Pennsylvania Intergovernmental Cooperation Authority

Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 2008 - Fiscal Year 2012

July 26, 2007

PENNSYLVANIA INTERGOVERNMENTAL COOPERATION AUTHORITY

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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2008-FY2012 FIVE-YEAR FINANCIAL PLAN

SECTION I:

EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

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EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

Unless the City changes course from the direction laid out in the FY08-FY12 Five-Year Financial Plan (the Plan), it will likely head into a severe fiscal crisis.

While the City has taken sufficient steps to bring the Plan into narrow balance, it has not taken steps to create a structural balance between recurring expenditures and recurring revenues and it has not taken steps to address the long-term issues that threaten to undermine the City's finances.

The potential fiscal crisis is unlikely to come in the first or second year of a new mayor's term, but if no corrective action is taken, that crisis is almost certain to come within the next decade. Moreover, the key decisions that are likely to determine whether that crisis occurs will have to be made within the first year of the mayor's term.

Several PICA reports have identified the likely components of that crisis, including the following:

- Substantial financial risks that could create massive deficits.
- A pension fund that can only meet about half of its long term obligations, but that, when combined with health benefits costs, will consume one out of every four general fund dollars by the end of the Five-Year Plan.
- A crumbling core infrastructure.
- Demands for substantially more service, particularly for increased public safety.
- Fixed obligations that equal almost 20 percent of the City's budget.
- Continuing increases in the prison population, which have translated into prisons expenditures that are budgeted to be 50 percent higher in FY08 than they were in FY01.
- A school district that continues to face its own fiscal threats.
- Collective bargaining agreements that expire at the end of the Plan's first fiscal year and that will be a key determinant of the City's fiscal future.
- An uncompetitive tax structure

Of the five years covered by the Plan, four and a half will occur after the Street Administration leaves office. The Plan includes operating deficits in each of those years. The annual deficits would mean that FY06's $254 million fund balance would quickly dissipate and would equal only 1.3 percent of revenues by the end of FY12.

The next mayor will face these shrinking fund balances, along with enormous risks and crushing structural issues even though revenues have grown 30 percent in the last seven years. The City has not been able to use its added revenues to tackle its financial issues because a small number of budget areas have grown much faster than 30 percent. Containing those areas of growth – pensions, health benefits, prisons and debt service will be among the largest financial challenges facing the next mayor.

Against that battalion of fiscal challenges, the City is armed with tax collections that came in even higher than the amounts added to the Plan as submitted to PICA. The strength of business privilege tax and wage tax collections will help offset some of the Plan's risks, but still leave the City vulnerable to any fiscal reversal.

The City's financial vulnerability was made clear by the actions it took to balance the Plan. In order to avoid projecting negative fund balances, the City recommends ending an unparalleled 14-year business tax reduction program; dissolving the productivity bank, which has become a national model, cutting most departments' FY08 personnel budgets by 2.5 percent and cutting the FY09 budgets of, among others, the Police Department, the Community College, the District Attorney's Office and the Art Museum.

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 narrowly meets that test.

Report Summary

The report focuses primarily on six areas:

1. **Actions the City took to address issues raised by PICA:** In order to address the issues raised by PICA, the City made over $570 million worth of changes to the Plan.

2. **Speculative items included in the Plan:** While the City addressed the vast majority 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.

3. **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, 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.

4. **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.

5. **The financial world that faces future mayors and members of City Council:** The City faces an array of issues that future elected officials must tackle 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. If not addressed, however, these issues would eventually cripple the City's finances.

6. **Approaches other cities are taking to their budgets.** A look at how a number of cities are attacking their long-term financial issues.

Actions the City took to address issues raised by PICA

Among the Actions the City took to balance the Plan were:

Shifting Department of Human Services Appropriations to the Grants Fund: PICA Staff's single biggest concern with the Plan as presented to Council in February was that it included over $80 million more in state and federal reimbursements for services provided by DHS than was included in the State's certified budget. If the City spent that money, but did not get reimbursed, it would create massive deficits. The City eliminated that risk by moving the appropriations to the grants fund where they can only be spent if the state and federal funding is received.

Capping the projected growth in the wage tax base: The initial Plan had more aggressive wage tax projections than any earlier plan, with projected increases in the base reaching 4.5 percent. In response to PICA concerns about those growth rates, the City scaled back its projections. In the approved Plan, the City does not project base growth of more than four percent in any year.

Providing Additional Funding for Prisons Costs: The initial Plan assumed that costs for the Philadelphia Prisons System's contracted health, housing, food and maintenance costs would grow two percent a year even though those costs have grown at an average of eight percent annually over the last ten years. The Plan now assumes growth rates of at least four percent in each year.

Halting the Reductions in the Rate for the Gross Receipts Portion of the Business Privilege Tax: Unfortunately, in balancing the Plan, the Administration took actions that while meeting the PICA Act's test of reasonableness dramatically differ from policies PICA has advocated. One of those actions was ending the City's gross receipts tax reduction program in FY10. By FY10, rates will have been reduced for 14 consecutive years and ending the program would send a negative message to the City's business community.

Eliminating the Productivity Bank: Another action the City took that was contrary to policies that PICA has advocated was proposing to shut down the productivity bank, which has been used to fund projects designed to increase the government's efficiency. In the long run, Philadelphia's city government needs to be able to operate more efficiently and effectively if the City is to be able to provide quality services while having a competitive tax structure. Eliminating the Bank eliminates one of the options for improving how the City does its work. In commenting on the City's proposal, Governing magazine said: "It borders on the ironic. In an effort to engage in long-term planning, the city is proposing to cut a model of long-term thinking for short-term savings."

Speculative Items Included in the Plan

Only two of the many speculative items initially included in the Plan remained in the revised submissions made to PICA on June 27 and July 18, 2007. Those two items were:

Philadelphia Gas Works: The Plan assumes that the Philadelphia Gas Works will repay a $45 million loan to the City in FY09. PGW's ability to make that repayment and to avoid future fiscal crises depends in large part on the outcome of its current rate case that is before the Pennsylvania Utility Commission.

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 $53 million that is the combined amount of the loan repayment from PGW and the sky box rental payments from the Eagles.

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

Among the Plan's largest risks are:

Labor Costs. The Plan is consistent with earlier plans in that it includes no money for pay raises in years not covered by existing collective bargaining agreements. Unfortunately, only the first year of the Plan is covered by collective bargaining agreements. The lack of funding for pay raises means that the Plan almost certainly has inadequate funding for payroll costs, which are budgeted to consume 35 percent of FY08's expenditures. Just a one percent annual increase in salaries would add almost

$140 million to the Plan's costs. In addition, the City and its unions have yet to come to agreement on healthcare costs for FY07 and FY08 for non-uniformed employees and for FY06 through FY08 for uniformed employees. **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;**

The School District of Philadelphia: In April, the School District announced that it was facing a $190 million FY08 deficit unless corrective actions were taken. In its proposed plan to eliminate that deficit, the School District included $27 million in new City revenue that had not been included in the City's budget. The Mayor and City Council took two steps designed to help the District get that $27 million. First, City Council passed legislation to shift from the City's general fund to the School District property tax revenues equal to about $18 million in FY08 and $95 million over the course of the FY08-FY12 five-year plan. Next, the Mayor and Council agreed to amend the FY08 budget to add $10 million that they said would be given to the School District. In a July 18th submission to PICA, however, the City said that instead of attempting to make a one-time $10 million contribution, it would make a $2 million recurring contribution, which would cost $10 million over the life of the Plan. In addition, the City said that it would attempt to help the District's finances by increasing delinquent real estate tax collections and by paying for contracts that are now paid for by the School District. The City has yet to specify how much in School District contracts it would assume or how it would pay for the cost of those contracts. If the City does pay for those contracts, but only for one year, the contracts will likely provide temporary, but not long-term, relief to the District. In addition because the State budget included a smaller increase in funding than the District anticipated and, if, as is likely, the District's deficit elimination plan is not fully implemented, the District may again turn to the City for more funding.

SEPTA: Legislation passed by the State that would provide additional funding to SEPTA requires that the City's contribution to the transit agency be increased annually by the rate of inflation. After FY10, the Plan includes no increases in funding for SEPTA;

Federal Budget Cuts: The threat of additional federal budget cuts continues to hang over the City's finances. As the reductions in federal funding for the Department of Human Services demonstrate, those cuts can have a dramatic impact on the City's budget;

Real Estate Tax Collections: The Plan assumes that real estate assessments will grow at least five percent each year from FY09 through FY12 and will increase by six percent in FY09 and FY10. While those projected assessment increases are not unreasonable, it could be difficult to obtain the revenues from those increases if the BRT's full value/equalization project is implemented and, as is likely, legislation is passed that will put a limit on the growth of individual tax bills;

Size of the Police Force: The Plan assumes that the size of the police force will be reduced in FY09, when the Pennsylvania State Police are scheduled to have taken full

responsibility for patrolling state highways within the City's borders. The Democratic and Republican nominees for Mayor, however, have each pledged to increase the size of the police department.

Freezing the rates of the Business Privilege Tax: The Plan assumes that, after 14 years, the City will end its business privilege tax reduction program beginning in FY10. Ending the program would increase the City's revenues by approximately $12 million. Both the Democratic and Republican nominees for Mayor have pledged to continue the tax reduction program.

Casino-Related Costs: The Plan assumes that the City will begin receiving fees from casinos in FY09, but it does not assume that the opening of those casinos will result in any social, police or infrastructure costs to the City's general fund.

Tax Revenue Projections

Some of PICA's concerns regarding the Plan were alleviated when the Administration reduced its projected growth rates for wage tax collections and for FY07 property tax collections. In addition, strong FY07 business privilege and wage tax collections helped mitigate some of the Plan's risks. The City does, however, appear to be losing one of its most reliable budgetary cushions. After growing by at least 20 percent in each of the last three years, real estate transfer tax collections were lower for FY07 than they had been for FY06.

The Financial World Awaiting the Next Mayor And His Successors

In a September 2006 report, PICA Staff speculated that the next mayor's first reaction to the City's finances would likely be "what have I gotten myself into?" Nothing has happened since last fall to make the financial challenges facing the next mayor less daunting. The next Mayor will have 90 days to develop a five-year plan and six months to negotiate new collective bargaining agreements while he is developing plans for tackling the long-term structural problems facing the City's finances, developing strategies for enhancing services, mitigating the very real risks that face the City's budget and attempting to maintain a positive fund balance.

Contrasting Municipal Management of Long-Term Fiscal Concerns

While New York, San Diego, San Francisco, Detroit, and Boston find themselves in very different fiscal conditions, they are each using their budget processes to attack their long-term issues.

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 FY08-FY12 Five-Year Plan. While the Controller's Office is preparing an opinion that finds that the Plan uses reasonable assumptions, that opinion has not yet been completed.

Staff Recommendation

PICA Staff finds itself facing a situation very similar to the one it faced a year ago. Like last year, based on the PICA statute, which requires that at a minimum the Plan demonstrate balanced budgets for the life of the Plan, the strength of the City's revenues leaves PICA Staff little choice but to recommend that the Board approve the Plan. In last year's report, PICA Staff said its recommendation should in no way be viewed as an endorsement of the Plan or its approach to fiscal management. That is still true, but with more urgency since a year has passed and the City has still shown very little progress in addressing the long-term issues it faces.

Time is not on the City's side in dealing with these issues. The longer the City waits to deal with theses problems, the more challenging they will become. Philadelphians cannot afford for the new mayor to propose a Plan that does as little as the FY08-FY12 Plan does to address the City's long-term issues

With all of the caveats discussed above, PICA Staff recommends that the Board of the Pennsylvania Intergovernmental Cooperation Authority approve the revised Plan as submitted to the Authority on July 18, 2007.

Pennsylvania Intergovernmental
Cooperation Authority

STAFF REPORT
ON
FY2008-FY2012
FIVE-YEAR FINANCIAL PLAN

SECTION II:

ACTIONS THE CITY TOOK TO ADDRESS PICA's CONCERNS

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The Plan as presented to Council in February contained so many unreasonable assumptions that it was clear that changes would be needed before PICA Staff could recommend to the Board that the Plan be approved. The Plan was then thrown further out of balance during the Administration's budget negotiations with City Council when real estate revenue totaling $95 million over the life of the Plan was shifted from the City's general fund to the School District, $16 million in funding was added to City agencies and another $10 million was shifted to City Council to be used to provide additional funding to the School District. The combined impact of those actions was to add $217 million to the problems that the Plan already faced.

By far the largest of the speculative assumptions in the initial Plan pertained to state and federal reimbursements and wage tax growth, but the Plan included a number of other speculative items. PICA Staff made its concerns known through letters and discussions with administration officials. In a May letter, PICA Staff wrote that unless the City removed the speculative items from the Plan or explained how the Plan would be balanced even if the speculative items were not removed, it would recommend to the PICA Board that it disapprove the Plan. In response, the City has made a substantial number of changes to the Plan, such as:

- Shifting $70 million of appropriations for the Department of Human Services from the general fund to the grants fund. In the initial Plan, the City included over $80 million more annually in state and federal reimbursements for the Department of Human Services than the State had included in its certified budget. If the City had spent that money and not received the anticipated state and federal reimbursements, it would have created a massive hole in the Plan. By taking the fiscally prudent step of moving the appropriations to the grants fund, the City ensured that the money would not be spent unless funding was actually received. This change reduced both revenues and expenditures by $350 million over the life of the Plan. The City also agreed to make $19 million in cuts to DHS expenditures if those cuts were necessary to balance the Plan and the State appears to have included additional funding in its budget for DHS.

- Capping projected growth in the wage tax base at four percent annually. The initial plan had annual wage tax base growth rates of at least 4.25 percent beginning in FY09 and of 4.5 percent in FY11 and FY12. None of the 15 earlier plans submitted by the City has had a projected growth rate that exceeded four percent in any single year. Over the last five years, wage tax base growth has averaged three percent. While some years have seen growth higher than four percent, when the economy slowed at the beginning of the decade, growth was far below four percent. Increasing the projected growth rate in the wage tax would increase the risk that the City would fall short of its projections for its largest single source of revenue and, as a result, incur deficits. By lowering the projected growth rate of the wage tax, the City improved the likelihood that wage tax collections will meet the projected amounts. This change reduced City revenues by $47 million over the life of the Plan.

- Increasing the projected rate of growth for prisons systems costs. The initial Plan assumed that costs for the prisons system's contracts would increase by two percent annually through FY12. PICA Staff thought that this assumption overly optimistic given the eight percent growth annually growth in those contracts over the last ten years. In response to PICA's concerns, the Administration doubled its assumed growth rate for prison's system costs, which would still mean that growth would be substantially lower than it has been over the past decade. The Administration contends that projection is reasonable because it has hired an employee with expertise in healthcare to manage the prison's healthcare contracts and has installed a new management information system that will allow it to better identify needs in its healthcare delivery system. PICA Staff believes that the Plan's projections are still aggressive, but not unreasonable. This change in assumptions added just under $25 million in costs to the Plan.

- Reducing the amount of projected real estate tax collections in FY07. Based on year-to-date collections, it became clear that the City would not meet its projection for FY07. As a result, the City reduced projected collections in FY07 by $5 million, but did not change projected growth rates from FY08 through FY12. This change reduced Plan revenues by $33.7 million. As discussed in the tax revenue projection section of this report, PICA staff still believes that the projected growth rates in the Plan are optimistic.

- Eliminating assumed savings from health benefit initiatives. The initial plan included assumed savings in FY10 from healthcare insurance initiatives, but those initiatives would have to be implemented by the next administration and would rely, at least in part, on arbitrators' decisions. Eliminating the assumption that these initiatives would be successfully implemented added $10 million in costs to the Plan.

- Providing additional funding to the School District. One of the risks to the Plan was that it did not include any additional funding to the School District even though the Mayor said that the District needed more money. As discussed above, Council and the Administration agreed to both transfer millage and provide additional funding to the School District. The combined impact on the Plan of these changes was $105 million.

The following list shows the actions the Administration and City Council took that lessened PICA's concerns about the speculative items that were included in the Plan.

Actions Taken That Lessened PICA's Concerns	
	FY07-FY12 $ Thousands
Move DHS Funding to Grants Fund	350,000
Capping Projected Wage Tax Growth at 4%	47,875
Increasing Projected Growth for Prisons Contracts	24,655
Reduce Projected Property Tax Collections	33,732
Eliminate Projected Health Benefits Savings	10,140
Add School District Funding	105,000
Total	571,402

While those changes helped reduce the number of speculative items in the Plan, combined with the addition of $21 million in funding for surveillance cameras, they also forced the City to take a number of steps to bring the Plan back into balance. Those actions included the following:

- Freezing the reductions in the gross receipts portion of the business privilege tax beginning in FY10. While the City projects that this change would increase revenues by $12 million, it would also send a damaging message to businesses. It would mean the end of what by FY10 would be a 14 year business tax reduction program that is unique among American cities. The City would, in essence, be telling businesses that it was deemphasizing the importance of reducing the cost of doing business in Philadelphia;

- Eliminating the funding that City Council added to the budgets of an array of City departments. In FY08, the reductions would apply only to departments directly under the Mayor's control, reducing costs by about $6 million, but from FY09 through FY12, the cuts would apply to virtually all $15.9 million that Council added to the FY08 budget. In total, these cuts would reduce obligations by $63 million over the life of the Plan. Among others, the cuts would be to Community College, the District Attorney's Office, the Free Library, the Health Department, the Recreation Department and the Art Museum;

- Eliminating the Productivity Bank. The Bank, which had become a national model, was established with funds borrowed by PICA in 1992 and has been used to fund projects that increase the efficiency and effectiveness of City government. When used properly, the Bank has been a key tool in improving the way government operates. Eliminating the Bank would close an avenue for needed changes. The action will provide the general fund with an additional $29.5 million over the life of the Plan.

- Recognizing additional wage and business privilege tax revenues collected in FY07. The City added $10 million to its FY07 wage tax collections projections and $15 million to its FY07 business privilege tax collections projection. Given the strength of collections, those adjustments were reasonable. Over five years, the adjustment in projected FY07 collections adds $160 million in revenues to the Plan;

- Reducing the amount of projected debt service payments. The City will reduce the size of its FY08 cash flow borrowing and refund outstanding long-term debt to save $7 million in FY08. The City will also benefit from the defeasement of Parking Authority bonds for which the City had agreed to guarantee debt service payments. The Plan had included about $1.3 million annually to cover the cost of those Parking Authority Bonds. In addition to helping balance the Plan, the refundings and defeasement will reduce the City's long-term obligations.

- Receiving PILOTS from the casino operators and the Phillies and Eagles. The SugarHouse operators, the Phillies and the Eagles have all agreed to make payments in lieu of taxes to the City. Over the years covered by the Plan, those payments will total $20 million.

- Cutting the Fleet Acquisition Budget. Recognizing the need to invest in the City's aging fleet, in the initial Plan the Administration proposed increasing the fleet acquisition budget in FY08 to $19 million and it proposed to pay for that increase by providing lower levels of acquisition funding in FY09 through FY11 than had been included in the FY07-FY11 Plan. During the budget process, however, Council voted to reduce Fleet's FY08 budget by $2.1 million and the Mayor agreed to the change. As a result, the influx of vehicles will not be as great as the Administration originally intended and the amount of funding for the fleet over the next five years will be lower than the amount that had been included in the FY07-FY11 Plan.

The following table shows a full list of the adjustments that the City made to the Plan:

City's Proposed Gap Closing Measures:		
	FY07-FY12 $000	FY07-FY12 $000
Changes to Tax Policy		
Freeze Bpt Reductions After FY09	12,350	
Total Tax Policy Shifts		12,350
Increased Projected Tax Revenues		
Wage Tax	63,070	
Business Privilege Tax	96,295	
Total Increased Projected Tax Revenues		159,365
Increased Local Non-Tax Revenues		
Casino PILOTs	12,320	
Phillies/Eagles PILOTS	7,560	
Total Increased Local Non-Tax Revenues		19,880
Expenditure Reductions		
Elimination of FY08 Council Additions to Budget	6,125	
Eliminate Productivity Bank	33,018	
Cut Fleet Spending	2,100	
Reduction in Projected Debt Service Payments	13,690	
Shift DHS Appropriatons to the Grants Fund	350,000	
Eliminate Council FY08 Additions in FY09 Through FY12	57,409	
Total Expenditure Reductions		462,342
Total Plan Balancing Proposals		**653,937**

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2008-FY2012 FIVE-YEAR FINANCIAL PLAN

SECTION III:

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. In response to PICA's concerns about the likelihood of the City's receiving repayment of its $45 million PGW loan and receiving the $8 million it asserts is owed the City by the Eagles, the Administration has agreed to maintain a fund balance of at least $53 million in each year of the Plan.

PHILADELPHIA GAS WORKS (PGW)

Overview
PGW continues to present an enormous risk for the City and the entire region. For the first time in many years, PGW has presented a roadmap for gaining control of its finances, though it is dependent on regulatory action out of its direct control and the outcome will not be known until the fall of 2007. Should PGW not get the rate relief it seeks, repayment of the $45 million loan to the City in FY09 remains unlikely. Moreover, there is 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 repay the loan from the City assuming a continuation of current conditions. 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
Following the failure of last year's focus on LIHEAP increases and the development of the LNG plan, PGW management has made a significant attempt to right its long-term finances. PGW submitted a request to the Pennsylvania Utility Commission (PUC) for a long-needed rate increase. The $100 million request is focused primarily on operations and debt reduction and would significantly stabilize PGW's fiscal outlook.

PGW has a compelling case to make in its 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.

If PGW were to receive its full rate request the utility would have more stable cash balances, have adequate funds to address ongoing capital needs, and begin to address its dramatically high long-term debt. Further, it would be able to pay back the City loan of

$45 million. If that rate increase were combined with continuous ongoing management improvements, the outlook for PGW would be encouraging.

However, 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.

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

The Eagles Luxury Box Payment
The FY08 budget projects that the City will receive $8 million from the Eagles before the end of FY07 in payment of rent for luxury boxes in Veterans Stadium. It is the fourth straight budget in which the City has made that assumption and it will be the fourth 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.

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SECTION IV:

ADDITIONAL RISKS TO THE PLAN

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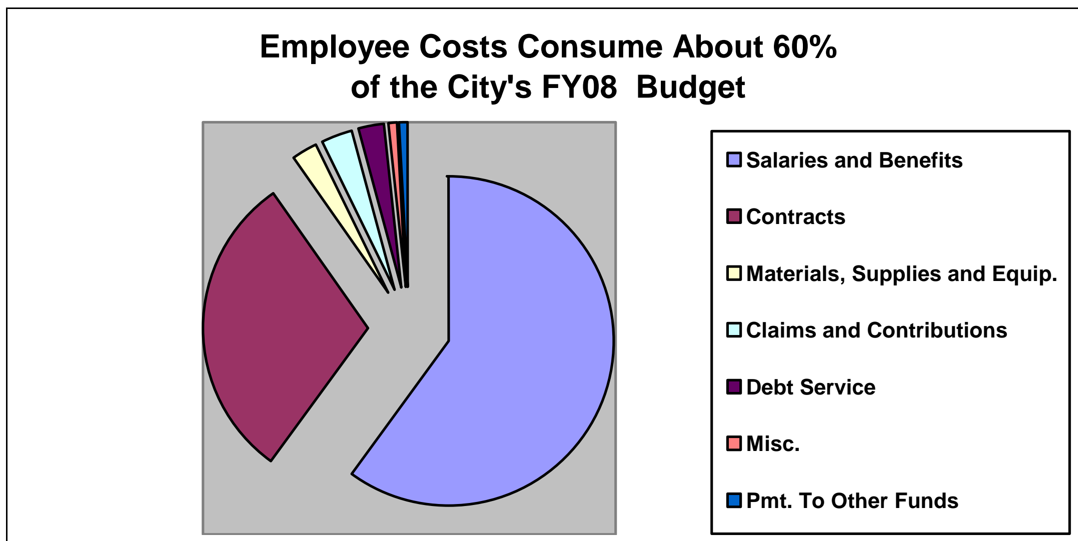
OVERVIEW

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
- The Finances of the School District of Philadelphia
- Gaming Costs
- Growth in the Number of Inmates in the City's Prison System
- Costs for Services Provided by the Department of Human Services
- Costs for the Pennsylvania Convention Center Authority

LABOR CONTRACTS AND THE MUNICIPAL WORK FORCE

By far the City's largest general fund cost is for personnel. Of every dollar City government spends, almost 60 cents goes to labor costs. Changes in labor costs can, as a result, have a major impact on the City's finances.



While all of the City's five-year plans have had labor costs risk, the FY08-FY12 Plan has *seven* years of labor cost risk. In addition to having the contracts of all four of its major unions expire at the end of FY08, the City still has unresolved health insurance issues dating back to FY06 for uniformed employees and to FY07 for non-uniformed employees. The potential that the contracts will cost more than budgeted is one of the largest risks facing the Plan.

The risk of cost increases for the City's police and fire unions is particularly high because their contracts are determined through an arbitration process. The Administration is still appealing awards given by arbitration panels that would have provided benefits to police officers and firefighters that would cost more than the amounts included in the Plan. One panel, for example, awarded firefighters health insurance cost increases of 11 percent for

the fiscal year that started July 1, 2005, 14 percent for the year that started July 1, 2006 and another 14 percent for the year that started July 1, 2007.

The panel tasked with deciding the FOP award for health insurance benefits that was scheduled to be in place July 1st 2005 ruled that the City's contribution for police health benefits should increase 15.7 percent in FY06 and an additional ten percent in FY07. The award has gone through a series of appeals, but has not yet been decided.

The Administration has more control over nonuniformed employees' contracts, which are negotiated between the Administration and unions. As a result, the City is better able to keep those contracts consistent with the Plan.

While the Five-Year Plan includes funding for increased employee health insurance benefits, it does not include any assumed increases in wages beyond the end of current collective agreements at the end of FY08. The assumption that there will be no increase in salaries beyond FY08 is consistent with the approach taken in previous plans, but still represents a particularly large risk to this Plan because only one year of the Plan is covered by current labor agreements. The potential costs to the Plan are enormous as even a one percent annual increases in wages each year from FY09 through FY12 would add almost $140 million in costs to the Plan.

There is also risk associated with the Plan's employee health insurance assumption. The Plan assumes that the City will save $7 million in health benefits costs in FY08, but does not explain how those savings would be achieved. In addition, arbitration awards and collective bargaining agreements could result in higher health benefit insurance costs than the Plan includes.

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.

SCHOOL DISTRICT OF PHILADELPHIA

The Mayor and City Council have agreed to provide at least $20 million in additional funding to the School District in FY08 and at least $105 million over the life of the FY08-FY12 Plan. The District, however, still faces substantial fiscal challenges and may eventually turn to the City for additional funding.

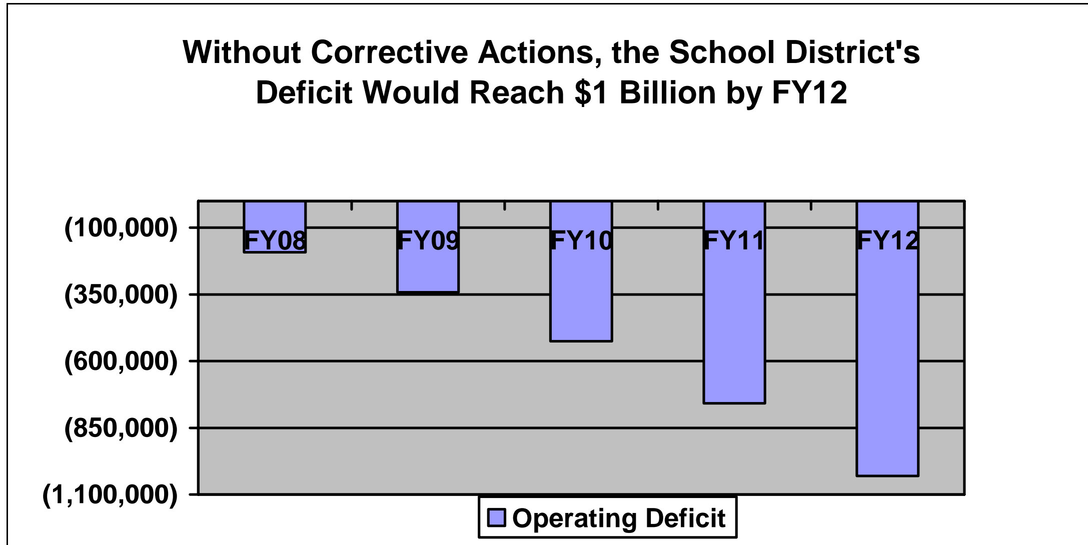
The District's Financial Condition

The School District's financial problems are not new. In FY02, in response to mounting deficits, control of the District was shifted to the School Reform Commission, the City and the State each provided additional funding (the City increased its share by $45 million) and the District issued over $300 million in deficit reduction bonds.

The additional funding was intended to help the School District enhance its educational performance, eliminate its existing deficit and implement changes to close the structural

gap between its revenues and expenditures. While the District did eliminate its FY02 deficit and has improved educational performance, it has not addressed its structural deficit.

The District was able to use the deficit funding bonds, refundings and asset sales to maintain positive fund balances each year from FY02 through FY05, but as it exhausted those one-time balancing options, the District again began to incur deficits. In April 2007, the District said the deficit would exceed $190 million in FY08 and would grow to $1 billion in five years if no corrective action were taken.



There are a number of reasons for the School District's recurring deficits, but by far the largest contributors to the imbalance between expenditures and revenues have been charter schools and debt service. In FY02, charter schools cost the school district $95 million. By FY06, charter school costs had risen to $221 million – a 133 percent increase in just five years. Those costs increased as the number of charters in Philadelphia increased from 39 in FY02 to 56 in FY09.

While debt service costs did not grow as quickly as charter school costs, they did jump 73 percent from $94 million to $163 million. Costs went up as the School District undertook an aggressive $1.5 billion capital program to build new facilities and refurbish existing ones. As part of its capital program, the District borrowed over $800 million in FY04 and over $300 million in FY07.

There may have been important reasons for the District to increase the number of charters and to issue additional debt, but when combined with other increases in expenditures, they were clearly more than the District could fund without incurring deficits.

The District's Deficit Elimination Plan

In order to bring its FY08 budget back into balance, the District developed a deficit elimination Plan that included just under $100 million in expenditure reductions, $55 million in increased funding from the Commonwealth and $27.6 million in new funding from the City. Without that increased City and State funding, the School District's proposed expenditure reductions would have to be even steeper.

The City has taken two steps to help fill the District's funding gap. The first step was transferring about $18 million in FY08 real estate tax revenues from the City's general fund to the School District. Over the life of the Plan, that transfer will reduce the City's general fund's revenue by about $95 million.

The second step was to provide funding in the budget for a $10 million grant to the School District. The combination of the $18 million millage transfer and the $10 million grant would provide the District with just slightly more City funding than the amount it had assumed in its FY08 budget.

While the FY08 budget included a $10 million contribution to the School District, in a July 18th submission to PICA, the Administration said that it will pay only $2 million of that contribution. If the City does pay the $10 million to the School District, it will be required by state law to make that payment each year. If the City pays only $2 million, it would be required to pay only $2 million each year and its cost over the life of the Plan would be $10 million. The City also said that it would assist the School District by improving delinquent property tax collections (60 percent of property tax collections go to the School District) and by assuming responsibility for some of the School District's contracts. The City has not said, however, how many contracts it would fund, what level of funding it would provide or what would happen to those contracts in FY09 if the City only provides funding for those contracts for one year.

Even if through a combination of the $2 million grant, increased real estate tax collections and the assumption of some of the District's contracts, the City provides most of the funding that the School District was seeking, there is still a substantial risk that the School District will continue to have deficits and that it will once again turn to the City for more assistance. The District's deficit elimination plan assumed $55 million in additional state funding, but it appears that the budget came in more than $20 million below that amount. The plan also assumes that the District will take a number of actions to reduce its costs, but the preliminary official statement that accompanied a recent School District borrowing described $60 million of those cuts as being "at risk" because of contractual provisions, possible legal or procedural challenges and potential implementation delays. In addition, about a third of the $60 million in at-risk cuts have not yet even been identified. The combination of the lower than budgeted increase in state funding and the possibility that the majority of the planned expenditure reductions won't be made means that the District could lose $75 million from its deficit reduction plan and face a huge deficit during FY08.

GAMING COSTS

Overview

The Administration's inclusion of revenues from proposed new casinos creates two distinct risks. The first is that any delay caused by the need for local legislation or by successful legal challenges would delay the City's receipts of revenues. Secondly, since the Plan includes revenues from gaming, but no City costs, any of the City costs that are likely to be created by the opening of new casinos will create a hole in the Plan.

When the casinos open, they will produce immediate tangible benefits for Philadelphia. The Five-Year Plan includes $70 million in gaming fees and $12 million in payments in lieu of taxes from casino operators. Moreover, casino revenues will also be used to reduce the City's wage tax, helping improve the City's competitiveness with other jurisdictions. At the same time, the casinos will clearly create new criminal justice, social and infrastructure costs for the City and their impact on the economy is not easy to predict.

While economists' views vary widely, the uncertain impact of gaming was summarized by University of Illinois economist Earl Grinols who said:

"Partly in response to negative perceptions, many in the gambling industry have promoted the idea that gambling is an economic development tool, creating jobs for depressed regional economies and revitalizing lagging areas. Gambling experts and even gambling spokesmen frequently suggest that such arguments are exaggerated or false, but their cautions are often ignored by elected officials who face pressures to do what they can to aid their communities and therefore want to believe that gambling will help. It is an empirical matter subject to a number of special factors as to how gambling affects a particular economy."

Costs of Additional Law Enforcement

A recent study conducted by Grinols and David Mustard concluded casinos can impose costs as much a 1.9 times the benefits. In addition, Grinols and Mustard found that in the five years after casinos opened, robberies increased five fold; aggravated assault increased six times on average in each county.

In another study, Grinols put the cost of apprehension, adjudication, incarceration, and regulation at between $20,500 and $45,700 per pathological gambler per year. The Mayor's Gaming Task force estimates Philadelphia's diagnosable pathological population to be as many as 9,450. Even on the low end of the estimated cost per pathological gambler, if Grinols numbers are accurate, the costs would be close to $200 million. Additionally, the likely additional criminal activity would further burden an already overtaxed criminal justice system.

Social Costs

The American Psychiatric Association estimates that 30,740 Philadelphians are at risk for pathological or problem gambling. The City has said that CBH funding will cover the

costs associated with gambling addiction, but it is not clear that gambling addiction is a cost that would be covered by CBH. If it is covered, there is a possibility that treatment would be effective for most, but not all, recipients. Minnesota's comprehensive study on gambling treatment shows that recidivism occurs roughly 30 percent of the time and that treatment merely decreases gambling activity, unable to eliminate it. According to Grinols, treatment of pathological gamblers costs state agencies an average of $1,700 per year, with problem gambler costs $670 per year.

Casino Effects on Local Businesses and Labor Market
Casinos directly benefit those they do business with; but they can also draw customers from other businesses. Calvin Kent, Vice President of Business and Economic Research Marshall University said in a recent interview, "It makes a lot more sense if you're going to do gambling to put it in a depressed area." In Chester, Harrah's Casino has spawned modest business growth, as several proprietors filled a needed supply gap.

Casino construction and operation can, but does not necessarily, mean job creation and growth. Of the 16 regressions run in an Illinois study, only three municipalities showed a statistically significant increase in employment or decrease in unemployment. The same regressions indicated that for every job created, local businesses lost one or more jobs. Another study, conducted by the New York Times found that 27 out of 57 counties analyzed experienced a *net job loss.*

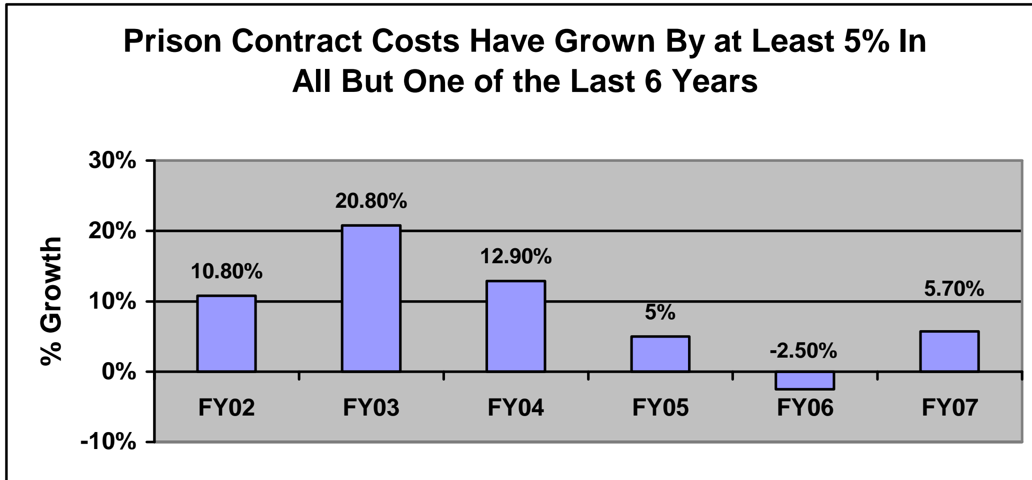
Casino Commitments to Offset Costs
While the potential costs of casinos are substantial, the City has secured an agreement with one of the operators – SugarHouse to help offset some of those costs. The casino's operators have agreed to pay for all infrastructure and security costs on the site. In addition, they have agreed to pay $1 million annually to a Special Services District to help cover costs for programs and improvements in the area surrounding the facility. The Administration is attempting to negotiate a similar agreement with Foxwoods. It is unlikely, however, that those agreements will be sufficient to offset all of the costs that new casinos will create for the City.

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

The Administration's previous plans have all proven to be overly optimistic in their projections for the growth in the prisons census and costs. It is likely that this Plan will continue that trend.

The Plan projects a 3.25 percent increase in the average daily inmate census to 9,138 in FY08, but 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. The projections for prisons contract costs also vary from recent history. Contract costs are estimated to have grown over eight percent in FY07, have grown by at least five percent in all but one year since FY02 and have grown by nearly 50 percent over the last five years. The initial plan, however, predicted contract costs would increase just two percent annually from FY09 through FY12. In response to PICA's concerns, the City raised its estimates to over four percent per year.

The City says that projecting a slower increase for prisons contract costs is reasonable because a new IT system and a newly hired medical contract administrator will help keep suppress the growth in obligations. The modified projections mitigated PICA Staff's reservations, but these projections still may be too low.



The rapid growth in the prisons census also has implications for personnel costs. From FY02 through FY07, Prisons' personnel costs grew by about 25 percent – more than twice as fast as personnel costs for the rest of City government. The Plan assumes that growth will continue for one more year as the City intends to add 100 prisons system employees in FY08 and personnel costs are budgeted to increase by 3.5 percent. After FY08, however, the Plan assumes no growth in personnel costs. Unfortunately, it is very unlikely that this forecast will turn out to be accurate.

As discussed above, the census increase has also led to rapid increases in contract costs particularly for the provision of healthcare services to inmates. In addition to being driven by the census, healthcare costs are driven by the nationwide surge in medical costs. In fact, the increase since FY97 in the healthcare cost per inmate –85 percent -- is not much different from the 79 percent increase in the cost for healthcare insurance for city workers. When that change is combined with the jump in the number of inmates, however, it boosts the increase in prisons healthcare costs to a staggering 187 percent in a decade.

While not as dramatic as the rise in healthcare costs, the costs for other contracted costs have also been driven up by escalation in the number of inmates. As City prison facilities have gotten more crowded, for example, the City has turned to non-city facilities to house inmates. In FY01, alternative housing contracts stood at $8.3 million. FY08's budgeted number is $17.9 million, a 115 percent increase. With no sign of a decreasing prison population, and no plan for new facilities, funding for alternative housing may consume a larger portion of aggregate funding in the Plan's out years.

Prisons Census Growth Control Measures

The Plan does propose some steps designed to slow the growth of the census including allocating $1.3 million for services for ex offenders and providing substance abuse treatment in lieu of incarceration for non-dangerous first offenders. While these measures could be successful, the Administration has repeatedly proposed prison population and cost control initiatives, but the population and costs have continued to soar.

Continuing Issues and Trends
As PICA wrote in its recent staff report, *City Budget Behind Bars: Increasing Prison Population Drives Rapidly Escalating Costs*, several trends have driven the increase in the prisons census, which has jumped 55 percent over the past ten years. Among the key contributors to the increase were:

- The number of inmates held for more than one offense increased 26 percent from FY95 to FY05
- The number of inmates held on bail has increased 135 percent over the same ten years
- Almost 70 percent of inmates currently in Philadelphia facilities serve the maximum sentence technically allowable for county prison
- In FY05, more than 25 percent of inmates' cases had five or more continuances.

Each of these factors complicates the timetable for release, leading prison population growth to outstrip both arrests and admissions. These factors also demonstrate that Prisons System officials can control the size of their census by themselves. Any successful effort will require collaboration among all of the agencies in the criminal justice system.

STATE AND FEDERAL FUNDING FOR THE DEPARTMENT OF HUMAN SERVICES

The Department of Human Services' spending increased by about $140 million from FY01 through FY07. That increase has been made possible, in large part, by increased reimbursements from the state and federal governments. Those reimbursements are projected to be over $100 million higher in FY07 than they were in FY01. The increased spending was largely for prevention programs designed to reduce the number of children who enter the dependency system.

In the initial FY08 budget, the City proposed another major expansion of its prevention programs, increasing DHS's budget by $85 million while increasing reimbursements for the department's costs by $75 million. The increase, however, was dramatically at odds with the spending level that had been certified by the Pennsylvania Department of Public Welfare (DPW). DPW certified expenditures that were over $80 million lower than the amounts the City projected.

During the budget process, the City moved $70 million in proposed DHS allocations from the general fund to the grants fund. By moving the appropriations to the grants

fund, the City ensured that the money would only spend that money if reimbursements were received. Even after the City moved those appropriations to the grants fund, however, the amount of revenue included in the FY08 budget was higher than the amount certified by the Commonwealth. The Administration, however, has pledged that if these reimbursements are not received, it will make over $19 million in cuts to the budget to offset the lost revenue. While the City has said that these cuts would have a negative impact, it has also said that they would be designed to have the least likely to threaten families most at risk for neglect and abuse. In addition, money added to the state budget for county child welfare programs could be given to Philadelphia.

While the added state money, pledge to cut programs if necessary and movement of appropriations to the grants funds mitigated the immediate threat to the Plan, there is still a possibility that attempts to contain state and federal spending will lead to cuts in funding streams on which the Department of Human Services relies. The federal government has already made substantial cuts in its DHS reimbursements. From FY05 to FY07, federal funding for DHS dropped by $150 million. Increases in state funding helped to compensate for the dramatic decline in federal funding, but additional reductions would put the City in the position of deciding either to increase City funding for these programs or to slash services.

REIMBURSEMENTS FOR THE PENNSYLVANIA CONVENTION CENTER

There have been substantial signs of progress in the potential construction of a new convention center. The state has included funding for the expansion in the FY08 budget and the City has included $15 million annually in the Plan beginning in FY10 to fund its commitment to an expanded center. The state funds for the expansion would be derived from the Gaming Economic Development and Tourism Fund and the City’s funds will come from the general fund.

Despite the progress, PICA has yet to see a financing plan for the expansion. PICA review and comment on such a plan is required by state statue as part of the expansion process. Until that financing plan and an agreement between the Commonwealth and the City are finalized, PICA staff will continue to view the expansion of the Center as a risk to the five-year Plan.

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Pennsylvania Intergovernmental
Cooperation Authority

STAFF REPORT
ON
FY2008-FY2012
FIVE-YEAR FINANCIAL PLAN

SECTION V:

TAX REVENUE PROJECTIONS

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OVERVIEW

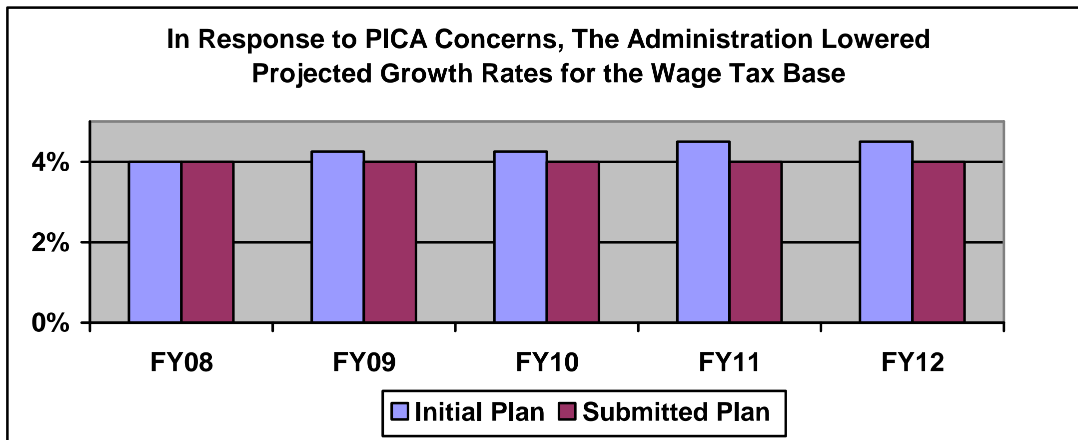
Taxes are by far the largest source of revenue for the City. As a result, the reasonableness of tax projections is perhaps the single most important item in determining whether a Plan is balanced. Overly aggressive tax projections substantially heighten the likelihood that the City will incur deficits. 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 maintains its dominant role in the City's finances, accounting for approximately 50 percent of tax revenues. The size of the wage tax makes the Plan's projections for its growth particularly important and the City has traditionally used appropriately conservative assumptions in formulating its wage tax projections. Over the last several years, however, the Administration has been using consistently more aggressive projections for the wage tax in its five-year plans.

This year's initial Plan used the most aggressive assumptions of any of the 16 plans that the City has submitted to PICA. Employee wages were predicted to grow four percent each year from FY08 through FY12, with employment unchanged in FY08, growing .25 percent in FY09 and FY10 and .5 percent in FY11 and FY12. This meant the wage tax base was projected to grow by four percent in FY08. 4.25 percent in FY09 and FY10 and 4.5 percent in FY11 and FY12.

In response to PICA's concerns that the projections were too aggressive, the City reduced its estimates for base growth to no more than four percent per year. While there are years, like FY07, that will have growth in excess of four percent, there will invariably be years when growth is under four percent. In fact, over the last five years, the wage tax base grew by more than four percent twice, at four percent once and below four percent twice. Projected growth of over four percent would increase the likelihood that the City would fall short of its projections, which, in turn, would make it more likely that the City would incur deficits.

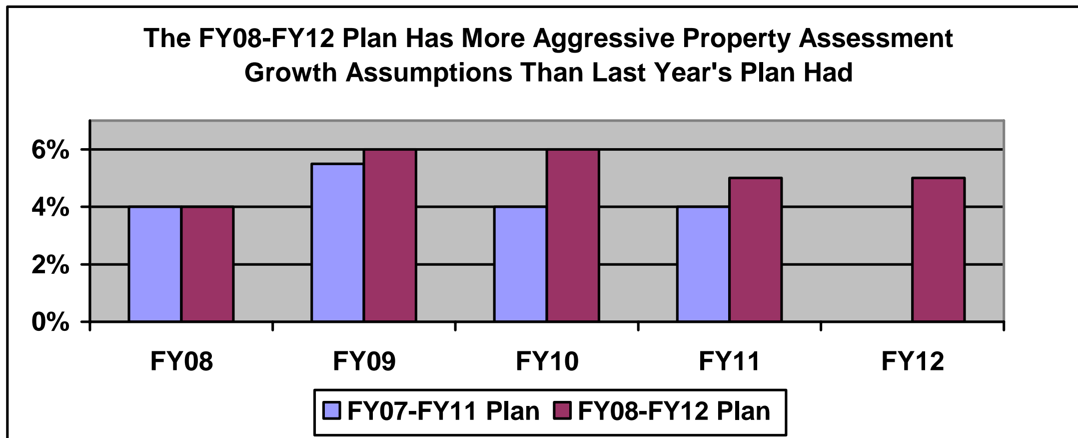


While PICA would view projected base growth of over four percent as being overly aggressive, strong collections allowed the City to increase its estimate for FY07 by $10 million.

PROPERTY TAX

Overview
Despite recent evidence of a slowdown in the housing market at the regional level, the FY08-FY12 Plan incorporates aggressive growth rates for real estate tax collections. While lower collections led the Administration to reduce FY07's estimates, the Plan maintains elevated estimates beginning in FY08. These aggressive growth projections increase the likelihood that revenues will fall short of the City's projections in the Plan's later years.

In the Plan, despite the slowdown in the real estate market, the Administration projects faster growth in assessments than it did in the FY07-FY11 Plan. In last year's Plan, projected assessment growth averaged 4.5 percent. In this year's Plan that average growth has been bumped up to 5.2 percent. While some of the projected increase is likely the result of the end of some abatements and the City's expecting more accurate assessments after the implementation of the Board of Revision of Taxes' full valuation project, it still appears to moving in the opposite direction from the market.



Market Conditions
There are clear signs that the property market in Philadelphia has been weakening. The inventory of properties for sale has been increasing as the number of homes sold has decreased even while prices have continued to trend upwards. The average monthly inventory increased 43 percent in calendar 2006 while through May year-to-date home sales had decreased by 4.5 percent and by 20 percent from 2005's level. At the same, year-to-date prices had increased 4.2 percent over calendar year 2006's level. The weakening of the market is also evident in real estate transfer tax collections, which fell about seven percent in FY07.

Even the Center City market showed some weakening as prices decreased 2.8 percent in 2006, monthly inventory jumped by more than 60 percent, and sellers experienced a 38 percent increase in time to sale. As the market begins to balance between buyers and sellers, prices across the country continue to slow their ascent.

Impact of Full Value Assessment
Efforts to move the City toward full value assessment and equalization may further constrain proposed real estate tax collection growth. As detailed in the PICA issue paper entitled "From Virtual Reality to Full Reality: Preparing for Reassessment," PICA Staff considers the full value assessment/equalization project vital to a transparent and equitable tax structure. As discussed in the paper, however, even if the change is revenue neutral for the City, some taxpayer will see large increases in their bills. In order to avoid creating sticker shock for some taxpayers, the City has been working with the State to craft legislation that would smooth the transition from the current fractional value system. While the eventual legislation to ease the transition to a new assessment methodology will likely provide a long-term benefit to the City, it will also likely limit the growth in individual taxpayers' bill, which, in turn, will depress the overall growth in the City's real estate tax revenues. By limiting the growth in the City's tax collections, the legislation will make it more likely that the City will not match the projections shown in the Plan.

BUSINESS PRIVILEGE TAX

The growth in the base for the business privilege tax follows the regional business cycle, making collections difficult to project. Because of its inherent volatility (over the past four years, actual growth vacillated between -3.3 percent and 22.7 percent), BPT projections in previous plans have been appropriately cautious.

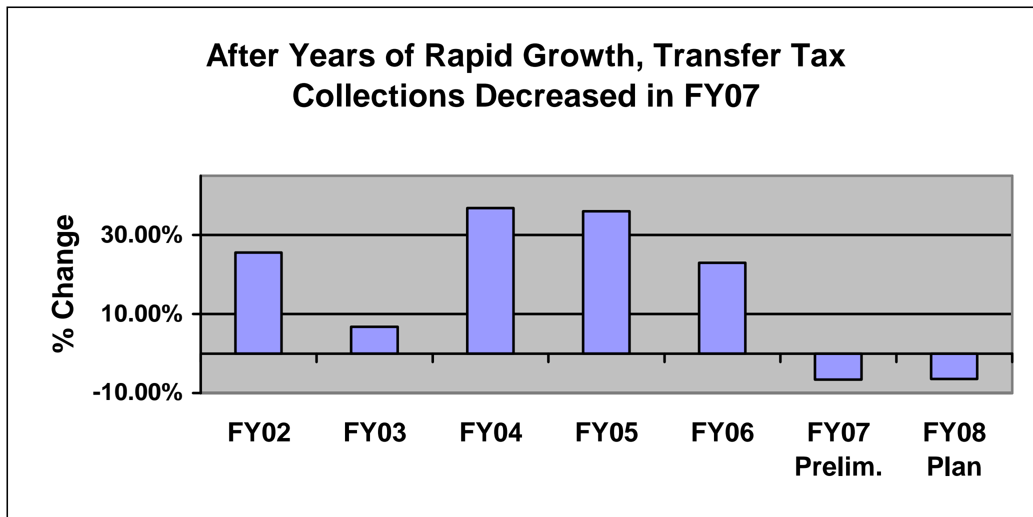
For the last several years business privilege taxes have reached historic highs and, as a result, have outpaced the Plan's projections. In FY06, the City collected $415.5 million—more than $27 million over the previous Plan's expectations and $36 million more than had been collected in any previous year. Again in FY07, strong collections allowed the City to add $15 million to its estimates based. The strength of collections over the last several years makes it appear reasonable to assume that the Plan will meet the projected four percent annual growth rate for gross receipts and two percent growth in the net income base in FY08 and four percent annually thereafter.

The Plan's BPT projections are not without risk. Given the cyclicality of BPT collections, and the base's susceptibility to a potential regional economic slowdown, there is a real possibility that there could again be years during which collections actually decrease.

REAL ESTATE TRANSFER TAX

After years of astronomical growth, real estate transfer tax collections returned to earth in FY07. From FY01 through FY06, collections increased from $80 million to $236 million – an increase of over 200 percent. Collections grew by at least 20 percent each from FY04 through FY06. Without the rapid growth in transfer tax collections, the City likely would have faced the prospect of making painful cuts in key services to pay rapidly increasing pensions, health benefits, debt service and prisons costs.

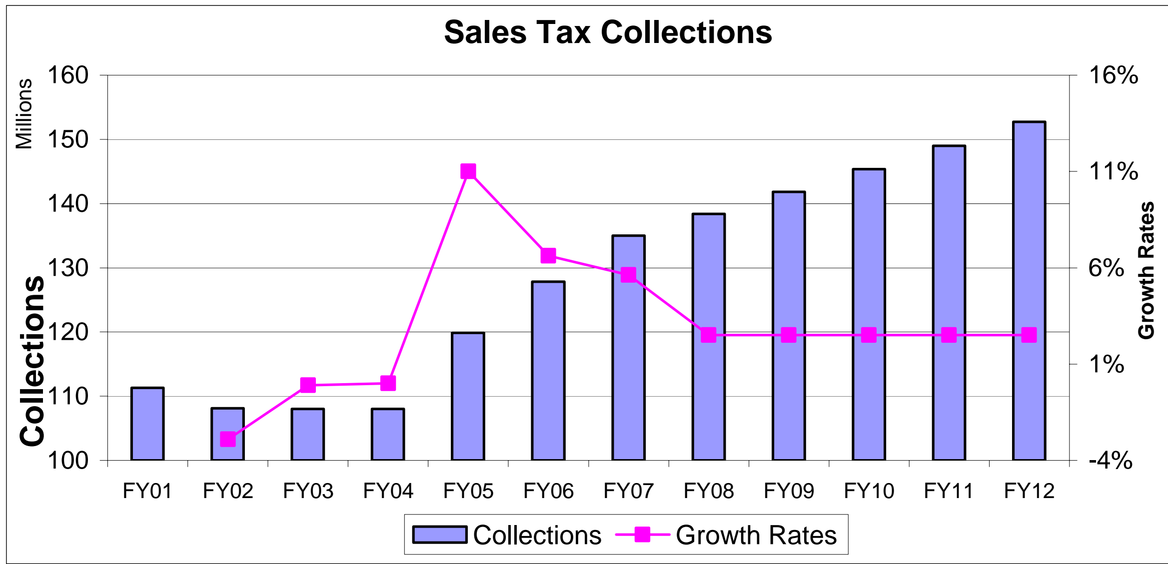
In FY07, the rapid growth in collections stopped. Collections dropped by about seven percent to $219 million. The Plan anticipated that cooling off and projects another drop – to $205 million in FY08. By using conservative projections and anticipating that transfer tax collections would decline, the City was able to avoid missing it estimate for FY07 In addition, the Plan projects that collections will remain unchanged at $205 million in FY09 and then increase by about 2.5 percent annually as the housing market cools.



The Plan's relatively conservative projections make it unlikely that the City will fall short of its projections. It is unlikely, however, that transfer tax collections will provide the type of cushion that they provided in the last several years when actual growth far exceeded amounts that the City could have reasonably projected. As a result, the slowing of transfer tax collections growth makes it even more important that the City develops strategies for controlling its fastest growing 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 and 5.6 percent in FY07. The Plan projects that the sales tax will grow 2.5 percent annually through FY12. Given the rate of growth in the tax over the last several years, it is reasonable to assume that the City will at least meet the Plan's collections projections.



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Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2008-FY2012 FIVE-YEAR FINANCIAL PLAN

SECTION VI:

THE FINANCIAL SITUATION FACING THE NEXT MAYOR, CITY COUNCIL AND THEIR SUCCESSORS

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OVERVIEW

The best way to understand the financial condition facing the next mayor and his successors is to compare the City to a family. If the City were a family, that family would be one that had saved some money, but was spending it very quickly. At the same time, the family would have taken out a second mortgage and be overextended on its credit cards. Despite having that second mortgage, the family would ignore the guidance of its financial advisors and would not have made necessary repairs to its house and the house would need a roof, a new paint job and repairs to its major utilities. In addition to having not invested in its house, the family would not have planned sufficiently for its retirement and the costs for its medical insurance, second mortgage and retirement would threaten to not only swallow all of the family's savings, but would have forced the family to spend less on things like an alarm system, a vacuum cleaner and books for the kids.

The City is much like that family because, while it has a positive fund balance, it projects that the fund balance will drop quickly over the next five years. In addition, the City has seen its fixed costs soar, has not invested in its infrastructure, has an enormous unfunded pension liability and has rapidly increasing health benefits costs.

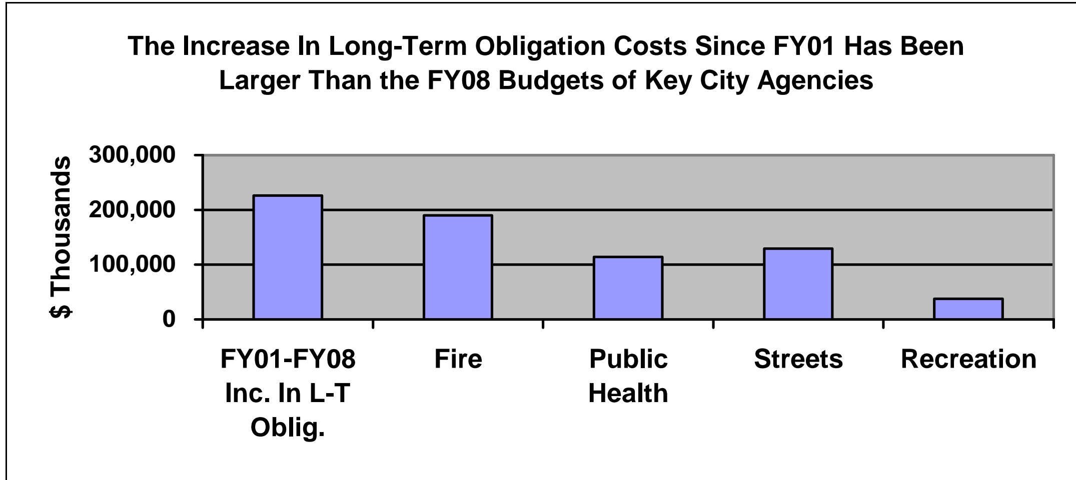
The rest of this section will review the details of how the City is like the family described above. [1]

LONG-TERM OBLIGATIONS

When the City's long-term obligations increase, it means that its financial flexibility decreases. Like the family with the second mortgage, the City has to put more and more of its money into fixed costs and, as a result, has less money for everything else. Unfortunately, the City has seen rapid growth in its fixed costs – things like debt service payments on its borrowings and its unfunded pension liability

In FY01, long-term obligations accounted for about 13 cents out of every dollar the City spent. In FY08, those obligations are budgeted to account for 16 cents out of every dollar spent. The increase of three cents per dollar may not seem like a lot, but that increase has meant that in FY08 the City will spend $260 million more on fixed costs than it did in FY01. That means that the increase in the annual cost of long-term obligations will be more than the combined amount the City spends on the Fire Department, the Free Library and the Fairmount Park Commission.

[1] All of the PICA reports mentioned in this section can be found on the PICA website at www.picapa.org



In part the rapid increase in debt service was the result of unprecedented borrowing for non-city owned facilities. In particular, three borrowings have added to the City's burden – the borrowing to help finance the construction of the Eagles and Phillies stadiums, the borrowing for the Neighborhood Transformation Initiative and the borrowing for the investment in commercial and cultural corridors. The combined debt service on those three issues will be over $65 million annually until FY27 and over $55 million until FY31.

In January 2006, PICA released an issues paper titled "Reversing the Trend of Doing Too Little With Too Much: Maintaining the City's Infrastructure While Reducing Its Dangerously High Debt Load." In the report, PICA said the City's long-term obligations had grown much more quickly than its revenues and were putting an increasing burden on the City's general fund. Since the release of the report, the City's long-term obligations have grown, making the task confronting the next mayor even more daunting.

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. In addition, rating agencies use the existence and structure of a rainy day fund in deciding cities' bond ratings. By establishing a fund, the City could 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.

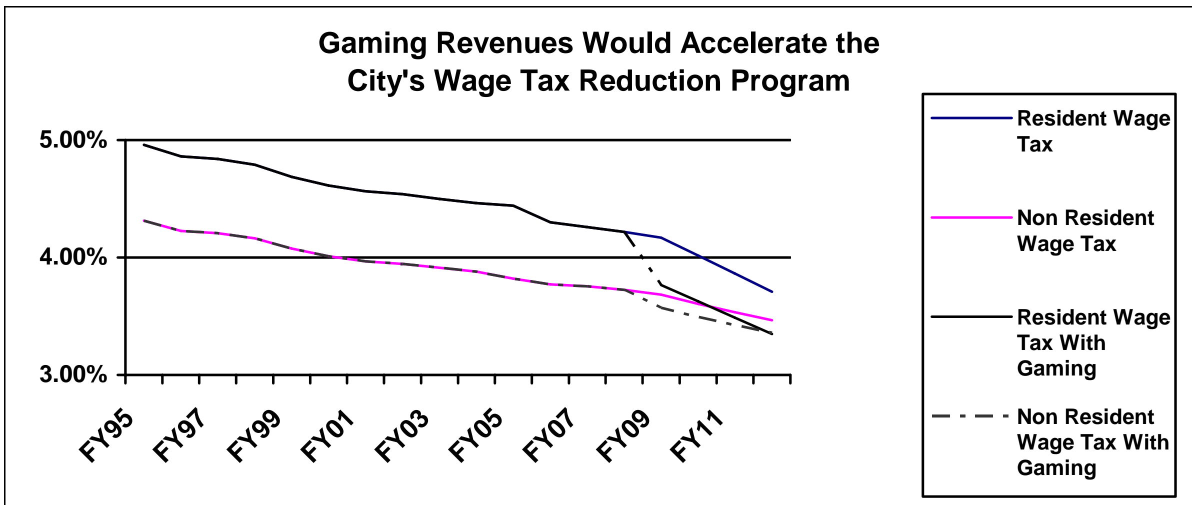
While there is no specific mention of the fund in the Plan, the City has reached a tentative agreement with representatives of City Council on the creation of a fund.

THE CITY'S TAX STRUCTURE

Philadelphia's uncompetitive tax structure remains an impediment toward growth. A number of studies have shown that the wage tax and the gross receipts portion of the business privilege tax have consistently driven away businesses. In order to attack that problem, the City has reduced both its wage tax rates and its gross receipts tax rates each year since FY96. While the Plan includes wage tax cuts in each of its years, it proposes ending the reductions in the gross receipts portion of the business privilege tax after FY09.

Ending the reductions in the BPT rates will hurt the City's competitiveness while only saving the Plan about $12 million. Ending these reductions will undoubtedly send a damaging message to both businesses that are already in Philadelphia and those that are considering relocating to Philadelphia.

While halting the business privilege tax reductions will hurt the City's competitiveness, gaming money will be used to accelerate the City's wage tax reduction program and, as a result, help the City's competitiveness. Even without gaming revenue, the Plan calls for reducing the wage tax rate to 3.7094 percent for residents and 3.469 percent for nonresidents in FY12. Wage tax rates were 4.96 percent for residents and 4.3125 percent for nonresidents when the tax reduction program began and are at 4.219 percent for residents and 3.7242 percent for nonresidents in FY08. With the gaming revenue, those rates would fall to 3.3501 percent for resident and 3.3591 percent for nonresidents in FY12. The changes will mean that the City's largest tax will have fallen 32.5 percent for residents and 22 percent for nonresidents.

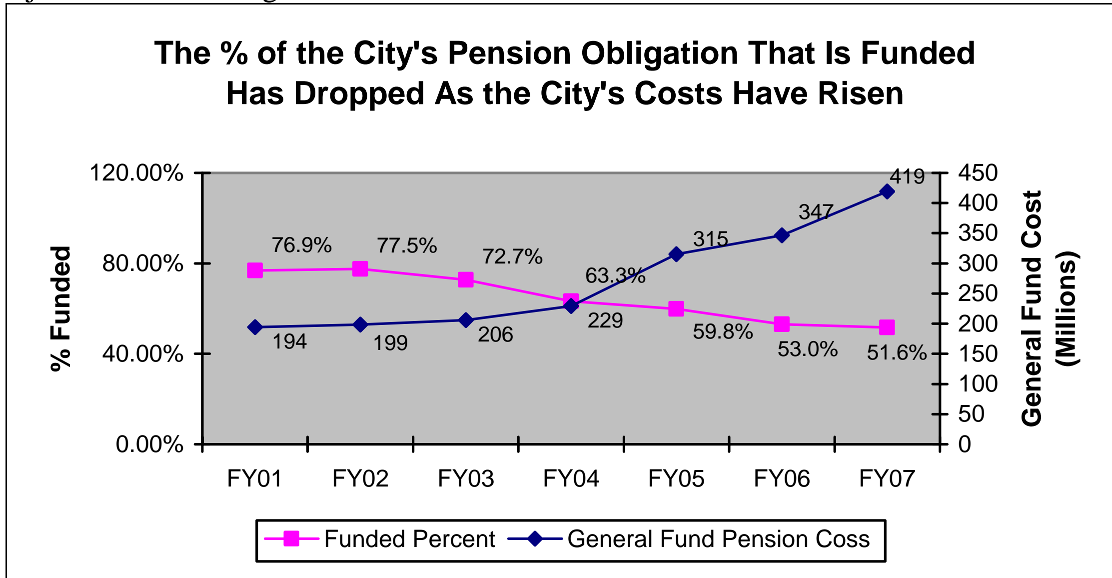


Even with the reductions that the City has made, Philadelphia's tax burden is higher than the burdens in other large cities. An analysis down by the Chief Financial Officer of Washington D.C. compared tax burdens in the largest cities in each state. When compared to the 12 largest cities by population in that study, Philadelphia ranks at the bottom on total tax competitiveness.

UNFUNDED PENSION LIABILITY

The two most sobering numbers in the City's latest actuarial report are 51.6 and $3.9 billion. The first number, 51.6, is the percent of the City's accrued pension liability that is funded. The second, $3.9 billion, is the dollar amount of the City's unfunded pension liability. The City's budget contains its own sobering number -- $242 million, which is the amount by which the City's annual pension costs have increased from FY01 through the FY08 budget.

As the following table shows, those numbers deteriorated quickly. The City's funded percent has decreased from almost 80 percent in FY01 as its costs have grown rapidly from under $200 million. The increase has been far faster than the increase in any other major area of the budget.



The increase in costs has been caused by a number of factors including:

- a decrease in the fund's earnings caused largely by a weak stock market early in this decade. Since the earnings are used help pay for pension costs, when they decline, the general fund must increase its contributions to pay for those costs;

- employees are retiring earlier. When employees retire earlier, they receive benefits longer, increasing the pension fund's costs; and

- retirees are living longer, which means that they receive benefits longer.

As the City's pension costs soared, the City was required to shift funding from other areas of the budget to cover its pension costs. In order to prevent that shift from being

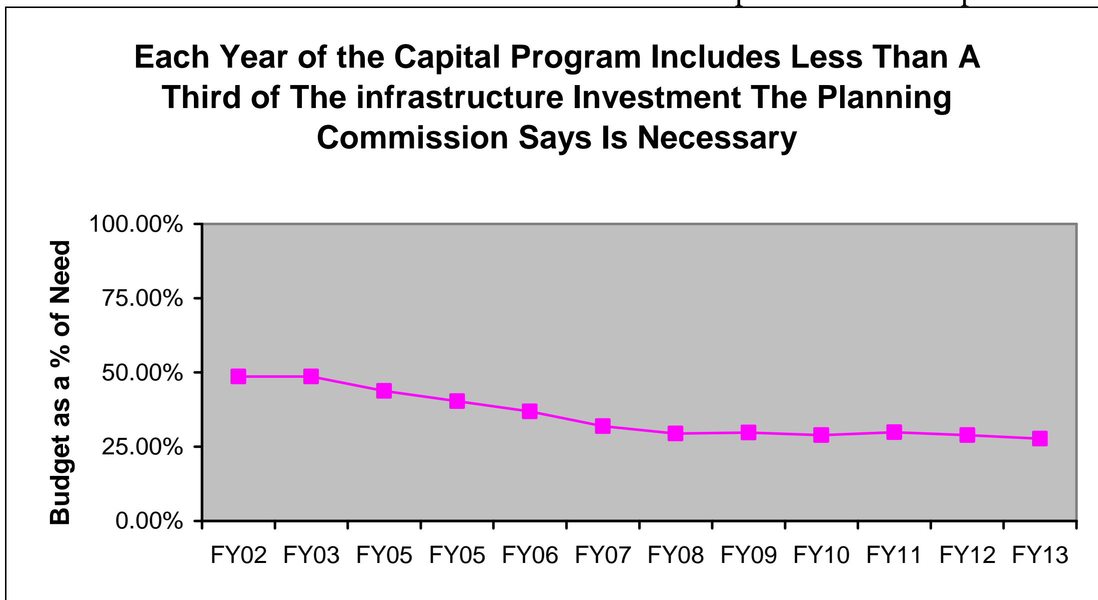
too dramatic and forcing draconian cuts to the budget, the City shifted its pension funding approach to paying the minimum allowed under state law. While that shift allowed the City to avoid making deep cuts, it was an important contributor to the sharp fall off if the City's funding percent.

Despite the combination of increasing costs and a decreasing funded percent, the Plan contains no suggestions for how to control the pension fund's costs or increase its funded percent. In fact, the Plan eliminates the City's commitment to explore PICA's recommendations for restructuring pension fund benefits. Those recommendations included increasing the minimum retirement age, decreasing the benefit multiplier, increasing the period to determine average final compensation and increasing the employee contribution.

It is crucial that the City begin to take steps to both control the cost of its pension fund and to improve that fund's health. Exploring the recommendations included in the PICA report would be an important first step in that process.

LACK OF INVESTMENT IN THE CITY'S INFRASTRUCTURE

The City has consistently under invested in its infrastructure. An analysis by the City Planning Commission in 2001 found that the City needed to invest $185 million annually to keep its infrastructure in good condition. The City, however, has invested less than half of that amount in each year since FY02 and the FY08-FY13 capital program – with an average of $53.8 million per year of new loans invested in the city's facilities – includes less than a third of the $185 million. Eventually, the City will either have to close facilities or invest substantial amounts in them to keep them safe and operable.



Because of the lack of adequate investment in the city's infrastructure, PICA decided to fund an assessment of each of the facilities in the Prisons System, City Hall and the Police, Fire and Health Departments. The goal of the project is to assess the physical

condition of the facilities in order to provide the City with a working tool that will allow it to prioritize and allocate adequate capital funding. Through the project, the City will also receive an appropriate ongoing maintenance schedule for the facilities covered by the project and an IT system to allow the City to track the condition of its infrastructure. The project is scheduled to be completed this fall.

While it is clear that the City needs to invest more in its infrastructure, it is also clear that the City's level of fixed costs constrains its ability to borrow money to fund that investment. One way in which the City could increase its infrastructure investment without incurring more debt is to use operating funds to pay for capital expenditures. City Council attempted to move the City towards pay-as-you-go funding for the City's capital costs by enacting legislation to transfer $30 million from the general fund to the capital fund in FY07 to pay for badly needed improvements for police, fire and recreation facilities. The legislation was enacted over the Mayor's veto, but the Administration did not spend any of the $30 million in FY07. The Administration did, however, include that $30 million in the FY08 capital budget, but the Administration has again said that it will not spend that money. In addition, the Law Department has said that City Council did not have the authority to transfer money from the general operating fund to the general capital fund and the City moved the money back into the operating fund. By refusing to spend the $30 million, the Administration missed an opportunity to improve facilities without increasing its fixed costs.

Request for PICA Funds

The Plan recommends utilizing $40.6 million of PICA funding to devote to capital projects. The $40.6 million is a combination of funds from PICA borrowings and interest earned on those funds. The requested projects are:

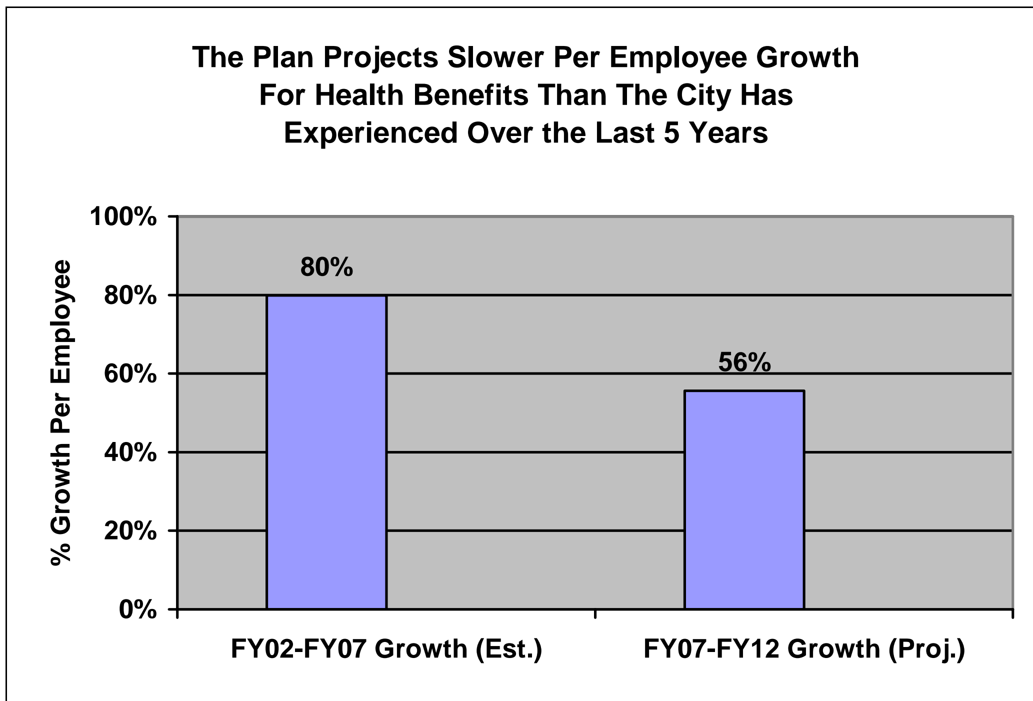
- $9 million in Central Library renovations;
- $5 million for improvements in Fire Department facilities
- $11.02 million for a new certified juvenile detention center
- $2.02 million for an emergency standby power project
- $13.5 million for improvements in Police Department facilities

Because many of the departments' facilities are part of the PICA funded assessment project, no decision has been made regarding the utilization of PICA funds.

EMPLOYEE HEALTHCARE INSURANCE COSTS

The health benefits line has the largest projected increase of any budget area over the life of the Plan, but that budget may not be enough to cover the City's health insurance costs. The Plan projects that health benefits will cost more than half a billion dollars in FY12 – 55 percent more than they are estimated to cost in FY07. Despite that large projected increase, benefits costs are likely to exceed the amounts included in the Plan unless the City implements healthcare cost containment initiatives and is successful in arbitration awards and collective bargaining negotiations.

While the projected increase in health benefits is large, it is not as large as the increase the City has seen over the last five years. From FY02 through FY07, healthcare costs grew just over 75 percent even while the number of employees dropped 2.5 percent. On a per-employee basis, healthcare costs grew 80 percent. The Plan's projected 55 percent increase is coupled with a projection that the number of employees will remain relatively stable, meaning that the per-employee cost is also about 55 percent.



In part benefits increased quickly because of awards given to police and firefighters by arbitration panels. The City's ability to reach the Plan's projections relies in large on its ability to convince those panels that changes are necessary to the City's healthcare plans. The City has had mixed success with arbitration panels and is still appealing the latest police and fire awards, which date back to FY06.

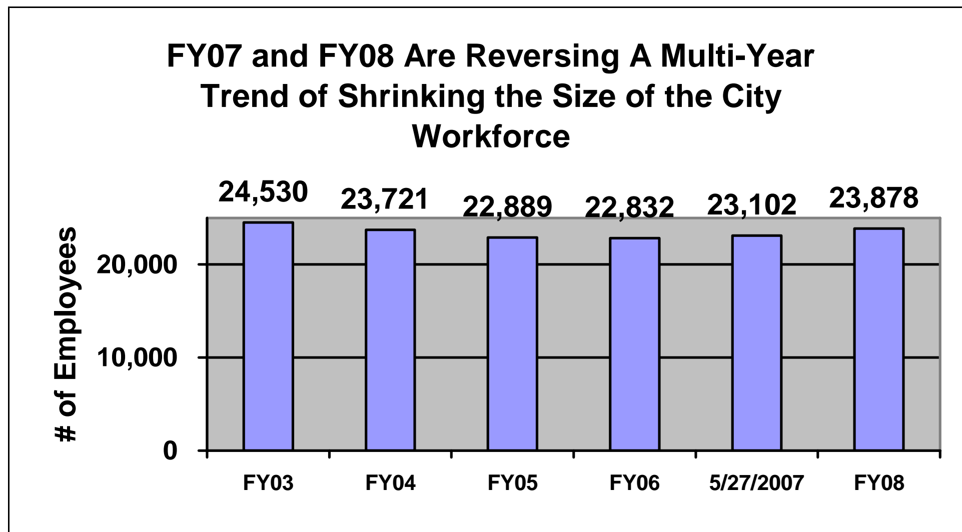
The risk to the Plan is not limited to arbitration awards. The City has to yet to negotiate healthcare costs for its non-uniform employees dating back to FY07, which means that the Plan has uncertainty not only for FY08 through FY12, but also for FY06 for

uniformed employees and for FY07 for uniformed and nonuniformed employees. As a result, the Plan has seven years of labor cost uncertainty.

REDUCING THE SIZE OF THE WORKFORCE

With healthcare, pension, and wage costs ballooning in recent years, the number of Philadelphia employees remains a pressing concern. Wages and benefits consume about 60 percent of the City's budget. As prisons, pensions, healthcare and debt service costs continue to grow faster than the City's revenues, the Administration determined that the only way it could reduce it costs and maintain a positive fund balance was to reduce the number of employees. From FY00 through FY06, the City managed to shrink its workforce by 7.5 percent.

The Plan, however, reverses the trend of shrinking the workforce. The Plan includes over 750 more employees in FY08 than the general fund had at the end of May 2007. Among the largest budgeted increases are 100 correctional officers for the Prisons System, 59 new employees in DHS and 100 new police officers. The Plan, however, does also include the elimination of 63 police officer positions in FY09 when the Pennsylvania State Police are scheduled to have taken full responsibility for patrolling state highways within the City's borders.



While the increases in staffing are designed to meet increased demands for service, they also create recurring costs for the City that will make it more difficult to balance the five-year plan.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2008-FY2012 FIVE-YEAR FINANCIAL PLAN

SECTION VII:

A TALE OF FIVE CITIES: CONTRASTING MUNICIPAL MANAGEMENT OF LONG-TERM FISCAL CONCERNS

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New York City

During the past year of continued economic expansion, New York managed another large budgetary surplus, almost $4.4 billion. Buoyed by a bullish commercial real estate market and gains on Wall Street, the City plans to continue last year's policy of "improving its financial position", while again avoiding recurring expenditures. According to this maxim, the surplus is mostly earmarked for one time enhancements. The budget does include some increased spending, almost entirely covered by projected recurring revenue increases.

The budget will use $2 billion of the surplus to help balance FY08, and nearly another $2 billion to narrow a projected gap in FY09. Continuing the city's efforts to strengthen its pension fund, the budget also makes a $500 million contribution from the surplus to the Retiree Health Benefit Trust Fund, established last year. In addition, $750 million will go towards a one time property tax reduction.

The Mayor plans to increase spending seven percent in FY07, and an additional six percent in FY08. Included in these increases is $2.2 billion in education expenditures, which offset a reduction in state funding, for a net increase in total education funding. While this increase appears to conflict with the City's goal of "limiting recurring expenditures," revenue is set to increase by an equal amount, as previously imposed property tax increases take effect over the next three years.

Even with Mayor Bloomberg's comprehensive financial plan, the Mayor points out that the City must overcome large obstacles in the later years of its four year plan. The plan projects a $1.6 billion budget gap in FY09, and a $4.3 billion gap in FY10. To make matters worse, several bond issues are scheduled for FY08. Debt service will rise 34 percent by FY11, while the City's debt burden as a share of revenue is slated to increase three percent. However, City officials are confident this increase is manageable.

Standard and Poor's appears to agree with the Mayor's assessment as it upgraded the city's General Obligation bond rating to AA-minus in May. The agency said the rating was a result of the "New York's intelligent financial management." According to Standard and Poor's, New York has consistently taken a "cautious approach to the deposit of revenue variance…treating it as essentially non-recurring revenue growth", combined with consistently sound fiscal policy. The City's financial watchdog, the Citizens Budget Commission, has also said the scheduled debt is well within New York's ability to pay.

San Diego

In a far different position from New York, San Diego is still attempting to regain both public trust and financial solvency after its recent fiscal crisis. This year the City instituted a five year plan, after acknowledging that previous budgets provided very little long term planning for infrastructure improvements, employee benefits, or long term debt obligations.

San Diego continues to make better financial decisions, building on transparency and ethics gains spurred last year. The City made good on all of last year's budget items—including increased funding for police, fire, the budget stabilization fund, and some deferred infrastructure maintenance—and projects to finish the year under-budget. The City also delivered on both its pension (which had precipitated its fiscal crisis) and employee benefit obligations in FY06, as dictated by its actuary.

In its five year plan, the City includes no new programs or spending, no restoration of cut programs, and no assumed new revenues save for natural economic expansion. The plan, does, however, include policies intended to get the City on track:

- The pension fund is just under 80 percent funded. Over the next five years, San Diego plans to add an additional $30M per year over its actuary's recommendation to help amortize the unfunded liability.
- In order to stave off a potential crisis, the City has also taken the first steps toward funding its employee's health care fund. The City provides employees who vest healthcare for life and, under new accounting regulations, must show its liability for those benefits in its financial statements. As of 2006, that liability equaled $978 million, but the City has proposed a plan to have the liability fully funded by FY12.
- The plan includes just under $300 million to help address a $900 million deferred infrastructure investment problem. About half of the $300 million will come from the City's operating funds.

Boston

Continuing economic stagnation and increases in health and personnel costs forced Boston to draw down its reserves by $25 million to balance its FY08 budget. However, the City's proactive and continuous investment in its infrastructure, and its debt management policies have helped it address long-term issues that have threatened the finances of other large cities. In March, S&P upgraded Boston's GO debt to AA+, signaling confidence in the City's financial outlook. The City does, however, have a number of fiscal challenges.

Like Philadelphia, Boston is heavily reliant on one tax. Unlike Philadelphia, Boston is reliant on the property tax, which makes it particularly susceptible to swings in the real estate market. Perhaps more importantly, a state cap of 2.5 percent growth in millage rates limits Boston's ability to generate revenue at a time when personnel, health, and fixed costs are all growing at rates well in excess of inflation. As a way to diversify its tax base, Boston plans to close loopholes in the telecommunications tax and institute a local option meals tax.

Detroit

Detroit has an FY08 budget that proposes to eliminate an accumulated deficit and produce a surplus. After losing its investment grade bond rating, the City of Detroit embarked on a plan of systematic personnel, pay, and benefit cuts in order to get its finances under control. Included in this year's budget are $27 million in wage givebacks and a $95 million reduction in healthcare costs, but no further job cuts. Despite a 39 percent workforce reduction over the past two years, the City plans to make improvements in municipal services in transit and indigent medical care. The budget also has allotted funds for 144 additional police officers, a net increase over eliminated positions. Last year, Detroit moved from a millage based system to a fee based residential waste collection system, and will implement a similar system for commercial waste starting this year.

The budget is not without risk. For example, the Mayor plans to lease the Detroit-Windsor tunnel for $75 million, with most of the proceeds going to pay for operating costs. The Mayor has also floated the idea of a $1 billion bond issue for neighborhood improvements. Further, the City plans to open three Casinos within the city limits this year, hoping that additional revenue will help to balance the budget without producing costs that will offset those revenues.

Detroit again boasts an investment grade for its bonds, but the City still faces an array of fiscal challenges. The City's pension fund, for example, has a $1.7 billion unfunded liability.

San Francisco

San Francisco differs from Philadelphia in that state law does not require it to balance its plan in the out years. As a result, the City currently plans two consecutive years of deficits. The plan incorporates last year's surplus to help close the gap, yet still comes up short by $24 million in FY08 and $84 million in FY09, compared with $1.7 billion in total tax revenue. A restructuring of property taxes for state programs administered in the City resulted in $300 million in foregone revenue, while benefits and other personnel related costs continue to rise.

As with other large cities, San Francisco's retiree health benefits present a looming liability. The total unfunded liability is estimated to be almost $5 billion and the City has been forced to dedicate increasing portions of its general fund to paying off that liability. This year, the Mayor has allocated funds to establish a trust, while voters approved a Charter measure to lower the City's contributions to retirement benefits. Both of these measures will help in the long run, but even making annual actuarial payments will only reduce the liability to $3 billion by 2030.

Though the City has substantial challenges, a regional economic recovery and cost savings from improved operations allowed San Francisco to again make a contribution to its budget stabilization fund. Ordinarily the City would draw down its fund to help

eliminate the deficits, yet the fund's structure prevents withdrawals during times of increasing revenue.

Pennsylvania Intergovernmental Cooperation Authority

STAFF REPORT ON FY2008-FY2012 FIVE-YEAR FINANCIAL PLAN

SECTION VIII:

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%) 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

<u>Staff Report</u> - The Plan was submitted to PICA by the Mayor on July 18, 2007 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 22, 2007 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 July 25, 2007.

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.

<u>Relationship to Future Plan Revisions</u> - 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 22, 2008 (100 days prior to the end of FY2008). At that time, the City is required to add its Fiscal Year 2013 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 $1,186 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	516,210
Retirement of Certain High Interest City Debt	381,300
TOTAL	**$1,186,510**

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 2008. 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 FY2007 is

August 15, 2007. Quarterly reporting deadlines for FY2008 are November 15, 2007, February 15, 2008, May 15, 2008 and August 15, 2008. 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 FY2007 is the report due July 20, 2007. For FY2008, the reporting dates are October 22, 2007, January 21, 2008, April 21, 2008 and July 21, 2008. 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 FY2008 are August 1, 2007, November 1, 2007, January 31, 2008 and May 1, 2008.