Class 700 Fact Sheet – General Obligation Debt Service

What's Class 700?

Class 700 is the City of Philadelphia's budget classification for repaying general obligation debt, which is debt backed by the full faith, credit, and taxing power of the City. Like an account a homeowner may create to make mortgage payments, Class 700 includes principal and interest payments on long-term and short-term general obligation debt. It also includes fees paid to lenders to back variable rate debt, and arbitrage expenses paid to preserve the tax-exempt status of certain debt when interest earnings exceed permitted thresholds. All Class 700 spending is done through the City's Sinking Fund in accordance with the City's debt management policy.

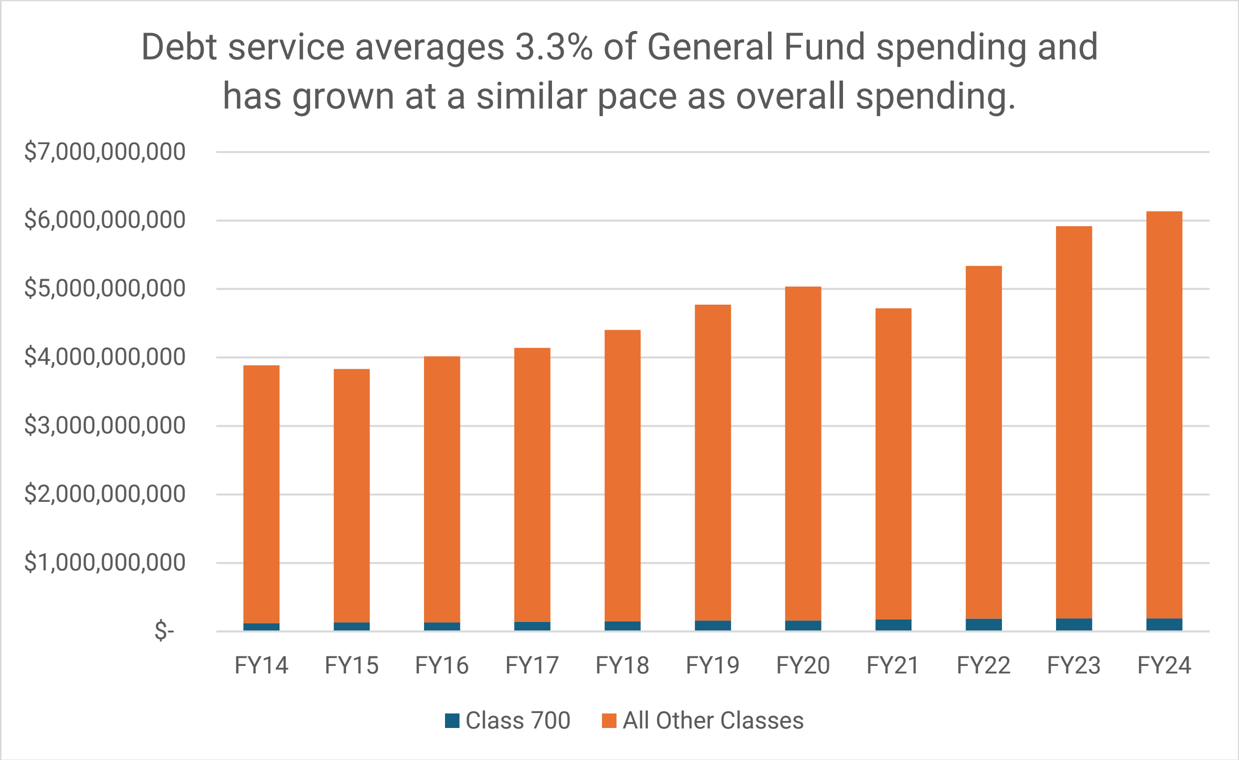
Image created by ChatGPT and edited by Rob Call

What's a Class?

The City organizes its budget into distinct categories, or classes, for grouping similar expenditures. There are nine classes, from Class 100 (Personal Services) to Class 900 (Reserves and Advances). A concise, helpful breakdown of each budget class can be found in PICA's Staff Report on the FY25-29 Five-Year Plan (page 48).

These classes are important because the annual budget passed by City Council appropriates funds by department and class. Departments must not only spend in accordance with the total departmental budget approved by City Council but must also abide by their class budgets. A department cannot choose, for example, to spend funds intended for employee salaries and benefits (Class 100) on new office chairs (Class 300/400) without an amendment to the budget legislation.

Changes in Class 700 (FY14-24)



From FY14 through FY24, Class 700 spending has been relatively stable as a portion of total General Fund spending, comprising a maximum of 3.8 percent in FY21, a minimum of 3.1 percent in FY24, and averaging 3.3 percent. Class 700 spending grew from $122.4 million in FY14 to $189.1 million in FY24 at an average annual rate of 4.9 percent, under the General Fund's average annual growth rate of 5.3 percent over the same period.

Uses of Class 700 Dollars

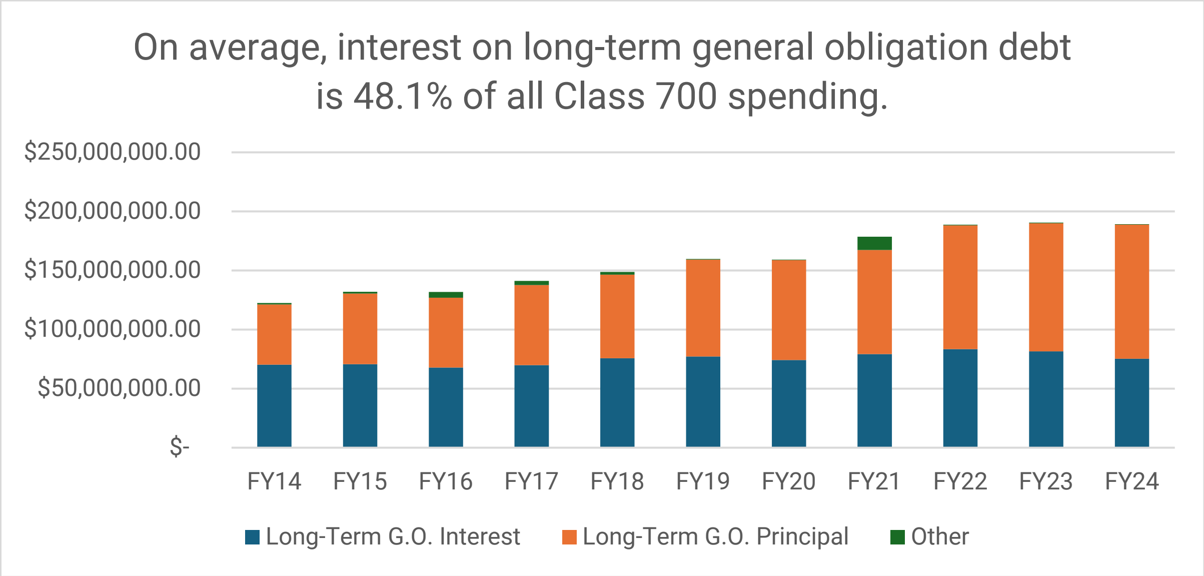
Class 700 allocations cover four categories of expenditure, servicing long-term general obligation debt, servicing short-term general obligation debt, paying commitment fees, and making arbitrage payments.

Long-Term General Obligation Debt

The City issues bonds – typically every other year – in the amount needed to fund the Capital Budget and other needs while staying in line with the debt management policy. Investors purchase the bonds in exchange for a promise of repayment plus interest from the City. Proceeds from the bond sales are typically used for capital investments, which must have a useful life of five years or longer. These investments fund activities like repairing roads, constructing new buildings and facilities, and maintaining existing ones. The City repays investor principal and interest over the term of the bonds, which is a minimum of 10 years for long-term debt.

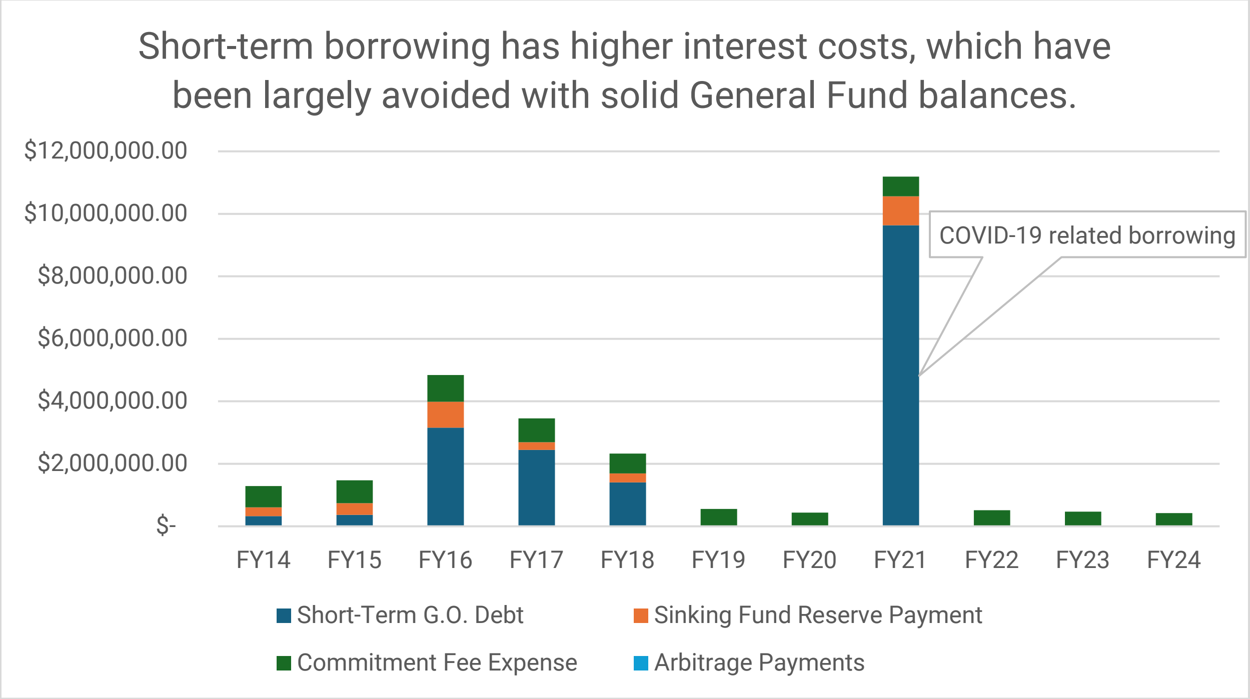
For long-term debt to be classified as general obligation debt, repayment of the bonds must be backed by the full faith, credit, and taxing power of the City. For investors, this provides assurance that they will be repaid with interest regardless of the City's overall fiscal condition. The City is legally obligated to do everything in its power to meet its obligations to general obligation investors.   For the City, this means that general obligation debt must be carefully managed to prevent committing funds to debt service at a level that would limit fiscal flexibility in lean times.

As of June 30, 2023, the City had $1.7 billion in General Fund long-term general obligation debt outstanding. The City also issues bonds for long-term debt backed by service agreements and leases. Service agreement and lease debt is issued by City-related authorities like the Philadelphia Authority for Industrial Development (PAID) and repaid in accordance with service agreements or lease agreements that budget and appropriate annual payments from the City's General Fund to the servicing authority in amounts sufficient to service outstanding debt. These service agreement and lease agreement payments are an unconditional and absolute obligation of the City. Servicing costs for the $1.5 billion in outstanding long-term debt from service and lease agreements are budgeted under Class 200 – Professional Services, rather than Class 700. The City also has long-term debt from Pension Obligation Bonds issued in 1999 to bolster the City's Pension Fund. Pension Obligation Bond payments are included in Class 100 – Employee Benefits.



From FY14 through FY24, principal and interest payments on long-term general obligation debt averaged 98.4 percent of all Class 700 spending. Principal costs are determined by the amount of debt issued. Interest costs are determined by the amount of debt issued, the City's credit rating, and prevailing market conditions. The better the City's credit rating, the more faith investors have in the stability of their investment, and the lower the cost of borrowing. The balance of annual interest and principal costs is set by the cumulative terms of the debt servicing arrangements for each long-term general obligation bond issuance. The City's debt management policy lays out general principles for debt issuance that address how principal and interest repayments should be scheduled. For each issuance of long-term general obligation debt, the City seeks to align the term of repayment with the useful life of assets being financed, structure repayment amounts to be about the same for each year of the repayment term, and structure repayment amounts to pay back half of the principal borrowed in the first 10 years of repayment.

Short-Term General Obligation Debt



The City issues short-term general obligation debt in the form of Tax and Revenue Anticipation Notes (TRANs) which are secured by General Fund taxes and revenue. The City's cash balance fluctuates throughout the year, peaking with receipt of Real Estate Tax payments in the spring. This fluctuation can create timing issues, where large expenditures need to be made in times of low cash balances. TRANs are intended to patch over timing mismatches between General Fund revenues and expenditures. As short-term borrowings, they must be repaid in full by the end of the fiscal year in which they are issued and typically carry lower interest rates than long-term debt. The City issued TRANs in all but one year from 1972 through 2018. In more recent years, the City has generally been able to avoid short-term borrowings with cash on hand from more robust fund balances and the federal funding support. FY21 is a notable exception, where the City issued a TRAN due to the economic uncertainty caused by COVID-19.

Sinking Fund Reserve Payments

Municipal bond investors like to have assurance that debt service will be paid regardless of a city's cash flow situation. Sinking Fund reserve payments are appropriations that can be used in a cash flow pinch to make a city's debt service payments in full for a particular fiscal year.

Because the amount of debt service due varies from year to year, so does the Sinking Fund reserve payment.

Commitment Fees

The City uses Letters of Credit from banks to back two series of variable rate bonds. The Letters of Credit establish that if the City were unable to make payments towards these bonds, the banks would make the payment on the City's behalf, and the City would repay the banks in accordance with agreed upon terms. Class 700 commitment fees are an annual fee to the banks based on the amount of principal each Letter of Credit is supporting.

Arbitrage Payments

The bonds the City issues for long-term general obligation debt are tax-exempt. The tax-exempt status makes investing in the bonds more appealing, because associated investment income won't be taxed. To earn tax-exempt status, bond proceeds must be used primarily for public purposes. Cities are prohibited from using tax-exempt bond proceeds purely for arbitrage, or the investment in higher yielding investments with lower yielding funds. Arbitrage situations can arise unintentionally because of changing economic circumstances. It's possible to incur arbitrage if, for example, long-term debt was issued in a time of low interest rates, the proceeds are held in an interest-bearing account, and rising interest rates drive interest earnings on the proceeds above the rate being paid to investors. When tax-exempt bond proceeds generate arbitrage profits, cities are required to rebate these profits to the US Treasury. The City of Philadelphia did not make any arbitrage payments from FY14 through FY24.

The Takeaway

Since FY14, Class 700 spending increased by 54.4 percent, which was outpaced by overall General Fund growth of 57.8 percent. The moderated growth and lack of volatility in Class 700 spending is the result of planning and adherence to the City's debt management policy but should be considered in the context of all long-term obligations. PICA was created in the early 1990s to issue bonds on the City's behalf and resolve an acute fiscal crisis caused by declining revenues, increasing obligations, and a cash flow crunch. PICA's bond issuance pulled the City out of its immediate fiscal crisis. PICA's ongoing oversight and collaboration with the City has fostered better debt management practices which have seen the City's credit ratings increase and cost of borrowing decrease.

About This Report

This report was written by Rob Call and edited by Marisa Waxman, with graphic support from ChatGPT's DALL-E feature. All AI-generated content was reviewed by PICA Staff prior to publication.