City Council *of* Philadelphia
Office of the President – Finance and Budget Team

To: City Council of Philadelphia
From: Matthew Stitt, Chief Financial Officer – City Council
Robert McDermott, Financial Policy Analyst – City Council
Date: 11/9/2017
Re: General Fund Balance Update: Actual Fund Balance Results from FY17 Annual Financial Report

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City General Fund Balance and Credit Updates[1]

The City released its FY17 Annual Financial Report on October 27th, 2017, which highlights the financial standing of the City at the end of the fiscal year. **The City's FY17 year-end General Fund Balance was $189.2 million, which is $81.7 million over the end of the 3rd Quarter Projection (as of mid-May 2017), meaning the City started the current fiscal year (FY18) with more reserves-on-hand than projected during the FY18 budget process.**

When the FY17 budget was adopted, the Administration projected a year-end fund balance of $40.2 million. During the FY18 budget process, the Administration updated the FY17 Fund Balance projection to $107.5 million, which was $67.3 million more than the previous projection, but still $81.7 million under where the City ended the fiscal year. *Due to this increase, the City's FY17 Fund Balance as a Percentage of Expenditures increased from an adopted 1% of Expenditures to an actual 4.57% of Expenditures.* As a general rule, the credit rating agencies recommend that cities maintain reserves that cover 16-17%, or two months, of annual expenditures in order to be able to address unexpected revenue decreases (e.g., recession) or expenditure increases (e.g., natural disaster) in the short-term without needing to alter service delivery or tax rates. For reference, a 17% fund balance at the end of FY17 would have equaled $703.6 million. **Given the critical need for services in the short-term and the need to place funds in reserve for labor agreements and other budget pressures, the Administration aims to maintain a target fund balance of 7% of expenditures, or about three and half weeks of annual expenditures.**

Several factors must be considered for the current fiscal year, following our fiscally encouraging FY17. First, following the renegotiation of the FOP and DC33 contracts, the $200 million "Labor Reserve" line-item maintained by the Administration in the FY18-FY22 Five Year Plan has been depleted, with the cost of the new contracts at an average of approximately $75 million annually (please note that costs increase year-over-year, starting with approximately $39.7M due in FY18 and over $92 million due in FY22). In addition to the Labor Reserve, the Administration, in conjunction with Council, added $51 million in FY18 to a "Federal/State Funding Reserve" line-item to prepare for decreases in revenues or increases in costs due to actions by the State or Federal governments (the approved FY18-FY22 Five-Year Plan includes $275 million in this reserve line-item).[2] **Pending liabilities and major cost drivers moving forward include the negotiation of two municipal contracts (Fire and DC47), funding the Philadelphia School District (PSD) deficit (inclusive of the new PFT contract), a potential repeal of the Affordable Care Act, reductions in block grants, proposed changes to municipal bonds, and potential economic cycle changes including economic contraction and/or market downturn, among others.** The upcoming School District budget, as well as any of the aforementioned policy changes, will have impacts on our ability to maintain healthy reserve levels. **Not only has the City and City Council prepared for these impacts through the increased reserves mentioned above, but the Administration has also ordered "Target Budget" reductions of 2% from each department.** These budget reductions, to prepare for budget pressures, aim to decrease the costs of each department by 2% with minimal impact to service delivery. For reference, 2% of the total General Fund Operating Budget equals approximately $83 million.

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[1] All figures in this document were compiled from the City's Quarterly Manager Reports (QCMR) and the City's Annual Financial Reports (AFR). All figures are reported on a budgetary basis (and not GAAP basis).
[2] This amount may decrease if appropriations from this "reserve" are needed to offset any potential funding cuts.

However, since certain fixed costs cannot be reduced in the General Fund Operating Budget (i.e., certain debt service payments, pension payments, indemnities, etc.), the actual Target Budget reductions – if fully utilized – will likely be considerably lower than $83 million, and likely closer to the $40 million range.

Despite the higher than expected year-end fund balances for FY16 and FY17, Philadelphia still maintains a 'Negative' credit outlook with credit agencies Standard and Poor's (S&P) and Moody's – citing low reserve levels, persistent levels of poverty, and a high unfunded pension-liability. Although reserve levels are outperforming projections, they are still low ($189 million is approximately 16 days of spending), and the City's fixed costs (e.g., debt, pension liability) are still above the recommended levels. **However, after three years of operating deficits, the City ended FY17 with a General Fund operating surplus. The City reduced its expenditures (when comparing FY17 actuals versus projections) by approximately $47.2 million – mainly fueled by reductions in professional service contracts, a reigning in of overtime costs, and the withholding of spending funds on the expansion of Pre-K and Rebuild due to pending Beverage Tax litigation. This reduction, coupled with an approximate $26.4 million increase in revenues above Q3 projections led to an approximate $18.2 million operating surplus for FY17.** Successfully addressing the City's trend of operating deficits while increasing the City's reserve levels and managing overtime demonstrates that the City has changed course in a positive way following the City's negative rating action a year ago, and is better prepared for unforeseen budgetary impacts than in recent years.

Summary

- During the planning of the FY18 budget, the Q3 City Managers Report estimated a year-end General Fund Balance of $107.5 million, which turned out to be $81.7 million lower than the actual year-end Fund Balance amount of $189.2 million.

- The most recently approved modified Five-Year Plan includes $275 million in reserves to account for potential reductions in State and Federal funding. The previously allocated $200 million in labor reserves were depleted due to the recent implementation of the FOP Arbitration Award.

- The School District is also projecting substantial deficits in its current Five Year Plan, which could strain the City's financial resources in FY19 and each year thereafter.

City of Philadelphia Budget Pressures: FY18-FY22 Five Year Plan	
District Council 33 Contract (expires 6/2020)	$130 million (costs could increase after FY20)
Fraternal Order of Police Contract (expires 6/2020)	$247 million (costs could increase after FY20)
PSD Deficit (including funding Teachers' Contract)	$750 million (*estimate*, potentially shared with State)
State and Federal Budget Cuts	*Unknown*
Fire Department Contract	*Unknown*
District Council 47 Contract	*Unknown*
Potential Economic Contraction	*Unknown*

- Target Budget reduction plans, to reduce department spending by 2% in FY18, have been distributed to departments in order to respond to potential revenue or expenditure instability.

- From FY13 to FY17, the projected year-end Fund Balances (as of the end of the 3rd Quarter) available during the budget process have been under the actual final Fund Balance by an average of $73.5 million per fiscal year. Projected year-end Fund Balances ranged from $9 million to $116 million under actuals.

- Actual Expenditures from FY13 to FY17 ended, on average, $74.4 million lower than projected in the Q3 City Managers Report for each year.

- Fund Balances as adopted in the Operating Budget have under-projected the actual final Fund Balance by an average of $120.5 million per fiscal year, from FY13 to FY17. Projected year-end Fund Balances ranged from $79 million to approximately $176 million under actuals.

General Fund Analysis

General Fund Balance	FY12	FY13	FY14	FY15	FY16	FY17	5Yr. Average	5 Yr. Sum
Adopted	$ 60.6	$ 81.3	$ 86.5	$ 68.4	$ 69.3	$ 40.2		
Q3 Projection	$ 66.9	$ 140.9	$ 119.8	$ 142.4	$ 70.2	$ 107.5		
Actual	$ 146.8	$ 256.9	$ 202.1	$ 151.5	$ 148.3	$ 189.2		
Difference: Actual & Q3	$ 79.8	$ 116.0	$ 82.4	$ 9.1	$ 78.1	$ 81.7	$ 73.5	$ 367.3
% Difference	119%	82%	69%	6%	111%	76%	69%	
Difference: Actual and Adopted	$ 86.2	$ 175.6	$ 115.6	$ 83.2	$ 79.0	$ 149.0	$ 120.5	$ 602.3
% Difference	142.25%	215.90%	133.65%	121.64%	113.92%	370.65%	191%	

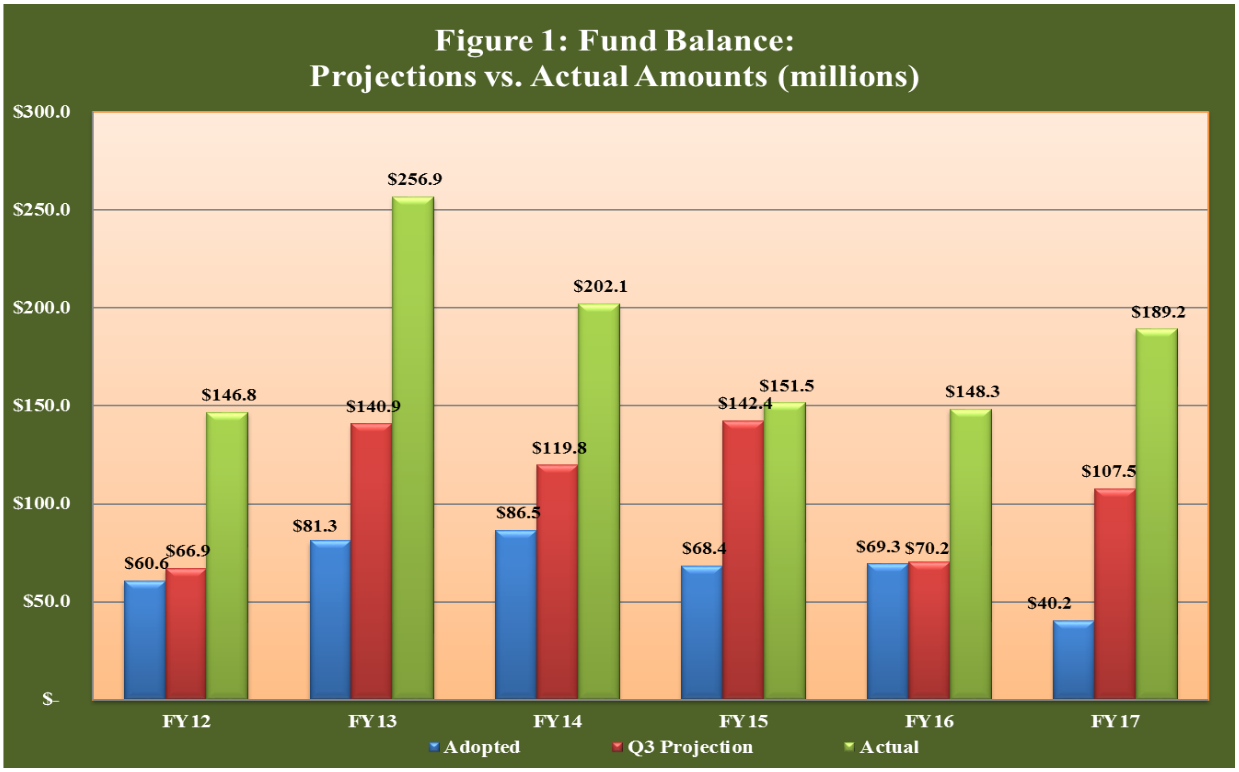


Figure 1: Fund Balance:
Projections vs. Actual Amounts (millions)

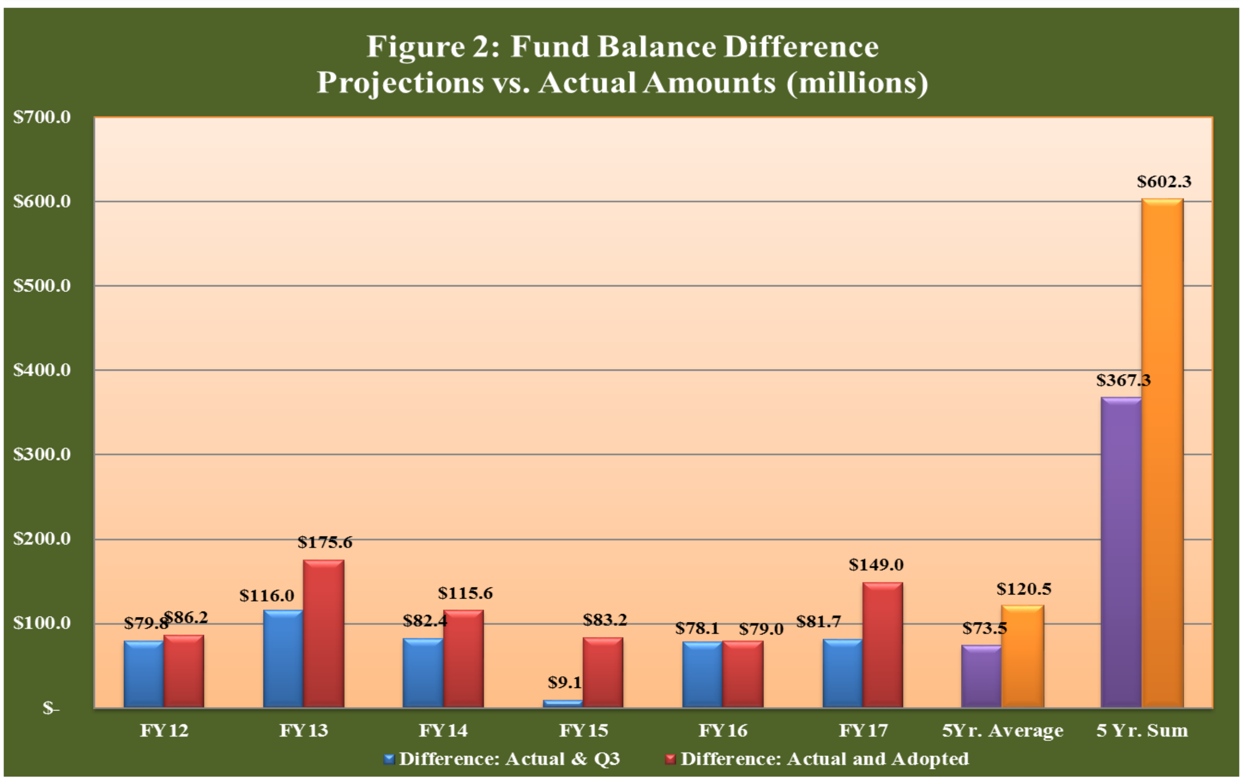
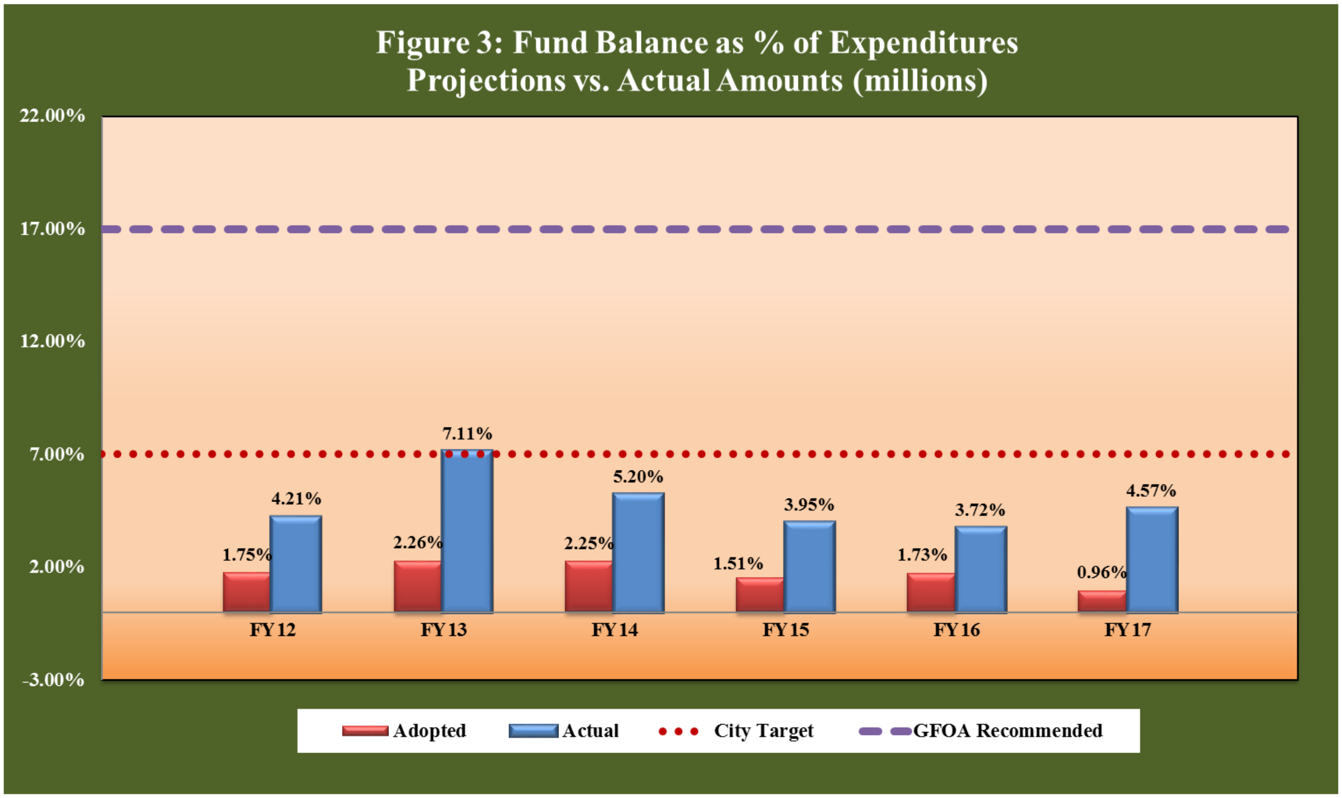
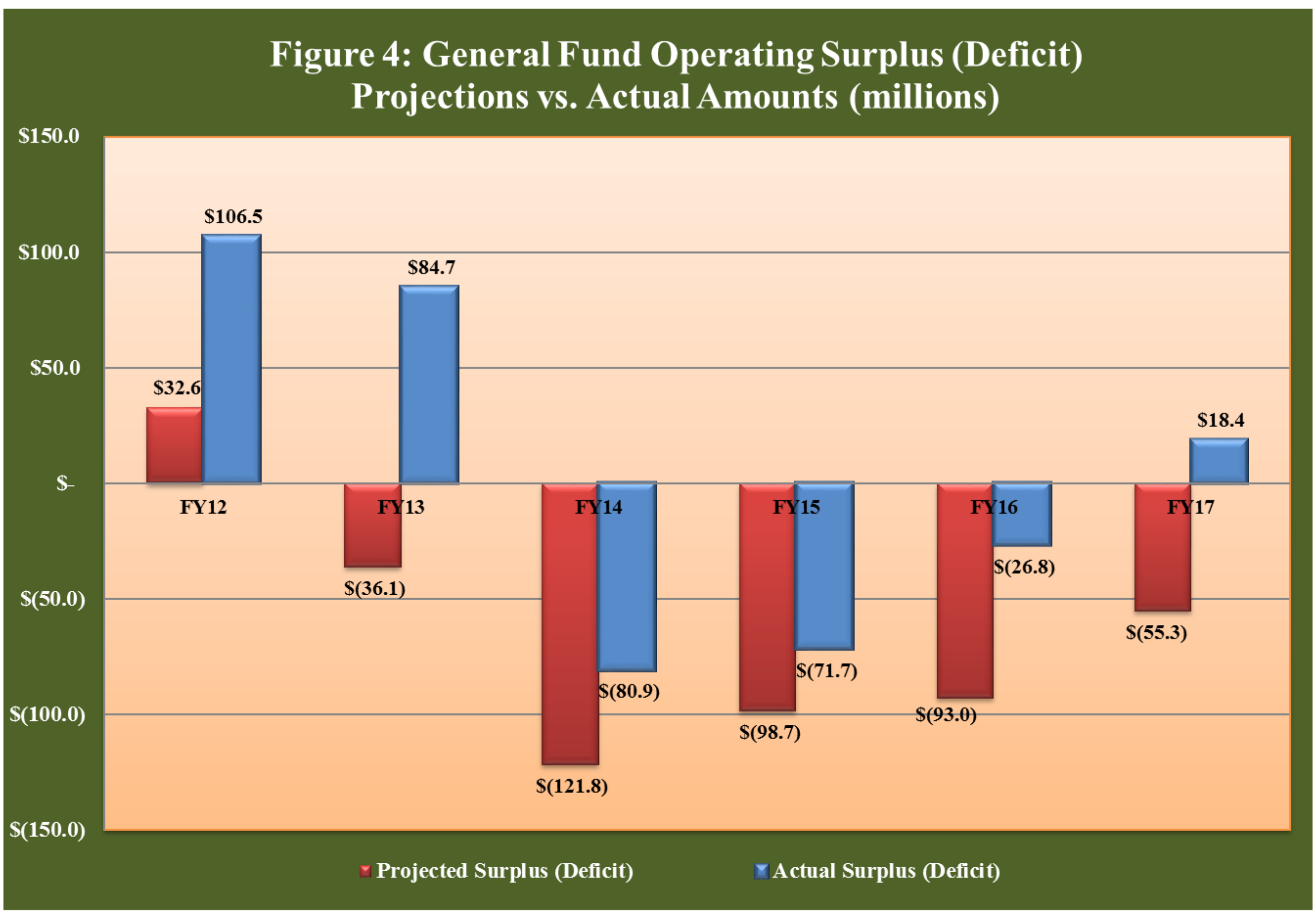


Figure 2: Fund Balance Difference
Projections vs. Actual Amounts (millions)

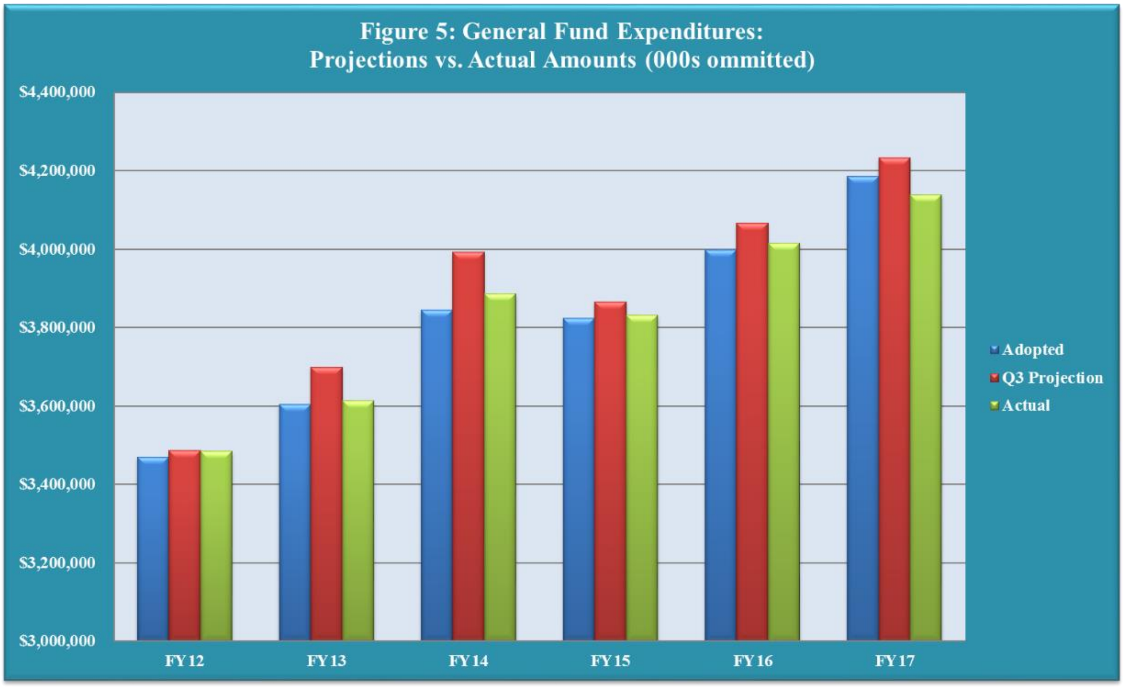
General Fund Ratio and Budget Analysis





General Fund Expenditure and Revenue Analysis

Expenditures	FY12	FY13	FY14	FY15	FY16	FY17	5Yr. Average	5 Yr. Sum
Adopted	$ 3,470,095	$ 3,603,867	$ 3,845,403	$ 3,824,565	$ 3,998,103	$ 4,187,087		
Q3 Projection	$ 3,487,470	$ 3,699,129	$ 3,993,471	$ 3,865,556	$ 4,067,098	$ 4,233,734		
Actual	$ 3,484,875	$ 3,613,266	$ 3,886,564	$ 3,831,515	$ 4,015,795	$ 4,139,792		
Difference: Actual - Q3	$ (2,595)	$ (85,863)	$ (106,907)	$ (34,041)	$ (51,303)	$ (93,942)	$ (74,411)	$ (372,056)
% Difference	-0.07%	-2.32%	-2.68%	-0.88%	-1.26%	-2.22%	-1.87%	
Difference: Actual - Adopted	$ 14,780	$ 9,399	$ 41,161	$ 6,950	$ 17,692	$ (47,295)	$ 5,581	$ 27,907
% Difference	0.43%	0.26%	1.07%	0.18%	0.44%	-1.13%	0.17%	



Revenues	FY12	FY13	FY14	FY15	FY16	FY17	5Yr. Average	5 Yr. Sum
Adopted	$ 3,502,721	$ 3,567,721	$ 3,723,585	$ 3,725,833	$ 3,905,141	$ 4,131,767		
Q3 Projection	$ 3,531,651	$ 3,675,564	$ 3,836,962	$ 3,789,737	$ 3,966,741	$ 4,169,233		
Actual	$ 3,591,353	$ 3,697,989	$ 3,805,649	$ 3,759,767	$ 3,988,967	$ 4,158,204		
Difference: Actual & Q3	$ 59,702.0	$ 22,425.0	$ (31,313.0)	$ (29,970.0)	$ 22,226.0	$ (11,029.0)	$ (5,532.2)	$ (27,661.0)
% Difference	1.69%	0.61%	-0.82%	-0.79%	0.56%	-0.26%	-0.14%	
Difference: Actual and Adopted	$ 88,632.0	$ 130,268.0	$ 82,064.0	$ 33,934.0	$ 83,826.0	$ 26,437.0	$ 71,305.8	$ 356,529.0
% Difference	2.53%	3.65%	2.20%	0.91%	2.15%	0.64%	1.91%