

Pennsylvania Intergovernmental Cooperation Authority



**Staff Report
on the
City of Philadelphia's
Five-Year Financial Plan
for
Fiscal Year 2004 - Fiscal Year 2008**

June 26, 2003

**PENNSYLVANIA INTERGOVERNMENTAL
COOPERATION AUTHORITY**

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**Pennsylvania Intergovernmental
Cooperation Authority**

**STAFF REPORT
ON
FY2004-FY2008
FIVE-YEAR FINANCIAL PLAN**

SECTION I:

**INTRODUCTION
AND
EXECUTIVE SUMMARY**

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INTRODUCTION

The Five-Year Financial Plan for FY2004 through FY2008 demonstrates the efficacy of both the Pennsylvania Intergovernmental Cooperation Authority and a multi-year budget document. First and foremost is the current fiscal condition of the City relative to surrounding municipalities and states. The stagnant national economy has had dramatic impacts on government budgets. New York City is planning to raise taxes and slash services. The Commonwealth of Pennsylvania passed a draconian budget as it faced a one-year deficit of nearly \$1 billion. New Jersey, New York State, and many others across the country find themselves in a similar position: forced to raise taxes and slash services.

Yet, the City of Philadelphia found itself able to produce a balanced Five-Year Plan that expanded some services and continued its incremental tax cuts. The key difference was that these other entities had been utilizing one-year budgets with no oversight of their projections. Each year, one-time budget fixes and overestimated revenue projections allowed these cities and states to meet their legal requirement and pass balanced budgets without any consideration of the consequences in the years ahead. When the economy faltered, they faced an immediate and dire fiscal crisis.

When Mayor Street announced a projected \$834 million deficit in December of 2002, he was referring to a cumulative anticipated deficit at the end of *five years*. In fact, even before the cost-cutting initiatives were announced, the City assumed a surplus at least through the end of FY2004. The five-year planning process required that the fiscal crisis down the road be dealt with now, even in an election year, when drastic cuts and crisis decisions could be avoided. Instead, a series of phased-in initiatives were devised to close the deficit in a planned and less-painful fashion.

Further, the City of Philadelphia found itself in an advantageous position when the looming fiscal woes became apparent. The use of these tools for over ten years assured a stable base as the deficit planning became necessary. The Five-Year Plan credits one-time fixes once; the budget must still be balanced for four additional years. Revenue projections are subject to scrutiny by PICA Staff, ensuring a level of reasonableness. Since PICA's inception, actual revenues have never been more than one-quarter of one percent under projected levels, and have usually been slightly higher.

There are numerous risks and concerns highlighted within this Staff Report which will continue to test the City's fiscal health. Though these problems, and other unforeseen challenges, are sure to raise concerns, the mechanism to handle them before they reach crisis status is in place. While no multi-year planning tool can anticipate every eventuality, and no oversight authority can one hundred percent accurately project the future economy, the Five-Year Plan for FY2004-FY2008 demonstrates the overwhelming advantage the City of Philadelphia has when facing fiscal challenges.

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EXECUTIVE SUMMARY AND STAFF RECOMMENDATION

The City of Philadelphia (City) submitted its *Five-Year Financial Plan, Fiscal Year 2004-Fiscal Year 2008* (the Plan) to the Pennsylvania Intergovernmental Cooperation Authority (PICA) on May 30, 2003. This Plan continues to increase its focus on overall strategic goals for the City as well as better use of performance measures throughout. PICA Staff applauds the changes and hopes that the City will continue to incorporate performance measures as part of its planning process.

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, and anticipates ending FY2008 with a surplus of nearly \$4 million.

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. These risks are dependent on a variety of circumstances, some of which are beyond the City's control. While the Plan often acknowledges these risks, few precautionary strategies are offered.

PICA Staff is pleased to note that several of the risks identified in previous years have been addressed. The Philadelphia Gas Works has continued its turnaround and shows signs of ongoing stability. Philadelphia has so far weathered the long-predicted recession reasonably well. Unfortunately, the City did not create a Rainy Day Fund, a safeguard that PICA Staff has long advocated.

The Plan confronts three significant risks, including:

- Rising Pension Plan Liabilities.
- No explicit funding in the Plan for any costs associated with new labor contracts for employees after FY04.
- Few contingencies for working with the cuts in the enacted state budget.

Report Summary

As in recent years, this report focuses primarily on significant risks to the Plan, with discussion of some department-specific and other issues that have a direct relationship to maintaining fiscal stability. PICA Staff 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 two concerns noted. During meetings with PICA Staff, City officials indicated concerns regarding revenues from the Philadelphia Parking Authority (PPA). At that time, PPA revenues were down nearly \$5 million for FY2003, with no assurance that the revenue levels will rebound in FY2004. City officials initially claimed that an agreement had been reached, but the City filed suit the next day regarding the outstanding revenues.

Subsequently, PICA Staff was able to meet with PPA officials regarding payments due to the City. PPA officials described certain one-time costs which lowered FY2003 payments, although they are now less than \$2 million below budget. FY2004 PPA projections are slightly above the City's budgeted numbers. PPA has agreed to share monthly results with PICA Staff.

During these discussions, it became clear that the greatest risk regarding these revenues, nearly \$100 million over the life of the Five-Year Plan, is the lack of communication between key officials of the City and officials of the PPA. PICA Staff strongly recommends that lines of communication be opened, and further offers to facilitate any efforts in that direction.

The Plan also assumes \$8 million in revenues from luxury box rentals at Veterans Stadium, the majority of which is due from the Philadelphia Eagles. As of this writing, the funds have yet to be turned over to the City. PICA Staff sent a letter to the City in April 2003 requesting information regarding collection of the outstanding funds including a suggestion that the City withhold scheduled Operations and Maintenance payments for the new stadium until the debt has been settled. The City is investigating the feasibility of that option.

In addition to the PICA Staff review, PICA Staff convened a group of regional economists to comment on the 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 three significant risks to its successful implementation as well as a dependence on unspecified future reductions.

The ongoing national recession had a dramatic impact on the investment returns for the City's Pension Fund. In response to overall budget pressures, the City has reduced its annual contribution to the Minimum Municipal Obligation (MMO) required by law. The payment schedule outlined in the Plan falls short of the MMO requirements set by the most recent actuarial report. If Pension Fund returns continue to fall below the assumed

nine percent rate of return, the City may be required to make up the difference out of the General Fund.

During the course of the FY2004-2008 Five-Year Plan, all of the collective bargaining agreements between the City and its unionized workers will expire. While it is impossible to assess the effect of any future wage and benefit related cost increases over the life of the Plan, recent arbitration awards and new legislation paint a dire picture for the City's budget over the next five years. PICA Staff's concerns also include the significant increase in the number of employees in the Independently Elected Officials offices, and the lack of a comprehensive human resource information system.

For the first time since the creation of PICA, a State budget was passed prior to City Council approval of the City's Five-Year Financial Plan. Although PICA Staff anticipates that a supplementary budget will be passed, the enacted State budget must be addressed. The existing State budget contains severe cuts in four key areas impacting the City: prevention program monies for the Department of Human Services; funds for drug and alcohol treatment programs; the Free Library of Philadelphia; and, SEPTA subsidies. The City does not adequately address these cuts in its proposed Plan.

The Plan anticipates a cumulative total of \$48 million in unspecified expenditure reductions over its final four years resulting from future government efficiencies. This figure is significantly lower than the previous Plan's assumption of savings. This risk is offset by the opportunity for the Administration and City Council to rescind the previously agreed upon tax cuts should these savings not be realized.

Additional Risks

The Philadelphia Gas Works (PGW) continues to make significant strides in improving its overall fiscal health. The long-term fiscal projection remains somewhat optimistic, but is no longer straining credibility. Numerous structural changes, including rate equalization, modifying the senior citizen discount, and refurbishing the Liquefaction facilities are contributing to a more stable fiscal outlook. For the first time in several years, PGW made its annual \$18 million payment to the City's General Fund on time, though repaying the \$45 million loan it received from the City remains in the end of the City's Plan. Also, PGW's large outstanding debt situation is a significant negative element in the City's overall financial well being.

When the City began preparing the FY2004-FY2008 Financial Plan, it faced a cumulative deficit of \$834 million. In order to close that deficit, the Plan includes a number of initiatives, including cost saving policy changes, efficiency improvements, revenue enhancements, and service reductions. Many of these initiatives could have been implemented in the past. These programs should be completed even if the City's fiscal situation improves as they advance the overall efficiency of the City government.

The City again anticipates increasing the percentage of locally generated dollars that are subject to long-term debt commitments and continues to approach its allowable debt limit. As stated in the Plan, this jeopardizes the infrastructure maintenance goals of the overall Capital Program. While the debt associated with some initiatives is exempt from the City's allowable debt limit, such projects add to the debt burdens on the local taxpayers.

Over the past several years, PICA Staff has disagreed with the City on the value of the target budgets utilized by the City. The City has claimed that the target budget process provides the opportunity to realize long-term savings over the course of the Plan; PICA Staff has viewed the target budgets as a reserve against unforeseen expenses. For the first time, the City is planning on using target budget "savings" to cover known costs, a dangerous precedent as target budget savings are not guaranteed, and the reserve available for unforeseen costs is sharply reduced. While PICA Staff is recommending approval of this year's Plan, future Plans which employ this technique will not receive a favorable recommendation.

Other General Fund Concerns

Unveiled in the spring of 2001, the Neighborhood Transformation Initiative (NTI) is a strategy to preserve and rebuild the City's neighborhoods as thriving communities with clean and secure streets, vibrant retail, and quality housing. Despite a long planning process, the overall progress of NTI has been at best sluggish. As was outlined in previous Staff Reports, there are major concerns regarding the lack of detailed performance measures and the slow pace of signature elements of NTI.

The City continues to show dramatic improvement in the development of useful performance measures and the collection of data. These improvements have not been as prevalent in some of the current Administration's newer initiatives. Despite the improved focus on outcome measurement, there remains a disconnect between new initiatives outlined in the Plan and projected measures related to these initiatives.

The national economy has been weak. Unlike previous recessions, the City economy has weathered the most recent economic downturn relatively well. The City's unemployment rate in the aforementioned period increased from 6.7 percent to 7.3 percent. The City continues to lose population according to the 2000 census, a trend that appears constant in the foreseeable future. The City cautiously projects flat employment growth, while appropriately estimating combined residential and commercial assessments to grow slightly more than two percent. These assumptions seem to be a reasonable short-term forecast for the City's economy with muted optimism over the last three years of the Plan.

Since the early 1990's, the Department of Human Services (DHS) has been able to significantly and consistently increase the revenue from other governments to fund the services provided by DHS. This capacity to garner additional state and federal funds has

allowed the City to increase service levels while simultaneously reducing net City costs to provide services. This dependence on outside sources of funding presents risks. The proposed funding reductions in the enacted State budget highlight the potential pitfalls for the City. In light of the current economic downturn, which has negatively impacted both the state and federal budgets, it is imperative that the City continues to be vigilant in maintaining external funding to serve the ever-increasing needs of its population.

There are a number of issues that either fall outside the duration of the Plan or are not addressed by the proposed Plan. The Plan provides minimal funding for an expansion of the Convention Center. The Plan does not attempt to address a comprehensive approach to tax reform in the City. While some Plan years anticipate an annual operating surplus (including adjustments), there is no attempt to eliminate annual structural deficits throughout the Plan.

Staff Recommendation

The identified potential risks to the General Fund in the FY2004-FY2008 Plan constitute a real threat to the fiscal health of the City. The Plan's reliance on Target Budget cuts for known obligations is troubling. PICA Staff is also greatly concerned by the inability of the City to provide sufficient information to the City of Philadelphia's Office of the Controller to enable a formal expression of opinion. The Controller's Office was unable to evaluate the City's assumptions regarding the restoration of state budget cuts, pension costs, and certain other assumptions. This will mark the first Five-Year Financial Plan without an opinion from the Controller's Office since PICA's inception.

However, the Plan is also predicated on a continuation of steady cuts to the Wage and Business Privilege taxes. Should the risks outlined in this Report be realized, rescinding the tax cuts would provide sufficient revenues to prevent a fiscal crisis. PICA Staff will continue to closely monitor the City's fiscal situation throughout the coming year, paying particular attention to labor negotiations and the performance of the Pension Fund. PICA Staff is further encouraged by the relatively stable performance of the City's economy despite the recession. With these caveats in mind, the FY2004-FY2008 Plan presents a reasonable prospect for balanced budgets in each year of its term.

PICA Staff recommends that the Board of the Pennsylvania Intergovernmental Cooperation Authority approve the Plan as submitted to the Authority on May 30, 2003.

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Cooperation Authority**

**STAFF REPORT
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SECTION II:

SIGNIFICANT RISKS

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RISING PENSION FUND LIABILITY

The ongoing national recession had a dramatic impact on the investment returns for the City's Pension Fund. Last year's continued poor performance by the Fund has caused the City's projected payments into the Fund to increase significantly. In response to overall budget pressures, the City has reduced its annual contribution to the Minimum Municipal Obligation (MMO) required by law. The payment schedule outlined in the Plan falls short of the MMO requirements set by the most recent actuarial report.

If Pension Fund returns continue to fall below the assumed nine percent rate of return, the City may be required to make up the difference out of the General Fund. However the impact of the Deferred Retirement Option Program, as well as the workforce streamlining outlined in the Plan, lessen the threat to the General Fund.

Weak National Economy Reduces Pension Fund Returns; MMO Required

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, returns for the City's Pension Fund were negative for 2001 and 2002.

Should the national economy continue to recover slowly, as has been the case in the first half of the year, it is possible that the Pension Fund will continue to fall below its expected nine percent rate of return. According to some estimates, each percentage point below the expected rate of return would require an additional \$10 to \$15 million City contribution.

The City's Pension Fund is governed in part by the Pennsylvania Pension Plan Act that dictates mandatory actuarial funding standards and the minimum annual contributions which the City must make in order to amortize the unfunded liability. Because of the poor returns, the City would have had to pay nearly double the amount originally scheduled. By paying only the legally required MMO, the City will reduce its scheduled pension payments by \$245 million over the life of the Plan.

Insufficient MMO Funding in the Five-Year Plan

The MMO payments outlined in the Plan correspond to those legally mandated according to the actuarial report from the Fall of 2002. However, a new actuarial report was issued in March after the submission of the initial Five-Year Plan. This report, due in large part to continued poor returns by the Pension Fund, indicated an increased liability and corresponding higher MMO payments.

The revised version of the Plan, passed by City Council on May 29, 2003, does not include adjustments to correspond to this actuarial report. As such, the Plan is underfunded by \$12 million for FY2004, and by over \$60 million over the life of the Plan. This shortfall is sufficient to render the Plan unbalanced.

This underfunding for FY2004 is somewhat mitigated by one of the other allowances of switching to the MMO payment schedule. The City is now permitted to make the Pension Fund payment at the end of the fiscal year rather than at the beginning. This allows the opportunity for a new actuarial report in March of 2004 which may indicate a lower MMO payment. If the national economy and corresponding returns do not improve over the next year, however, the General Fund will have to make up the difference through funds projected to be spent elsewhere.

Long-Term Risk Mitigated by DROP and Workforce Streamlining

The actuarial analyses prepared for the Pension Fund cannot take into account some of the benefits the City will realize from the DROP. If the City achieves its goals, over seven hundred positions will not be replaced. Additionally, the other DROP positions will be replaced by employees with shorter City tenures (and therefore fewer accrued pension benefits) and lower salaries.

Additionally, the Plan outlines some workforce streamlining initiatives (see new initiatives section) which will also reduce the size of the workforce, and therefore the projected obligations of the Pension Fund. Once these factors can be included in the actuarial analyses, the City's pension funding requirements should lower.

LABOR CONTRACTS AND THE MUNICIPAL WORK FORCE

During the period covered by the Plan, all of the collective bargaining agreements between the City and its unionized workers will expire. While it is impossible to assess the effect of any future wage and benefit related cost increases over the life of the Plan, recent arbitration awards and new legislation paint a dire picture for the City's budget over the next five years.

The Deferred Retirement Option Program (DROP) will provide an opportunity for rightsizing the City's workforce, but may also threaten the delivery of some City services. Several of the new initiatives planned to offset the projected deficit will also help control the size of the City's workforce, if they are implemented in accordance with the Plan. PICA Staff's concerns also include the significant increase in the number of employees in the Independently Elected Officials offices, and the lack of a comprehensive human resource information system.

Municipal Union Contracts

The largest unknown variable in the Plan is personnel costs. The collective bargaining agreement between the City and its Police Department employees expires in FY2004, while the contract with its Fire Department employees expires at the end of FY2005; the other municipal employee contracts expire at the end of FY2004. As is standard procedure, the Plan assumes no increases in wages or benefit costs after these expiration dates, except a baseline annual increase in health care costs of approximately nine percent. Personnel costs account for fifty-seven percent of the FY2003 budget; thus even a minimal increase in wages and benefit costs will have a significant impact on the City's expenditures throughout the life of the Plan.

While traditionally PICA Staff has been most concerned with the projected impact of wage increases, it is the recent health benefit increases which truly threaten the fiscal viability of the City. Although health care costs are increasing at nearly fourteen percent nationally, the recent Act 111 Police and Fire Arbitration awards were deplorable, with a first year increase of over ***thirty-seven percent***. The arbitration panel acted irresponsibly with a decision that both ignored and undermined many years of logically progressive health benefit awards. This aberrant decision is unprecedented and should be discounted by future arbitration panels. The City was mistaken in its failure to appeal.

Further clouding any projections of the impact of Act 111 is the passage of Act 230 by the Pennsylvania Legislature. Buried in this law is a clause which repeals a fundamental section of the PICA Act. This change would eliminate the City's ability to appeal an award that fails to give substantial weight to the Five-Year Financial Plan, particularly where it jeopardizes the City's ability to provide services. Considering that the recent unjustifiable arbitration decision was made under the existing statute, the risks are amplified as there are fewer restraints on the next arbitration panel.

The Act 111 decision has serious consequences for the non-uniformed contracts to be negotiated for FY2005 and beyond. If these unions were to receive a health benefit increase in parity with the Act 111 awards for Police and Fire, the cost to the General Fund in just the first year is nearly **\$30 million** over current Plan projections.

Employee wages also remain a concern. From FY1997–FY2002, represented employees average annual wage increase was over 3.5 percent, while over the same period inflation averaged just over 2.2 percent, private industry gains averaged just under four percent, and the State and Local government average was three percent. While the Philadelphia municipal average seems only slightly higher than the norm, it does not take into account automatic step and longevity pay increases included in municipal employee contracts which can add anywhere from two to nine percent to the annual base salary of an employee.

It should also be noted that during this past year's mild recession, while the City's labor force shrunk by several thousand jobs, no represented City employee was laid off. It is plausible to suggest that municipal employee job security during such tumultuous times is a priceless employee benefit.

Deferred Retirement Option Program (DROP)

Since the DROP began in October 1999, well over 3,100 employees, or twelve percent of the workforce, have enrolled in the program. The City has taken important steps to make use of the opportunities afforded by the DROP. PICA Staff applauds the stated goal of filling only one of every two non-uniform jobs affected by the DROP. The use of an outside consultant to aid departmental reorganization and reassess workflow is vital to the continued rightsizing of the City's workforce. The DROP has also highlighted the need for better succession planning within City Departments, an effort that should continue beyond preparing for the DROP. PICA Staff would welcome a comprehensive City strategy regarding training and utilization of its workforce.

PICA Staff believes that if the City is able to meet its stated goals, the net savings over the life of the Plan, including salaries, benefits, and pensions could net over \$100 million in savings with additional benefits to the Pension Plan through a reduction in projected future obligations (see the Pension Plan chapter for further discussion).

The DROP does present some service related challenges for the City. The Police Department is of the greatest concern as the Police Department is slated to lose more than 750 uniformed personnel, including the Commissioner and many senior commanders, as a result of the DROP. PICA Staff is skeptical that the Department will be able to meet its stated goal of filling multiple classes of 125 recruits, particularly in light of ongoing difficulties in finding qualified individuals to apply. It is therefore extremely puzzling that the City declined to eliminate the requirement for recruits to live in the City one year **prior** to applying to the Police Department.

Unnecessary Increases in Personnel and Salaries

While much has been made about an increase in the size of the City's workforce, it is important to note where those increases have occurred. Since the beginning of the current Administration, the largest growth has been in the direct service delivery areas – Human Services, Police, Fire and the Free Library while internal services Departments have been reduced – Fleet, Public Property and Revenue. For the first time, in large part due to the cost cutting initiatives outlined in the Plan, the workforce is projected to realize a significant overall decline.

There continues to be a disturbing growth trend in a few areas. PICA Staff is pleased to note that the Mayor's Office has begun a return to previous staffing levels. The Mayor's Office had grown from 43 positions to 67 positions by the end of FY2002. Current projections have the Mayor's Office returning to FY2000 levels – 48 by the end of FY2004. However, the independently elected officials have grown even more dramatically in both staff complement and salaries. This group is led by City Council, which went from 181 positions and a budget of \$9.6 million at the end of FY1999 to a projected 226 positions and a \$14.5 million budget by the end of FY2003. These figures represent a twenty-five percent growth in staff, and an increase of more than fifty percent in the budget for City Council in just four years.

The most egregious example of seemingly unnecessary dramatic growth is the three-year history of the City Commissioner's Office. From FY2001, the City Commissioner had a staff complement of 75; by the end of FY2003 staffing is expected to grow a total of **thirty-five percent in just two years**. In addition to staffing increases, the City Commissioner's budget has grown at a similar pace, and was given by City Council an additional \$1.3 million over the next two years on top of increases already outlined in the initial proposed Plan. This despite the introduction of new electronic polling machines which were purchased in order to **reduce** the manpower required to oversee elections.

Although the independently elected officials are not subject to the City's normal budget process, they should be required to explain and justify their dramatic growth to the taxpayers of Philadelphia. Despite repeated requests from PICA Staff, the City Commissioner's Office declined to meet to discuss these increases.

Human Resource Information System is Needed

Despite the City's enormous personnel costs, the Personnel Office functions without a comprehensive Human Resource Information System (HRIS). The absence of such a system results in significant costs through non-automated paper processing, duplication of effort, and an inability to properly manage personnel needs throughout the City. Unusual personnel initiatives such as DROP and the recent hiring freeze only increase the need for a HRIS.

According to a City Personnel Department report, the City employs 160 clerks to complete and route over 70 paper forms used to establish and maintain employee status. At an estimate of \$33,000 per employee (salary and benefits), the City pays \$5 million every year to support this function. Updates on employee status take an average of 27 days resulting in delays in information availability and hampering City Departmental management of personnel.

The Personnel Department estimates that a comprehensive system would cost \$5-\$7 million. This cost would be even lower now that the City owns the license for the Oracle Systems human resource management module as part of its recent information technology improvements. Obvious savings generated would include the reduction in staff support by half. The system would be largely paperless, reducing staff time currently spent filing documents in the operating departments and in Central Personnel. Personnel related time delays would be eliminated with the advent of real-time information updates allowing for better human resource management.

A HRIS system also provides new tools for programs such as employee development and training, and compensation support. It can provide logistical support for running training programs, such as automatically posting employees to class lists, generating notices and tracking attendance. Data on employee performance can be collected and used to support performance-based pay initiatives. In short, to best manage the largest piece of its budget, the City needs to strongly examine the implementation of a HRIS.

STATE BUDGET IMPACT

For the first time since the creation of PICA, a State budget was passed prior to City Council approval of the City's Five-Year Financial Plan. Although PICA Staff anticipates that a supplementary budget will be passed, the enacted State budget must be addressed.

The existing State budget contains severe cuts in four key areas impacting the City: prevention program monies for the Department of Human Services; funds for drug and alcohol treatment programs; the Free Library of Philadelphia; and, SEPTA subsidies. The City does not address these cuts in its proposed Plan.

Enacted State Budget

In March of 2003, the Commonwealth of Pennsylvania enacted its FY2004 budget. Due to a number of political machinations between Governor Rendell and the General Assembly, the budget included severe cuts across the state. For Philadelphia, these cuts included \$85.5 million in General Fund and Grants costs, and approximately \$15 million from SEPTA subsidies.

The enacted budget did not include a funding scheme for public education in the state, and did not address Governor Rendell's proposals for revamping public school funding and instituting gaming, so some form of supplemental budget is expected to be enacted before the end of the fiscal year. However, the decision by the federal government to provide over \$900 million to Pennsylvania, slightly improving state revenues, and a lack of public negotiation have left the likely outline of a supplemental budget uncertain. It is impossible to determine how much, if any, of the proposed cuts to Philadelphia will be reinstated.

Impact of State Cuts

In discussions between PICA Staff and City officials, the City acknowledged that the Plan did not take into account the enacted budget cuts. The Plan neither acknowledged that it would have to make up for the lost funding, nor did it take into account the impacts of cutting the unfunded programs.

- **Human Services Programs** – The enacted budget eliminates \$23 million for a variety of social service programs, including assistance for the homeless, funding for abused, neglected, and delinquent children, and other public health initiatives. Without these funds, the City believes it can continue to fund existing programs, but its proposed expansion of human service prevention programs would be halted. This would presumably result in more costly service requirements in subsequent years.

Under the Needs Based Budgeting system utilized by the state, the City believes that it would still be entitled to these funds and has indicated its preparedness to litigate on behalf of these funds if necessary.

- **Drug and Alcohol Treatment Programs** – The enacted budget cuts over \$45 million from drug and alcohol treatment programs. The absence of these programs is certain to lead to increases in crime and homelessness with costly reverberations throughout the social service delivery and criminal justice departments of the City. These resulting costs are not addressed by the Plan.
- **The Free Library** – The enacted budget includes \$4.7 million in cuts to the Philadelphia Free Library. The Library has developed a contingency plan if the cuts remain, including a reduction in the hours of service, in the purchase of materials, and a reduction in computer access. While the contingency plan is sound, it does not address what impacts will result from the reduction in services for City residents.
- **SEPTA** – The enacted budget contains nearly \$15 million in cuts to SEPTA subsidies. SEPTA has proposed a series of service cuts to close its resulting budget shortfall, but these cuts could have dramatic impacts on City residents and the City economy. Without public transit services, many individuals will be unable to reach their jobs, or continue their daily pursuits. The Plan does not address any impacts resulting from these proposed cuts.

Conclusion

Due to the volatile nature of the State budget at this writing, it is impossible for PICA Staff to fully assess the impacts on the City budget. Should these cuts not be restored in a subsequent budget, the City's Plan may be in variance, and PICA Staff will advise corrective measures to the PICA Board.

**Pennsylvania Intergovernmental
Cooperation Authority**

**STAFF REPORT
ON
FY2004-FY2008
FIVE-YEAR FINANCIAL PLAN**

SECTION III:

ADDITIONAL RISKS

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PHILADELPHIA GAS WORKS

The Philadelphia Gas Works (PGW) continues to make significant strides in improving its overall fiscal health. The long-term fiscal projection remains somewhat optimistic, but is no longer straining credibility. Numerous structural changes, including rate equalization, modifying the senior citizen discount, and refurbishing the Liquefaction facilities are contributing to a more stable fiscal outlook.

For the first time in several years, PGW made its annual \$18 million payment to the City's General Fund on time, though repaying the \$45 million loan it received from the City remains in the end of the City's Five-Year Plan. Also, PGW's large outstanding debt situation is a significant negative element in the City's overall financial well being.

The current management team deserves credit for dramatically improving its operations, while continuing to be burdened by the City's requirements that it also serve as a social service delivery operation. PGW has also strengthened its working relationship with the Pennsylvania Public Utility Commission (PUC) which now oversees PGW. Whether the City is still willing to sell PGW is unclear.

PGW's Fiscal Condition

While in the recent past PGW experienced several years of below average revenues and poor cash flow, a combination of a harsher winter, rate equalization, and better billing practices has significantly strengthened the reliability of PGW's revenues. Debt service costs, as well as the high cost of continued short-term debt strategies, strain PGW's finances, although low borrowing rates have also strengthened PGW's overall financial picture. PGW has also seen its bond rating stabilize, a strong signal that its fiscal situation has improved.

PGW's long-term planning process is based on optimistic though achievable projections. A renewed emphasis on billing and collections allows PGW's five-year financial plan to reasonably assume steady revenue increases after years of continued revenue decrease.

Short-term Risk: The \$18 million Payment to the City's General Fund; \$45 million Loan Repayment by FY2007

For the first time since FY1998, PGW remitted its annual rent payment to the City on time. This step not only relieves the utility from potential interest costs, but is a good indicator of its healthier cash flow. In addition, last year's suggestion that some or all of the \$18 million payment will be available to PGW as a "give-back" has ended.

The \$45 million revolving fund loan given to PGW in FY2001 remains on track to be paid back by FY2007. The amount available in the fund has stabilized over the past year, providing a cushion rather than a desperation cash-flow support. In light of the City's

fiscal concerns, PICA Staff suggested that PGW pay back a portion of the loan early by reducing the revolving fund amount by \$9 million to \$36 million. This number would represent the equivalent of two annual rent payments, and would demonstrate to the rating community the improved fiscal position of PGW. The suggestion was rejected by PGW leadership.

While PICA Staff no longer views the net \$135 million over the life of the Plan as a significant risk, PGW's finances will be monitored closely as it continues to rebound. Early repayment of even a portion of the loan would further reduce the risk to the City's finances as well as demonstrate PGW's improved fiscal outlook.

PGW Operations: Noticeable Improvements and the Burdens of a Social Services Organization

PGW management can rightly take credit for a vast improvement in many of the operational problems discussed in previous years. The billing system is working and customers now wait a few minutes on the phone as opposed to a few hours. PGW management has also indicated that many of the employee attendance and performance issues have been dealt with, although no meaningful performance and productivity measures were provided.

The new management information system has passed the transitional stage and is beginning to be utilized. PGW's delinquency shut-off program began with much fanfare in April 2002, supported by newly reliable data. Based on the cash receipts for the last year, the program appears to be having positive effects. PICA Staff looks forward to continued improvement resulting from utilization of the management information systems.

Concerns continue regarding the high labor costs for PGW. Although improvements were achieved in the most recent labor agreements, employee work rules continue to impact PGW's ability to work efficiently. The benefits package for PGW employees is singular in its munificence, and ultimately fiscally untenable.

PICA Staff was pleased to note PGW's efforts to eliminate the senior citizen discount. Even though a compromise was reached which did not eliminate it entirely, a more equitable rate system is nearing reality.

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

PGW has restructured its capital program to meet pressing needs despite 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, and given the City's history of coming to the aid of its citizenry even when not legally liable, the likelihood of the City assuming such liability is strong.

Competition in the Natural Gas Industry

Since July 2000, PGW's operations have been regulated by the Commonwealth's Public Utility Commission. The General Assembly is still considering a number of proposals for allowing customers to choose a natural gas supplier. Although PGW, with a legally limited service area, expects to avoid full-fledged competition, it is likely to be included in some way in the movement toward natural gas deregulation.

PICA Staff has previously reported on the challenges PGW would face in a competitive environment, particularly as a result of its high debt load, City Council-mandated discount programs, and significant number of delinquent accounts. Significant uncertainty remains about how the industry, and how PGW itself, will look in the future. PGW's current leadership team has promised to keep PICA Staff informed as it explores options for the utility, including privatization of certain operations.

Administration Plans for PGW: To Sell or Not to Sell

For the first time in three years, Mayor John F. Street did not address the notion of selling PGW in his Budget Address. PICA Staff questions regarding a sale of PGW went unanswered.

In the past, options have included selling the utility to the first serious bidder; improving the utility to make it more attractive to prospective buyers; or, improving the utility and maintaining City control. The City commissioned a study to look at the feasibility of selling PGW originally due to be released in December 2001. The initial study was found to be incorrect however, and was sent back for revisions; no date has been set for release of the new study.

PICA Staff believes that the City must continue to fully evaluate the potential sale of PGW.

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INITIATIVES TO CLOSE THE BUDGET DEFICIT

When the City began preparing the FY2004-FY2008 Financial Plan, it faced a cumulative deficit of \$834 million. In order to close that deficit, the Plan includes a number of initiatives, including cost saving policy changes, efficiency improvements, revenue enhancements, and service reductions. While not all of these proposals are discussed below, those with the greatest impact are discussed in this section and elsewhere within this Staff Report.

Many of these initiatives could have been implemented in the past. These programs should be completed even if the City's fiscal situation improves as they advance the overall efficiency of the City government.

Pay Minimum Municipal Obligation on Pension Bonds

The ongoing national recession had a dramatic impact on the investment returns for the City's Pension Fund. Last year's continued under-performance by the Fund has caused the City's projected payments into the Fund to increase significantly. In response to overall budget pressures, the City has reduced its annual contribution to the Minimum Municipal Obligation (MMO) required by law. The full impact of switching to MMO payments is discussed in the Rising Pension Fund Liability section.

Replace Only Fifty Percent of DROP Retirees

Since the DROP began in October 1999, well over 3,100 employees, or twelve percent of the workforce, have enrolled in the program. The City has taken important steps to make use of the opportunities afforded by the DROP. PICA Staff applauds the stated goal of filling only one of every two non-uniform jobs affected by the DROP. The use of an outside consultant to aid departmental reorganization and reassess workflow is vital to the continued rightsizing of the City's workforce. The DROP has also highlighted the need for better succession planning within City Departments, an effort that should continue beyond preparing for the DROP. The full impact of DROP is discussed in the Labor Contracts and the Municipal Workforce section.

Form Administrative Service Centers

PICA Staff strongly endorses this effort to reduce redundancy, waste, and inefficiency with the departmental administrative function. Of greatest concern is the Administration's track record in regard to similar reorganizations, notably the long delayed reorganization of housing agencies and personnel in conjunction with the Neighborhood Transformation Initiative. The City has promised to provide PICA Staff with periodic updates on the status of this effort.

Use of Floating Rate Rather Than Fixed Rate for New General Obligation Debt

PICA Staff readily endorses the City taking advantage of historic low rates in the debt markets. In discussions with PICA Staff, the City demonstrated its preparedness to act quickly to respond to changes in the bond market. The City should also consider a similar approach to its other issuances.

Eliminate Fifty Senior Administration Positions

The City provided PICA Staff with a list of the fifty positions eliminated. Though not all were senior positions (some support staff was included), the savings are in line with projections. Since it appears that some of these positions were superfluous, PICA Staff will be closely monitoring to ensure that these positions do not “reappear” should the fiscal situation improve.

INCREASING DEBT SERVICE

The City again anticipates increasing the percentage of locally generated dollars that are subject to long-term debt commitments and continues to approach its allowable debt limit. As stated in the Plan, this jeopardizes the infrastructure maintenance goals of the overall Capital Program. These risks are further heightened by any future borrowing to fund the proposed expansion of the Pennsylvania Convention Center. While the debt associated with these is exempt from the City’s allowable debt limit, these projects add to the debt burdens on the local taxpayers.

Increasing Reliance on Long-Term Debt

During the last few years of the prior Administration, the City was able to slowly reduce the percentage of locally generated dollars that were devoted to long-term debt costs. As the chart below details, the current Administration’s Plan reverses that trend. In fact, by the first year of the Plan, this percentage will be above thirteen percent, higher than in FY1995.

Fiscal Year	Locally Generated Dollars¹	Total Fixed Costs²	Fixed costs as a % of Locally Generated
1995	1,998,355,000	256,919,307	12.86%
1996	2,048,305,000	259,989,423	12.69%
1997	2,099,164,000	258,893,561	12.33%
1998	2,149,455,248	253,322,174	11.79%
1999	2,267,505,000	254,263,652	11.21%
2000	2,334,169,000	263,588,374	11.29%
2001	2,379,233,000	280,208,100	11.70%
2002	2,358,257,000	282,089,900	11.96%
2003 (Current Estimate)	2,403,774,000	311,490,300	12.96%
2004 (Projected)	2,445,744,000	327,061,000	13.37%

¹ Locally Generated Dollars includes City Tax Revenues, PICA Tax Revenues, Locally Generated Non-Tax Revenues, and Revenue from Other Funds of the City.

² Total Fixed Costs includes Debt Service payments, PICA Debt payments, Leases, and the Convention Center Subsidy.

The increasing reliance on long-term debt is a concern in light of the other risks highlighted within the Plan and in this report. The cost of long-term obligations is dedicated monies that cannot be rebudgeted. Should the national economic downturn continue, revenues may not increase as projected; should welfare reform lead to an increased need for services, additional monies will be required in the appropriate service

agencies; if revenues fall short of projections, or if other unbudgeted costs arise, the City will be forced to reallocate from among a smaller pool of funds.

The City is Quickly Approaching its Legal Debt Limit

At the end of FY2002, the City's general obligation debt borrowing capacity was down to \$133.9 million. As a result, the City's Capital Budget for FY2008 is expected to be under \$48 million, about one-third of the average Capital Program from FY1993-FY2001. This shrinking of the Capital Program places at risk the routine construction and renovation necessary to maintain the City's buildings, facilities, and infrastructure. Additionally, much of the State and Federal construction monies that the City receives is dependent on the local matching of funds. Without the availability of capital fund dollars to provide these matching funds, the City risks losing tens of millions of dollars in State and Federal funds for SEPTA infrastructure, highway repair, etc. The City will also be unable to make commitments to long-term projects (City Hall, the Art Museum, etc.), commitments which are often used to gain private funding to complete a project.

Although the Plan acknowledges the approaching debt limit constraint, there is no defined approach to solving the problem. While the Plan presents a series of measures for evading the debt limit, there are no plans for fixing the problem. The City has not even updated its own Debt Policy Statement, published most recently in December 1997. As an example, a stated policy is that the Debt Service on Net Direct Debt of the City of Philadelphia will not exceed 6.9 percent of the total General Fund obligations of the City. Yet in the very first year of the policy, FY1997, this ratio was seven percent.

PICA Staff does agree with the City that the formula for determining the City's debt limit is not equitable with other municipalities in the State. However, before seeking redress from the State Legislature, or even putting itself within danger of reaching the current debt limit, the City should observe the directive found in the introduction to the most recent Debt Policy Statement: "This Debt Policy is intended to be a dynamic, not a static document. Therefore it should be annually reviewed and updated."

TARGET BUDGETS

Over the past several years, PICA Staff has disagreed with the City on the value of the target budgets utilized by the City. The City has claimed that the target budget process provides the opportunity to realize long-term savings over the course of the Plan; PICA Staff has viewed the target budgets as a reserve against unforeseen expenses.

For the first time, the City is planning on using target budget “savings” to cover known costs, a dangerous precedent as target budget savings are not guaranteed, and the reserve available for unforeseen costs is sharply reduced. While PICA Staff is recommending approval of this year’s Plan, future Plans which employ this technique will not receive a favorable recommendation.

The Theory Behind Target Budgets

The target budget process was developed by the previous Administration as a way to constrain spending below budgetary levels. Following City Council’s adoption of a budget, the Administration adopts target budgets for each department and cost center, typically 1.5 percent below the appropriated level. Each department and cost center is then given the opportunity to explain extenuating circumstances for a change in their assigned target budget. Any savings generated by keeping to the target budget either provides a cushion for unexpected revenue shortfalls or expenditure needs during the year, or adds to the end-of-year General Fund balance.

Target Budgeting Results in the Short-Term

Target budgets do provide a valuable cushion for unexpected costs that may arise during the year. For example, some of the costs resulting from the September 11, 2001 attacks were met by utilizing target budget savings. At a minimum, when they are properly used, target budgets force departments to justify their expenditure needs to the Administration during the fiscal year. The Administration can then push departments to find offsetting efficiencies or savings elsewhere in their budget.

It is difficult to gauge the effectiveness of the target budget process and how it affects the City’s overall General Fund balance. A multitude of decisions coupled with unexpected costs throughout the fiscal year affect target budgets and actual expenditures. Determining how each one affects the target budget process and the General Fund balance is a subjective effort. However, the evidence indicates that the use of target budgets has not resulted in large amounts of savings. Over the past two years, total obligations have far outpaced target budget obligations.

An Unprecedented Use of Target Budget “Savings”

For the first time, the City has known obligations which are not included in the Plan. These include Pension Plan payments required by law which are \$12 million higher than the funds allocated in the Plan; costs associated with a new “Homeless Initiative” estimated at a minimum \$2.5 million; and other expenditures which arose between initial presentation of the Plan in January 2003, and its final passage by City Council in May 2003.

When questioned on these unfunded, projected obligations by PICA Staff, the City asserted that these costs would be covered by target budget savings. Immediately after City Council passed the proposed budget, the City requested that Departments identify \$70 million in target budget cuts, “to bring the FY04 operating budget into balance.”¹ As of this writing, the specific cuts have not been identified.

Never before has a Plan been presented which assumed that target budget savings would cover known costs. Particularly in light of the fact that the proposed Plan projects a final fund balance of just \$4 million, this budgeting practice is highly questionable. **Future Plans which utilize this technique will not be considered in balance by PICA Staff.**

Conclusion

PICA Staff recognizes that target budgets can be an innovative and effective management tool which provide the Administration with extra leverage to ensure department accountability and short-term flexibility. While applauding the City’s continued use of target budgets to better manage unforeseen expenditures within a budget year, PICA Staff has reservations about the ability of the target budget process to generate significant savings over time. The use of target budget savings for known costs is both unprecedented and risky, and will not be acceptable in future City proposed Five-Year Plans.

¹ Memo of May 29, 2003 from City Managing Director Phil Goldsmith to all City Commissioners and Directors.

**Pennsylvania Intergovernmental
Cooperation Authority**

**STAFF REPORT
ON
FY2004-FY2008
FIVE-YEAR FINANCIAL PLAN**

SECTION IV:

OTHER GENERAL FUND CONCERNS

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NEIGHBORHOOD TRANSFORMATION INITIATIVE

Unveiled in the spring of 2001, the Neighborhood Transformation Initiative (NTI) is a strategy to preserve and rebuild the City's neighborhoods as thriving communities with clean and secure streets, vibrant retail and quality housing. Despite a long planning process, the overall progress of NTI has been at best sluggish.

The issuance of \$275 million of Blight Remediation Bonds to fund a large portion of NTI services is the centerpiece of the project, although the expenditure of borrowed funds has been gradual. As was outlined in previous Staff Reports, there are major concerns regarding the lack of detailed performance measures and the slow pace of elemental pieces of NTI.

Since January 2003, the pace of NTI activities has improved, albeit haltingly. Under the auspices of NTI, the City has exceeded land acquisition expectations, planning efforts have begun in nearly thirty regions, and tree maintenance efforts have improved.

Communication and Community Support Shortfalls Delay Projects

One of the tenets of NTI is the goal of facilitating and supporting community based planning and development of City neighborhoods. While the initial projects at Byberry State Hospital and Logan Triangle began haltingly,² the number of communication problems seems to be diminishing, though have not been eliminated. Errors such as the conveyance of forty erroneous notices of condemnation are inexcusable in such a sensitive process.³

Planning efforts are underway in twenty-six NTI "planning areas" and three NTI "corridors." The commencement of additional projects will demonstrate whether or not NTI planning and communications have truly improved.

The early lack of communication, as well as contracting difficulties, has largely contributed to the delay of sixty percent of the proposed demolition projects in various City neighborhoods, an average delay of twenty-two weeks.⁴

² Young, Earni, "Blight? What Blight? Street today expected to unveil 7 developments", The Philadelphia Daily News, February 3, 2003

³ Young, Earni, "Lawmaker wages own blight fight", The Philadelphia Daily News, June 4, 2003

⁴ Neighborhood Transformation Report Card, Philadelphia Daily News, June 2, 2003

Housing Reorganization Remains Stalled; No Action on Building Costs

Another glaring example is the long delayed, much discussed, reorganization and consolidation of City departments and agencies related to housing. For three consecutive years, NTI officials have stated unequivocally in meetings with PICA Staff that the aforementioned streamlining and reorganization of housing departments and agencies was imminent. Although plans have been repeatedly discussed, new responsibilities described and charts made available, the consolidation effort has been lethargic. With the appointment of a Secretary of Housing and Neighborhood Preservation, PICA Staff has been told that the long awaited consolidation will require another 12 -18 months. PICA Staff looks forward to frequent, periodic updates regarding the status of the reorganization.

The long term success of NTI depends on the development of private-sector residential reinvestment in blighted areas in the City. Anecdotal evidence suggests building costs associated with either new construction or major renovations within the City limits are thirty percent higher than in the suburbs. There is a lack of demonstrable results from attempts to control these costs, which historically drive private developers from Philadelphia. Although NTI officials point to antiquated “work rules” rather than development costs as the prime issue that must be addressed, PICA Staff conversations with area developers centered on the high labor costs.

“Supplemental” Programs Show Some Success

Ironically it is the programs designed to supplement NTI and not funded by NTI bond proceeds, which have shown the greatest impact. The on-going success of towing abandoned cars (approximately 190,000 to date) cars and the removal and pruning of over 45,000 street trees is a testament to the value of ample resources, a defined plan in identifying and solving a quality of life problem.⁵

While the year-old Community Life Improvement Program (CLIP) which aggressively seeks code violations has shown positive results, expansion of the program has been limited. The Administration has been unable to provide objective criteria for justification of limiting CLIP expansion to certain neighborhoods. The selective expansion of CLIP leaves the perception that it is more a political reward than a well designed quality of life initiative.

Although Operation Safe Streets is entering its second year, the impact it has had on reducing crime is unclear. While statistics do indicate an overall drop in crime (unlike many other metropolitan areas over the same period) perceptions about crime reduction vary from neighborhood to neighborhood. A recent Temple study showed no appreciable impact from Safe Streets. Administration officials have added to the confusion by

⁵ Five Year Plan, Fiscal Year 2004 – Fiscal Year 2008, p. 36

touting both sides of the perception and the statistical justification of Safe Streets when confronted with criticism.⁶

Fiscal Elements of NTI

The total dollar amount available for the NTI continues to be adjusted based on changing bond market conditions. While the formula for determining available funds is based on the budgeted debt service figures, the ever changing total project amount (currently \$275 million), points to a poorly defined program. While NTI has established a framework of goals, it has been unable to demonstrate a clear set of specific objectives, and what resources are required to achieve those objectives.

The Plan budgets NTI debt service for total project borrowing even though less than sixty percent of the bonds have been issued. Each year that the remaining bonds are not issued, results in approximately \$8 million in excess budget obligations. Of the \$145 million of bonds issued to date, only \$68 million has been expended. This indicates a lack of immediate need for the issuance of additional bonds.

Program Measurement Concerns

Since the inception of NTI, PICA Staff has continually focused on the evaluation of the success of NTI beyond counting the number of buildings demolished and lots cleared. Many of the problems outlined above would be addressed by more formal, demonstrable program goals which could be objectively evaluated. Again, PICA Staff strongly recommends expanding performance measures and even adding these measurements to the Quarterly City Managers Report under a NTI departmental service delivery report.

⁶ Egan, Nicole Weisensee and Mark McDonald, "Effect of Operation Safe Streets Uncertain", The Philadelphia Daily News, May 1, 2003

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PERFORMANCE MEASUREMENT

The City continues to show dramatic improvement in the development of useful performance measures and the collection of data. These improvements have not been as prevalent in some of the current Administration's newer initiatives. Despite the improved focus on outcome measurement, there remains a disconnect between new initiatives outlined in the Plan and projected measures related to these initiatives.

Development of Useful Measures and Reliable Data Continues to Improve

For a true performance measurement system to work, it must have outcome-based measures which relate directly to the service mission of the department. In many City Departments, the ongoing emphasis on useful performance measures spearheaded by the Office of Budget and Program Evaluation has dramatically improved the quality of measures developed. The focus is shifting to true outcomes – how is the Department performing relative to its mission, rather than what the Department is doing.

Some Departments are further along in the process than others. The Social Services Departments have begun to capture data on key measures that relate closely to Department-wide objectives. While this data alone will not give a complete picture of Departmental activities, it should give some indication of progress toward achieving goals, as well as highlighting activities which are not achieving success. PICA Staff hopes to begin seeing this data reported next fiscal year, along with a connection to Departmental activities (see DHS chapter).

While the reliability of data remains a concern, PICA Staff is encouraged by indications that improved technology and vigilance will enhance data reliability.

New Initiatives Lack Clear Performance Measures

One of the difficulties with instituting a performance measurement system is the natural resistance to applying new techniques to existing programs. The reverse is usually true as well, so that newly instituted programs which incorporate performance measures into their formation will work well. Unfortunately, key initiatives of the current Administration have failed to follow this model.

The most disappointing of these failures is the Neighborhood Transformation Initiative (NTI). Other than a few broad goals (demolish a certain number of buildings, clear a certain number of vacant lots) there is very little detail regarding ongoing performance measures. This shortcoming will make assessing the impact of the nearly \$300 million in NTI funds nearly impossible. Administration officials acknowledged the lack of specific measures, but continue to give no timetable for developing measures.

Plan Initiatives are not Reflected in Performance Goals

While reviewing the Plan and during meetings with City Departments, PICA Staff continued to be disappointed by the lack of relationship between objectives stated in the Plan and performance goals. In several Plan chapters, specific initiatives were described with specific aims. Yet, performance measures were either not provided in the Plan or the projected measures showed no impact from the initiatives.

Many of the Social Services Departments described new emphases on prevention programs in the new Plan. However, many measures for client services displayed little or no change following these new initiatives. Fires in vacant buildings are projected to remain stable, despite the projected decrease in vacant properties resulting from NTI.

When questioned, many Departments indicated that their projections are based on trends and do not incorporate the initiatives described in the Plan. This approach hinders any attempt to tie desired service goals with programs to achieve those goals. It becomes impossible to justify certain expenditures, if the City itself does not indicate any future impact. Ideally, projected measures should be set where Departments reasonably believe their level of achievement should reach. Goals should reflect where we want to be as opposed to where we already are.

ANALYSIS OF THE CITY'S ECONOMY

The national economy has recently been described as “sluggish, subpar or even subdued.”⁷ Recent Labor Department statistics report the nation’s unemployment rate was the highest level in nine years, climbing to 6.1 percent in May 2003. Unlike previous recessions, the City economy has weathered the most recent economic downturn relatively well. The City’s economy did not significantly grow during the preceding national economic boom, which has allowed it to evade the demoralizing effects of the economic downturn. The City’s decreased reliance on manufacturing, and a relatively small high tech industry, enabled the City to alter the historical economic trends.

Data released by the Commonwealth’s Center for Workforce Information & Analysis indicates the number of jobs in Philadelphia has decreased by 2,700 from April 2002 to April 2003. The City’s unemployment rate in the aforementioned period increased from 6.7 percent to 7.3 percent. The City continues to lose population according to the 2000 census, a trend that appears constant in the foreseeable future. Concurrently, the City can boast of a growing property tax assessment base, and a FY2002 General Fund balance of \$139 million.⁸

The City cautiously projects flat employment growth, while appropriately estimating combined residential and commercial assessments to grow slightly more than two percent. These assumptions seem to be a reasonable short-term forecast for the City’s economy, with muted optimism over the last three years of the Plan.

Reversal of Historical Trends

The City’s history of leading the region into periods of economic downturn and lagging the region in rebounding from such slowdowns is notable. On the contrary, during this most recent recession, the Philadelphia economy escaped the national decline and remained relatively stable. A number of reasons can be attributed to this unusual event:

- The City’s economy has diversified over the last twenty years, moving away from its heavy reliance on the manufacturing sector.
- The recession was primarily concentrated in the information technology and manufacturing sectors, which do not play a large role in the City’s overall economy.
- The City’s major industries such as financial services, educational services and the healthcare industry have remained relatively stable during the downturn.

⁷ *Crutsinger, Martin, “Economy poised to rebound”, The Philadelphia Inquirer, June 12, 2003*

⁸ *Five Year Financial Plan , Fiscal Year 2004 – Fiscal Year 2008, p. 19*

The City's Revenue Projections

Philadelphia's tax base grew from FY1992 to FY2002 at an average annual rate of 3.4 percent. During this same period the average rate of inflation was 2.4 percent. The Plan assumes the tax base will no longer grow more quickly than inflation, averaging 2.8 percent compared to an average inflation rate of 2.5 percent.

Estimates for the Real Estate Property Tax are important since property tax is the second largest source of City revenue, approximately twenty percent of the General Fund tax revenue. The tax is levied on behalf of both the School District and the City at a combined rate of 8.264 percent of assessed value of residential and commercial property. Since FY2002, the General Fund's share is 3.474 percent and the School District's is 4.79 percent.

Real estate tax assessments for commercial, industrial and residential properties have grown for each respective year since 1998. This is due to a very strong residential and commercial real estate market and improved assessment techniques. The pattern of slight but consistent growth in real property assessments can be expected to continue. The Philadelphia real estate market continues to be vigorous. Vacancy for office space in the Central Business District was 11.5 percent in the third quarter, well below the peak of eighteen percent during the last economic slowdown.⁹ While these rates are satisfactory, the two planned Center City office towers threaten to saturate the supply of office space which in turn could possibly drive vacancy rates higher. Another factor that could negatively impact vacancy rates is the expiration of a number of leases of large businesses in Center City. PICA Staff will continue to monitor the fluid Center City market.

The City projects that commercial assessments will grow by 1.6 percent annually and residential assessments will grow by slightly more than 2 percent annually through the life of the Plan.¹⁰ Based on the past four years of property assessment growth and property tax revenue, and after discussions with regional economists, the Board of Revision of Taxes, and local real estate industry leaders, PICA Staff feels that the City's projections throughout the life of the Plan are justified.

Other Impacts on the City Economy

The City is in the midst of its most serious fiscal challenge in over ten years. A number of potential economic hurdles pose serious risks to the long-term viability of the City's fiscal health.

The recently enacted State budget includes \$85.5 million in funding reductions for various services that would severely impact the City's fiscal health. Public transportation funding has also been reduced approximately \$15 million which could drastically alter

⁹ *Five Year Financial Plan, Fiscal year 2004 –Fiscal year 2008, p.25*

¹⁰ *Five Year Financial Plan, Fiscal year 2004 –Fiscal year 2008, p. 26*

service for thousands of riders and impact the long-term economic development goals for the City and the region.

Analysts predict that the Philadelphia region is likely to remain one of the nation's slower growing metropolitan regions. Data from the 2000 Census point to an ongoing loss of middle income population, leaving behind a population that is proportionately poorer, less able to contribute to the tax base and more in need of City services.¹¹

Another risk to the City's economy is the unresolved question of expansion of the Pennsylvania Convention Center. Hospitality and tourism growth in the City during the last decade parallels the building and completion of the Convention Center. In order for Philadelphia to compete with other East Coast convention destinations, expanding the Center to 2.4 million square feet has been proposed. Approximate costs to complete the expansion are upwards of \$460 million. PICA Staff is concerned with the negative impact of higher than average labor costs and rebooking rates that can be described as dismal on the Convention Center's operations.

Data from the Greater Philadelphia Hotel Association project a thirty-one percent decrease from out of town visitors in 2004 compared to 2002. Projected hotel occupancy rate for 2004 is 61.6 percent. The report also points to "the virtual disappearance of citywide conventions" due to the Convention Center's nationwide reputation as expensive and inefficient.¹²

¹¹ *Five Year Financial Plan, Fiscal Year 2004- Fiscal Year 2008, p. 11*

¹² *Gelbart, Marcia, "Hotel Industry Lowers its Expectations more," The Philadelphia Inquirer, May 16, 2003*

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DEPARTMENT OF HUMAN SERVICES

Since the early 1990's, the Department of Human Services (DHS) has been able to significantly and consistently increase the revenue from other governments to fund the services provided by DHS. This capacity to garner additional state and federal funds has allowed the City to increase service levels, while simultaneously reducing net City costs to provide services. The dependence on outside sources of funding does present some risk. The proposed funding reductions in the enacted State budget highlight the potential pitfalls for the City.

PICA Staff congratulates the City for the constant increase of state and federal funding levels, but notes that challenges that could negatively affect net City costs still remain. In light of the current economic downturn, which has negatively impacted both the state and federal budgets, it is imperative that the City continues to be vigilant in maintaining external funding to serve the ever-increasing needs of its population.

State and Federal Funding Levels

The City started to aggressively pursue additional funding opportunities for human service functions well over a decade ago. When meeting with PICA Staff, DHS Staff provided a historical analysis of the City share of these costs by fiscal year.

Analysis of City Share of Department of Human Services Costs (numbers in thousands)

Fiscal Year	City Costs	State/Federal	Total	City % of Costs
'94	64.6	195.1	259.7	24%
'95	48.5	235.5	284.0	17%
'96	38.5	256.7	295.2	13%
'97	44.7	263.2	307.9	14%
'98	48.2	288.7	336.9	14%
'99	45.7	318.3	364.0	12%
'00	39.2	368.7	407.9	9%
'01	51.8	392.0	443.8	11%
'02	40.9	433.1	474.1	9%
'03	36.9	507.6	544.5	7%

As the above information illustrates, the City share of DHS service costs decreased from twenty-four percent in FY1994 to seven percent in FY2003, simultaneously the total costs of the department services rose from \$259.7 million in FY1994 to \$544.5 million in FY2003. Throughout the life of the Plan, the City share of costs is projected to consistently decline from 7 percent to 4 percent.¹³ Given the historical trend of the

¹³ PICA Review, Department of Human Services, FY 2004-FY2008, p. 14

Department to proactively seek out and maximize funding opportunities, PICA Staff feels that the anticipated “non-City” funding projections are reasonable.

Projected City Share of Department of Human Services Costs
(numbers in thousands)

Fiscal Year	City Costs	State/Federal	Total	City % of Costs
'04	43.0	556.3	599.3	7%
'05	34.3	563.0	597.3	6%
'06	26.5	569.7	596.2	5%
'07	25.6	569.7	595.3	4%
'08	24.6	569.7	594.4	4%

Needs-Based Budgeting Formula Continues

DHS persistently expands the amount of “non-City” funding even with the continuance of the Commonwealth’s Needs-Based Budgeting System to determine the appropriate levels of funding. As was the case in previous Staff Reports, the absence of a clear and equitable reimbursement process is disconcerting to PICA Staff. The criteria utilized by the Commonwealth to determine county-funding allocations continue to remain confusing and more importantly at odds with the realities that face human service departments across the State. Even with the new Rendell Administration in Harrisburg, this system continues to hamper the efforts of DHS to effectively plan and allocate expenditures.

Various demographic factors are also not taken into consideration when the Commonwealth determines funding levels for DHS. The 2000 census reports that a single parent heads 51 percent of the families in Philadelphia.¹⁴ In general, there is a high correlation between the incidence of child poverty and the incidence of children raised in single parent households.¹⁵ The City’s welfare population represents nearly 50 percent of Pennsylvania’s total welfare caseload, whereas the City’s population comprises only 12 percent of the state’s population.¹⁶

While the current utilization of the Needs-Based Budgeting process has not yet hampered the City’s ability to obtain and even increase its fair share of funding for human services, PICA Staff believes that the funding inequities pose a potential risk.

¹⁴ *The Bottom Line is....Children, Philadelphia Citizens for Children and Youth 2001, p.25*

¹⁵ *The Bottom Line is....Children, Philadelphia Citizens for Children and Youth 2001, p.24*

¹⁶ *Recommendations to Strengthen TANF: A State Briefing Paper, The Stoneleigh Roundtable, Nov. 2001, p. 4*

Expansion of Prevention Services Threatened by State Budget Cuts

Since late 2000, DHS has focused on a strategy of prevention investment. The establishment of the Division of Community-Based Prevention Services allows the Department to develop and support a coordination of prevention services with other public and private agencies. This approach is intended to increase the services to families and children with the goal of diverting them from utilizing more intensive and expensive services. The Beacon Center model is a primary example of DHS prevention services. Located in various neighborhoods schools, Beacon Centers provide after-school and evening services such as tutoring, job training and parenting courses.

Funding targeted for prevention services has risen from \$14.4 million in FY2000 to close to \$90 million anticipated in FY2004.¹⁷ The escalation in funding originates from the federal Temporary Assistance to Needy Families (TANF). DHS needs to develop clear, measurable performance standards that will allow the Department to determine which programs have been successful in reducing abuse, neglect, and delinquency.

The current uncertainty of the Commonwealth's budget and the proposed funding cuts may well negatively impact the planned expansion of prevention services. Analysis of the State budget illustrates approximately \$32.7 million reduction in funding targeted for services for abused, neglected and delinquent children. These reductions would not only severely hamper current programs but also the planned expansion efforts of DHS. These cuts would lead to eliminating after school programs and bring to an end the expansion of programs designed to prevent child abuse, neglect and truancy. Should the cuts remain in place, the prevention strategy of DHS will be threatened.

Improvements and Deficiencies DSS Structure: Management

Since the development of the Division of Social Services (DSS) in FY2001, PICA Staff has continued to monitor the efforts to streamline services, eliminate duplication of effort, and enhance performance measures. The holistic look at City service delivery, combined with efforts like the *Children's Report Card*, allow for a more comprehensive approach to meeting the various needs of DHS customers.

The on-going development of an integrated case management system will allow DHS staff members to access relevant data from all city systems insuring that all customer needs can be met at one point of contact. Additionally, the anticipated implementation of performance-based contracting will ensure that contractors are providing the services that meet the City's standards.

While PICA Staff supports the increase in performance measures, we are troubled by the lack of synchronization between the Departments goals and the projected prevention expenditures. In theory, the increased focus on prevention services should reflect a significant decrease in families and children utilizing Juvenile Justice Services. For

¹⁷ Five-Year Financial Plan, FY2004-FY2008, p. 164

example, while DHS has increased funding and services to combat delinquency, there is only a negligible drop reflected in the projected performance measures for delinquent youth placements.¹⁸

Conclusion

The consistent, annual increase in non-City funding for DHS services has been extraordinary over the last decade. These increases have allowed the Department to amplify service levels for its needy clients while also beginning to implement systemic reform based on accountability, accessibility, and prevention. PICA Staff recommends the augmentation of the Departments performance measurements to accurately assess the planned investment of resources in prevention services.

A risk to the non-City funds is the uncertainty of the Commonwealth's budget and the proposed reduction of prevention services and expansion efforts. In order to continue the past successes, the City must be proactive in working collaboratively with its state and federal partners and it must also be vigilant in identifying new funding sources to serve the City's neediest residents.

¹⁸ Five-Year Financial Plan, FY2004-FY2008, p. 169

OUTSIDE THE FIVE-YEAR PLAN

There are a number of issues that either fall outside the duration of the Plan or are not addressed by the proposed Plan. The Plan provides minimal funding for an expansion of the Convention Center. The Plan does not attempt to address a comprehensive approach to tax reform in the City. While some Plan years anticipate an annual operating surplus (including adjustments), there is no attempt to eliminate annual structural deficits throughout the Plan.

Convention Center Expansion

As last year's PICA Staff Report highlighted, the major issues surrounding expansion of the Convention Center are secondary to the management issues of the current Center. In the Mayor's Budget Address on January 29, 2002, expansion of the Pennsylvania Convention Center was deemed a priority. Hospitality and tourism growth in the City during the last decade parallels the building and completion of the Convention Center. In order for Philadelphia to compete with other East Coast convention destinations, expanding the Center to 2.4 million square feet has been proposed. Approximate costs to complete the expansion are upwards of \$460 million. Even if this cost were to be shared with the Commonwealth, less than \$5 million has been proposed in the Plan for expansion.

The greater concern however is the viability of expansion given the higher than average labor costs and lower than average rebooking rate at the current Convention Center. Little discussion in the Plan centers on concerns that this economic engine has a rebooking rate of just fifteen percent. Labor disagreements and costs are continually cited as problems by Convention Center customers, not the size of the facility.

For the past year every stakeholder has proposed solutions to the problem, while no appreciable change has occurred. While PICA Staff takes no position on the various proposals, we reiterate what was written one year ago: The ideal would be a well-managed large Convention Center that would continue to drive the City and state economy. The reality today is a smaller, unevenly-managed Convention Center which drives customers away. If the likely result is a large, poorly-managed Convention Center, then the City should save taxpayers millions of dollars in debt and refrain from expanding the Convention Center.

Tax Reform

Though numerous changes in City taxes were proposed over the past year, including some in structure of the tax, others related to the amount of the tax, no comprehensive examination of the tax structure has been attempted by the Administration. Many factors contributed to the astonishing number of tax proposals, including last year's Wage Tax

debate; the City Controller's report on City Taxes; the National Economy; and, the pressures of the election cycle. The often conflicting proposals have mostly obscured the need for a discussion on comprehensive tax reform in Philadelphia.

The Tax Reform Commission is expected to have its report completed by the end of November 2003. Although its proposals are unknown, the hope is that it will stimulate a holistic review of the City's tax structure rather than the current piecemeal approach.

Annual Structural Deficits

As PICA Staff first noted last year, the City does little to address the problem of annual structural deficits. Though the Five-Year Plan framework has many strengths as a fiscal planning tool, the City's proposal to "spend down" any accumulated surplus over the five-year period allows for scheduled annual operating deficits. While this year's Plan does include some years with annual operating surpluses (adjusted), it is not an overall goal of the Plan.

PICA's mandate has always been to determine whether or not the City's proposed Plan presents a reasonable projection for a balanced spending plan over the ensuing five-year period. In effect, the City's projected revenues and fund balance should equal or better the proposed spending over five years. However, as the dwindling fund balance at the end of the Plan demonstrates, annual structural deficits pose an ongoing risk to the City's long-term fiscal health.

Most years of the current Plan assume an annual operating deficit, ranging from \$15 million to over \$100 million. It would be logical to assume that if the Plan extended to FY2009, the City would be faced with a negative fund balance. PICA Staff believes the City needs to begin striving for projected annual operating fund balance in order to achieve true fiscal stability.

**Pennsylvania Intergovernmental
Cooperation Authority**

**STAFF REPORT
ON
FY2004-FY2008
FIVE-YEAR FINANCIAL PLAN**

SECTION V:

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, as approved by City Council on May 29, 2003, was submitted to PICA by the Mayor on May 30, 2003 and the PICA Act provides a 30 day period for review which expires June 29, 2003. 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 28, 2003 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 June 25, 2003.

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, 2004 (100 days prior to the end of FY2004). At that time, the City is required to add its Fiscal Year 2009 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 \$1,152 million in funding to assist the City, allocated to the following purposes:

<u>Purpose</u>	<u>Amount (thousands)</u>
Deficit Elimination/Indemnities Funding	\$ 256,200
Productivity Bank	20,000

Capital Projects	494,584
Retirement of Certain High Interest City Debt	<u>381,300</u>
TOTAL	<u>\$1,152,084</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 2004. 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 FY2003 is August 15, 2003. Quarterly reporting deadlines for FY2004 are November 17, 2003, February 16, 2004, May 17, 2004 and August 16, 2004. 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. For FY2004, the reporting dates are October 20, 2003, January 20, 2004, April 20, 2004 and June 20, 2004. 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 FY2004 are August 1, 2003, November 1, 2003, January 31, 2004 and May 2, 2004.