

Pennsylvania Intergovernmental Cooperation Authority



**Annual Report
for
Fiscal Year 2005**

October 27, 2005

**PENNSYLVANIA INTERGOVERNMENTAL
COOPERATION AUTHORITY**

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Professional Advisors

Authority Counsel

Reed Smith LLP

Independent Auditors

Isdaner & Company, LLC

The Mission of the Authority

The mission of the Authority, as stated in its enabling legislation, 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; and*
- (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.

Source: Pennsylvania Intergovernmental Cooperation Authority Act for Cities of the First Class (Act of June 5, 1991, P.L. 9, No. 6) (the "PICA Act") Section 102.

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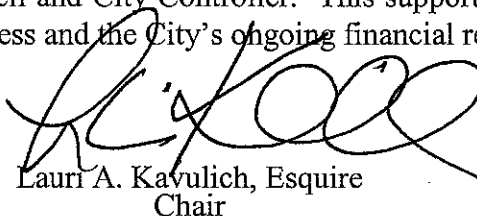
October, 2005

To: The Governor and the General Assembly of the Commonwealth of Pennsylvania
The Chairperson and the Minority Chairperson of the Appropriations Committee of the
Pennsylvania Senate
The Chairperson and the Minority Chairperson of the Appropriations Committee of the
Pennsylvania House of Representatives
The Mayor, the City Council and the Controller of the City of Philadelphia
Other Parties Concerned with the Maintenance of Financial Stability of and Achieving
Balanced Budgets for the City of Philadelphia

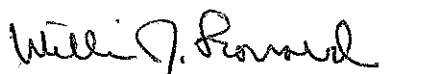
As the Pennsylvania Intergovernmental Cooperation Authority ("PICA") marks its fourteenth anniversary, we are pleased to provide you with this Annual Report for the fiscal year ended June 30, 2005 ("FY2005"). In 1991, the City of Philadelphia ("City") faced a deficit of \$137 million, and lacked a coherent fiscal planning mechanism. The City ended FY2005 with a surplus of nearly \$97 million, a projected balanced budget for the next five years, and the continued success of the annual Five-Year Financial Plan required by PICA. Though the City faces challenges, including a high debt burden, an uncompetitive tax structure, a struggling Philadelphia Gas Works, the threatened loss of federal reimbursements for social services, and an underperforming Pension Fund, we remain confident in PICA's ability to help the City maintain a positive fiscal outlook.

Even after fourteen years, PICA continues to have a significant role in the ongoing City financial recovery. FY2005 activity included: (1) for the first time, a requirement for the City to submit a revised Five-Year Financial Plan (for Fiscal Years 2005-2009) and subsequent approval of that revision; (2) the approval of a Five-Year Financial Plan for Fiscal Years 2006 through 2010 which anticipates balanced budgets and tax reductions in each component year; (3) monitoring Five-Year Financial Plan compliance; (4) continuing review and monitoring of the City's operations; (5) oversight as to utilization of remainder moneys borrowed by PICA for City capital projects, productivity enhancements and indemnity costs; and (5) service as the primary independent source of objective financial information and opinion for the benefit of the citizens of the City and the Commonwealth as well as for the media, the financial community and other outside observers.

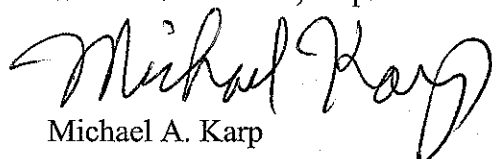
The PICA Board has been gratified by the recognition PICA regularly receives from the financial community and the media for its successful performance as the agency charged with the responsibility for oversight and monitoring of the City's finances. We would be remiss if we failed to acknowledge and express our sincere appreciation for the continuous support PICA receives from the Governor and the General Assembly, and also for the ongoing cooperation of Philadelphia's Mayor, City Council and City Controller. This support and cooperation are vital factors to PICA's continuing success and the City's ongoing financial recovery.



Lauri A. Kavulich, Esquire
Chair



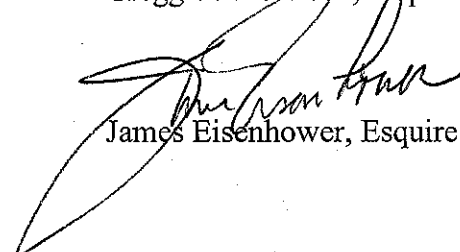
William J. Leonard, Esquire



Michael A. Karp



Gregg R. Melinson, Esquire



James Eisenhower, Esquire

PICA Annual Report Requirements

The Pennsylvania Intergovernmental Cooperation Authority Act for Cities of First Class, Act of 1991, P.L. 9, No. 6 at §203(b)(5) requires PICA:

To make annual reports within 120 days of the close of the Authority's fiscal year commencing with the fiscal year ending June 30, 1992, to the Governor and the General Assembly describing its progress with respect to restoring the financial stability of assisted cities and achieving balanced budgets for assisted cities, such reports to be filed with the Governor, with the presiding officers of the Senate and the House of Representatives, with the Chairperson and the Minority Chairperson of the Appropriations Committee of the Senate and the Chairperson and the Minority Chairperson of the House of Representatives and with the Governing Body, Mayor and Controller of the assisted city.

§207 of the Act further provides for an annual audit to be included with the Annual Report, as follows:

Every Authority shall file an annual report with the Chairperson and the Minority Chairperson of the Appropriations Committee of the Senate and the Chairperson and the Minority Chairperson of the Appropriations Committee of the House of Representatives, which shall make provisions for the accounting of revenues and expenses. The Authority shall have its books, accounts and records audited annually in accordance with generally accepted auditing standards by an independent auditor who shall be a certified public accountant, and a copy of his audit report shall be attached to and be made a part of the Authority's annual report. A concise financial statement shall be published annually in the Pennsylvania Bulletin.

Overview - PICA and its Role

PICA Act

The Pennsylvania Intergovernmental Cooperation Authority ("PICA") was created in 1991 to assist the City of Philadelphia (the "City") in overcoming a severe financial crisis. At that time, the City was burdened with a growing cumulative operating deficit, lacked resources to pay mounting overdue bills from vendors, had been pushed below the investment grade level by national rating agencies, had instituted an across-the-board hiring freeze, was in a mode in which the quality of municipal services being provided was rapidly eroding, and verged on bankruptcy. PICA was created through the joint efforts of concerned Philadelphians and State officials who envisioned a structure which would assist the City in putting its revenue collection and spending processes in order, and at the same time reach a consensus on its future priorities, assets and limitations. The PICA Act was a compromise fashioned to meet the requirements of the Pennsylvania Constitution, the concept of local government Home Rule, and the interests of the State in the preservation of the financial integrity of its municipalities. PICA's role, a combination of cooperation, assistance and oversight was determined to be of vital importance in both a financial and political sense. PICA was designed to be a catalyst in the City's re-evaluation of the role and priorities of municipal government.

Cooperation Agreement

The Intergovernmental Cooperation Agreement negotiated by and between PICA and the City and finalized in January of 1992 formalized the relationship contemplated by the PICA legislation. The powers and duties of the respective participants envisioned in the legislation were put into place with the execution of the Agreement. PICA was designed to be much more than a vehicle to raise otherwise unavailable funds for Philadelphia. It has the responsibility to evaluate and approve annually revised Five-Year Financial Plans, to monitor compliance by the City with such Plans, and the power to instruct the Commonwealth's Secretary of the Budget to withhold both substantial Commonwealth financial assistance and the net proceeds of the PICA Tax (after PICA debt service) should the City fail to comply with its duty to balance such Plan in each of its years.

The PICA Organization

The Authority Board determined at the outset that PICA should not become overburdened with staff, preferring instead to impress upon the City the necessity for Philadelphia to develop and implement its own solutions to its problems. The Authority's staff, which totals eight, is organized to evaluate the actions of the City and to issue appropriate reports thereon to assist those who are properly charged with administration of City affairs or development of underlying policies.

PICA Financial Assistance to the City

The issuance of bonds to provide the funds directly required to assist the City to avoid insolvency and for essential capital programs was an important initial role of the Authority. That role has been successfully completed and the Authority's "new money" bond issuance powers have expired. Authority bond issuance is currently limited to refinancing existing Authority debt in order to realize net debt service savings to the City.

Through debt issuance and capital program earnings the Authority has provided in excess of \$1,184 million to directly 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	515,991
Retirement of Certain High Interest City Debt	<u>381,300</u>
TOTAL	<u>\$1,186,291</u>

The Five-Year Financial Plan Process

PICA has consistently emphasized its firm belief that the City's continuing fiscal rehabilitation is dependent upon its continuing success in addressing both financial and managerial issues; that the process is less one dealing with finance than assessing the financial results of managerial decisions. Effective strategic planning and the institutionalization of change are matters which the City must continue to focus upon in order to assure that its considerable assets continue to be applied intelligently and consistently. The Plan process helps to document the City's intentions and the results of its actions.

As mandated in the PICA Act (and as further refined by the Intergovernmental Cooperation Agreement), the Plan is required to include:

- Projected revenues and expenditures of the principal operating funds of the City for five fiscal years (the current fiscal year and the next four); and
- Components to (i) eliminate any projected deficit for the current fiscal year; (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 Plan through sound budgetary practices, including, but not limited to, reductions in expenditures, improvements in productivity, increases in revenues, or a combination of such 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- and long-term credit markets.

There also are statutorily mandated standards for development of the Plan (and the manner in which it is to be evaluated by PICA):

- all projections of revenues and expenditures are to be based upon consistently applied reasonable and appropriate assumptions and methods of estimation;
- revenues are to be recognized in the accounting period in which they become both measurable and available; and

- cash flow projections are to be made based upon reasonable and appropriate assumptions as to sources and uses of cash, including factors intended to provide a complete picture of cash demands.

The PICA Act also mandates standards for the basis for estimation of City revenues:

City Sources - current or proposed tax rates, historical collection patterns, and generally recognized econometric models;

State sources - historical patterns, currently available levels, or on levels proposed in a budget by the Governor;

Federal sources - historical patterns, currently available levels, or levels proposed in a budget by the President or in a Congressional budget resolution; and

Non-tax sources - current or proposed rates, charges or fees, historical patterns and generally recognized econometric models.

Deviations from such standards for estimation of revenues and appropriations which are proposed to be used by the City are to be disclosed specifically to the Authority and approved by a "qualified majority" of the Authority (four of its five appointed members). The Authority's Board generally has required that conservative criteria be used, and the result of the PICA process has been credible budget and Plan-making.

The Plan is also required to include a schedule of projected City capital commitments (and proposed sources of funding), debt service projections for existing and anticipated City obligations, a schedule of payments for legally-mandated services projected to be due during the term of the Plan and a schedule showing the number of authorized employee positions (filled and unfilled), inclusive of estimates of wage and benefit levels for various groups of employees.

The PICA Act requires that the Authority solicit an opinion or certification from the City Controller, prepared in accordance with generally accepted auditing standards, with respect to the reasonableness of the assumptions and estimates in the Plan. The PICA Act does not, however, require that the Controller's determinations bind the Authority in its evaluation of a proposed Plan.

The PICA Act (§209) and the Cooperation Agreement (§409(b)) require submission of quarterly reports by the City concerning its compliance with the current 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 a qualified majority declare the occurrence of a "variance", which is defined in §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 (1%) 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 §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 Effect of a "Variance"

The statute mandates the submission of monthly reports to PICA by the City in the event of a determination by the Authority of the occurrence of a variance. That situation occurred once in PICA's history. In November of 1992, the City projected a variance of \$57 million (2.5%) for the 1993 fiscal year, and the Authority agreed with that assessment on December 9, 1992. Thereafter, until May of 1993, the City filed required monthly reports. The City was relieved of its burden to make monthly reports when the Authority approved the City's plan of correction in conjunction with its approval of the City's Five-Year Financial Plan for FY93-FY98 in May of 1993.

As provided in §210(e) of the PICA Act, legal consequences flow from a determination by the Authority of the existence of a variance. 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 deal with a continuing variance are to direct the withholding of both specific Commonwealth funds due the City and that portion of the 1.50% tax levied on the wages and income of residents of the City in excess of the amounts necessary to pay debt service on PICA's bonds. Any amounts withheld would be paid over to the City after correction of the variance.

PICA "Threshold" Policies

From its inception, PICA has held to the following policies in its evaluation of Philadelphia's Plans, initiatives, proposals and performance:

Emphasis on Structural Change - Consistent City failure to deal effectively with a long list of areas of government operations and service delivery contributed to the need for PICA. The City shall continually be encouraged to rethink existing policies and practices and to avoid sacrificing long-term progress for short-term gain.

Focus on Long-Term Progress - Meaningful strategic planning, institutionalization of appropriate change, focus on attaining long-term structural balance and on implementing pragmatic economic stimulus policies and procedures are matters of paramount importance and are to be emphasized in the PICA oversight process.

Infrastructure Programs - A meaningful capital program is a visible and tangible element of a City's social contract with its residents. The capital program, including proper maintenance of capital assets, is a key element to long-term fiscal stability. A consistent policy to adequately fund and staff infrastructure maintenance shall be continually encouraged.

Consistent Application of Stated Assumptions - Inconsistent application of unstated assumptions frequently caused pre-PICA City budgets to lack credibility, and made reliable assessment of prospects of attaining the results of such budgets impossible. PICA's Plan review process shall focus on assumptions utilized being both visible and consistent in their application.

Use of Credible Revenue Estimates - Realistic revenue estimates are a vital component of the City's budgeting and Plan preparation process and shall be a matter of primary concern in PICA's Annual Plan review process.

While it would be incorrect to claim that PICA threshold policies have resulted in all desired effects coming to fruition, they have contributed substantially to City procedural improvements.

Philadelphia City Controller

An unforeseen benefit of the PICA Act's requirement that PICA solicit an opinion from the City Controller as to the reasonableness of Plan assumptions and estimates has been the extensive cooperative professional relationship which has developed between PICA Staff and the Controller's Office. The mutually beneficial professional relationship includes ongoing cooperation on matters of common concern and regular staff meetings with respect to such matters; joint reviews of Plan components including appropriate joint meetings with City department heads and chief operating personnel pertinent thereto; cooperation on capital project reviews and reviews of PICA funded special purpose grants to the City; PICA assistance for Controller special situation studies; and specific Office of the Controller personnel assigned responsibility for effective ongoing liaison with PICA Staff. The City Controller provides copies of all City audit reports and copies of special situation studies to PICA on a timely basis. The assistance provided to PICA by the City Controller is sincerely appreciated. Cooperation between its "oversight" and "watchdog" entities has substantially benefited the City.

Providing Comment on Pending Legislation

In accordance with its oversight duties, PICA continues to provide comments and fiscal analysis on City legislation which impacts the City's fiscal situation. Further, PICA will uphold its responsibility to provide analysis on appropriate legislation before the General Assembly, in accordance with the PICA Act § 203 (c) (5), which empowers the Authority "to make recommendations to the Governor and the General Assembly regarding legislation or resolutions that affect Commonwealth aid or mandates to an assisted city or that concern an assisted city's taxing power or relate to an assisted city's fiscal stability."

Corporate Entities and The School District of Philadelphia

"Corporate Entities" are defined in §1.01 of the Cooperation Agreement as "an authority or other corporate entity, now existing or hereafter created, of which one or more members of its governing board are appointed by the Mayor and which performs governmental functions for the City". The Agreement provides that the City shall cooperate with PICA in any PICA request to look into the operations of either the Corporate Entities or the School District of Philadelphia.

To date, PICA has not devoted any substantial attention to the operations of such City related institutions, but it has offered its expertise to the School Reform Commission

as well as the CEO of the School District of Philadelphia, and has provided informal assistance where appropriate.

In accordance with legislation passed by the General Assembly, PICA Staff has had initial discussions with the Pennsylvania Convention Center regarding development of a Financial Plan for expansion. PICA Staff is ready to prepare an analysis of the plan and risks once it has been completed. PICA Staff also remains prepared to play any appropriate role in regard to developments at the Philadelphia Gas Works.

The Work of PICA - Fiscal Year 2005

Request for, Review and Approval of Revised FY2005-FY2009 Plan

In the Fall of 2004, the City accepted an Act 111 interest arbitration award between the City and Lodge 5 of the Fraternal Order of Police and also reached a labor agreement with District Council 47. In response to the substantial deviations from the approved FY2005-FY2009 Plan resulting from these agreements, and in accordance with Section 5.08(e) of the Cooperation Agreement, on October 25, 2004, PICA required that the City submit a Revised FY2005-FY2009 Plan incorporating changes in projected revenues and expenditures while meeting the mandated requirements for a balanced Five-Year Financial Plan.

The City submitted some suggested revisions on November 15, 2004. After review by PICA and in response to several issues raised regarding those revisions, the City formally submitted a Revised FY2005-FY2009 Plan on December 17, 2004. This Revision, which included modifications to anticipated revenues and expenditures agreed upon between the City and PICA, was approved by the PICA Board on December 21, 2004.

Approval of the FY2006-FY2010 Plan

Review and recommendation for approval of the City's FY2006-FY2010 Five-Year Financial Plan was a major component of PICA Staff activities during FY2005. The City submitted the Plan on June 20, 2005, continuing the recent practice of precariously late submissions by the City resulting from protracted disputes between the Mayor and City Council over passage of the City budget. In the months preceding this submission, PICA noted several concerns with the proposed Plan during meetings with representatives of the City. Despite numerous warnings, the Plan as submitted on June 20, 2005 did not address PICA's concerns and 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 marked a continuing deterioration in the ability of the City to complete its mandated fiscal responsibilities in a timely fashion. As a result of PICA's desire to maintain the fiscal integrity of the City of Philadelphia, PICA Staff expedited its review of the proposed Plan. The approved Plan proposes continued annual cuts in wage and earnings and business privilege taxes. Estimates of the impact of the tax cuts on revenues were carefully weighed during the review process.

Although recommended for approval, the Plan contained risks to the continuing fiscal health of the City. The Staff Report cited four significant risks:

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

- The continued use of assumed revenues from unproven initiatives to balance the Plan.
- A reduction 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.

The Staff Report on the City of Philadelphia's Five-Year Financial Plan for Fiscal Year 2006-Fiscal Year 2010, dated August 8, 2005 and comprising 39 pages, is available by contacting PICA at 215-561-9160 or at our website www.picapa.org.

City Capital Program

Oversight of the capital program continued to be a key element of PICA's work in FY2005. PICA Staff has continually noted the need for the City's capital program to be guided by an overall strategic plan. Progress in this area has been limited by the fact that the strategic planning process remains incomplete. PICA Staff continues to monitor the relationship of the capital program and capital budgets to other Citywide programs.

PICA Staff notes that the City has yet to complete all of the projects originally approved at the time of the various bond issuances. PICA Staff will continue to press the City to complete these projects.

The Tax Base and the Local Economy

The City's high tax burden for individuals and businesses remains a major obstacle to economic development. The continuing tax cuts proposed in the FY2006-FY2010 Plan are a positive step toward addressing this problem. However, even with the implementation of the tax reductions, significant tax differentials will remain between the City and competing locations in the suburbs and elsewhere. While State and Federal policies drive some of the tax differential, the City government can still do much to promote a more competitive tax structure. The City can further increase productivity, cut costs, improve tax enforcement and make appropriate changes in the levels and mix of City services provided, consistent with a strategic plan.

During FY2005, PICA Staff provided testimony and technical support to the Administration and City Council in their efforts to review and reform the tax structure.

Indemnities

During FY2003, the City began its effort to draw down the outstanding funds from the Special Indemnity Accounts that were created with PICA bond proceeds that were not needed to finance initially projected deficits. As of June 30, 2005, less than \$127,000 remained in such accounts, including proceeds from the 1992 bond issue granted to the City by PICA and subsequent interest earnings. These funds continue to be available for indemnity payments associated with cases resolved under the Court of Common Pleas Day Backward/Day Forward backlog reduction program.

Goals for PICA - Fiscal Year 2006

Ongoing Goals

During the next fiscal year, PICA Staff will continue to:

- Encourage the City to address long-term issues such as the need for a Rainy Day Fund, the City's dangerously high debt burden, Philadelphia's uncompetitive tax structure, the pension fund's growing cost and increasing unfunded liability, and the persistent underinvestment in the City's infrastructure.
- Focus on the need for City departments and agencies to produce strategic plans which delineate specific actions to be undertaken and measurable goals to be achieved that assist in attaining the goals of the Five-Year Plan, particularly in light of staff reductions.
- Promote the further development and use of departmental performance measures that contribute to a better understanding of and capacity to manage departmental activities.
- Oversee PICA-funded City capital projects, stressing essential improvements to the City's capital project management and the benefits derivable from coordinated strategic and capital planning.
- Encourage identification of additional City capital funds available for reprogramming and utilize these funds for projects meeting PICA's statutory criteria.
- Provide technical assistance to help inform the ongoing debate about reforming Philadelphia's tax and regulatory structures.

Plan Review and Approvals

PICA Staff looks forward to the FY2006 review of the City's Five-Year Financial Plan, Fiscal Year 2007-Fiscal Year 2011 (including Fiscal Year 2006) with the input of the professional staff of the City Controller. The Plan will need to produce reasonable revenue and expenditure projections and reasonable prospects for continued General Fund balance while addressing the long-term issues facing the City.

Achieving Balanced Annual Budgets

Four of the five years of the current Plan assume an annual operating deficit, ranging from \$18 million to over \$37 million. PICA Staff believes the City needs to strive for projected annual Operating Fund balanced budgets in order to achieve true fiscal stability.

Providing Reliable Information to Inform Policy Debates in the City

PICA Staff will renew its efforts to provide reliable and unbiased data and analysis to help inform the public policy debates which are sure to arise during the coming Fiscal Year. Through Issue Papers, periodic Staff Reports, public testimony, and briefings for the executive and legislative branches of the City and the Commonwealth, PICA will aim to spur discussion about the issues which challenge the City's ongoing fiscal stability.

The School District of Philadelphia

The possibility of PICA being of substantial assistance to both the Commonwealth of Pennsylvania and the City of Philadelphia in the matter of School District financial oversight was originally proposed by the Courts, has twice been a matter of legislative discussions, and has been endorsed by the Mayor and several members of City Council. That opportunity and the challenges it would present would be welcomed by PICA Staff. PICA's budget includes reserve funding for such an event. PICA Staff will continue to provide informal assistance to the School District.

Improving Philadelphia's Tax Structure

PICA will continue to publish papers, provide testimony, and provide technical assistance regarding the ongoing efforts to make Philadelphia's tax structure more efficient and effective while maintaining the integrity of the City's Five-Year budget planning process.

Overall Goal

PICA's overall goal continues to be assisting the City to become more proactive in serving its citizens; to define its service delivery philosophy; and then to consistently deliver such services within the constraints of available resources. No less will be acceptable.

Future City Reporting to PICA

Regular Reporting Required

The reporting system established in the Cooperation Agreement and in the PICA Act requires a regular flow of data from the City to PICA. This system is the fundamental device used by PICA Staff in its ongoing evaluation of City progress in its fiscal rehabilitation. PICA is generally satisfied as to the information being provided to it. PICA Staff anticipates working closely with the Administration to ensure that there is no lapse in the flow of information PICA requires to fulfill its mission.

Data to be Received by PICA Includes:

Revised Plan. The PICA Act and the Cooperation Agreement contemplate the continuous existence of a Plan encompassing the current fiscal year and the four fiscal years thereafter, and require that a new year be added to the then-existing Plan not later than 100 days prior to the end of each fiscal year. The City's Five-Year Financial Plan, Fiscal Year 2007-Fiscal Year 2011 (including Fiscal Year 2006) is thus anticipated to be received by PICA by March 22, 2006.

Quarterly Plan Reports. Under the Cooperation Agreement (§409(b)), the Authority receives reports from the City on a quarterly basis (within 45 days after the end of each fiscal quarter) concerning the status of compliance with the Plan and associated achievement of initiatives. The Cooperation Agreement (§409(e)) 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, by department, be prepared and submitted not later than 20 days after the close of each fiscal quarter. This report details the receipt and use of Federal and Commonwealth Funds by the City. A separate report details the eligibility for fund withholding by the Commonwealth (at PICA's direction) in the event the City cannot propose credible measures to balance a Plan which has been declared at "variance" by PICA.

Prospective Debt Service Requirements Report. 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, and upon each issuance of bonds or notes or execution of a lease.

Time Table of FY2006 Reporting Requirements

Due Date	Description
October 20, 2005	Receipt of 1st Quarter FY2006 Grants Revenue Fund Contingency Account Report
November 1, 2005	Receipt of 3rd Quarter FY2006 Prospective Debt Service Requirements Report
November 15, 2005	Receipt of 1st Quarter FY2006 Plan Report, Supplemental Funds Report and report concerning Commonwealth funds which may be withheld
January 20, 2006	Receipt of 2nd Quarter FY2006 Grants Revenue Fund Contingency Account Report
January 31, 2006	Receipt of 4th Quarter FY2006 Prospective Debt Service Requirements Report
February 15, 2006	Receipt of 2nd Quarter FY2006 Plan Report, Supplemental Funds Report and report concerning Commonwealth funds which may be withheld
March 22, 2006	Submission of proposed revision to Plan and addition of FY2011
April 20, 2006	Receipt of 3rd Quarter FY2006 Grants Revenue Fund Contingency Account Report
May 1, 2006	Receipt of 1st Quarter FY2007 Prospective Debt Service Requirements Report
May 15, 2006	Receipt of 3rd Quarter FY2006 Plan Report, Supplemental Funds Report and report concerning Commonwealth funds which may be withheld
July 20, 2006	Receipt of 4th Quarter FY2006 Grants Revenue Fund Contingency Account Report
August 1, 2006	Receipt of 2nd Quarter FY2006 Prospective Debt Service Requirements Report
August 15, 2006	Receipt of 4th Quarter FY2006 Plan Report, Supplemental Funds Report and report concerning Commonwealth funds which may be withheld

Appendix A:
Financial Statements
and
Report of Independent Auditors

ISDANER &
COMPANY, LLC

**ISDANER &
COMPANY, LLC**
CERTIFIED PUBLIC ACCOUNTANTS

ISDANER &
COMPANY, LLC

**PENNSYLVANIA INTERGOVERNMENTAL
COOPERATION AUTHORITY**

JUNE 30, 2005

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Management Discussion and Analysis

The Board of the Pennsylvania Intergovernmental Cooperation Authority (the "Authority" or "PICA") offers the following narrative overview and analysis of the financial activities of the Authority for the fiscal year ended June 30, 2005.

Financial Highlights

- The total net assets (deficit) of the Authority at the close of the fiscal year were (\$592,851,138) representing a decrease in net deficit of \$48,354,876 over the prior year.
- At the close of the current fiscal year, the Authority's General Fund unreserved balance increased by over \$1,800,000 to \$5,717,324 from the prior fiscal year. All Administration costs during fiscal year 2005 were funded from the Authority's earnings on its General Fund and on its Debt Service Reserve Fund.
- The Authority's outstanding long-term debt decreased by \$47,115,000 during the current fiscal year.

Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Authority's basic financial statements. The Authority's basic financial statements comprise three components: 1) government-wide financial statements, and 2) governmental funds financial statements and 3) notes to the financial statements. This report also contains other supplementary information in addition to the basic financial statements themselves.

Government-wide financial statements. The government-wide financial statements are designed to provide readers with a broad overview of the Authority's finances, in a manner similar to a private-sector business.

The statement of net assets presents information on all of the Authority's assets and liabilities, with the difference between the two reported as net assets (deficit). Over time, increases or decreases in net assets may serve as a useful indicator of whether the financial position of the Authority is improving or deteriorating.

The statement of activities presents information showing how the Authority's net assets (deficit) changed during the fiscal year ended June 30, 2005. All changes in net assets are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenues and expenses are reported in this statement for some items that will only result in cash flows in future fiscal periods (e.g., uncollected taxes).

The government-wide financial statements can be found on pages 2-3 of this report.

Fund financial statements. A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Authority uses fund accounting to ensure and demonstrate compliance with finance-related legal requirements.

Governmental funds are used to account for all of the functions that are reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, governmental fund financial statements focus on near-term inflows and outflows of spendable resources, as well as on balances of spendable resources available at the

end of the fiscal year. Such information may be useful in evaluating near-term financing requirements.

Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the Authority's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenues, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and governmental activities.

The Authority maintains eleven individual governmental funds. Information is presented separately in the governmental fund balance sheet and in the governmental fund statement of revenues, expenditures, and changes in fund balances.

The basic governmental fund financial statements can be found on pages 4-5 of this report.

Notes to the financial statements. The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes to the financial statements can be found on pages 6-24 of this report.

Government-wide Financial Analysis

As noted earlier, net assets may serve over time as a useful indicator of a government's financial position. In the case of the Authority, liabilities exceeded assets by \$592,851,138 at the close of fiscal year 2005.

By far the largest portion of the Authority's net deficit reflects its bonds payable. Proceeds from the PICA Tax as well as the corresponding interest earned are in part utilized to fund such debt service requirements. The Authority's bonds payable activity for the year ended June 30, 2005 is summarized as follows:

	Amount (in thousands)
Outstanding Debt at July 1, 2004	\$770,700
Debt Retired	<u>(47,115)</u>
Outstanding Debt at June 30, 2005	<u>\$723,585</u>

The Authority's cash, cash equivalents and short-term investments make up the largest portion of the total assets. Such assets are derived from the proceeds of bond issuances of years past and the related investment income. These assets are used to provide grants to the City of Philadelphia for various capital projects and to fund the required debt service reserve. During fiscal year 2005, the Authority granted approximately \$1.8 million to the City of Philadelphia.

Governmental activities decreased the Authority's net deficit by \$48,354,876, thereby accounting for the total growth in assets during fiscal year 2005. Asset growth was due primarily to the retirement of long-term debt as well as better than budgeted operating fund results during fiscal year 2005.

Governmental Funds Financial Analysis

As of the end of the current fiscal year, the Authority's governmental funds reported combined ending fund balances of approximately \$137 million, a decrease of approximately \$157,000 in comparison with the prior year. Approximately 63 percent of this total amount (\$86 million) constitutes fund balances reserved for debt service. Approximately 24 percent of the total (\$32.7 million) constitutes fund balances that are reserved for the benefit of the City of Philadelphia. The remainder of the reserved fund balances is reserved primarily for the administration of the Authority. Approximately, \$10.8 million is designated for future swaption activity relating to various derivative transactions. Approximately \$5.7 million constitutes unreserved fund balance, which is available for spending at the Authority's discretion.

General Fund. All fiscal year 2005 administration expenses of the Authority were funded from the Authority's earnings on its General Fund and on its Debt Service Reserve Fund (established from proceeds of the Authority's bond issues) and residual balances of similar earnings from prior fiscal years. No City of Philadelphia or Commonwealth of Pennsylvania tax revenues were used to pay any portion of the Authority's administrative costs in fiscal year 2005, nor are any expected to be used in fiscal year 2006 for such purpose.

The PICA Act allows the Authority several sources of income to support its operations. The statute specifically provides that the Authority may draw earnings from the various funds and accounts created pursuant to its Trust Indenture, and also directly from the proceeds of PICA Taxes to the extent investment income is insufficient. The latter allowable revenue source has never been utilized by the Authority.

The PICA Act requires that the Authority adopt an annual budget (for the fiscal year commencing July 1) before March 1 of each year and also stipulates the format thereof, and information to be provided therewith to the Governor and General Assembly of the Commonwealth of Pennsylvania. The Authority's annual General Fund budgets, since its inception, have all produced surpluses.

Details as to anticipated and actual fund balances as of June 30, 2005 and as to the fiscal year 2006 budget are as follows:

Anticipated Residual Fund Balance:

Unreserved Fund Balance at June 30, 2004	\$259,028
Excess Revenues over Expenditures	<u>0</u>
Anticipated Unreserved Fund Balance at June 30, 2005	<u>\$259,028</u>

Fund Balance at June 30, 2005 (Anticipated/Actual):

Anticipated Unreserved Fund Balance at June 30, 2005	\$259,028
Add: Net FY05 "Better than Budget" Operating Results	<u>5,458,296</u>
Actual Unreserved Fund Balance at June 30, 2005	<u>\$5,717,324</u>

General Fund Budget for FY06:

Revenues - General Fund Interest Earnings	\$ 150,000
Other Financing Sources - Transfer from Bond Issue Investment Earnings ("Reserved for subsequent Authority Administration" in the Debt Service Reserve Fund at June 30, 2005)	1,694,994

Utilization of portion of FY05 fund balance
Total Estimated Expenditures

0
\$1,844,994

The Authority's fiscal year 2006 budget recognizes the possibility that the Authority may be requested to become involved in oversight matters as directed by the Pennsylvania General Assembly; and provides funding to study and/or implement such a role. Though the fiscal year 2006 budget reflects a three percent increase over the fiscal year 2005 budget, PICA also recognizes the importance of controlling budget growth; the fiscal year 2006 budget remains more than five percent below the fiscal year 2003 budget.

The philosophy underlying the Authority's general fund operations remains that the Authority should maintain a personnel and expenditure level sufficient to permit it to respond to the demands placed upon it, but not so large as to present an opportunity either for the City of Philadelphia to use the Authority's resources to bypass the re-creation of its own management systems or to establish a permanent Authority structure that would develop its own reason for continued existence.

Special Revenue Fund. The Authority's Special Revenue Fund receives PICA taxes, interest earnings on such collections, and net interest earnings on bond issue funds other than Capital Projects Funds (the earnings on Capital Projects Funds are restricted to use for grants to the City of Philadelphia for PICA approved capital projects). The Special Revenue Fund receipts are utilized to provide, monthly, from the first available funds in that month, one-sixth of the next semi-annual interest requirement on PICA bonds outstanding and one-twelfth of the next annual principal requirement on PICA bonds outstanding, in a manner calculated to provide the total required semi-annual interest and the total required annual principal at the close of the month prior to such required date. After provision of monthly debt service requirements, the residual balances in PICA's Special Revenue Fund are paid to City of Philadelphia as grants to the City's General Fund.

The Special Revenue Fund earned in excess of \$129,000 on its invested balances during fiscal year 2005. Thus, PICA grants to the City of Philadelphia's General Fund during fiscal year 2005 exceeded the equation (PICA taxes minus provision for PICA Debt Service equals PICA grants to the City) by in excess of \$2,000,000.

Debt Service Funds. The Debt Service Funds account for the accumulation of financial resources for the payment of principal and interest on PICA's long-term debt.

Debt Service Reserve Fund. This fund is used to hold assets for debt service reserve purposes as required by the Trust Indenture. Current year investment earnings were transferred to pay current year debt service requirements and to aid in paying for the General Fund's administration expenditures.

Rebate Fund. This fund is maintained in order to fund future potential rebates and/or debt service requirements. The only activity that occurred during the current fiscal year was the increase from investment earnings.

At June 30, 2005, the Fund Balances held in the combined Debt Service Funds, by individual fund groups, consisted of:

Debt Service Funds -- Current assets held for interest
due 12/15/05 and principal due 6/15/06

\$ 6,597,434

Debt Service Reserve Fund -- Current assets held for debt service reserve purposes as required by the Trust Indenture	77,681,668
Rebate Fund -- Current assets held for future potential rebate/debt service purposes	<u>1,765,072</u>
Amount Reserved for Debt Service	\$86,044,174
Debt Service Reserve Fund -- Current assets held for subsequent PICA administration purposes (Debt Service Reserve Fund earnings held for PICA FY05 operations – per adopted budget)	<u>1,694,994</u>
Fund Balances at June 30, 2005-- Combined Debt Service Funds	<u>\$87,739,168</u>

Expendable Trust/Capital Projects Funds. Expendable trust funds include amounts held separately, by bond issue from which such funds were provided, for purposes of grants to the City of Philadelphia for specific PICA approved capital projects. The PICA Act restricts the City of Philadelphia's use of PICA provided capital projects dollars to specific "emergency" and "productivity" projects approved by the PICA Board and, where necessary, by specified Commonwealth of Pennsylvania elected officials.

The Authority, in connection with its three new-money bond issues, approved specific City capital projects totaling approximately \$426 million, while providing bond issue funds of approximately \$400.8 million for such projects. The difference, \$25.2 million, as anticipated, has been raised from investment earnings of funds dedicated to capital projects. At June 30, 2005, sufficient PICA controlled capital projects funds were available to complete all of the initially approved PICA projects, to complete \$16.3 million of additional projects subsequently approved by the PICA Board, and an additional \$26.4 million of yet to be designated projects. Capital project funds held for PICA capital project grants to the City of Philadelphia totaled approximately \$33 million at June 30, 2005.

Additional information. In accordance with IRS regulations, certain funds already granted to the City of Philadelphia by PICA continue to be classified as PICA Arbitrage Reportable Funds until the City of Philadelphia expends such funds for the purpose for which they were provided. Accordingly, and also for oversight purposes, PICA tracks the uses/balances of such grant funds and interest earnings thereon as yet unexpended by the City of Philadelphia. As of June 30, 2005, such PICA provided funds as yet unexpended by the City of Philadelphia included:

	<u>Amount (in thousands)</u>
'92 Indemnity Fund	\$ 2
'95 Indemnity Fund	123
'92 Capital Projects Encumbered Funds	1,952
'93 Capital Projects Encumbered Funds	4,778
'93 Criminal Justice Project Encumbered Funds	745
'94 Capital Projects Encumbered Funds	4,812

Report of Independent Certified Public Accountants

To the Board
Pennsylvania Intergovernmental Cooperation Authority

We have audited the accompanying financial statements of the governmental activities and each major fund of the Pennsylvania Intergovernmental Cooperation Authority (the "Authority") as of and for the year ended June 30, 2005, which collectively comprise the Authority's basic financial statements as listed in the foregoing table of contents. These financial statements are the responsibility of the Authority's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Authority's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities and each major fund of the Pennsylvania Intergovernmental Cooperation Authority as of June 30, 2005, and the respective changes in financial position thereof for the year ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying Management's Discussion and Analysis preceding this report on pages i to v is not a required part of the financial statements, but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consist principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit such information and, therefore, express no opinion on it.

Our audit was conducted for the purpose of forming an opinion on the financial statements that collectively comprise the Authority's basic financial statements. The supplemental schedules listed in the foregoing table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. These supplemental schedules are the responsibility of the Authority's management. Such supplemental schedules have been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, are fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

Isidaner & Company, LLC

October 27, 2005

PENNSYLVANIA INTERGOVERNMENTAL COOPERATION AUTHORITY
STATEMENT OF NET ASSETS
JUNE 30, 2005

ASSETS

	Governmental Activities
CURRENT ASSETS:	
Cash, cash equivalents and short-term investments	\$ 158,279,741
PICA taxes receivable	3,560,532
Accrued interest receivable	230,500
Total current assets	162,070,774
OTHER ASSETS—Prepaid rent, security deposit and bond issuance costs	1,998,273
TOTAL	\$ 164,069,046

LIABILITIES AND NET ASSETS

CURRENT LIABILITIES:	
Accounts payable	\$ 80,166
Accrued payroll and taxes	75,589
Due to the City of Philadelphia	4,892,175
Deferred revenue	28,287,255
Bonds payable—current portion	49,270,000
Total current liabilities	82,605,185
BONDS PAYABLE—Long-term portion	674,315,000
Total liabilities	756,920,185
NET ASSETS (DEFICIT):	
Restricted for debt service	86,044,174
Restricted for benefit of the City of Philadelphia	32,792,027
Restricted for subsequent PICA administration	1,694,994
Unrestricted deficit	(713,382,333)
Total net assets (deficit)	(592,851,138)
TOTAL	\$ 164,069,046

The accompanying notes are an integral part of this statement

PENNSYLVANIA INTERGOVERNMENTAL COOPERATION AUTHORITY
STATEMENT OF ACTIVITIES
YEAR ENDED JUNE 30, 2005

	<u>Governmental Activities</u>
EXPENSES:	
Grants to the City of Philadelphia	\$ 216,616,578
General management and support—	
General operations	982,340
Interest expense on long term debt	<u>39,209,523</u>
Total program expenses	<u>256,808,441</u>
PROGRAM REVENUES—	
Premium amortization	1,198,872
Interest	<u>5,202,962</u>
Program revenues	<u>6,401,834</u>
Net program expenses	<u>250,406,607</u>
GENERAL REVENUES:	
PICA Taxes	298,633,971
Interest	<u>127,512</u>
Total general revenues	<u>298,761,483</u>
DECREASE IN NET DEFICIT	48,354,876
NET ASSETS (DEFICIT)—Beginning of year	<u>(641,206,014)</u>
NET ASSETS (DEFICIT)—End of year	<u>\$ (592,851,138)</u>

The accompanying notes are an integral part of this statement

