



CALIFORNIA SCHOOL DISTRICT FINANCE

General Obligation Bonds

There are over 1,100 K-12 school districts and 72 community college districts in California. To fund the cost of building and equipping their education facilities, most public school and college districts in the state issue general obligation (G.O.) bonds. These general obligation bonds are distinguished by several credit features and debt service structures.

General Obligation Bond Credit Features

Voter Election

General obligation bonds must be approved in an election by a majority of the school district's voters. Under Proposition 13, G.O. bonds issued by the State of California and local governments require a two-thirds (66.67%) majority vote. Under Proposition 39, however, school districts may authorize G.O.s with a 55% plurality. Most school district G.O. bond measures are authorized in Prop. 39 elections.

Ad Valorem Tax Levy

G.O. bonds are secured by a pledge to levy an ad valorem tax on property in the school district. The tax is levied annually as a uniform percentage of each parcel's assessed value (AV), and collected by the county treasurer through the property tax bill. The treasurer then forwards the tax revenue required to pay debt service on the bonds directly to the bond trustee.

The amount of tax levied is calculated based on assessed property values and the amount of debt service due on the bonds in a given year. In California under Prop. 13, property values may not increase by more than 2% annually. Thus, to maintain a level G.O. bond tax, most school district G.O.s are structured with debt service that similarly increases by 2%.

School districts are restricted by statute in the amount of general obligation bonds they may sell in a fiscal year. The total amount of outstanding and new G.O. bonded debt may not exceed 1.25% of the assessed value of taxable property within elementary and high school districts, and 2.5% of the AV of unified school districts and community college districts.

If the bonds were authorized in a Prop. 39 election, school districts must structure their issues so that debt service can be paid from an annual tax rate less than or equal to a specified threshold. Elementary and high school districts must set their annual tax at or below \$30 per \$100,000 of assessed value; unified school districts \$60 per \$100,000 of AV; and community college districts \$25 per \$100,000. The school district issuing the bonds is required to certify at the time of sale that it expects the ad valorem tax to remain within these limits over the life of the bonds. (Bonds approved by a two-thirds majority of voters are not subject to these restrictions.)

Unlimited Tax Pledge

The tax rate limits set by Prop. 39 elections are not binding on counties levying the ad valorem tax to repay the G.O. bonds. The tax pledge is *unlimited* and requires the county to levy a tax sufficient to cover debt service payments through the bonds' maturity, regardless of changes in property values, school district finances, district management, student enrollment, or attendance. While some states allow the issuance of school G.O.s supported by *limited* taxing powers – limited revenue sources and a maximum tax levy – this structure is not permitted in California.

The unlimited ad valorem tax is collected for one purpose – to pay bond debt service – and by law must be collected in the amount needed and may only be used for that purpose. If AV growth slows and a higher tax rate than the Prop. 39 ceiling is needed to pay debt service, the county must levy at whatever tax amount is required to pay the bonds.

In a period of declining property values, school districts may choose to delay new G.O. bond sales until AV regains momentum and reaches a target level.

Given the unlimited property tax pledge securing school district G.O. bonds, these issues do not typically have reserve funds.

General Obligation Bond Debt Service Structures

Standard General Obligation Bonds

G.O. bonds generally are structured as serial and term bonds, with a final maturity in 25-40 years. Interest is paid to bondholders semiannually and principal paid upon maturity. Debt service usually increases by 2% per year to match the slope of California's permitted annual increase in AV under Prop. 13.

Bond Anticipation Notes

Bond anticipation notes (BANs) serve as bridge financing while assessed values rise. The notes are secured by the issuance of future G.O. bonds. The BANs must be approved in a G.O. bond election, and their maximum maturity, including any rollover issuance, cannot exceed five years from the date of initial issuance. Since BAN issuance includes assumptions about AV growth and bonding capacity at note maturity, school districts often make provisions for issuing other forms of future debt – such as certificates of participation – should AV targets not be met.

Capital Appreciation Bonds

Capital appreciation bonds (CABs) are another financing structure used by California school districts to take advantage of future assessed values. CABs, also known as "zero-coupon bonds," are bonds where both principal and interest are paid at maturity. Interest accretes over time rather than being paid semiannually to investors as in a standard G.O. current interest bond (CIB) structure. The statutory interest rate cap in California for all types of municipal debt is 12%.

The increased use by school districts of longer-term CABs is a consequence of a change in law (effective January 2010) which allows G.O. bonds with final maturities exceeding 25 years to have zero-coupon and other debt service structures that synchronize rising annual payments to rising assessed values. CABs also allow school districts to minimize the addition of new bond debt service on top of outstanding G.O. debt service – both of which are paid from the same tax rate.

Recent decreases in the AV of many school districts have resulted in higher taxes for outstanding bonds, in some cases exceeding the tax rate indicated to voters at the authorizing election. Long-term CABs help a school district better manage its annual tax by shifting debt payments to future years when assessed values are likely to be higher, after they have rebounded from earlier declines and resumed their basic 2% annual growth.

Build America Bonds

In an effort to stimulate spending on public infrastructure nationwide, the American Recovery and Reinvestment Act of 2009 (ARRA) authorized new financing structures for states and local governments. The most popular and visible new structure has been Build America Bonds (BABs). General obligation BABs are standard G.O. bonds with a federal interest subsidy: the school district is reimbursed for a portion of its interest cost, which results in more funds being available for school construction within the tax rate approved by voters. This federal subsidy makes the G.O. BABs federally-taxable, but they remain exempt from California state income tax.

Qualified School Construction Bonds

Another new bond structure authorized by ARRA, and specifically for use by school districts nationwide, is qualified school construction bonds (QSCBs). Similar to BABs, general obligation QSCBs are G.O. bonds with a federal interest subsidy, but in this case the school district is reimbursed for 100% of its interest cost. School districts thus can issue more bonds for voter-approved capital projects, while principal and interest is paid to investors from the annual G.O. tax levy per normal. When there is a timing mismatch between receipt of the subsidy and debt service due on the bonds, the school district pays the gross debt service owed to bondholders from its general fund and is reimbursed from the bond trustee when the federal monies come in.

School District Credit Considerations

Basic Credit Analysis

Most California school district G.O. bonds receive investment-grade ratings by the three major rating agencies: Moody's, Standard & Poor's, and Fitch. It is rare for a school district G.O. to receive a low credit rating or no rating, given the unlimited ad valorem tax pledge that secures the bonds.

When issuing credit ratings, analysts consider the following characteristics of a school district:

- Demographic features and economic conditions
- Total amount of assessed value, the history of and outlook for AV growth, and taxpayer diversification
- Overall net debt burden, as measured per capita and by percentage of AV (excluding self-supporting debt such as utility revenue bonds and tax allocation bonds)
- Amount of the tax rate and reasonableness of AV growth assumptions
- School district general funds: although unlimited tax G.O. bonds are not paid for from school district general funds, rating agencies consider fund balances, fund balances as a percentage of expenditures, and unreserved fund balances
- School district management.

Other Credit Considerations

Proposition 98 guarantees a minimum level of annual funding for K-14 districts in California from the state's general fund. Prop. 98 payments to school districts are based on a percentage of general fund revenues and have a first lien on them. (Debt service on California state G.O. bonds is second in line for payment from the general fund.) In recent years, actual funding to California schools has exceeded the constitutionally-required minimum.

Basic aid districts are K-12 school districts with property tax revenues sufficient to fund a district's basic operations without state assistance other than the minimum allocated under Prop. 98. Generally these school districts are in areas of higher-than-average property values, or in fairly large areas with relatively small student populations. Of California's approximately 1,140 public school districts, 70-80 are designated as basic aid each year.

Most California counties participate in the *Teeter Plan*, whereby county treasurers send eligible local governments their full property tax levies, regardless of collections. In exchange for these "advances," counties collect and keep the delinquent tax payments and penalties. Most Teeter Plan counties include tax collections for school district G.O. bonds in their annual disbursements.

AB 1200, enacted in 1992, is a state law that imposes a legal process on stressed school districts to compel them to regain financial stability. The law mandates that school districts submit semiannual interim budget reports, which in turn receive "positive," "qualified," or "negative" certification by the district's County Office of Education (COE). To receive a positive certification, the school district must demonstrate its ability to meet its financial obligations for the current and subsequent two fiscal years. A qualified certification (to which the district can self-certify) indicates the possibility that current or future obligations may not be met. A negative certification is a statement that budget requirements will *not* be met.

Qualified and negative "certs" trigger a process whereby the COE steps in to help the district balance its budgets. A fiscal consultant may be appointed to work with the district's management and board, or in the most difficult cases, a state-appointed trustee will take charge of the district when other forms of assistance have been unsuccessful. This regular oversight of California school districts, and the early intervention mandated by AB 1200, ensures that K-12 districts are precluded from filing for bankruptcy if unable to pay their bills.

Because of the unlimited tax pledge securing California school district G.O.s, a district's financial health – and the financial status of the State of California – is not material to the cash flow used to pay bond debt service. As noted above, counties are obligated to levy a tax sufficient to pay principal and interest regardless of a district's fiscal and budgetary condition.

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