FitchRatings

Fitch Rates Philadelphia, PA's $350MM GOs 'A-'; Outlook Stable

Fitch Ratings-New York-16 June 2017: Fitch Ratings has assigned an 'A-' rating to the city of Philadelphia, PA's, $350 million general obligation (GO) bonds, series 2017.

The bonds are expected to sell through a negotiated sale on July 11, 2017.

The Rating Outlook is Stable.

SECURITY

GO bonds are backed by the city's full faith and credit and are payable from an ad valorem tax without limitation as to rate or amount.

KEY RATING DRIVERS

Philadelphia's 'A-' rating reflects the strength of the city's economic base and revenue growth prospects, somewhat offset by risks related to expenditure constraints and a limited reserve cushion. The city's long-term liability burden is somewhat elevated but well within the capacity of its resource base to absorb. Philadelphia's comparatively constrained expenditure framework will pressure the budget, but expectations for solid revenue growth from a steadily growing economy should support these spending pressures. Long-term budget forecasting, active budgetary management, and close oversight from a state fiscal board help mitigate the risk of reserve levels that are well below those of most local tax-supported governments.

Economic Resource Base
Philadelphia serves as a regional economic center in the northeast, with a stable employment base weighted toward the higher education and healthcare sectors. Jobs expansion since the recession has been steady and

strong, but comparatively low wealth levels and weak population increases persist and limit growth prospects. The population is estimated at 1.6 million.

Revenue Framework: 'aa' factor assessment
The income, property, and sales taxes that are Philadelphia's primary revenue sources will likely grow ahead of inflation but below national GDP given economic prospects. Philadelphia retains ample legal ability to raise revenues without specific commonwealth authorization.

Expenditure Framework: 'a' factor assessment
Philadelphia's recent expenditure growth has been measured reflecting ongoing budgetary management efforts. The city faces manageable but persistent fixed-cost growth pressures and has limited flexibility regarding labor expenses given a highly unionized workforce and statutory collective bargaining framework. The future trajectory of spending growth will likely exceed baseline revenue growth, requiring continued proactive budgeting.

Long-Term Liability Burden: 'a' factor assessment
Long-term liabilities are somewhat elevated but still in the moderate range relative to Philadelphia's resource base due to both comparatively elevated debt levels and unfunded pension obligations.

Operating Performance: 'bbb' factor assessment
Budgetary management practices are strong, offsetting Philadelphia's very modest reserve levels and supporting the city's adequate ability to respond to changing economic and fiscal circumstances. Fiscal stress is likely in the event of a downturn, but the city has the tools and demonstrated ability to manage through and restore financial flexibility.

RATING SENSITIVITIES

CHANGES IN FINANCIAL FLEXIBILITY: Philadelphia's rating is sensitive to sustained structural balance that improves reserve levels materially, aiding the city's financial flexibility, which could support upward rating movement. While Fitch anticipates some imbalance during an economic downturn, deficits well beyond current projections resulting in deeper reserve draws could trigger negative rating concern.

PENSION FUNDING IMPROVEMENT: Material reductions to the unfunded actuarial accrued liability or annual funding demands for the city's pension plan would be viewed positively for the city's rating.

CREDIT PROFILE

Revenue Framework

Philadelphia has a diverse revenue base, with personal and business income and receipts taxes, property tax and sales tax each generating a significant portion of local revenues. The wage tax (essentially a personal income tax without a capital gains component) accounts for one third of general fund revenues, and the other key revenue sources noted above make up another third. An additional 10% of revenues are transfers in from the Pennsylvania Intergovernmental Cooperation Authority (PICA) and come from the wage tax, net of deductions for debt service on revenue bonds issued by PICA.

Historically the wage tax has proven relatively resilient with limited declines. Growth has been slow, partially reflecting low wealth levels but also steady rate reductions implemented to enhance economic competitiveness. Property taxes have been stable through economic cycles as well, with more robust growth attributable to the city's position as a regional economic center. Other tax revenues have been more volatile due mainly to policy changes at the city and commonwealth levels.

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

Fitch anticipates solid general fund revenue growth, absent future policy actions, ahead of inflation but somewhat below national economic growth.

Significant policy changes implemented by the city include small but regular rate reductions in the wage tax, and restructuring business income and receipts tax (except for three years around the Great Recession, when the city held rates steady), and sales tax rate changes authorized by the commonwealth.

Philadelphia maintains ample legal authority to adjust revenues, other than the sales tax, under provisions of Pennsylvania's Sterling Act. The city has regularly utilized that ability to adjust wage and business income, property tax and receipts taxes to improve Philadelphia's economic competitiveness or provide additional budgetary flexibility.

Expenditure Framework

Philadelphia pays for a wide range of public services but public safety represents the largest expenditure category (about half of spending), like many local governments. The city does not directly pay for education but does support the contiguous School District of Philadelphia (SDP) with direct appropriations and through other policy measures such as statutory allocations of specific taxes. In recent years, the city issued short-term bonds to finance an SDP operating deficit and the commonwealth legislature permanently redirected part of the city's local sales tax levy to the district.

Spending growth absent policy actions will likely exceed projected revenue growth due to both a high demand for services given the city's low wealth levels, and moderating, but still persistent, growth in pension costs. The recently implemented sweetened-beverage tax will fund new policy initiatives including expanded pre-kindergarten. Revenues for the current fiscal year are short of initial expectations and the city is still engaged in litigation challenging the tax. Fitch considers prudent the city's actions to moderate spending on initiatives funded with the sweetened-beverage tax pending the outcome of litigation and the future trajectory of tax revenues.

Philadelphia has solid expenditure flexibility with a moderate carrying cost burden of 14.4% in fiscal 2016, but a constraining workforce environment. Pension costs escalated sharply in recent years due partially to actuarial adjustments to revise down the investment return assumption (to a still somewhat aggressive 7.7%) and apply findings from the most recent experience study. Growth should moderate and remain in line with to marginally ahead of revenue growth, if actuarial assumptions are met. The city consistently directs any new and otherwise unallocated revenues to the pension fund. This could reduce the long-term liability burden and carrying cost over time.

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

A recent agreement with the largest blue-collar union (AFSCME DC 33) reflects positively on the administration's ability to maintain stable labor relations on reasonable financial terms. Salary increases are well within the city's fiscal capacity and the contract includes a stacked hybrid pension plan that is mandatory for new hires and could reduce costs over the long term if implemented with other unions. Most contracts, other than AFSCME DC 33, expire on June 30, 2017. Negotiations are underway for those unions and current terms will remain in place until new contracts are settled.

The city's commitment to the school district represents an ongoing expenditure pressure point. SDP faces its own significant challenges (IDR of 'BB-'/Stable Outlook) and relies heavily on the city for fiscal support. Philadelphia has historically contributed to the school district via both direct appropriations and imposition of new taxes or allocations of existing taxes. Unlike all other Pennsylvania school districts, SDP has no ability to set its own local tax policy.

Long-Term Liability Burden

Philadelphia's long-term liability burden of approximately 20% of 2016 personal income is somewhat elevated but still in the moderate range relative to its resource base with roughly equivalent levels of net tax-supported debt and Fitch-adjusted unfunded pension liabilities for its primary single employer plan (the city maintains a separate single employer plan for Philadelphia Gas Works, an independently operated enterprise unit, revenue bonds rated 'BBB+'/ Stable Outlook).

For the city's pension fund, market performance below recently reduced but still somewhat aggressive assumptions, and recent actuarial changes to revise down the return assumption and implement findings from an experience study were the primary contributors to growth in the unfunded liability in recent years. The burden could moderate over the long term if actuarial assumptions are met and the city successfully rolls out plan changes across its labor bargaining units; however, Fitch anticipates the burden will remain sizable.

The city has contributed at least the actuarially determined employer contribution for many years, though Philadelphia did defer (and repay within five years) a portion of the statutorily required minimum municipal obligation in fiscal 2010 and 2011. The pension liability was re-amortized several years ago over a closed 30-year term, which reduced the annual cost. Positively, as noted above, the city typically adds any otherwise unallocated revenue to the pension fund to help reduce the liability.

Long-term debt is issued for capital needs and has been managed particularly closely in recent years as evidenced by the gradual decline in outstanding amounts. More significant issuance is likely under the current administration to finance new initiatives but will be funded with revenues from a recently enacted sweetened-beverage tax. The city has indicated that it will not issue any bonds supported with sweetened-beverage tax revenues until the ongoing litigation is resolved.

The city does have variable-rate debt and swap exposure, but Fitch does not view it as a material rating concern. Approximately 9% of outstanding direct debt is swapped to a fixed rate with various counterparties. Philadelphia is required to post collateral if its GO rating falls below investment grade. A swap policy outlines when swaps can be entered into and sets stringent guidelines around counterparty credit exposure with swap agreements required to include a provision allowing the city to terminate if counterparties fall below 'A' category ratings. Philadelphia also has modest exposure to variable-debt put risk with approximately 6% of outstanding direct debt supported with letters of credit. If the letters are triggered, amortization would accelerate, and Fitch anticipates the city would consider refinancing the debt given its solid market access.

Operating Performance

Philadelphia's reserve levels are relatively modest and would likely be drawn down during a downturn, but would be expected to recover. To address budget gaps, Fitch anticipates the city would rely primarily on its high budget flexibility. Likely budget measures include halting currently planned reductions in wage and business income and receipts tax rates, and headcount reductions and furloughs. Philadelphia took such steps during the Great Recession. Close monitoring of fiscal performance by PICA, the state-appointed oversight board, provides further assurance the city would quickly address economic downturns. The mayor submits annual five-year financial plans and quarterly intra-year updates to PICA. PICA must certify that the plans resolve any projected deficits while quarterly reports assess the city's ongoing compliance. If PICA certifies non-compliance, the city forfeits commonwealth funding including a large share of state-authorized tax revenues, providing strong incentive for the city to maintain long-term fiscal balance.

Philadelphia has an extensive statutory and policy-based framework for timely and proactive budget management throughout the economic cycle, revolving around PICA's reporting and certification requirements. However, Philadelphia's efforts to rebuild flexibility during periods of economic recovery remain somewhat inconsistent. Fund balances improved in the years following the Great Recession, but have been drawn down in recent years to meet recurring needs, despite economic and revenue growth. The current five-year plan anticipates additional reserve drawdowns through fiscal 2018.

Philadelphia's liquidity is comparatively limited, but stable and adequate for its fiscal needs given the superior level of budget flexibility and close monitoring from PICA. The city, or a related entity, has demonstrated clear and consistent market access, having issued tax and revenue anticipation notes virtually every year since fiscal 1972.

Current Developments

Philadelphia ended fiscal 2016 on June 30 with estimated revenues 2% ahead of the enacted budget, with growth across all major tax categories reflecting the city's solid economic performance. The city reported an available general fund balance of $148.3 million (3.7% of general fund revenues), which is ahead of the $106 million (2.7% of general fund revenues) assumed in the last five-year financial plan.

The current five-year financial plan includes steady draws on that already limited fund balance for several years, but it also includes scheduled gradual reductions in wage and business taxes that the city could slow, halt or even reverse depending on economic circumstances. Philadelphia also tends toward conservative revenue and expenditure forecasts. Fund balances in the current financial plan (as well as the proposed plan reflecting the fiscal 2018 budget nearing council adoption), while still relatively modest, are well ahead of levels projected last year.

Philadelphia's current estimate for fiscal 2017 general fund revenues is very slightly ahead of the enacted budget. Particularly strong sales tax growth is offsetting modest weakness in real estate related taxes. The city estimates general fund spending is very slightly ahead the enacted budget, but the higher fiscal 2016 ending balance results in an improved current year surplus and fund balance projection of $88.5 million versus the enacted $40.2 million.

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

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Applicable Criteria
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