Credit Pressure Rising for Some Florida School Districts

Special Report

Near-Term Pressures Increasing: Fitch believes rating pressure on Florida school districts will grow in the near term given the termination of federal stimulus funding, reductions in state funding levels, more limited expenditure flexibility, and expectation for continued economic and tax base instability.

Rating Stability to Date: Despite enormous dislocation in the housing market and significant weakening in Florida’s overall economy in the past few years, rating and outlook changes affecting Florida school district general obligation (GO) bonds and certificates of participation (COPs) ratings have been infrequent. Fitch has downgraded only three GO or COP ratings of the 25 Florida school districts it rates since the start of 2008. The GO or COP ratings of two school districts carry a Negative Rating Outlook.

Management Prudence Key: Rating stability to this point has been derived largely through sound management practices and the maintenance of satisfactory financial flexibility. Given the constraints of the Florida school district revenue environment noted below, Fitch believes prudent management practices and expenditures controls continue to be crucial to maintaining credit quality during this period.

Successful Practices Identified: Districts that have successfully managed their financial environments have followed similar sets of practices. These include realigning spending with recently reduced resources, developing contingency expenditure reduction plans that deal with potential further revenue deterioration, taking advantage of categorical flexibility provisions, a history of accurate budget results, and consistently adhering to a formal fund balance policy, preferably one that augments the 3% reserve required by the state.
Constrained Revenue Environment Presents Challenges

The Florida Education Finance Program (FEFP) is the primary mechanism for funding the operating costs of Florida school districts. The FEFP determines a total appropriation level based on a per student funding level and establishes the required local effort for each school board, which is almost entirely derived from the levy of ad valorem property taxes.

In fiscal 2012, FEFP funding will total $16.64 billion, a reduction of $1.58 billion, or 9.5% from the year prior. The fiscal 2012 decline reflects the loss of federal stimulus money, which had totaled $910 million and $870 million in fiscal years 2010 and 2011, respectively. Per pupil funding is 9.1% lower than in fiscal 2011 and 12% lower than the pre-recession peak amount approved for fiscal 2008. Reductions in FEFP funding have helped the state legislature close budget gaps totaling $2.8 billion for fiscal 2011 and $3.6 billion for fiscal 2012. Fitch rates the state of Florida’s GO bonds ‘AAA’ with a Negative Outlook. For more information, see “Fitch Rates Florida’s $2010MM GO PECO Bonds ‘AAA’; Outlook Negative,” dated July 6, 2011 available on Fitch’s Web site at www.fitchratings.com.

School districts retain very limited discretionary revenue raising authority to counter declines in FEFP funding. The state legislature has provided some relief measures that require a supermajority vote of the school districts governing body or authorization through a local referendum. These revenue measures provide only temporary relief, but Fitch considers them preferable to drawing down fund balance and/or spending cuts that reduce the relative quality of education.

Continued declines in taxable value and, in some cases, rising property tax delinquency rates have lessened the benefit derived from various locally imposed millage rates. Certified school taxable value statewide has fallen more than 26% from fiscal 2008–2011. The certified tax roll for fiscal 2012 declined an additional 4.1%, exceeding earlier estimates released by the Florida Office of Economic & Demographic Research (EDR). The most recent EDR forecast of school taxable value for fiscal 2013 depicts growth of 2% from the year prior.

Fitch believes there is some risk in the EDR forecast. According to Zillow.com, the median market value of a Florida home is down 8.5% year over year as of April 2011. Global Insight reports that in fourth-quarter 2010, the percentage of mortgages in foreclosure climbed to 14.2%, by far the highest in the country. University Financial Associates forecasts an aggregate 7% decline in Florida house prices over the next five years.

**Spending Cuts Drive Rating Stability**

Personnel costs generally represent 70% or more of a school district’s operating budget. Therefore, Fitch believes reductions to total wages and benefits are nearly unavoidable following several years of cuts that centered on nonpersonnel spending.

Reductions in classroom spending are complicated by the 2002 constitutional amendment to reduce class sizes. According to the Florida Department of Education, 35 of the 67 school districts failed to comply with the final stage of class size implementation in fiscal 2011. Fines totaling $31.3 million were imposed as a result, a relatively small sum in the context of statewide education spending, but potentially damaging given the strenuous condition of most school district budgets. Fitch notes for some districts, the cost of compliance appears to exceed the level of financial penalties, making the decision to comply one of educational quality rather than financial prudence.
State legislation gives workers the right to bargain collectively. In recent years this process has become contentious. Resolution of a bargaining impasse may incorporate the recommendation of an arbitrator; however, the elected officials of the school district retain ultimate authority to impose a contract. In general, Fitch views favorably an environment of healthy cooperation among key stakeholders where expenditure reductions are predicated on bilateral or multiparty cooperation.

Pension pressures are generally manageable. Florida school district employees participate in a multi-employer state-sponsored pension plan. The state plan is fairly well funded and well managed, so Fitch does not believe that annual district contributions will need to rise dramatically.

The fiscal 2012 state budget for the first time requires a 3% salary contribution from all employees participating in the Florida Retirement System pension plan, including public school teachers. The Florida Education Association recently filed a class action suit challenging the mandate. Fitch will continue to monitor the status of the legal proceedings, as pension savings have been incorporated in school districts fiscal 2012 budget plans.

**Sales Tax Revenue Squeezed**

A number of Fitch-rated Florida school districts have obtained voter approval to levy a sales tax for capital outlay purposes. Most of these districts use it as security for revenue bonds. Legal characteristics of these transactions tend to be somewhat liberal, with most additional bonds tests at 1.25x maximum annual debt service (MADS).

Generally, districts have heavily leveraged the revenue, leaving little tolerance for the recent decline in collections. Of the eleven school districts with sales tax debt rated by Fitch, five have been downgraded since 2008, two on multiple occasions. All are still at investment-grade levels despite the pledged revenue declines. Fitch anticipates continued pressure on sales tax performance in the near-term, based on the high rate of unemployment that persists throughout the state and the low consumer confidence indexes reported by the University of Florida Bureau of Economic and Business Research.

**Significant Abatement in Capital Pressures**

Debt issuance and construction activity prior to the recession combined with more recent slowed enrollment growth alleviates near-term capital demands for many school districts. Fitch’s focus on the capital and debt profile of Florida school districts will continue to center on future needs and the ability to fund debt service from the capital outlay millage (for COPs) or sales tax (for sales tax revenue bonds).

Historically, districts were able to levy up to 2.0 mills for capital outlays, of which 1.5 mills could be used to support lease rental payments on COPs. Of the 1.5 mills, many districts targeted a maximum of 1.0 mills for lease rental payments. However, the state legislature recently lowered the total capital outlay millage to 1.5 mills from 2.0, and tax base contraction has further reduced available revenue. The residual cushion has been greatly diminished, and could pose a risk to future infrastructure financing needs. However, most districts still have what Fitch believes is an adequate margin to make debt service payments from the capital outlay millage without having to tap other available resources.
Short-Term Debt Poses Risks

Fitch reviews exposure to variable-rate or short-term debt products given school districts' inability to raise discretionary revenue and limited balance sheet resources. For school districts with exposure to variable-rate demand bonds, Fitch assesses the reasonableness of plans to replace expiring external liquidity. The inability to secure replacement facilities at affordable rates poses risk to a mandatory tender, which in most cases would then have an accelerated principal repayment schedule. Fitch believes this scenario is unlikely but such acceleration would further pressure budget resources.

Short-term floating-rate notes or private bank placements eliminate costs associated with external liquidity but present risks to bullet maturities or hard puts. Fitch expects issuers of short-term notes to be highly rated frequent market participants with well-established processes for refinancing. Lastly, Fitch will consider a school district's derivative or swap exposure, noting collateral posting provisions and potential termination risk.