

The Marin Common Message

Executive Summary

May Revision, 2014-15

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Introduction

This edition of the Common Message is intended to provide information and guidance to assist Districts in developing 2014-15 adopted budgets. It contains significant updates from the Second Interim edition related to the Governor's May Revision Budget, new K-12 Audit Guide procedures for 2014-15, and a number of technical clarifications.

Important new information since Second Interim is highlighted up front in the *Significant Changes since Second Interim* section, including a summary of key planning factors for budgets and MYPs, and a listing of material changes to various sections of the document. Sections not listed in the material changes summary are unchanged since the last edition, and are included here for reference.

Significant Changes since Second Interim

Governor's May Revision Proposal

On May 13, Governor Brown released his May Revision to the 2014-15 proposed budget. While state revenues are now projected to be \$2.4 billion higher, total K-14 (Proposition 98) spending in the May Revision will only increase by \$242 million, and this increase is largely dedicated to cover increases in services due to projected ADA growth. The most significant change in terms of district budget planning since the Governor's January budget release is the proposal to begin immediately addressing the STRS unfunded liability with increased employer, employee, and state contributions starting in 2014-15. Details of this proposal are covered in *Planning Factors for Budgets and MYPs* immediately following this section, and in the *Retirement* section.

Other significant proposed changes in the May Revision relative to the January budget include:

- K-12 High Speed Internet – A one-time \$26.7 million increase for the K-12 High Speed Network to conduct a comprehensive network assessment and to allocate grant funding to school districts with the greatest connectivity needs.
- ADA Growth – An additional \$103.1 million and \$121.1 million for projected ADA growth in 2013-14 and 2014-15 respectively.
- LCFF Unduplicated Pupil Calculations – Changes to the current methodology for determining unduplicated pupil counts in the LCFF related to Provision 2 and 3 schools, and optional substitution of 2014-15 data for 2013-14 – see *LCFF* and *CALPADS* sections for details.
- Cost-of-Living Adjustments – A decrease of \$258,000 to reflect the revised COLA of 0.85%.
- Independent Study – revises the January reform proposal as detailed in the *Independent Study* section.
- K-12 Mandate Claims – Adds five new mandates: Parental Involvement, Williams Implementation I, II and III, and Developer Fees. \$1,000 in general fund costs was added for each new mandate.
- Rainy Day Fund – Changes to ACA 4 will be placed before voters in November.

Subsequent to the release of the May Revision, the LAO announced a significantly higher revenue forecast. Budget committees in both houses of the Legislature subsequently adopted their own budget proposals that used the LAO's higher revenue forecast to fund additional K-12 spending in career technical education/regional occupational programs (CTE/ROP), preschool, and Common Core implementation among other items.

If the pattern of the past few years holds, negotiations between the Governor and legislative leaders over their competing proposals should produce a final budget by June 15.

Planning Factors for Budgets and MYPs

Key planning factors for Districts to incorporate into adopted budgets and MYPs are listed below, based upon the latest information available as of this writing (5/30/2014).

<i>Planning Factor</i>	<i>Fiscal Year</i>		
	2014-15	2015-16	2016-17
COLA (DOF)	0.85%	2.19%	2.14%
LCFF Gap Funding Percentage (DOF)	28.06%	30.39%	19.50%
STRS Employer Rates (May Revision)	9.50%	11.10%	12.70%
PERS Employer Rates (PERS Board / Actuary)	11.77%	12.60%	15.00%
Lottery - unrestricted per ADA*	\$126	\$126	\$126
Lottery - Prop 20 per ADA*	\$30	\$30	\$30

* Government Code 8880.5(a)(2) extended lottery funding based on the 2007-08 ROP ADA and Adult Education ADA through 2014-15. Under current law these two ADA counts will no longer be part of the lottery calculation for 2015-16 and beyond.

Additional guidance on budget and MYP planning can be found in the *Guidance for Adopted Budgets and MYPs* sections.

Guidance for Second Interim Reports

Situational Guidance to Districts and Multiyear Projections

The LCFF uniquely impacts each district and, consequently, budget guidance must be situational. Specific MYP guidance recognizes each district's unique risk factors combined with overarching risk factors such as uncertainty over the state's economic forecast.

Key MYP Considerations under the LCFF:

- The LCFF is still new and unfamiliar, which adds increased uncertainty in assessing risks, especially since districts have not yet received external validation of their LCFF calculations through a CDE certification.
- Each district will have a unique set of financial risk factors.
- There is a varying impact of projected state revenue increases from district to district.
- Districts must assess the impact of increased or improved services to English language learner, low income and foster youth students.

Shift in Funding Creates a Shift in Managing Risks

Districts have typically managed economic risks largely through projections of revenues. Under the LCFF the most effective way to manage financial risks will be in the expenditure side of the budget. The following highlights are further described in detail below.

- The administration's commitment to close the LCFF gap, as fortified by an improved economy and projected Prop. 98 growth, creates high expectations to incorporate additional revenue into the MYP budget.
- Effective economic risk management necessitates a shift to the management of risk onto the expenditure side of the budget - districts will need to carefully manage MYP expenditure commitments.
- New funding is not likely to be sufficient to meet competing demands for increased expenditures.
- The changing environment creates a greater need for contingency reserves.

Each district will have a unique set of financial risk factors. These risk factors are critically important in determining appropriate reserve levels and contingency planning. Best practices for assessing district risk factors begin with using the Fiscal Crisis and Management Assistance Team's (FCMAT's) Key Fiscal Indicators (Appendix B).

Since 2008-09, most district budget decisions have been driven by the fact that revenues were generally falling and districts were forced to react by cutting expenditures. Those districts that came into the recession with low reserve levels and or structural deficits experienced the greatest disruption to their educational programs. Going

forward, districts will need to change the budgeting discussion to one focused on how to prioritize the use of new resources on expenditures most needed to meet the needs of all students, and especially the needs of students who are foster youth, low income, or English language learners.

Available information indicates that most districts in the state will receive significantly more funding next year, and further revenue growth is projected in 2015-16 and 2016-17. It is also clear the new funding will not be sufficient to meet all the competing demands for increased expenditures. Funding for most districts will remain below 2007-08 levels. Districts will need to prioritize new expenditures based on the LCAP while still maintaining fiscal flexibility and solvency.

Notwithstanding the improving revenue outlook, districts should be cautious about making ongoing expenditure commitments based on projections unless they have the financial flexibility to maintain the core educational program, and fiscal solvency, even if those projections do not come to fruition. Financial flexibility can be achieved by having the ability to reduce expenditures quickly without doing significant harm, or by having reserves sufficient to absorb unanticipated changes.

Multiyear Projections

Districts are required by law to project revenues and expenditures for the budget year and the two subsequent fiscal years. To make multiyear projections, districts rely on a variety of assumptions and sources of information available at the time the projection is created.

The further into the future a projection is made, the greater the likelihood the variables used to create the projection will deviate from assumed values. Subsequent year projections are predicated on trying to forecast variables that are entirely outside the control of the district, including the actions of current and future elected officials and the direction of the global, national and state economy. The implementation of the LCFF has in some ways increased the uncertainty for districts because it is new and unfamiliar, and it has a varying impact from district to district.

MYPs have always been challenging, but districts are faced with a new set of challenges related to MYPs in the current environment, in particular:

1. How does the district approach planning, budgeting, and MYPs in such an inherently unfamiliar environment?
2. How does the district approach planning, budgeting, and MYPs while complying with the LCFF and LCAP requirements to make decisions in a transparent and locally inclusive manner?

Some possible approaches to answering these questions are listed below, and while the list is by no means comprehensive it does cover many common practices districts have been implementing successfully for many years. These include:

- gathering and documenting the best information available about all the known factors that will impact future revenues and expenditures
- making reasonable, supportable, and conservative assumptions about how these factors will impact future revenues and expenditures
- using the best tools available to model the impact of these assumptions on future ending fund balances and cash flows

- assessing the district’s ability to absorb unanticipated changes in future revenues or expenditures by modeling varying assumptions and scenarios
- maintaining budget flexibility to allow for possible unanticipated changes by:
 - maintaining adequate reserves
 - building in room for contingencies in expenditure plans, including collective bargaining agreements if possible
 - *not* using one-time resources for ongoing commitments
 - *not* locking in ongoing spending commitments that the district can only afford in the future if projections play out exactly as predicted (or better)
- clearly documenting assumptions
- clearly communicating and explaining assumptions to stakeholders including the ability to respond in a reasoned, transparent, and logically justified manner if assumptions are challenged
- making sure expenditure plans are aligned with the educational mission of the district as delineated in the LCAP

Projecting Expenditures

Districts are well versed in the task of projecting known costs including personnel costs like step and column movement associated with existing bargaining agreements, and other well-established costs and associated inflation trends such as utilities, insurance premiums, consumable materials, existing contracts for services, and non-voter approved debt service, etc. The challenge comes in trying to estimate changes in expenditures that are likely and yet not known with certainty, and to build in flexibility for contingencies.

Risk factors districts would be wise to incorporate in MYPs under the “likely and not yet known with certainty” category include:

- Costs associated with implementing locally established priorities as documented in the LCAP
- Costs associated with providing increased or improved services associated with minimum proportional percentage (MPP) requirements
- Costs associated with meeting adequate progress toward class size requirements for the LCFF K-3 GSA
- Costs associated with maintaining programs that were previously funded with categorical funding and now must be funded with unrestricted funds if they are to continue. Examples include instructional materials, CTE, deferred maintenance, various professional development programs, additional instructional programs in support of gifted students, etc.
- Increases in PERS contribution rates - recent actuarial forecasts from CALPERS have projected employer contribution rates to rise as high as 20% for the schools pool by 2020. Districts are

advised to incorporate the actuarially projected rates into their MYP. See the *Retirement* section for details

- Increases in STRS contribution rates - The May Revise proposes immediate action to address the STRS unfunded liability in 2014-15. While the Legislature has subsequently proposed an alternate implementation plan, districts are advised to incorporate the rates proposed in the May Revise into adopted budgets and MYPs until a final agreement is reached between the Governor and the Legislature
- Increased administrative costs associated with the Affordable Care Act including staff time and possible penalty fines and taxes
- Depending on district bargaining agreements and employment practices, possible increased costs associated with the Affordable Care Act requirements to extend coverage to all full-time equivalent employees
- Costs associated with implementing Common Core State Standards and Smarter Balanced Assessments
- Requirements to restore routine restricted maintenance to the 3% minimum level in 2015-16
- Long-term maintenance costs and facility repairs
- Costs associated with meeting maintenance of effort requirements and shifting cost structures for regionally provided programs under LCFF

Factors districts may want to incorporate in MYPs under the “contingency” category include costs associated with possible legal claims, accidents or natural disasters, changes in the cost of borrowing for cash flow or other non-bond funded purposes, and a host of other possible local risk factors.

Projecting Revenues

There are several calculations that determine the amount a district will receive in a given year under the LCFF. The core components of this formula are the calculation of each district’s Floor, Minimum State Aid (commonly referred to as “hold harmless”), LCFF Target, and Economic Recovery Target (ERT), if eligible. Each calculation is separate and distinct and contributes to the determination of funding for each district. Some districts will receive no additional funding, while others are receiving substantial increases in funding.

The LCFF Calculator located on the FCMAT website is the tool recommended for calculating and assessing a district’s sensitivity to risk factors. This calculator provides input fields for modeling varying scenarios. These variable input fields include ADA, unduplicated percentages, gap percentages and COLA percentages, allowing districts to create multiple models when building MYPs. These models will assist in planning and assessing risk levels by calculating various scenarios.

The current DOF estimates for LCFF gap funding for 2014-15, 2015-16 and 2016-17 are as follows:

Year	2014-15	2015-16	2016-17
Gap Funding	28.06%	30.39%	19.50%

In forecasting state general fund revenues and the share attributable to Prop. 98, the Department of Finance (DOF) relies on conventional best practices for economic projections. The DOF builds sophisticated economic

models based on the available data and makes assumptions about future trends centered on historical experience and commonly accepted economic principles (e.g., mean reversion). The DOF's models and projections, just like district MYPs, rely in part on data that is outside the control of the administration, such as forecasts for the national and state economy. The DOF's projections for the portion of Prop. 98 that will be dedicated to LCFF implementation, and the resulting LCFF gap funding projections, are based on the administration's proposals and the Governor's stated commitment to prioritize the implementation of the LCFF.

Under the current administration, DOF projections have generally been conservative, and alternate forecasts from the LAO and other sources such as UCLA seem to indicate this continues to be the case.

Based on the information above, it would appear the DOF's projections for LCFF gap funding percentages are reasonable and supportable. Districts that use factors other than those provided by the DOF will need to be prepared to communicate and justify alternative projections to their communities in a transparent manner.

A Note about the Shift from Revenue Limit to LCFF

Historically, projected COLAs and deficits were the standard for building MYPs. The application and significance of COLAs takes on new meaning under the LCFF. Under revenue limits, year-to-year funding changes were the result of ADA growth or decline and funded COLAs. In contrast, during implementation of the LCFF, year-to-year funding changes will be the result of ADA growth or decline, COLAs, unduplicated English language learner, low income and foster youth counts, and the percentage of implementation (gap) funding.

Upon full implementation of the LCFF, year-to-year funding changes will be the result of ADA growth or decline, COLAs, and unduplicated English language learner, low income and foster youth counts.

Reserves

The experience of the past six years has clearly demonstrated these minimum levels are not sufficient to protect educational programs from severe disruption in the event of an economic downturn. The typical 3% reserve minimum represents less than two weeks of payroll for most districts. Many LEAs have established reserve policies calling for higher than minimum reserves. The adequacy of a given reserve level should be assessed based on the LEA's own specific circumstances, and numerous reasonable models are available for consideration. Examples included:

- The Government Finance Officers Association recommends reserves equal to two months of average general fund operating expenditures, or about 17%
- Rating agencies like Fitch or Moody's typically assess the adequacy of a district's reserves by comparing them to statewide averages, which have hovered around 15% for California unified school districts in recent years
- FCMAT emphasizes the need to assess not only fund balance but also actual cash balances during each of the twelve months

There are multiple benefits to carrying higher than minimum reserves. These include:

- Financial flexibility to absorb unanticipated expenditures without significant disruption to educational programs

- Protection against exposure to significant one-time outlays such as disasters, lawsuits, or material audit findings
- Protection against the volatility of state revenues
- Protection against the volatility of property tax revenues for basic aid districts
- Cash management / avoiding the cost of borrowing for cash flow purposes
- Protection against declining enrollment
- Protection against the expiration of parcel taxes

This is not an exhaustive list. Of all the reasons for carrying higher than minimum reserves, protecting against state revenue volatility is one of the most compelling. This is especially true during LCFF implementation, because gap percentage funding is directly tied to the state's ongoing ability to fund the LCFF through Prop. 98 growth. Most importantly, by providing a buffer from volatile state revenues, maintaining higher than minimum reserves creates a more stable educational environment for students.

Negotiations

School districts are accustomed to periods of uncertainty, especially in recent years. The LCFF adds a new type of uncertainty. While the state is providing additional revenue for the first time in many years, its distribution is vastly different than it was under revenue limit funding. This, coupled with an uncertain economic recovery, creates an environment of caution for school districts considering a multiyear contract.

Districts need to exercise caution and maintain flexibility through contingency language that protects the district from cost increases and/or revenue shortfalls beyond their control.

Summary

Transitioning to a new funding formula and new accountability system has changed the way we plan and how we communicate and share those plans. During this economic recovery expectations are high and the pressures to do more are great. Additionally, for decades districts have been asking for more flexibility to let local communities decide how to use education funding. Now that this request has been granted, the responsibility rests with the education community to demonstrate that local control produces better educational outcomes for all students.