

Pennsylvania Intergovernmental Cooperation Authority



Reversing the Trend of Doing Too Little with Too Much: Maintaining the City's Infrastructure While Reducing Its Dangerously High Debt Load

PICA Issues Report

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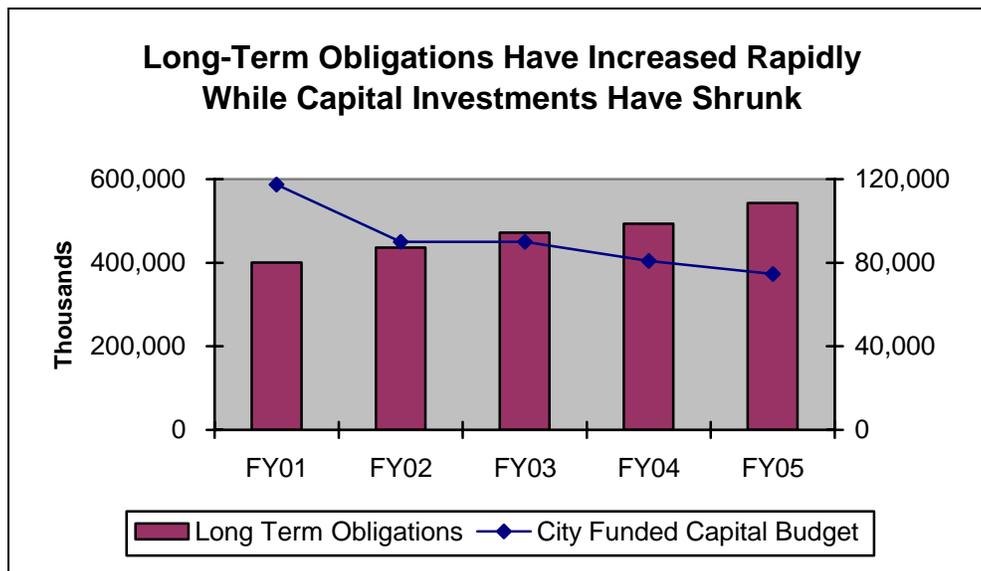
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Reversing the Trend of Doing Too Little with Too Much: Maintaining the City's Infrastructure While Reducing Its Dangerously High Debt Load

Introduction and Summary

The City could soon face a rapid deterioration in the condition of its facilities at the same time that it sees its financial flexibility eroded. The City faces these twin problems because for the last five years, its infrastructure investment has dropped rapidly while its fixed costs have skyrocketed.

Either of these issues would be hard to tackle on its own. The fact that the City is facing them at the same time is particularly challenging. If the City only faced having too high a debt burden, it could reduce its debt issuance and infrastructure investment until its debt burden had moderated. If, on the other hand, the City only faced the need to increase its infrastructure investment, it could issue more bonds and use the proceeds of those bonds to invest in its capital budget. Unfortunately, the City finds itself in a situation where the most obvious solutions to each of these substantial problems would only exacerbate the other problem.



This report will examine the threat posed to the City by its shrinking infrastructure investment and increasing long-term obligations and provide recommendations for how to begin to ameliorate the problems they create.

After providing some background, the report will focus on the City's rapidly increasing long-term obligations. It will show that those obligations are consuming more and more of the budget, squeezing out other expenditures and limiting the City's financial flexibility. The report will also show that other cities use a variety of methods to determine appropriate levels of debt.

After discussing long-term obligations, the report will shift to the other of the twin threats – the shrinking infrastructure investment. This section of the report will show that the City is falling far short of the infrastructure investment that its own Planning Commission says is necessary to keep the City’s assets in good condition.

Finally, the report will provide recommendations for how to handle those problems, including:

Financial Recommendations

- Funding more capital spending on a pay-as-you-go basis
- Reducing the number of facilities that the City maintains
- Retiring some of the City’s outstanding bonds

Monitoring/Reporting Recommendations

- Basing its debt incurring limit on its total revenues or expenditures rather than assessments
- Including projections for long-term obligations as a percent of revenues in each five-year plan and detailing how it will stay within its target levels
- Updating regularly the City Planning Commission’s needs assessment and making that an appendix to the annual proposed capital program
- Updating and publicizing the City’s debt policy.

Background

The City faced the twin problems of shrinking infrastructure investment and limited debt capacity as recently as the early 1990s. As the City’s FY94-FY98 Five-Year Plan said, the City’s infrastructure investment had “all but come to a halt.” At the same time, the City was nearing its Constitutional Debt limit and, because of the fiscal crisis, the City had lost the ability to borrow at reasonable rates.

PICA was instrumental in helping the City avert its twin debt and infrastructure crises of the early 1990s because, at the City’s request, PICA borrowed funds both to pay for new capital projects and to refund existing debt. The PICA borrowings provided the City with funds both to invest in infrastructure and to free up borrowing capacity for future needs. The City used the PICA borrowings and additional capacity to invest in facilities such as branch libraries, police and fire stations, recreational facilities and health centers and to make strategic investments in items like the Avenue of the Arts, the Art Museum and Penn’s Landing. City tax-supported debt funding for capital investments, which plummeted to \$5 million in FY1992, was at least \$100 million each year from FY93

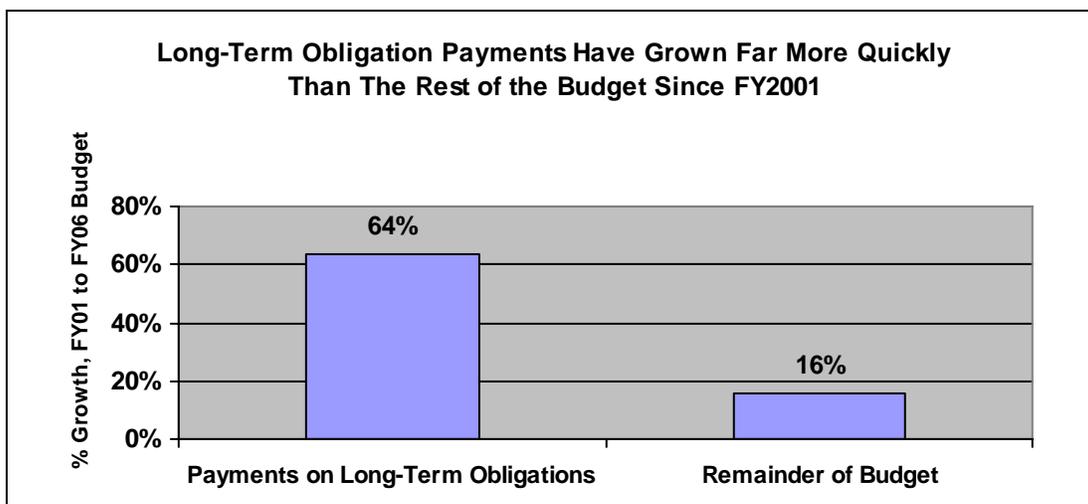
through FY2001. By FY2002, however, the City was again beginning to run out of borrowing capacity, and it began to reduce capital spending.

Now the City faces the same challenge it faced in 1992: it must reduce its debt burden at the same time that it increases its investment in its infrastructure. This time, however, the City's debt has risen so quickly that it would be unwise to do the type of borrowing done in the early 1990s to help the City.

Up, Up and Away: Long-Term Obligations Have Grown Substantially Since FY2001

The City's annual costs to pay for its long-term obligations have grown far faster than the rest of the budget. In FY2001, long-term obligations – debt service, long term leases and payments to eliminate the City's unfunded pension liability – totaled about \$400 million. By FY2006, those obligations were budgeted to be just under \$540 million. The \$140 million increase in spending was so large that it was more than the combined FY05 spending for the Health and Recreation Departments. The spending on long term obligations is projected to continue to increase as the FY2006-FY2010 Five-Year Plan projects that it will reach \$620 million by FY2010.

Not surprisingly, that rapid growth in payments for long-term obligations has been much faster than the growth in the rest of the budget. In fact, those payments grew four times faster than did all of the other costs borne by the general fund. The rapid growth in debt and unfunded pension liability payments means that dollars that could have been used to provide services, invest in the City's infrastructure, establish a rainy day fund, reduce the City's unfunded pension liability or lower taxes are instead going to service these long-term obligations.



Where are the Payments Going?

The portion of the City's long-term obligations dedicated to investment in infrastructure has been shrinking. Not only has the City seen its payments on long-term obligations increase, but it has also seen a change in where those payments go. In FY2001, almost one fifth of the City's long-term obligation payments were for debt service on borrowings to pay for improvements to basic city infrastructure like libraries, police stations and recreation centers. Another quarter of the payments were for PICA debt service.

In the FY2006 budget, the payments on debt service for City bonds to fund infrastructure improvements and for PICA's infrastructure borrowings have declined to under 12 percent and about 15.5 percent respectively for a combined total of just over 27 percent – far less than FY2001's almost 45 percent of long-term obligations.

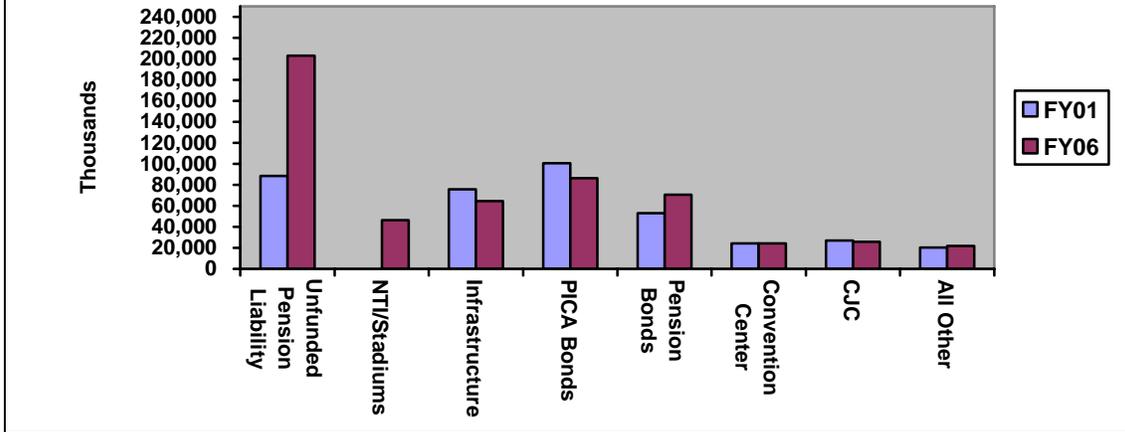
As City and PICA infrastructure borrowings declined as a percent of long-term obligations, they were replaced by increased payments for unfunded pension liabilities,¹ debt service on stadium and Neighborhood Transformation Initiative bonds and operations and maintenance payments for Lincoln Financial Field. In FY2001, there were no stadium or NTI payments and the unfunded pension liability equaled less than a quarter of long-term obligation payments. By FY2006, stadium and NTI payments combined to equal almost 8.5 percent of long-term obligations and unfunded pension liabilities equaled just under 39 percent of long-term obligations. In total, stadium, NTI and unfunded pension liability payments went from less than a quarter of long-term obligations in FY2001 to almost a half in the FY2006 budget.

If infrastructure debt service payments were the same percent of long-term obligations in FY2006 as they had been in FY2001, the City could have dedicated an additional \$43 million annually in debt service for its infrastructure without increasing its total long-term obligations payments. At this level, the City could have issued about \$650 million more in bonds to pay for infrastructure improvements – roughly \$130 million each year from FY2001 through FY2006. The City chose to increase its long-term liabilities at the same time that it was sacrificing investment in its infrastructure when it decided to issue bonds for NTI and for new stadiums, while the unfunded pension liability was skyrocketing.

The following chart shows the change in total dollars spent on the various components of the City's long-term obligations. As the chart shows, the unfunded pension liability has a much larger cost than any of the City's other long-term obligations.

¹ For a more detailed discussion of the growth in the City's pension liabilities, please see the PICA report "An Ounce of Prevention: Managing the Ballooning Liability of Philadelphia's Pension Fund" which can be found at www.picapa.org.

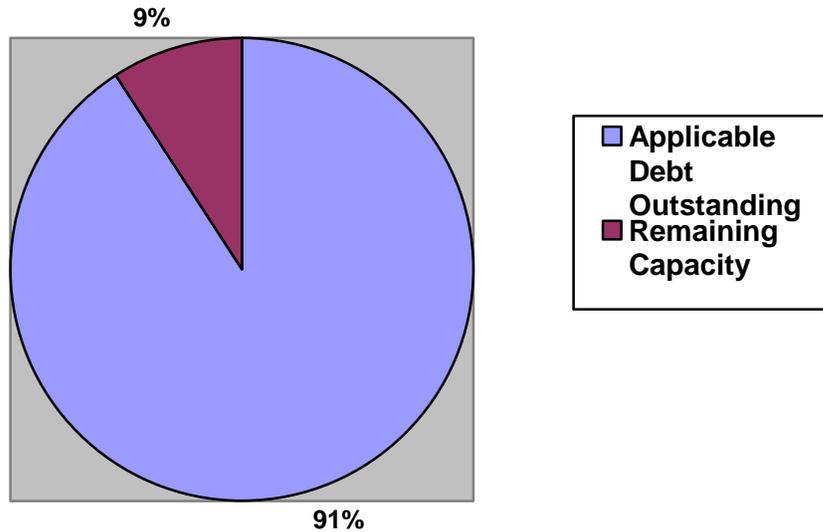
As Unfunded Pension Liability, NTI and Stadium Payments Have Increased, Payments for Debt Service on Infrastructure and PICA Bonds Have Decreased



Are There Any Limits on the City’s Debt?

The City has exhausted almost of all of its borrowing capacity under the Pennsylvania Constitution, but the Constitution’s debt limit has lost much of its importance for Philadelphia. Under the Pennsylvania Constitution, the City’s debt is limited to 13.5 percent of the 10 year moving average of assessed value of property in the City. The City’s FY2005 financial statements show that its legal debt limit is now \$1.3 billion, but that the City has \$1.19 billion of outstanding debt applicable to that debt limit. The City’s remaining legal debt margin is just \$119 million.

The City Has Used Almost All of Its Constitutional Debt Capacity



While the City is close to its Constitutional debt limit, that limit's importance has been lessened by several factors, including:

- The City has circumvented the debt limit by using authorities to borrow. Unlike debt issued directly by the City, borrowings by authorities do not count against the City's debt limit. The stadium and NTI debt, for example, were each issued through authorities. As a result, none of that debt counts against the Constitutional debt limit. In fact, almost 85 percent of the City's long-term obligations do not count against the City's debt limit. Since authority debt accounts for such a large portion of the City's long-term obligations, any analysis that does not include authorities does not provide a meaningful measure of the City's fixed costs.
- The Constitutional debt limit calculation includes only assessed values, but property taxes account for less than one fifth of general fund tax revenues and only slightly more than one tenth of total general fund revenues. Since property taxes bring in such a small portion of the City's revenues, a calculation based solely on the City's ability to generate property tax revenues does not provide a true barometer of the City's ability to incur debt.
- When the Board of Revision of Taxes (BRT)'s full value project² is completed, assessed values in the City will increase because the BRT will be moving from a system that assesses properties at roughly a quarter of their value to one that values properties at 100 percent of their value. That change in the BRT's process will mean that the City's debt limit under the Pennsylvania Constitution will roughly quadruple. Under the limits included in the State Constitution, the City will be able to borrow substantially more, but there will have been no change in the City's financial ability to support that borrowing.

In order to state its approach to borrowing, the City needs a public debt policy. While the City has a policy, it has not been updated since 1995. Until the City updates and publicizes its debt policy statement, there will be no clear guidance from the Administration as to what it believes is an appropriate level of debt service.

What Do Other Cities Do?

Cities use a variety of methods to determine appropriate levels of debt. In its recommended practices, the Government Finance Officers Association said cities can determine their ability to afford debt by looking at a number of measures, including: debt per capita, debt as a percent of personal income, debt as a percent of taxable property value, and debt service payments as a percentage of general fund revenues or

² For a more detailed discussion of the BRT's Full Value Project, please see the PICA report "From Virtual Realty to Full Value Realty: Preparing for Reassessment," which can be found at www.picapa.org.

expenditures. PICA looked at debt management practices in a dozen cities and at the practices recommended by the three major ratings agencies and found that cities used a number of guidelines for determining their debt limits, including all of the ones recommended by the GFOA. Among the approaches used were the following:

Limits based on assessed value of property. Many jurisdictions base their debt limits on assessed values. As discussed above, under the Pennsylvania Constitution, the City is also required to limit its issuance based on assessed values, but since the City is not heavily reliant on the property tax that is not a good yardstick for the City.

Limits Based on Total Revenues. A number of jurisdictions limited their debt to some portion of their revenues. Examples of this approach include the following:

- Under the Local Government Unit Debt Act, municipalities in Pennsylvania other than Philadelphia are permitted to borrow an amount equal to 250 percent of the average amount of revenues collected during the prior three years, excluding state and federal reimbursements. If that criterion were applied to Philadelphia, the City's debt limit would be \$5.8 billion, which is much higher than the City's limit will be even after the BRT's full value project. This is not a useful guideline for Philadelphia.
- In its Local Government General Obligation Rating Guidelines, Fitch Ratings says "Debt service above 10% of budget for cities and counties constitutes a level at which budgetary competition is a significant consideration." At 10 percent of budget, the City would spend roughly \$350 million annually on long-term obligations. Philadelphia, which pays \$600 million, is \$250 million above this measure.
- The City of Los Angeles limits direct debt service to 15 percent of general fund revenues and indirect debt to another six percent of revenues. Los Angeles' debt policy also explicitly says "except in extenuating circumstances, the City will fund routine maintenance projects in each year's capital program with pay-as-you-go financing." By way of comparison, Philadelphia's long-term obligations are projected to equal between 15 percent and 16 percent of revenues in each year of the FY2006-FY2010.

Limits Based on Expenditures. Another approach localities take is to limit their debt service to a set percentage of expenditures. Examples of this approach include the following:

- The Chief Financial Officer of Washington D.C. recently recommended that the District limit its debt to ten percent of its expenditures and said "A debt service-to-total expenditures ratio above 10 percent has been traditionally viewed by many analysts in the industry as a 'red flag' indicating movement into the high range." The City of Long Beach, California, one of five cities to get at least an A- from the Government Performance Project run by Governing Magazine and

Syracuse University, has already adopted a policy limiting its long-term debt payments to no more than ten percent of operating expenditures. Philadelphia, by contrast, has a long-term obligation to expenditure ratio of nearly 16 percent.

- Standard and Poor's says that a debt burden is considered high when debt service payments represent 15 percent to 20 percent of the combined operating and debt service fund expenditures. Even under this more generous standard, the City's long-term obligations, which are budgeted to be just above 15 percent in FY2006 and to reach almost 16 percent in FY2010, would be in the high range, albeit at the low end.
- In its Rating Methodology, Moody's says the typical range for debt service is five to 15 percent of expenditures. The City is again at the high end of a rating agency's range.

Limits Based on a Combination of Factors. Rather than analyzing long-term debt using just revenues or expenses, some cities look at a combination of factors, an approach which makes sense for Philadelphia. Virginia Beach, another of the cities that got an A-minus from the Government Performance Project, is limited by both its state constitution and city charter to having debt that equals no more than ten percent of the assessed value of the real estate in the city. Virginia Beach, however, takes additional steps to make sure that it does not issue too much debt. The city has identified the following four indicators of debt affordability:

- Annual debt service should be no greater than 10 percent of general government expenditures;
- Overall net debt should be no greater than 3.5 percent of estimated full value assessments (property taxes are by far the largest single source of revenue for the city);
- Overall debt per capita should be no greater than \$2,400; and
- The ratio of overall debt per capita to per capita income should be no greater than 6.5 percent.

Under Virginia Beach's debt management policy, the city will not issue debt that would put it at variance with any of its affordability guidelines.

The City of Boston's debt management policies also include a combination of factors used to determine debt affordability. Key components of that policy ensure that:

- Combined net direct debt does not exceed three percent of taxable assessed value (the property tax is Boston's primary revenue source);
- At least 40 percent of the overall debt is repaid within five years and 70 percent is repaid within ten years;
- Annual gross debt service does not exceed seven percent of general fund expenditures; and

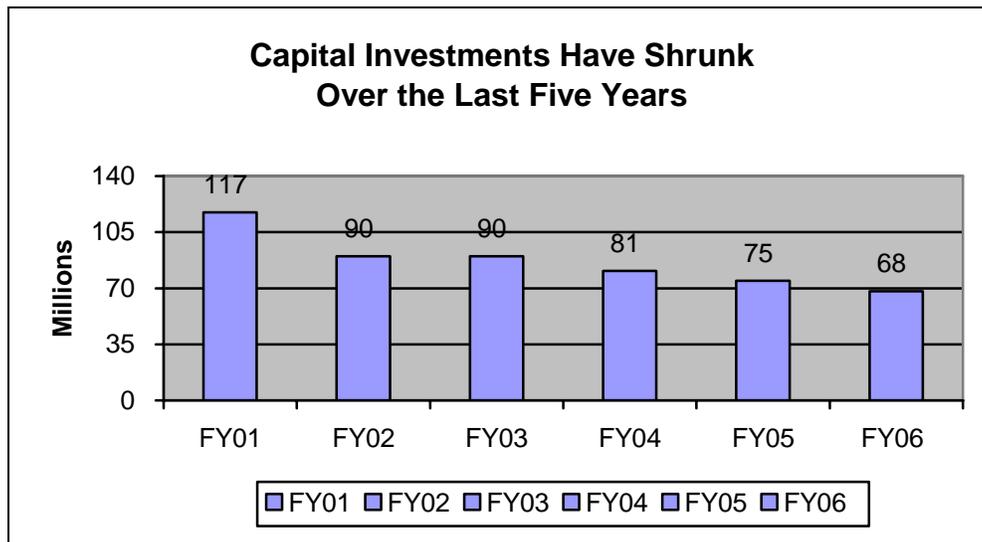
- Variable rate debt does not exceed 20 percent of the City’s total currently outstanding bonded debt.

While the indicators Boston and Virginia Beach use might not be the right ones for Philadelphia, the policy of using indicators in addition to a legal debt limit to determine how much debt a local government can issue is one that Philadelphia should pursue.

Dedicating Taxes to Pay Off Debt. Minneapolis, another city that got an A- for financial management from the Government Performance Project, is required by its state constitution to certify an irrevocable tax levy to the county auditor covering annual principal and interest requirements plus five percent for any general obligation debt issuance. The annual tax levy can be reduced by an amount equal to the issuing agency’s annual certification based on the amount of funds on hand.

The Incredible Shrinking Investment: The City Funded Portion of the Capital Budget Has Been Rapidly Declining

The City’s declining investment in its infrastructure has meant that it is falling further and further short of the amounts its own Planning Commission says are needed to keep the City’s infrastructure in good condition. From FY2001 to the FY2006 budget the City’s tax supported investment in its infrastructure declined 42 percent from \$117 million to \$68 million. Even at \$117 million the City’s investment was well below the levels that the City Planning Commission³ said were required to keep the City’s infrastructure in good condition.



³ The City Planning Commission is responsible for guiding the orderly growth and development of the City of Philadelphia. Its duties include the development of a comprehensive plan for the City; the Capital Program and Budget; and, proposed zoning ordinances and amendments. The Mayor, who appoints the Director of the Planning Commission, has included the director as a member of his cabinet.

The rapid reduction in investment in the City's facilities over the last five years is part of a longer-term trend. As recently as FY1996, City general obligation debt was supporting \$152 million in the capital budget. That number is budgeted to decline to \$45.8 million in FY2011, a 70 percent drop from FY1996's level.

As the City continues to under-invest in its libraries, recreation centers, fire stations and other city facilities, the likelihood increases that those facilities will deteriorate to the point at which they are unusable and the City will be unable to provide key services. In addition, the City will not be able to make the kinds of investments it has made in the past to energize its economy such as funding for improvements to the Avenue of the Arts, the Art Museum and Penn's Landing.

How Does the City's Infrastructure Investment Compare to Levels that the City Planning Commission Says Are Necessary to Keep that Infrastructure in Good Condition?

The City's investment in its infrastructure is well below levels its planning commission says are necessary to keep that infrastructure in good condition. In a report completed in 2000, the City Planning Commission studied the City's infrastructure and described the impact on that infrastructure of providing each of four different levels of funding.

Level A: \$185 million. At \$185 million, which the Commission called Level A, the City would be able to keep all of its infrastructure resources in good condition, which should be the City's goal. While the Commission said this level of funding is sufficient to allow for more than generic maintenance improvements, it also said that it is not enough to fully fund new economic development and housing initiatives or to address investments in major structures such as the Art Museum. The City is now below 37 percent of this level and has not come within \$50 million of it since FY1996, when funding was at \$152 million.

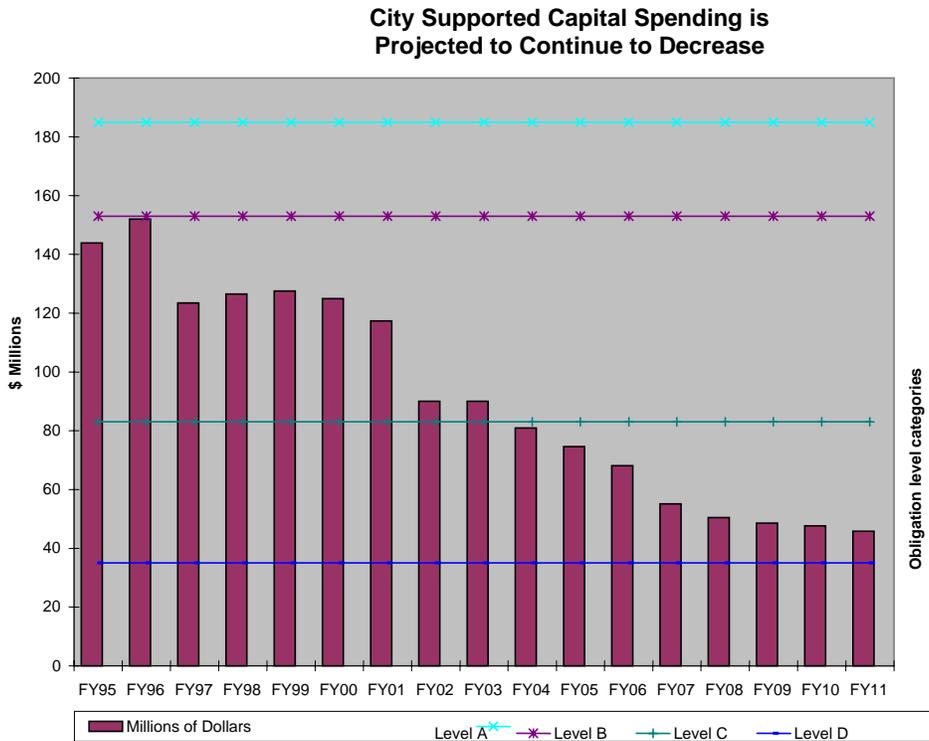
Level B: \$153 million. The City last provided this level of funding, which the Commission called Level B, in FY1996. At this level, the City would be able to renovate facilities; invest some funds in major economic development initiatives such as the Avenue of the Arts and Naval Base conversion; meet regulatory requirements for the environment; and invest in projects to improve technology and energy conservation. Even at this level of funding the City could only partially fund streets, prisons and courts improvements, large scale renovations and modernization initiatives. In FY2006, the City will only be providing funding equal to 44 percent of Level B.

Level C: \$83 million. The City was funding at or above \$83 million, which is Level C, each year until FY2004, when the budget dipped to \$81 million. Funding is not budgeted to reach this level again through FY2011. Level C funding is sufficient only to maintain basic infrastructure; provide some funding for economic development initiatives and fund the basic support for transit systems and general efficiency initiatives. While only

sustaining the most essential maintenance projects, this level of funding neglects critical large scale renovations, transit system needs, economic development initiatives and long-term maintenance updates of the prisons and courts.

Level D: \$35 million. The City’s capital program calls for it to provide funding in excess of this level, which is level D, each year through FY2011. The City Planning Commission states that this funding level would “result in the widespread and highly visible deterioration of Philadelphia’s Public Infrastructure”. Unfortunately, the City’s capital program shows that through FY2011, the City’s infrastructure investment will be perilously close to Level D. The City must find ways to avoid the inevitable consequences of the projected reduced investment.

The chart below illustrates that over the last 10 years the City’s level of investment has dropped quickly from just below the second level of funding in FY1996 to just below the third level of funding in FY2004 and that it is projected to be only slightly above the lowest level of funding by FY2009. The colored lines represent each of the four levels of funding described by the Planning Commission.



What Options Does the City Have?

Financial Recommendations

The City Should Do More Pay-as-You-Go Capital Spending by Shifting Items from the Capital Budget that Can Appropriately Be Funded Through the Operating Budget

Almost all of the City's capital spending is funded through bond issues. While it is appropriate to use long-term borrowings to fund long-term capital investments, the City should not continue to increase its debt levels. As a result, the only way the City can prudently make essential investments in its infrastructure is to pay for some of those costs out of operating funds. For example, the City could shift \$37.3 million from new borrowings to the general fund operating budget over the life of the current FY2006-FY2011 capital program by shifting the Capital Program Office's payroll for administration and architects and engineers to pay-as-you-go funding. That funding is now included in the capital budget and funded through bond issues. Shifting to more pay-as-you-go financing could allow the City to reduce its projected debt service at the same time as it was increasing its investment in its infrastructure

The City Should Consider Retiring Some of Its Outstanding Bonds

By purchasing some of its bonds, the City would lower its debt service going forward. While that payment would increase current year spending, it would reduce the city's costs in the long-term, providing additional future budgetary flexibility.

The City Should Consider Reducing the Number of Facilities It Maintains

Given its level of existing long-term obligations, the City can not substantially increase the amount it borrows for infrastructure improvements. At the same time, given the pressures on its operating budget, it cannot provide enough money to adequately fund infrastructure improvements while maintaining short-term fiscal stability and addressing long-term structural challenges such as establishing a rainy day fund, reducing the City's unfunded pension liability and making the City's tax structure more competitive. The only way the City could provide adequate funding to properly maintain its facilities, is if it had fewer facilities. The City should continue to look for ways to close, outsource or sell facilities. Reducing the number of facilities would also likely allow the City to increase the amount it invests in its remaining facilities, which would mean that the facilities the City retained would be in better condition.

Monitoring/Reporting Recommendations

The City Should Base Its Debt Incurring Limit On Its Total Revenues

The State Constitution's limit is too narrowly based since it only focuses on the City's property tax base. A more meaningful test would look at all of the City's revenues rather than only at one source that accounts for only about one tenth of revenues. When those long-term obligations become too high a percentage of total revenues, they inhibit the City's ability to react to unforeseen contingencies. As the examples from rating agencies and other cities show, there are a range of percents that are appropriate, but each City that looked at total expenditures or revenues used a percent from five to fifteen. The City's goal should be to get total long-term obligations as a percent of revenues below 15 percent in the short term and below ten percent in the long term. In the FY2006-FY2010 Five-Year Plan, long term obligations were between 15 percent and 16 percent of revenues each year.

Each Year's Five-Year Plan Should Include Projections for Long-Term Obligations as a Percent of Revenues

In addition to setting a limit on long term obligation payments as a percent of revenue, the City should report on how it does against that limit. The City's five-year plans should show what those obligations would be as a percent of revenues given existing commitments and projected borrowings, long-term commitments and amortization payments for the City's unfunded pension liability. If the Plan showed that long-term obligations exceeded the City's target, the Five-Year Plan should include a strategy for reducing that percentage to a level below the target.

The City Planning Commission Should Regularly Update Its Needs Assessment and That Document Should Be Specifically Discussed in the Capital Program Chapter of the Five-Year Plan

The needs assessment should show the amount the City should invest in its infrastructure each year to keep that infrastructure in good repair and the implications of various levels of investment. When this discussion is included in the plan, the Mayor and City Council will understand the choices they are making when they agree on a capital budget amount.

Updating and publicizing the City's debt policy. The debt policy should detail what the City believes are appropriate types and levels of debt. After the policy is made public, it should be updated at least once every four years.

Appendix: How Does the City Develop Its Capital Budget?

As part of the City's annual budget process, the City Planning Commission prepares a capital budget and program. The capital budget is the first year of a six year schedule of funding for physical improvements to be financed wholly or partially by tax supported funds. Projects are also funded by the federal or state government, private funds; or can be classified as self sustaining if, like airport and water projects, they are funded with bonds that will be paid by revenues generated by the airport or the water fund

The capital program process begins with the submission in the fall of project requests by city departments to the City Planning Commission. Based on a review of those requests, the Commission submits a suggested list of projects to the mayor for his review and transmittal to Council for adoption. Each year's capital budget indicates the amount which is to be financed out of the city's current funds and the amount to be financed from long-term borrowing. While the Planning Commission recommends the specific projects to be funded, the amount of City funding that is proposed in the capital budget is based on an analysis of the City's remaining debt capacity under the Pennsylvania Constitution. Since the remaining debt capacity is so small, the Planning Commission proposes budgets and programs that contain a much lower level of funding than the Commission says is necessary to keep the City's infrastructure in good condition.

Before the City can borrow money to fund projects included the capital budget, City Council must approve a loan ordinance and voters must approve a ballot question authorizing the financing. The loan ordinance for the FY2006 capital budget has not yet been enacted.