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Colorado School Districts' Subdued State Funding Ruled Constitutional

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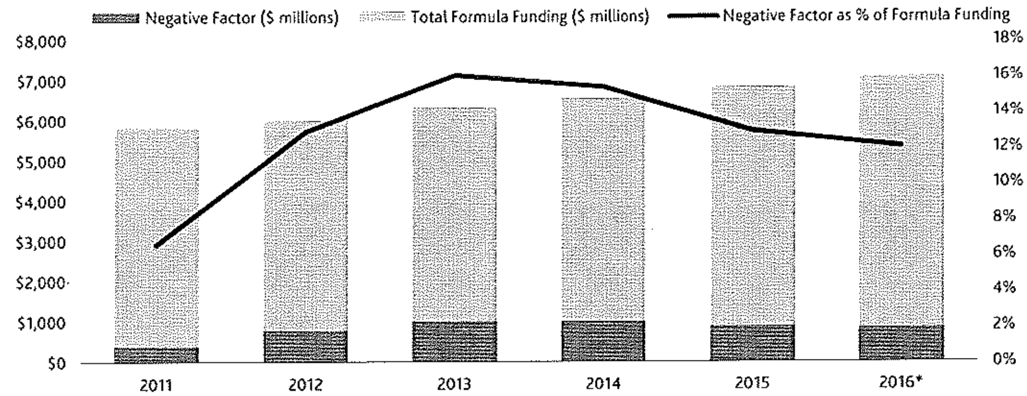
On September 21, the State of Colorado's (Aa1 stable) Supreme Court ruled that recent sizable educational funding cuts were indeed constitutional. Since 2011, the state has cut roughly $5 billion, which has stressed many local public school district budgets statewide. The state Supreme Court decision foreshadows education funding levels below the state's defined formula for the foreseeable future. Subdued funding levels will continue to place pressure on individual school district budgets, requiring local management teams to hold down expenditures and/or seek additional taxpayer authorization to augment tax rates to maintain operations and reserve levels.

The ruling dismissed a June 2014 lawsuit brought by school districts and parents, which claimed that the educational funding cuts were unconstitutional and did not adhere to Amendment 23. The voter-approved Amendment 23 requires that base per-pupil funding levels increase on an annual basis. The state Supreme Court ruled that the cuts have not affected the base per-pupil funding amount and instead highlighted the state's use of the negative factor provision. This provision allows the state to adopt its budget for education at a level below the calculated funding formula so long as the base per-pupil increases by the rate of inflation.

The negative factor provision has created a $5 billion discrepancy between the state's defined funding formula and actual total education funding from fiscal 2011 to fiscal 2016. The negative factor amount increased significantly through fiscal 2013 and remained around $1 billion annually as state legislators have continued to approve educational appropriations below the funding formula (see Exhibit 1). The cuts also reached a high of 16% off the total funding formula amounts in fiscal 2013, though has slightly subsided to an estimated 12% for the current fiscal year.

EXHIBIT 1

Negative Factor Level Increases Substantially, Remains High Through Fiscal 2016



*Estimated

Source: Colorado Department of Education

Although the negative factor amount has dropped and actual average per-pupil funding throughout the state has increased by roughly 4% over the last three fiscal years to $7,294, the cuts have left local management teams with tough budgetary decisions. Most school districts across the state fared well during this period of turmoil by making the necessary expenditure reductions and/or seeking local voter approval for additional ad valorem taxes called mill-levy overrides. The state allows individual school districts to receive up to 25% of total program revenues through these voter-approved override levies. Per the *Colorado School Finance Project*, 72 of the state's 178 public school districts asked voters for mill-levy overrides between fiscal 2010 and 2013. Only 38 were approved. The research further concludes that nearly half of the statewide enrollment benefited from a successful override election.

Exhibit 2 highlights the dollar amount of discrepancies between the state funding formula and actual total program amounts in fiscal 2015 for the state's top 10 districts by enrollment. All of these districts benefit from some level of mill-levy override support from its tax base, but at varying levels. Without the additional property tax support, large budgetary gaps would exist and subsequently lead to tapping reserves or deep budgetary cuts. Six of the top 10 districts had enough additional voter support to outweigh their fiscal 2015 negative factor amounts with mill-levy overrides. All 10 of the largest school districts have maintained strong underlying credit quality at either Aa1 or Aa2 ratings during the period of funding cuts given their willingness and ability to make budget adjustments or the success of mill-levy overrides.

EXHIBIT 2

Largest School Districts Show Resiliency and Utilize Mill-Levy Overrides to Help Offset Cuts
Fiscal 2015 ($ millions)

District	Moody's Underlying GO Rating/Outlook	Actual Funded Pupil Counts	Formula Funding at 100%	Negative Factor	Total Program After Negative Factor	Override Property Tax Revenues	Override as a % of Total Program	Override as a % of Negative Factor
Denver City and County School District 1	Aa2/Stable	84,044	$710	$(92)	$618	$131	18.5%	142.4%
Jefferson County School District R-1	Aa2/Stable	81,130	$639	$(83)	$556	$113	17.7%	136.8%
Douglas County School District RE 1	Aa1/Stable	63,354	$492	$(64)	$429	$34	6.8%	52.8%
Arapahoe County School District 5 (Cherry Creek)	Aa1/Stable	51,433	$413	$(54)	$359	$85	20.5%	158.1%
Adams 12 Five Star Schools	Aa2/No Outlook	41,182	$325	$(42)	$282	$35	10.9%	84.1%
Adams & Arapahoe Counties Joint School District 28J	Aa2/Stable	39,600	$334	$(43)	$291	$37	11.0%	85.0%
El Paso County School District 11 (Colorado Springs)	Aa2/No Outlook	30,135	$240	$(31)	$209	$27	11.2%	86.8%
Boulder & Gilpin Counties School District RE 2 (Boulder Valley)	Aa1/Stable	29,398	$234	$(30)	$204	$64	27.3%	210.8%
Poudre School District R-1	Aa2/Stable	28,935	$221	$(29)	$193	$35	15.8%	121.9%
St. Vrain Valley School District RE 1J	Aa2/Stable	28,741	$227	$(29)	$197	$32	14.3%	110.5%

Source: Colorado Department of Education, Moody's Investors Service

The Colorado Supreme Court decision means that subdued state funding is likely for the foreseeable future. During a period of statewide enrollment growth, muted funding levels will likely continue to present operational pressures for public school districts. Districts may be challenged to make expenditure reductions and/or seek voter approval for mill-levy overrides to help sustain operations. We note a history of anti-tax sentiment within the state can impact voter approval. Continual use of the aforementioned remedies is not viable for long-term operating sustainability. Any increases to the current education cuts in the future would put greater stress on district budgets, which may lead to downward shifts in creditworthiness.

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