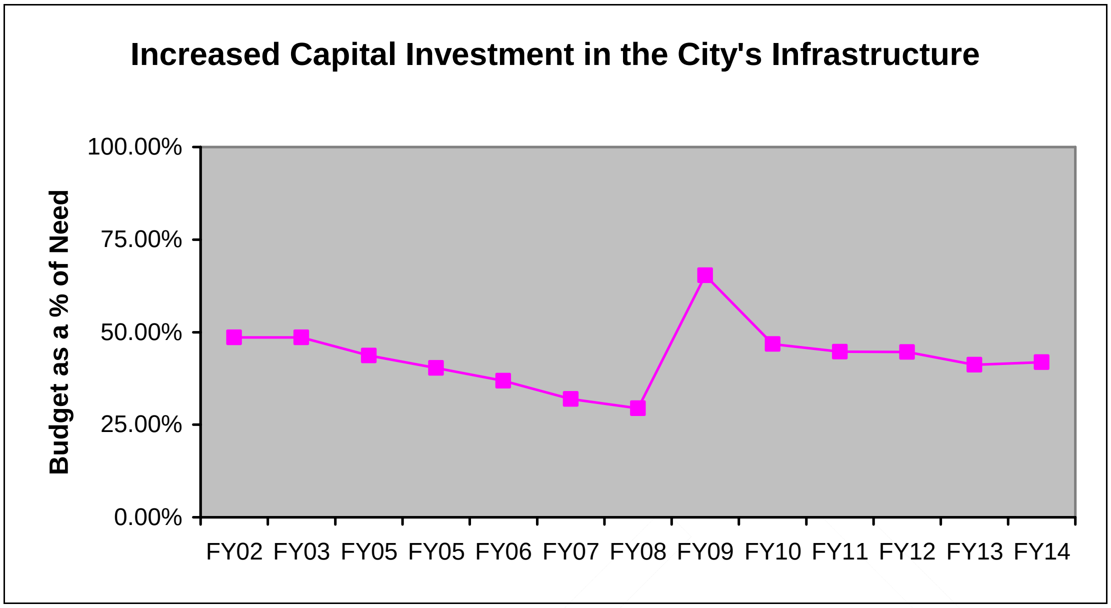
The problems in the Pension Fund are discussed in detail in the "Pension Obligation Bonds" section of this report. The Plan assumes that the City will issue nearly $3 billion in Pension Obligation Bonds (POBs) as a means for trying to control the nearly $3.8 billion liability in the Pension Fund. Short of tax increases or dramatic service cuts, the City cannot keep up with the annual Pension Fund payments and also increase the health of the Pension Fund. POBs alone will not solve the problems in the Pension Fund – failure to realign fund contributions with fund benefits will continue to leave the Pension Fund at risk while the City will be saddled with the additional debt service on $3 billion of new debt.

Currently, the City faces a Pension Fund which is only 54 percent funded according to the most recent actuarial analysis (April 2008). The Fund should have $8.2 billion; its current funding level is $4.4 billion, leaving an unfunded liability of $3.78 billion. While this figure represented an increase from the previous year's 52 percent funding level, the slight improvement in funding level resulted from a very good investment year, with the Pension Fund earning over 18 percent. It is improbable that the Fund will be able to sustain that level over time; because the actuarial analysis assumes that the fund will earn 8.75 percent annually, the City is effectively carrying this liability at that assumed earnings rate in its accounts.

As a result of the liability and the outstanding 1999 Pension Obligation Bonds (POBs), the City is projected to make payments toward its Pension Fund in FY09 totaling $473.6 million ($377 million to meet the Minimum Municipal Obligation payment; $96.6 million toward debt service on the 1999 Bonds). These annual payments have been rising steadily and dramatically for some time – in FY2001 Pension costs totaled $194 million – placing increasing pressure on the City's General Fund. The problems in the fund are exacerbated by generous pension benefits and a relatively low contribution rate for the City and its employees.

## LACK OF INVESTMENT IN THE CITY'S INFRASTRUCTURE

After years of under investing in the City's infrastructure, the Nutter Administration has pledged to invest $120.8 million starting in FY09. In 2001 the City Planning Commission found that the City needed to invest $185 million annually to keep its infrastructure in good condition. From FY02 to FY08 the City invested less than half of that amount each year; an average of $53 million per year of new loans invested in the city's infrastructure. The FY09-FY13 Plan begins to address the lack of investment.




Because of the lack of investment, in early 2007, PICA funded a Facility Assessment Project. This project assessed the physical condition of each of the facilities in the Prisons System, City Hall and the Police, Fire and Health Departments. The project was completed in October of 2007 and it provided the City with a working tool to prioritize and allocate adequate capital funding. The City also received an ongoing maintenance schedule for the facilities covered by the project as well as an IT system to track the condition of its infrastructure.

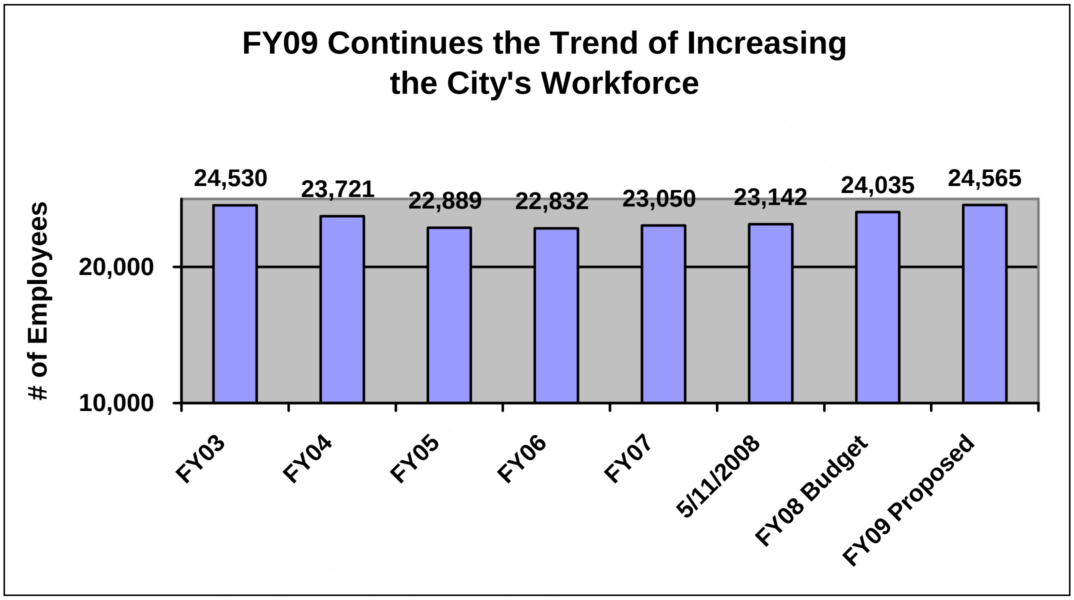
Over the past few years, PICA has recommended that the City institute pay-as-you go funding for certain capital projects. Starting in FY09 the city will attempt to tackle the ever growing back log of Streets resurfacing by utilizing $10 million per year of this type of funding. The funds will be generated by a twenty percent increase in the parking tax.

*Request for PICA Funds*
The Plan recommends utilizing $40.3 million of PICA funding to devote to capital projects. The $40.02 million is a combination of funds from PICA borrowings and interest earned on those funds. The requested projects are:

- $9 million in Central Library renovations;
- $5 million for improvements in Fire Department facilities
- $12.52 million for a new certified juvenile detention center
- $13.5 million for improvements in Police Department facilities

Much of the aforementioned requested funding for departmental facilities is as a result of the PICA Assessment Project that was completed in the fall of 2007. PICA staff is currently reviewing the requests and it is anticipated that the projects will be considered for approval in early FY09.

**REDUCING THE SIZE OF THE WORKFORCE**
Finding a viable solution for the issue of balancing the increasing demand for services while healthcare, pension and wage costs are also ballooning has been a significant challenge for the current Administration. In prior years, while prisons, health, pension, and debt service costs grew faster than City's revenues, the City tried to cut costs by shrinking its workforce. However, that trend has not only ended, but rather completely reversed.




When dealing with today's reality of crime-infested neighborhoods, lack of EMS workers, an overloaded legal-system, an ever-increasing prison census, and streets and facilities that have been neglected and require continuous care, the Administration has responded with increasing staffing in certain departments. Of the 530 additional positions proposed in FY09 compared to FY08's budget, 87.2 percent come from the following departments: Police, Fire, Streets, Public Health and Law*. Moreover, there is a continuous aggressive recruiting effort to meet budgeted positions in the Department of Human Services, Recreation, and Prisons system, among others. There is optimism in the departments that they will be able to increase their staffing since, in addition to other efforts, recruiting from outside City limits is now permissible.

While these increases may help departments meet service demands, they also create an additional recurring cost for the City.

*Law Department's increase in staffing is primarily used for offsetting contract costs.

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# SECTION VI:

# APPENDIX

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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 percent) 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 was submitted to PICA by the Mayor on June 2, 2008 and the PICA Act provides a 30 day period for review. 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 February 14, 2008 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 12, 2008.

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 the 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 23, 2009 (100 days prior to the end of FY2009). At that time, the City is required to add its Fiscal Year 2014 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 $1,188 million in funding to assist the City, allocated to the following purposes:

| Purpose | Amount (thousands) |
|---|---|
| Deficit Elimination/Indemnities Funding | $ 269,000 |
| Productivity Bank | 20,000 |
| Capital Projects | 518,003 |
| Retirement of Certain High Interest City Debt | 381,300 |
| **TOTAL** | **$1,188,303** |

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.

*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 2009. 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 FY2008 is

August 15, 2008. Quarterly reporting deadlines for FY2009 are November 17, 2008, February 16, 2009, May 15, 2009 and August 17, 2009. 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 FY2008 is the report due July 20, 2008. For FY2009, the reporting dates are October 20, 2008, January 20, 2009, April 20, 2009 and July 20, 2009. The report details the receipt of Federal and 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 FY2009 are August 1, 2008, October 31, 2008, January 30, 2009 and May 1, 2009.