Florida School District Credit Commentary

Public Financial Management, Inc. (PFM) has the privilege of serving as Financial Advisor to twenty school districts in Florida, both large and small. This commentary is intended to highlight aspects of current legislation that, in our capacity as advisors to these districts, we feel could have a materially negative impact on Florida school district revenues and credit ratings. What follows represents our opinion on both general and specific policy matters in the legislation.

Executive Summary

- HB 7037 proposes changes in the use of local capital outlay millage levy (COML) to require a portion of the revenue to be redirected to charter schools if the State does not provide sufficient funding to the charter schools. While the loss of COML would only occur IF the State does not provide the funds, we note (i) current state funding for charter school capital is less than would be required under HB 7037 and (ii) the rating agencies will certainly consider the potential impact—both near-term and over time—of HB 7037 and will most likely assume no state funding (since there is no dedicated state source of funding) when evaluating the credit ratings of Florida school districts.

- HB 7037 provides for charter schools to receive a portion of a school district’s COML for capital projects if the State does not provide the funding prescribed in the statute.

- The proposed legislation likely creates significant policy and management issues for school districts and, if it becomes law, we believe that it could have a negative impact on the financial credit ratings of the districts that have funded well over $10 billion in schools in Florida.

Credit weaknesses

- Credit rating agencies will very likely be forced to analyze the “worst case” which is 100% funding by school districts.

- Liquidity - The legislation creates multiple liquidity concerns for the districts including: (i) charter school capital outlay payments must be made by February 1 which is prior to the deadline for which districts receive ad valorem tax revenues and (ii) school districts will not know the precise payment due to charter schools when creating the annual budget, thus potentially forcing reprioritization of the budget midyear.

- COML revenues have historically been very stable, which the credit rating agencies view more favorably than other,
more volatile revenue streams. The legislation could result in a material decrease in revenue to the district over time and increase volatility from year to year due to potential changes in charter school populations.

– Charter school funding would be mandated and thus, paid “prior to” lease payments and other financing obligations of the district which could also result in lower credit ratings.

– Policy and Management
  • Formulaic allocation of funding directly to a charter school ignores evaluation of need. Many charter schools are in comparatively newer facilities and thus do not require additional capital funding.
  • Many charter school facilities are owned by private entities and thus, school districts could potentially be forced to provide public funding for non-public assets with no recourse for the sponsoring district in the event of charter school closure.
  • Direct funding to charter schools does not consider the value of long-term ownership of educational assets by the public.

Most COP programs in Florida have very strong credit ratings in part due to the history of stable and growing tax assessed valuations. The proposed legislation would potentially require a significant portion of COML to be diverted to charter schools, materially weakening the credit strength of COP programs.

Detailed Discussion

Summary of Legislative Proposal - HB 7037 expands the eligibility criteria for charter schools in the State of Florida to receive charter school capital outlay funds and revises the methodology for calculating the amount of State funding for charter schools from 1/15th to 1/40th of the cost per student station, as determined by the State for an elementary, middle or high school, as appropriate. Each eligible charter school would receive funding equal to its enrollment multiplied by 1/40th of the applicable cost per student station. If State funding for charter schools capital outlay does not fully fund the lesser of (i) 1/40th of the applicable cost per student station for such school or (ii) the amount of revenue per fixed capital outlay FTE student generated by a school district’s COML, then the school district would be required to allocate a portion of its COML revenues to the eligible charter schools in order to make up the shortfall in State funding. The financial impact to Florida school districts could be material (over $20 million for larger districts and well over $1 million for medium/smaller districts based on FY2015 data).

This legislation will likely create material concerns regarding credit ratings, management and policy matters.

• Credit rating issues – Credit ratings are the primary factor that impacts the cost of financing new school construction. Credit ratings are driven by short-term and long-term financial factors and the legislation likely creates credit risks in both areas. The credit rating agencies typically consider the worst case scenario when evaluating payment liabilities. Therefore, they will likely evaluate the credit based on the assumption of full funding of charter school capital by the district (i.e. no state funding) and increasing charter school enrollment over time. As a result, the proposed legislation could have a material impact on the credit quality of school district financing programs that have funded billions of dollars of educational facilities in Florida in a very cost effective manner to date.

  – Short-term credit risks - The legislation creates multiple liquidity concerns for the districts.
    • First, the charter school capital outlay payments must be made to the charter schools in February, which is prior to when the districts are required to receive ad valorem tax revenues.
    • Second, each district will not know the exact payment due to charter schools when the district is creating the annual
budget. Therefore, when the district is notified in December regarding the amount due in February, the district may need to amend the budget and provide for immediate payment to the charter schools. This will typically require cutting other budget items. Furthermore, since the budget amendment would occur 6-8 months into the fiscal year, most capital expenditures will already be programmed/under contract and thus, exacerbate the cash flow challenge referenced above. The end result would likely be further deferral of critical maintenance and delayed delivery of technology to the classroom.

– Long-term credit risks – Many districts use between 50% and 75% of COML to make payments on Certificates of Participation (COPs), which are long-term lease obligations used to finance schools. Although this represents a significant amount of available COML allocated to debt, most COP programs in Florida have very strong credit ratings, in part due to the history of stable and growing tax assessed valuations. The proposed legislation would potentially require a significant portion of COML to be diverted to charter schools over the next 5, 10 or 20 years, materially weakening the credit strength of COP programs. In addition to the volatility created by changes in State funding from year to year, the amount of COML that must be provided to charters will fluctuate with charter school enrollment, creating even greater volatility in the revenue stream school districts rely upon to make lease payments.

– Priority of payment – credit rating agencies focus on “who gets paid first” when assigning credit ratings. Under the legislation, charter schools receive payment as the first priority, which further dilutes district creditors, weakens district COP credit structures, and will likely place greater pressure on district “pay as you go” capital projects such as technology in the classroom, replacement of aged school buses and regular maintenance.

- Management - It is very difficult for cash starved districts, particularly medium and smaller districts, to manage the capital budget. HB 7037 likely will make this even more difficult. Prudent planning requires that districts actively manage their five-year capital budgets since many projects require funding over multiple years. In order to avoid overcommitting capital dollars, the districts would have to budget for the anticipated worst case payments to the charter schools. This would, in turn, force the deferral of critically needed capital projects throughout the districts.

- Policy considerations

– Prioritization – the legislation creates a mandated funding formula that gives priority to charter schools, without any analysis of relative need. Many charter schools are housed in relatively new facilities and thus have minimal capital funding needs. However, the legislation would provide the same relative amount of capital funding to all charter schools without any need based prioritization. Conversely, school districts must evaluate capital needs at each discrete school and allocate scarce capital dollars to the most critical needs.

– Ownership/equity – The vast majority of COML is currently used to purchase assets (buildings, buses, computers, etc.) that will remain property of the district—(which is public property)—for the asset’s entire useful life. Conversely, the legislation requires COML to be transferred to charters and used for

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leases and to construct facilities that will not be owned by the public. As a policy guideline, it would seem appropriate for taxpayer funds to be allocated to public assets prior to private assets.

- **Legislation drafting issues** – HB 7037 appears to include a technical/drafting error. Our interpretation of the funding formula is that the districts’ Capital Outlay FTE (“COFTE”) does not include charter schools. However, the legislation appears to determine the amount paid to charters based on the COML generated per COFTE. Therefore, since it currently ignores charter school FTEs, the calculation would overweight funding to the charters. We do not know whether this was a drafting error, or a policy decision. Either way it should be clarified.

In summary, we highlight a few of the very complicated policy and management issues created by the proposed legislation. At a minimum, the potential allocation of COML to charter schools creates a hierarchy/prioritization favoring charter schools and does not acknowledge inequity regarding ownership of facilities funded by COML.

At the State and district level, it seems appropriate that these and many other strategic matters be better defined and addressed in legislation before allocating local tax dollars to charter schools. After considering these general comments, the primary point of this discussion is to highlight the significant financial ramifications of the legislation. From the perspective of a Financial Advisor, we believe the loss of Capital Outlay Millage Levy combined with uncertainty regarding future revenues is a material credit weakness that will undermine the credit quality of school districts, both large and small. This will work against the reasonable goal of maximizing financial resources by lowering credit ratings which, in turn, will increase interest expense to the districts and reduce funds available for school construction, technology, maintenance of existing facilities and replacement of aging school buses.

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