

ISSUER/OBLIGOR: Philadelphia, PA, Pennsylvania  
ISSUE CREDIT RATING: BBB/STABLE(SPUR)  
CATEGORY: Tax Secured  
SECURITY: General Obligation

Rationale

Standard & Poor's Ratings Services assigned its 'BBB' rating to Philadelphia, Pa.'s series 2007 GO bonds. In addition, Standard & Poor's affirmed its 'BBB' long-term ratings and 'BBB' underlying ratings (SPURs) on the city parity debt.

The 'BBB' rating reflects the following weaknesses:

- The city's operating results have been historically erratic, although financial position has improved over the past two years.
- The city continues to face cost increases related to health care and pensions, which coupled with expiring union contracts and expected continued tax rate cuts, will pressure future financial operations.
- There are continuing long-standing fiscal problems at the Philadelphia School District and Philadelphia Gas Works (PGW), which could cause the city operating stress.
- Overall net debt burden is high, largely because of significant deficit financing related to fiscal distress during the early 1990s, a significant neighborhood revitalization program, and the issuance of general-fund-supported debt to finance the construction of two new stadiums.

Debt levels are even higher when pension obligation bonds, issued in 1999 to partially extinguish the city's unfunded pension liability, are factored in.

Also reflected in the rating are the following credit strengths:

- Continued fiscal oversight provided by the Pennsylvania Intergovernmental Cooperation Authority (PICA); and
- The city's location in the center of a diverse regional economy that, despite the addition of several notable development projects, has experienced only modest growth over the past several years.

The Philadelphia regional economy is highly diversified, with an emphasis on health care services, pharmaceutical manufacturing, education services, and tourism. However, out-migration from the city to the suburbs, relatively high business costs, a large number of poorly educated workers who live in Philadelphia, and high tax rates have served to constrain economic growth.

In an effort to stimulate growth, the city has, since 1995, cut wage and business privilege tax rates 13% and 27% respectively, and expects to continue to do so through 2012 (an additional 6% and 3%, respectively). However, the combination of these cuts and expected 11% decline in real estate transfer taxes are expected to limit future budgetary resources and flexibility.

Better-than-projected growth in wage, business privilege, and real estate transfer taxes have enabled the city to post positive financial operations over the past two years. On a GAAP basis, Philadelphia's unaudited unreserved general fund balance at fiscal-year-end 2007 was \$153 million (4% of expenditures), up from \$111 million the previous year and negative (\$36) million at fiscal-year-end 2005. On a legally enacted basis, which includes unearned business privilege tax receipts, the city had a \$295 million balance.

The adopted 2008 budget, net of adjustments, calls for a \$87 million draw down of reserves. Year-to-date fiscal 2008 operations project an \$49 million operating deficit, better than originally budgeted. However, there is some uncertainty associated with the city's five-year financial plan (2008-2012), which incorporates \$125 million of operating deficits and does not include provision for wage increases beyond 2008, when the current contract expires.

The five-year plan also incorporates revenue in 2009 from casino's that have yet to be sited or constructed, (and are now not expected to be completed until mid-2010), and the repayment of a \$43 million loan by the financially challenged PGW--half in 2008 and half in fiscal 2009. However, the plan does include provision for increasing minimum municipal obligation pension payments, (that have increased from \$146 million in 2003 to \$436 million in 2008 and are expected to rise modestly through 2012 as the city progresses from the current 53% to 92% by 2025) and rising health care costs.

Standard & Poor's considers Philadelphia's management practices "strong" under its Financial Management Assessment methodology, indicating that practices are strong, well embedded, and likely sustainable. Concern over Philadelphia's financial condition is mitigated, to a degree, by the oversight provided by PICA, which requires the city to submit five-year financial plans. This, in turn, has resulted in a level of budgetary discipline and strong financial reporting. Nevertheless, the city's financial condition remains tenuous and will continue to be challenged by weak demographic trends, uneven revenue growth, policies of tax reductions to spur economic expansion, and items in the out-years of the financial plan that are not fully within the city's control.

The bonds are being issued for refunding purposes and roughly \$17 million of present value savings are being taken over the next five years to achieve budgetary relief. Overall net debt burden is high at \$4,952 per capita and roughly 18% of market value, especially high, given household effective buying income at about 75% of the national average. Debt levels increased considerably in recent years because of debt issued for pension funding, urban renewal, and construction of two

sports stadiums. Carrying charges, inclusive of pension debt and debt secured by service agreements, are roughly 5% of general fund expenditures.

The ratings on the city's outstanding parity obligations have been affirmed.

Philadelphia has been assigned a Standard & Poor's Debt Derivative Profile overall score of '2' on a scale of '1' to '4', with '1' representing the lowest risk and '4' the highest. The overall score of '2' reflects Standard & Poor's view that Philadelphia's general fund-related swap portfolio represents a neutral credit risk at this time.

#### Outlook

The stable outlook reflects the combination of oversight from PICA and the expectation of continued prudent financial management, ensuring that future budgetary growth is appropriately matched to revenues. Should balances suffer substantive additional weakening, the rating could come under pressure.

Complete ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at [www.ratingsdirect.com](http://www.ratingsdirect.com). All ratings affected by this rating action can be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com); under Credit Ratings in the left navigation bar, select Find a Rating, then Credit Ratings Search.

Primary Credit Analyst: Jeffrey Panger, New York (1) 212-438-2076;  
jeff\_panger@standardandpoors.com Secondary  
Credit Analyst: Karl Jacob, New York (1) 212-438-2111;  
karl\_jacob@standardandpoors.com