

Pennsylvania Intergovernmental Cooperation Authority



**Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 2006 - Fiscal Year 2010**

August 8, 2005

**PENNSYLVANIA INTERGOVERNMENTAL
COOPERATION AUTHORITY**

1429 Walnut Street, 14th floor, Philadelphia, PA 19102
Telephone: (215) 561-9160 – Fax: (215) 563-2570
Email: pica@picapa.org

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**Pennsylvania Intergovernmental
Cooperation Authority**

**STAFF REPORT
ON
FY2006-FY2010
FIVE-YEAR FINANCIAL PLAN**

SECTION I:

**INTRODUCTION
AND
EXECUTIVE SUMMARY**

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INTRODUCTION

*“For all sad words of tongue or pen,
The saddest are these: “It might have been!”
- John Greenleaf Whittier*

One of PICA’s central roles in serving as the fiscal oversight body for the City of Philadelphia is ensuring that revenue estimates are reasonable. The result has been a remarkable record of establishing a responsible baseline of what resources the City has available to spend. Since PICA’s inception in 1991, the City has met or exceeded its revenue estimates in every year. From FY2002 through FY2005, for example, tax revenues exceeded the amounts projected in the City’s FY2002-FY2006 Five-Year Financial Plan (Plan) by \$150 million. Having revenue that exceeds projection has provided the City with an opportunity to address some of the long-term issues that, as the Plan describes, put the City at a financial and competitive disadvantage. Unfortunately, the City has not capitalized on that opportunity.

Over the past several years, the City of Philadelphia has used its Plan to highlight challenges to the City’s fiscal health. These include a high tax burden and weak tax base; escalating personnel benefit costs; high long-term debt obligations; and, a costly pension system. Despite the ability to clearly articulate these challenges, and in some cases highlight possible solutions, the City has failed to address these fiscal burdens in a meaningful way.

Even with the opportunities presented by more than \$150 million in excess revenues the City did not make progress in its efforts to solve any of the fiscal challenges listed above. Previous Plans suggested new models for pension benefits and contributions, as well as other employee benefits. Though all labor contracts with City employees were negotiated within this time period, there were no significant changes in employee benefit models. The City did not address its unfunded Pension Fund liability. The City did not dramatically change its tax structure. The City did not reduce its reliance on long-term debt. The City did not take meaningful steps to align its service infrastructure with its changed demographics. The City did not even set aside revenues to establish a Rainy-Day Fund for future fiscal difficulties.

Although these excess revenues have now been spent without the City having made the strategic investments that are essential for long-term fiscal health, a lesson remains for the City. The sound fiscal policy of conservative revenue projections should result in a small amount of excess funds. The elected officials of the City must commit themselves in the future to dedicating these revenues to addressing the underlying structural challenges to Philadelphia’s fiscal health.

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EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

The City of Philadelphia (City) submitted its *Five-Year Financial Plan, Fiscal Year 2006-Fiscal Year 2010* (the Plan) to the Pennsylvania Intergovernmental Cooperation Authority (PICA) on June 20, 2005. In the months preceding this submission, PICA noted several concerns with the proposed Plan during meetings with representatives of the City. As the Administration and City Council negotiated a final budget, PICA sent two letters to the Mayor and City Council (dated May 18 and May 25)¹ which further highlighted these specific concerns. Despite all of these warnings, the Plan as submitted on June 20, 2005 failed to meet the standards established in Section 4.02 of the Cooperation Agreement between PICA and the City. On June 27th, PICA notified the City that the Plan as submitted could not be considered for approval and made several recommendations for achieving a balanced Plan.

In response to the June 27th letter, the City began a dialogue with PICA in order to address the concerns which had been outstanding since May. On July 19th, the City submitted technical amendments to the Plan designed to address PICA's concerns. The length of time it took the City to begin seriously discussing PICA's concerns marks a continuing deterioration in the ability of the City to complete its mandated fiscal responsibilities in a timely fashion. PICA's unease with the City's budget process is discussed in detail later in this report. As a result of PICA's desire to maintain the fiscal integrity of the City of Philadelphia, PICA Staff has expedited its review of the proposed Plan. Consequently although this Staff Report maintains PICA Staff's history of a rigorous review of the budget, it will not deal extensively with lesser risks or more general issues impacting the City's fiscal health.

Expenditures and revenues are projected utilizing realistic assumptions except where noted in this Staff Report. The Plan presents a reasonable prospect for balanced budgets over the life of the Plan, although the second and third years of the Plan are most tenuous with projected surpluses of \$2.6 million and less than \$1 million, respectively. The Plan projects a surplus of just over \$70 million by the end of FY2010.

As in the past, there are a number of risks which threaten the fiscal health of the City over the life of the Plan. Many of these risks are ongoing issues previously documented by PICA Staff. While the Plan often acknowledges these risks, few precautionary strategies are offered.

The Plan confronts four significant risks, including:

- Uncertainty regarding the costs of arbitration awards for members of the Firefighters union in FY2006 and health benefits for all employees beginning in FY2007.

¹ Copies of these letters are attached to this report.

- The continued use of assumed revenues from unproven initiatives to balance the Plan.
- A shift in the level of reimbursement funds available to the City's Department of Human Services (DHS).
- The assumption of \$81 million in revenues from the Philadelphia Gas Works (PGW) over the life of the Plan.

Report Summary

As noted above, this report focuses primarily on significant risks to the Plan, with limited discussion of some department-specific and other issues that have a direct relationship to maintaining fiscal stability. PICA is pleased to note that, as suggested in its White Paper published last year², the Philadelphia Police Department is continuing to cut costs, including overtime, without reducing the number of officers on the street. PICA continues to track departmental progress in numerous areas and will report on those areas as significant issues arise, as well as continuing to produce White Papers to provoke discussion on areas of concern to the fiscal health of the City.

City's Revenue Assumptions

PICA Staff found the assumptions underlying the City's revenue projections to be reasonable with the following concerns noted.

Over the past several years, PICA has noted the ongoing challenge for DHS to maintain its laudable level of reimbursements. As funding from other governments for these programs is reduced and redefined, the ability of the City to meet its DHS needs without increasing local funding is threatened. A reduction of nearly \$40 million in reimbursement funds was narrowly avoided during the current budget negotiation with the State. PICA will be meeting with DHS and State officials to closely monitor ongoing funding issues.

Some of PICA's concerns regarding the Plan were alleviated by the continued dramatic growth in the Real Estate Transfer Tax (RETT), which ended FY2005 at \$195 million, \$30 million above the original projections. While these revenues continue to increase at a dramatic rate (nearly tripling since FY2000), they are highly dependent on factors beyond the City's control. PICA will continue to exercise caution in regard to its analysis of long-term RETT projections.

² PICA White Paper No. 10 "The Crime of Inefficiency: The Cost of Policing Philadelphia," can be found at the PICA website: www.picapa.org

Although total Real Estate tax collections for FY2005 were nearly six percent higher than in FY2004, the initial estimates from the City indicate that all of the increase came from delinquent tax collections while current year collections actually dropped. While this result would reflect well on the renewed focus on increasing collection rates, it raises questions about the overall health of this revenue source. The City is reviewing its data to ensure that the revenues from this tax were allocated properly between current year and delinquent collections and will report back to PICA.

As part of its review process, PICA Staff convened a group of regional economists to comment on the Plan's revenue assumptions. The group's consensus was that the estimates used in the Plan were reasonable in light of the current economic outlook.

Significant Risks

As mentioned earlier, the Plan confronts four significant risks to its successful implementation as well as a dependence on unspecified future expenditure reductions.

- The City is currently in Act 111 arbitration with the union representing City firefighters. Although the Plan includes some funding for increases in line with the current Police contract, recent arbitration awards raise the possibility of salary and benefit awards beyond the City's ability to pay. Additionally, the health benefits of all employees are subject to renegotiation beginning in FY2007. **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 monies to cover these costs.**
- The Plan continues to assume significant revenues from largely unproven initiatives. While the sale of city assets and a Strategic Marketing Initiative are potentially good sources of revenues, the City has yet to demonstrate the ability to generate significant funds from these programs. More disturbing is a continued lack of coordination and urgency among the various City entities involved in turning these initiatives into reality.
- One of the great successes for the City over the past decade has been the increasing ability to get State and Federal reimbursement funds for meeting the City's Human Services needs. Reimbursement levels have gone from fifty percent to as high as ninety-one percent as the DHS budget has emerged as the single largest department in the City's budget. As State and Federal funding priorities change, these funds are increasingly threatened, in turn putting the City's ability to deliver these necessary services at risk.
- PGW continues to present a perplexing problem for the City. PGW made significant strides this past year as it used newly available managerial tools to dramatically increase collection rates and overall revenues. Although the utility is on better fiscal footing, it remains unable to make its annual payment to the City. The Plan still

assumes an \$18 million payment in FY2009 and FY2010 as well as repayment of the \$45 million loan. PICA Staff does not consider receipt of those revenues to be likely. PICA Staff only feels comfortable recommending approval of a Plan that includes these revenues because the Plan's projected fund balances in FY2009 and FY2010 are sufficiently high that PICA Staff believes it is reasonable to assume that the City would be able to balance those years even without any of the PGW revenue, and the City has committed to maintain a balance of at least \$15 million in the Productivity Bank to cover PGW related shortfalls.

Additional Concerns

PICA continues to have concerns about the ability of the Prisons Department to meet its mandated obligations within the budget allotted. The Department is confronted with a growing population as well as a new prison, a move of the Youth Studies Center and chronic staff shortages. The Department has so far failed to highlight convincingly how it expects to meet these varied challenges within its current budget. PICA will be closely monitoring the Prisons Department budget during FY2006.

PICA remains concerned about the use of the Productivity Bank. The Productivity Bank is one of the most successful government innovations in Philadelphia and has become a national model, most recently adopted in San Diego, CA. It has generated savings valued at many times its original investment. The Productivity Bank is predicated on funding worthy innovations whose cost savings allow for repayment of the loans. Last year's budget eliminated a repayment of some Bank loans, and another attempt was made during this year's budget process to eliminate repayments. Further, there have been indications that the City is using these funds in ways inconsistent with the standards of the Productivity Bank including for projects with no clear payback. Without the good faith promise of repayment, and adherence to specific standards, the Productivity Bank's value is greatly diminished.

The Plan anticipates a cumulative total of \$60 million in unspecified expenditure reductions over its final four years resulting from future government efficiencies. In light of the other cost-cutting measures already included in the Plan, these unspecified reductions will be difficult to achieve without a commitment from the City to making the types of fundamental changes that have been outlined in Five Year Plans, but that have not been implemented. While PICA will continue to provide recommendations for greater savings and maximizing taxpayer value, PICA no longer believes it is reasonable to include these projections in the Plan and has directed the city not to include this reduction in future Plans.

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 FY2006-FY2010 Five-Year Plan. The City Controller noted several concerns with the Plan, but none so significant as to warrant a negative opinion. The Controller's Schedule of Findings is contained in Appendix B of this Staff Report

Staff Recommendation

The identified potential risks to the General Fund in the FY2006-FY2010 Plan constitute a real threat to the fiscal health of the City. PICA Staff will continue to closely monitor the City's fiscal situation throughout the coming year, paying particular attention to labor negotiations and the revenues generated by the City's new initiatives. **Any new labor contracts which increase General Fund costs will require a revision to the Plan which demonstrates sufficient revenues to cover the increased costs.**

In response to PICA concerns, the City recognized approximately \$100 million in revenue and expenditure adjustments. Given these changes and the above mentioned caveats, the FY2006-FY2010 Plan as amended presents a reasonable prospect for balanced budgets in each year of its term.

PICA Staff recommended that the Board of the Pennsylvania Intergovernmental Cooperation Authority approve the Plan as submitted to the Authority.

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**Pennsylvania Intergovernmental
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FIVE-YEAR FINANCIAL PLAN**

SECTION II:

**SIGNIFICANT RISKS
AND CONCERNS**

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LABOR CONTRACTS AND PENSION FUND LIABILITIES

Personnel costs account for nearly sixty percent of the City's budget; any material change in wages or benefits can dramatically impact the City's fiscal stability. **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 monies to cover these costs.**

Act 111 Arbitration with City Firefighters; Health Benefit Increase for all Employees

The City is currently in Act 111 arbitration with the union representing City firefighters. The Plan assumes that the firefighters will be awarded a salary increase equal to the percent increase included in the current Police contract. However, the Plan only assumes funding that award for half of FY2006. While the City's amendments to the Plan acknowledged that risk, there are no funds available should the arbitrators award wage increases larger than those included in the Police award.

While traditionally PICA Staff has been most concerned with the projected impact of wage increases, it is the recent record of health benefit increases which truly threaten the fiscal viability of the City. Although health care costs are increasing at nearly ten percent nationally, the most recent Act 111 Police and Fire Arbitration awards gave increases that were far in excess of any reasonable rate, with first year increases of over **thirty-seven percent**. The arbitration panel severely undermined their own practice by effectively nullifying the FY2002 arbitration award, and reestablishing the baseline for health care benefits. Their actions were unprecedented; the City was mistaken in its failure to appeal. PICA Staff awaits the results of the current Fire Arbitration with some trepidation that it will throw the FY06-FY10 Plan out of balance.

The Act 111 decision has serious consequences for other City personnel costs as well. In its most recent contracts, the City allowed for the reopening of the health benefits portion of its contracts with Police Officers and all non-uniformed personnel. If these new health benefits exceed the increases provided for in the Plan, the City may be required to identify new expenditure reductions to offset these costs.

Pension Fund Liabilities

While improving investment returns should lessen the level of required Pension Fund payments, the amount of those payments is not yet known. When calculating its funding requirements, the Pension Fund assumes a nine percent rate of return; these calculations help determine the amount of the annual contribution from the City to the Pension Fund. In the years immediately prior to 2001, Pension Fund rates of return were well above ten percent. Like many pension funds nationally however, the City's Pension Fund had negative returns for 2001 and 2002. When actual returns are lower than the Pension Fund's assumed nine percent rate of return, the City has to compensate for those lower

than anticipated earnings by putting added money into the Pension Fund. Rising investment returns will be reflected in the next actuarial report, and should result in lesser minimum municipal obligation (MMO) payment levels. Even if the MMO levels are reduced, the City should at least maintain the budgeted Pension Fund payment to begin addressing the Pension Fund's long-term liability.

The recent significant increases in the City's projected payments into the Pension Fund highlight the ongoing threat posed to the General Fund. According to the City's actuary, each percentage point below the expected rate of return would require an additional \$10 million to \$15 million City contribution. While the City has reduced its annual contribution to the minimum amount required by law in order to meet short-term budgetary needs, the long-term Pension Fund liability continues to escalate. The City failed to implement its own proposal, first included in the FY2004-FY2008 Plan, to address these concerns by switching from a defined pension benefit plan to a defined pension contribution plan. Such a step would eliminate the unpredictability of the current system and realize some long-term savings for the City even if there were some short-term costs.

Deferred Retirement Option Program (DROP)

Since the DROP began in October 1999, over 4,000 employees have enrolled in the program. In many cases, the Program has provided opportunities for City Departments to reorganize, reassess workflow, and rightsize in accordance with current demands. DROP has also provided an opportunity for improved succession planning, a feature put to particularly good use by the Police Department.

However, the original DROP was not revenue neutral with a cost estimated at \$12 million to \$14 million, funds the Pension Plan can ill afford to lose as indicated above. Simply modifying the four percent rate of return guaranteed to pension fund members on their DROP accounts would have negated much of the cost risk to the Pension Fund. Despite this adverse material impact, the Pension Board, over the objections of the Administration, chose to maintain the program with no changes. The potential costs of the ongoing DROP exacerbate the long-term Pension Fund liability.

While the program provides an opportunity for rightsizing the City's workforce, it is also subject to abuse by officials for whom it was never intended. Elected officials whose positions cannot be terminated, and face no reorganization or succession planning issues were never the intended target of the DROP. While it is within the rules for these officials to enter the Program, it is clearly a violation of the spirit of the DROP.

REVENUES FROM NEW INITIATIVES AND AN UNPRODUCTIVE BUDGET PROCESS

PICA will always encourage the City to embark on new initiatives designed to enhance revenues, improve service delivery, or reduce expenditures. However, the Plan continues to assume significant revenues from largely unproven initiatives. Additionally, the City has begun to destabilize its own budget process undermining the veracity of the Plan.

New Initiatives

Over the past few years the City has identified numerous initiatives designed to enhance revenues or control costs. Unfortunately, the City failed to implement some of the most significant cost-saving measures (such as a switch to defined pension contributions). Of greater short-term concern is the City's increasing willingness to base its fiscal stability on revenues projected from unproven initiatives.

Two years ago, the City declared a renewed focus on identifying unused City assets that could be sold. This program would not only result in one-time revenues but also return these assets to a productive use. The City originally projected \$30 million would be realized from these sales; after consulting with PICA, revenue estimates were changed to \$10 million in FY2005, and \$20 million in FY2006. In fact, the sale of city assets realized less than \$2 million in FY2005. During the protracted negotiations between the City and PICA over the Plan, the City was reluctant to change its asset sales revenue estimates until the last minute.

Similarly, last year the City introduced a Strategic Marketing Initiative. Despite a lack of contracts in place, and the time-lags experienced by other cities starting similar initiatives, the Plan confidently projected nearly \$50 million in revenues over the next five years. Again, after discussions with PICA, and a review of its own information, the City cut its projections in half, and delayed the projected initial receipt of revenues by one year.

Like all proposed government activities, these new initiatives should have clearly developed implementation plans with reasonable projected timeframes and revenues as well as a system for measuring their performance. Both of these programs are examples of good ideas which need to be fully implemented before their proceeds can be assumed.

Perhaps most disturbing about many of these initiatives was the inability of various government entities to work together. As proposed, the asset sale program would have identified a complete inventory of available City assets, advertised and marketed them, and then sold them in a way to maximize revenues and beneficial use to the citizens of Philadelphia. Instead, the City identified a select number of properties, attempted to

identify buyers, and marketed some properties in a haphazard fashion. There was little apparent coordination or cooperation among the various City entities.³

Unproductive Budget Process

The process whereby the City established its budget and Five-Year Plan for FY2006-2010 was the most disturbing since the creation of PICA. In recent years, the Administration has increasingly tied service changes to deficit prevention. Proposed changes in the delivery of recreation, firefighting, and library services were all presented as being necessary in order to prevent shortfalls. When new monies were “found,” these service initiatives were halted.

The reality is that many, if not all, of these proposals began as service initiatives – how can the City better deliver services to the citizens of Philadelphia? Which recreation facilities are used? How should the Fire Department evolve in light of its phenomenal success at reducing structural fires? When do people use the library? All of these are good public management issues which resulted in proposals to better meet the needs of Philadelphians, and maximize taxpayer value. Unfortunately, the political decision to characterize these changes as “budget cuts” for negotiation purposes doomed their implementation. The opportunity cost of having failed to improve and streamline citizen services is large and growing.

This year’s Plan process also continued the recent approach of delaying finalizing the City’s budget until the last possible moment. The Mayor and City Council did not complete a budget until the middle of June. In the months preceding completion of the budget, PICA noted several concerns with the proposed Plan during meetings with representatives of the City. The City ignored PICA’s concerns and submitted a Plan which failed to meet the standards established in Section 4.02 of the Cooperation Agreement between PICA and the City. The City did not present a balanced Plan until the last possible moment, when it faced PICA’s rejection of the Plan.

These approaches to budgeting undermine the ability of the City to institute legitimate and necessary service realignments and maintain the credibility of the City’s long-term spending plan. Continuation of these methods can only lead the City back to the poor fiscal management which necessitated the creation of PICA.

³ The Philadelphia Industrial Development Corporation, Department of Public Property, Law Department, Neighborhood Transformation Initiative, Finance Department, and Commerce Department all had roles to play in the sale of City assets.

REIMBURSEMENT FOR THE DEPARTMENT OF HUMAN SERVICE (DHS)

One of the great successes for the City over the past decade has been the increasing ability to get State and Federal reimbursement funds for meeting the City's Human Services needs. Reimbursement levels have gone from fifty percent to as high as ninety-one percent as the DHS budget has emerged as the City's single largest departmental budget. As the City and State respond to changing Federal funding priorities, these funds are increasingly threatened, in turn putting the City's ability to deliver these necessary services at risk.

In recent years, the federal government has been decreasing its commitment of funds to many of the programs which ultimately go to reimbursing the City of Philadelphia for many of its expenditures on DHS programs. While the State has increased its resources to make up for some of the lost funding, it is limited in the amount that it can provide. In addition, as different funding streams are used for reimbursements, different rules apply for determining which activities qualify for reimbursement and for determining the level of reimbursement which they will generate.

None of these changes are a surprise for DHS. They have been discussed many times with PICA over the last several years. The City has demonstrated a good ability to understand and utilize the myriad funding streams which exist in order to maintain DHS programs. However, the City must carefully monitor changes at the State and federal level. In June, the City discovered that it had misinterpreted one new program, and risked losing over \$40 million in reimbursement funds from the State. Although the City was able to work with the State to identify its local share and obtain those funds, that incident highlights the increasing risks associated with DHS funding.

DHS has been successfully expanding its prevention programs over the past several years, buoyed by high levels of reimbursement funds. While these prevention programs have costs, they should significantly help reduce long-term costs and stress on the DHS system. These programs would be the first to go if the City were unable to maintain reimbursements and current funding levels. While the City continues to monitor changes in funding programs, the City needs to continue to develop strategies to maintain current DHS service levels within its own fiscal constraints.

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PHILADELPHIA GAS WORKS

PGW continues to present a perplexing problem for the City. PGW made significant strides this past year as it used newly available managerial tools to dramatically increase collection rates and overall revenues. Although the utility is on better fiscal footing, it remains unable to make its annual payment to the City.

PGW's \$18 Million Payment

For the first time since it was established, PGW missed its annual \$18 million payment to the City in FY2004. No payments have been made since that date. However, the Plan still assumes an \$18 million payment in FY2009 and FY2010 as well as repayment of the \$45 million loan. PICA Staff does not consider receipt of those revenues to be likely. As requested by PICA Staff, the City has committed to maintaining a balance of at least \$15 million in the Productivity Bank through FY2010. Combined with the projected \$70 million fund balance in FY2010, this will ensure that the Plan is in balance even if those funds are not received.

PGW's Plan For Recovery

During discussions with PICA last year, the management of PGW placed its hope of regaining fiscal stability on three factors: a lowering and stabilization of gas prices; a dramatic increase in Federal funding of the Low Income Home Energy Assistance Program (LIHEAP); and, an increase in PGW collection rates from eighty-seven percent to ninety-two percent. PGW officials also believe they will be on better financial footing when their proposed Liquified Natural Gas (LNG) plant is operational.

Thanks in large part to new tools given to PGW by the State Public Utility Commission, PGW was able to increase collection rates to an average of ninety-three percent. This dramatic increase enabled PGW to stabilize its finances and continue to pay down its long-term obligations. This new fiscal stability resulted in better coverage ratios for the utility and resulted in a positive fund balance for FY2005 and a similar projection for FY2006. In making its projections, PGW assumed that it would not make an \$18 million payment to the City in either FY2005 or FY2006.

Unfortunately, the other fixes anticipated by PGW were not forthcoming. According to US Department of Energy forecasts which are supported by numerous economic surveys as well as the pricing of oil and gas futures, residential natural gas prices are not expected to drop and stabilize until the middle of next winter and then are expected to begin rising again. There is no reasonable expectation of stabilization in the near future.

LIHEAP is currently funded at \$1.8 billion, with an additional discretionary contingency funding of \$200 million. The American Gas Association and other related associations have proposed a bill that would increase LIHEAP funding to \$3.4 billion. However,

PICA Staff discussions with key Association lobbyists and senior officials at the US Department of Health and Human Services, indicate that LIHEAP funding will remain at the current level for FY2006 and is "capped out for the foreseeable future." President Bush's proposed budget maintained the \$1.8 billion funding level for LIHEAP.

While the proposed LNG plant could help PGW's finances, its existence is far from assured. PGW does have the facilities available, and has identified a viable private sector business to run the facility. However, there are an estimated fifty proposed LNG sites and experts estimate that only ten will be approved. Security concerns and local zoning and environmental issues have significantly slowed the approval process for these plants. In addition, the approval process is proposed to be taken over by the federal government.⁴ It is highly unlikely that the current federal administration will endorse a municipal-owned utility by awarding it a LNG permit.

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

PGW has restructured its capital program to meet pressing needs despite the large amount of outstanding debt. PGW currently has well over \$900 million in outstanding debt. It is conceivable that the combination of increasing capital demands combined with a loss in revenue could render PGW unable to meet its debt obligations.

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

⁴ According to the Energy Bill approved by the US House of Representatives July, 2005.

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SECTION III:

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

Staff Report - The Plan was submitted to PICA by the Mayor on June 21, 2005 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 January 25, 2005 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 20, 2005.

Under Section 5.07 of the Cooperation Agreement, PICA agreed not to disclose information provided to it in confidence by the City with respect to negotiation of collective bargaining agreements and ongoing arbitration proceedings, and the Authority has consistently followed that requirement.

Relationship to Future Plan Revisions - The City is obligated under the both the Cooperation Agreement and the PICA Act to submit a revised Plan in the event it enters into a collective bargaining agreement, or receives a labor arbitration award, at variance with that which was assumed in the Plan. The Cooperation Agreement anticipates that the Plan must be revised to deal with such matters within 45 days after declaration of a "variance" by PICA.

Apart from labor-related revisions, or those required by declaration by PICA of a variance in the Plan in the future, the Plan is subject to mandatory revision on March 22, 2006 (100 days prior to the end of FY2006). At that time, the City is required to add its Fiscal Year 2011 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 \$1,184 million in funding to assist the City, allocated to the following purposes:

<u>Purpose</u>	<u>Amount (thousands)</u>
Deficit Elimination/Indemnities Funding	\$ 269,000
Productivity Bank	20,000

Capital Projects	514,056
Retirement of Certain High Interest City Debt	<u>381,300</u>
TOTAL	<u>\$1,184,356</u>

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.

Whether PICA will also become involved in the financial oversight of the School District of the City Philadelphia is a matter that presently is in the hands of the Appellate Courts of the Commonwealth.

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 2006. 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 FY2005 is August 15, 2005. Quarterly reporting deadlines for FY2006 are November 15, 2005, February 15, 2006, May 15, 2006 and August 15, 2006. 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 FY2005 is the report due June 20, 2005. For FY2006, the reporting dates are October 20, 2005, January 20, 2006, April 20, 2006 and July 20, 2006. 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 FY2006 are August 2, 2005, November 1, 2005, January 31, 2006 and May 2, 2006.

APPENDIX B

The following are letters from PICA to the Mayor and City Council (dated May 18th and May 25th), highlighting PICA's concerns with the proposed Plan.

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**Pennsylvania Intergovernmental
Cooperation Authority**

14th Floor - 1429 Walnut Street, Philadelphia, PA 19102
Telephone 215-561-9160 Fax 215-563-2570

May 18, 2005

Honorable John F. Street,
Mayor of the City of Philadelphia, and
The President and Members of the City Council
of the City of Philadelphia
City Hall
Philadelphia, PA 19107

Dear Mayor Street and Members of City Council:

As you know, the Philadelphia Home Rule Charter, Section 2-300(1), requires that an annual operating budget be adopted for the next fiscal year no later than May 31. This budget serves as the base year for the City's Five-Year Financial Plan ("Plan") which, under the terms of both the Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class, and the Intergovernmental Cooperation Agreement between the City of Philadelphia and the Pennsylvania Intergovernmental Cooperation Authority (PICA), PICA has at least thirty days to review after its submission by the City. In order to permit PICA to complete that review prior to the start of the new fiscal year on July 1, the City has traditionally adopted and submitted the Plan to PICA prior to May 31.

It is imperative that all parties be aware of significant PICA concerns with the Plan proposed by the Mayor on January 25, 2005, which is the basis for the current budget discussions. With the recent receipt of the City's Quarterly Managers Report and tax receipts through the month of April, PICA is further able to quantify many of these concerns.

Regarding proposed revenues, PICA has significant doubts about the likelihood of receiving PGW rent payments and loan repayment (\$81 million over the life of the Plan), realizing revenues from strategic marketing initiatives (\$47.5 million), and reimbursement for patrol of the State highways (\$25 million). Further we believe that new gaming facilities will take longer than expected to become operational (\$17.5 million), Parking Authority receipts will fall short of projection (\$42 million), as will asset sales (\$16 million).

Regarding projected expenditures, PICA believes that the Plan does not include the costs of increased trash disposal fees (\$4 million) and the costs of instituting trash collection for City condominium buildings (\$6 million). Additionally, there are the unknown costs of pending arbitration awards for members of the City's fire union as well as the renegotiation of health benefits for other municipal employees; unresolved issues surrounding the budget of the Police Department; and, costs resulting from ongoing litigation surrounding the provision of City services.

Although PICA projects that City tax revenues will exceed budgeted amounts in FY2005 by over \$21 million, and nearly \$60 million throughout the life of the Plan, this is not sufficient to balance the Plan. Even without the unquantifiable costs listed above, PICA projects a negative fund balance by FY2010 of nearly \$116 million for the Plan as currently presented. Unless these shortfalls are addressed, the Plan will not be approvable under the terms of the PICA statute or the Cooperation Agreement.

Under Section 4.07 of the Cooperation Agreement, should the City fail to file a balanced Plan as required, PICA will be required to certify to the Secretary of the Budget that the City is not in compliance. Such certification would result in the suspension of certain grants, loans, entitlements, and payments to the City, as detailed in the Cooperation Agreement and the Act. These consequences can be avoided if you present PICA with a balanced five-year financial plan, as required by law.

We look forward to continuing discussion regarding the Plan. If you have any questions about the concerns outlined above, or wish to discuss any aspect of the Plan, please contact me at your convenience.

Very truly yours,

Joseph C. Vignola

C PICA Board Members
Joyce Wilkerson, Esquire, Chief of Staff
Dianne Reed, Budget Director



**Pennsylvania Intergovernmental
Cooperation Authority**

14th Floor - 1429 Walnut Street, Philadelphia, PA 19102
Telephone 215-561-9160 Fax 215-563-2570

May 25, 2005

Honorable John F. Street,
Mayor of the City of Philadelphia, and
The President and Members of the City Council
of the City of Philadelphia
City Hall
Philadelphia, PA 19107

Dear Mayor Street and Members of City Council:

PICA is in receipt of a copy of Mayor Street's letter to City Council President Verna dated May 24, 2005, which sets forth an amended FY2006-FY2010 Five Year Plan ("Plan"). The letter suggests that the amended plan addresses all of the concerns raised by PICA in its letter dated May 18, 2005, and that PICA approves these amendments. The Mayor's letter is incorrect in both instances.

It is inappropriate for the City to adopt the "good news" from PICA of the increased revenues, while ignoring PICA's warnings of revenue shortfalls. For example, regardless of any litigation between the City and the Philadelphia Parking Authority (PPA), payments from the PPA are expected to continue to be \$1.5 million below budget for the foreseeable future. This represents a shortfall of \$14 million to the projected surplus through FY06, and the loss of \$42 million to the Plan.

Although the letter claims \$45 million in completed appraisals, the City has only demonstrated approximately \$30 million in appraisals. Further, as the current Fiscal Year has demonstrated, appraisals do not guarantee sales or sale prices. The City had well over \$12 million in appraisals last summer, projected \$10 million in revenues in FY05, and only realized \$2 million. The City's track record underlies PICA's projected revenues from City asset sales.

Currently the City has no contracts in place regarding the Strategic Marketing Initiative, and has only presented PICA with the outline of how a Strategic Marketing Plan was reached. As of this date, the City has not yet determined who will serve as the broker for any agreements, let alone negotiated them. Until one dollar has been realized under this initiative, it is irresponsible to assume revenues of \$7.5 million in FY06 and \$47.5 million over the life of the Plan.

PICA does believe that the City has a legitimate claim to reimbursement for patrol of the State highways in Philadelphia. However, no agreement has been reached as of yet, and no provision exists for these funds in the proposed State budget. The \$5 million in FY06 are highly speculative, and leave the full Plan amount of \$25 million questionable.

As the Mayor himself noted in his January 2005 budget address, there are serious doubts about receipt of the PGW rent payments and loan repayment (\$81 million over the life of the Plan). The Plan no longer contains a sufficient surplus in FY2010 to allow for non-payment of these funds, setting aside the concerns raised above.

Regarding projected expenditures, PICA is pleased that the Plan does include costs associated with increased trash disposal fees and instituting trash collection for City condominium buildings. However, it is not appropriate to state that Prisons costs may be higher “if the prison population continues to increase” when the Five-Year Plan document itself projects such an increase (Appendix 1, Page 9). PICA also notes that the letter dedicates revenues generated from billboard license fees twice – once to offset City Council expenditure requests, and once to offset new expenditures in the Department of Licenses and Inspections.

The letter does acknowledge PICA’s concerns with the unknown costs of pending arbitration awards for members of the City’s fire union as well as the renegotiation of health benefits for other municipal employees. However the threat to the Plan is heightened because of the Administration’s practice of not appealing unreasonable awards.

In short, the combination of new spending, new taxes, and remaining questionable revenues results in a PICA projected deficit in FY06 of at least \$11 million, and a Plan deficit of over \$100 million. Budgets based on uncertain revenues and unsubstantiated expenditure projections are what led to the fiscal crisis which precipitated the creation of PICA.

We look forward to continuing discussion regarding the Plan. If you have any questions about the concerns outlined above, or wish to discuss any aspect of the Plan, please contact me at your convenience.

Very truly yours,

Joseph C. Vignola

C: PICA Board Members
Joyce Wilkerson, Esquire, Chief of Staff
Dianne Reed, Budget Director

APPENDIX C

Schedule of Findings, Office of the City Controller

In accordance with Section 4.04(g) of the Intergovernmental Cooperation Agreement between PICA and the City, the City Controller's Office submitted to PICA its report upon the Forecasted Statements of General Fund Revenues, Obligations and Changes in Fund Balance for the Fiscal Years Ending June 30, 2006 and June 30, 2007, included in the Plan. That report included the Controller's Office opinion that the underlying assumptions provide a reasonable basis for City management's forecast. At the request of the PICA Board, the City Controller's Office also prepared a report upon the results of agreed upon procedures with respect to the Plan. PICA Staff is grateful for the assistance provided by the Controller's Staff in evaluating this Plan.

The Schedule of Findings of the Controller's Office resulting from its work with respect to the Plan, formally reported to PICA on June 20, 2005 (as a component of the Controller's report upon the performance of agreed upon procedures) is reproduced in this Appendix. Certain findings have been previously discussed in this report from a PICA Staff perspective. PICA Staff believes the reader will gain added value from a review of the Office of the Controller's perspective on such matters.

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City Controller's Office
FIVE-YEAR FINANCIAL PLAN - Schedule of Findings
FOR THE FISCAL YEARS 2008 THROUGH 2010

Economic and General Fund Revenue Forecasts

The Controller's comparative economic and General Fund revenue forecasts appear to be consistent with the Plan's estimates. The key underlying assumptions for both projections include (1) continuation of Wage Tax cuts and Gross Receipts Tax reductions, and (2) growth in the national economy but at a slower pace at the local level. It has been assumed that the city will maintain a relatively stable economic base throughout the life of the Plan.

Wage Tax Base

The most recent data published by the Bureau of Labor Statistics show that, despite growing employment both nationally and in the surrounding suburbs, city payrolls continue to shrink. History tells us that during national expansion it takes considerable time for the city to share in any national growth. While the pace at which the city has been losing jobs has abated since the recession it is unlikely that payrolls will flatten out over the next two fiscal years as assumed in the Plan.

It follows that growth in the wage tax base over the next two fiscal years is expected to stem entirely from wage gains. Much of the recent job growth has been centered in the information and health and educational service sectors, which pay higher than average wages.

The Plan assumes that average wage growth will rise 3.5 percent over the next two fiscal years and 4.0 percent in FY 2008, 2009, and 2010. While this is slightly more robust growth compared to the recent past, it is consistent with the greater wage pressures that some economists are predicting and the changing industrial structure throughout the city.

Real Property and Real Estate Transfer Taxes

Despite the recent hikes by the Federal Reserve Bank, interest rates remain at historically low levels. The national and local housing markets are likely to remain strong. However, if inflationary pressures continue to escalate, it is likely that the Federal Reserve Bank will take additional steps to raise rates. This could prospectively dampen the real estate activity that has brought significant gains in Real Estate Transfer Tax collections. It could also constrain the demand for real estate and therefore growth in assessed values, which is the basis for levying Real Property Taxes. This risk is reflected in the modest growth assumed in the Plan for both Real Property and Transfer Tax collections.

Sales Tax

The Plan assumes strong growth in collections in FY 2005 and modest growth in FY 2006-2010. These estimates are consistent with what has been collected thus far in FY 2005, as

well as the slightly greater inflation at the retail level and more stable employment patterns projected for the area.

Business Privilege Tax

The Business Privilege Tax base (business gross receipts and profits) tends to follow patterns consistent with the general economic cycle. While imperfect, the best measure of the general state of the city's economy is employment. Thus, as employment in the city stabilizes, it is likely that the Business Privilege Tax base will grow in a more robust manner. This is quite consistent with the assumptions offered in the Plan.

Revenue from Other Governments

Department of Human Services (DHS)

DHS receives a considerable amount of State and Federal funding, primarily from Federal program Title IV-E and State program Act 148. The Plan assumes 3.2-percent growth in FY 2006 for Title IV-E reimbursements and 2.9-percent growth in each of the out years. Act 148 grows by one percent in FY 2006 and an average annual growth of 5.2 percent for the remainder of the Plan. For FY 2006 and beyond certain state funds will require a 20 percent local match, approximately \$10 million annually. The source of these matching funds is not identified in the Plan.

Philadelphia Gas Works (PGW)

As a result of PGW's precarious financial situation, the Street Administration entered into an agreement whereby the city forgave the \$18 million payment due for FY 2004. For FY 2005 through 2009, the agreement stipulates that the city will grant back to PGW the annual \$18 million rental payment. In FY 2010, the city expects to receive the \$18 million payment, as well as repayment of the \$45 million loan. PGW has recently improved collection levels, but remains unable to resume the annual \$18 million payment. The Administration has committed to maintain a minimum balance of \$15 million in the Productivity Bank over the life of the Plan, and may use these funds should PGW be unable to resume its annual payments and repay the \$45 million loan.

Philadelphia Parking Authority (PPA)

Under the terms of the State takeover of the Philadelphia Parking Authority, PPA is obligated to forward up to \$25 million annually in parking violation revenues. To date, PPA has not made this payment in full for FY 2005. Failure by PPA to make these payments has led to litigation by the city, and if not resolved to the benefit of the city could result in cuts in delivery of service and lack of predictability of future revenue. Due to accounting changes, this revenue stream is now considered Revenue from Other Governments.

Locally Generated Non-Tax Revenue

Several initiatives included in the Plan, such as increased fees for Police Accident Reports and Gun Permits, have not had necessary legislation introduced in Harrisburg. As this legislation cannot be introduced until the fall, several months of increased revenues will be foregone, assuming the measures are eventually adopted.

GENERAL FUND OBLIGATIONS

Base Methodology

The projected General Fund obligations as presented in Appendix V of the Plan are at variance with the obligation growth rate assumptions shown in Appendix VII, despite revisions to the base obligation methodology following revisions to the obligation summaries over the life of the Plan.

In particular, the projected growth rates for Class 100 (Wages/Benefits), Class 200 (Purchase of Services), Class 3/400 (Materials, Supplies & Equipment), Class 500 (Contributions, Indemnities & Taxes), and Class 800 (Payments to Other Funds) are inconsistent. The base methodology shows 2.0-percent growth for civilian wages and 3.0-percent growth in uniformed wages in FY 2006 for Class 100 Payroll Obligations. These are the negotiated wage increases for non-uniformed employees and Police Officers, and the anticipated wage increase for Fire Fighters. However, Appendix V shows these obligations increasing by 2.5-percent in FY 2006 and 3.0-percent in FY 2007.

Additionally, the base methodology in Appendix VII shows zero-percent growth in Class 200 obligations annually over the life of the Plan; Appendix V shows the Class 200 obligations to increase by approximately 7.8 percent over the same time period. The base methodology in Appendix VII shows a zero-percent growth in Class 3/400, however Appendix V shows Class 3/400 increasing by 5.2 percent between FY 2006 and FY 2010. In Appendix VII, Class 500 is projected to have zero-percent growth over the life of the Plan. Appendix V indicates a 19.0 percent decline over the same time period. Class 800 is also projected to have zero-percent growth in Appendix VII for FY 2006 through FY 2010, while Appendix V shows a 1.0-percent decline.

Payroll

Fire Fighter contracts expired on June 30, 2005. Given that Police Department uniformed employees settled an arbitration award through FY 2008, which included a 3.0-percent increase each year on July 1, 2004-2006 and a 4.0-percent increase on July 1, 2007, it is likely that the Fire Department uniformed forces will receive some salary increase, beginning in FY 2006. Additionally, there is no provision in the Plan for any salary increases for any other organized labor group beyond FY 2008. While we are not able to predict the outcome of the ongoing Fire arbitration, any salary increases above what was awarded to the other unionized employees will have significant financial impact on the city's budget over the life of the Plan. Furthermore, the already completed contracts with the Police and non-uniformed employees include reopeners for health care – Police after years one and three, non-uniformed after year two. Also included is a wage reopener for the non-uniformed employees during years three and four. Should these reopeners occur there could be significant financial impact on the Five-Year Plan.

Fringe Benefits

The FICA and Medicare line items appear to be overstated in all years of the Plan, given the anticipated reduction in personnel.

Debt Service

Based upon our review of the current General Fund General Obligation Bond maturity registers and related debt service schedules, the General Fund Debt Service Obligations may be over-estimated throughout the life of the Plan.

Debt Service obligations include principal and interest payments for General Obligations Bonds issued in each year of the Plan. While it is possible that the Administration will authorize and sell General Obligation (GO) bonds during the life of this Plan, it is highly unlikely that they will sell GO bonds each year. We believe that the amounts budgeted may exceed the actual costs.

The Plan includes commitment fees of \$1 million annually, and arbitrage payments of \$350,000 each year over the next five years. The city has not utilized any type of credit enhancement for the last five short-term note sales. It appears the city will not need, or use, any credit enhancement for its short-term borrowings in the future.

Future Government Efficiencies

The Street Administration included \$60 million in unspecified future government efficiencies beginning in FY 2007 and continuing over the life of the Plan. The Plan does not detail how the city will attempt to rightsize the government other than one percent expenditure reductions in an undisclosed number of departments, nor divulges where the efficiency savings can be found. Given the other significant cuts included in the Plan, additional savings may be difficult to achieve. Failure to attain these cuts will put the city's budget at a risk.

CAPITAL PLAN

Capital Budget

We reviewed the FY 2006 Capital Budget included in Appendix VIII of the city's Five-Year Plan. Our review consisted of agreeing the Plan amounts to the City Planning Commission's six-year funding schedule for FY 2006-2011 and verifying the mathematical accuracy of both. In addition, we reviewed all projects in the FY 2006 Capital Budget to determine whether they were capital in nature.

Included in our review was a computation of the current and future legal debt capacity. We also compared potential debt service costs associated with the Capital Plan with projected debt service costs shown in the General Fund section of the Plan. Again, as stated in the Debt Service section of this schedule, it appears that debt service obligations are over-budgeted throughout the life of the Plan.

To date, City Council has failed to pass the necessary Capital Budget legislation to enact the budget. Therefore the proposed capital budget remains on hold, pending reintroduction and subsequent approval of new capital budget legislation. Should this not happen in the early fall after City Council reconvenes, there is a risk that the capital budget question will not be

on the November ballot. Without the ballot question being approved by the voters the city is powerless to enact the capital budget.

OTHER FUNDS

Aviation Fund

Based upon the assurances from Aviation Fund officials, it appears unlikely the city will be required to make a General Fund subsidy payment for the Outside Terminal Area (OTA) and the International Gates.

The Division of Aviation continues to achieve surpluses from the OTA. These surpluses are carried in the Aviation Fund Unrestricted Cash Account. Division of Aviation representatives stated that these holdings plus any interest earned, will be sufficient to prevent the General Fund from contributing to the Aviation Fund over the life of the Plan.

Water Fund

Water Department officials assured PICA officials that there is minimal risk that the General Fund will not receive an annual transfer, albeit not at the levels of past years. For fiscal year 2005 the payment was approximately \$3.4 million.

The Water Department continues to cut costs at both their wastewater treatment and biosolids recycling center. In addition, the Water Department realized significant savings in its energy costs through successful implementation of multiple energy savings initiatives. As a result of these cost cutting measures, energy initiatives, and increased delinquent collections through the enforcement of the Utility Services Tenant's Rights Act, Water Department management believes that the annual transfer to the General Fund will continue over the life of the Plan. However, should the Street Administration choose to utilize the Water Fund Debt Service Reserve to fund economic development activities, this annual transfer may cease to exist.

CASH FLOWS

The cash flows presented in Appendix VI of the Plan for FY 2005 and FY 2006 agreed with the estimates for General Fund revenues and obligations as presented in Appendix V of the Plan. The forecast for the monthly distribution of revenues and obligations were materially consistent with historical patterns.