

REPORT OF THE EXECUTIVE OFFICER
State Allocation Board Meeting, May 3, 2005

FINANCIAL HARDSHIP EQUITY ISSUES

PURPOSE OF REPORT

To present a report regarding the trends in financial hardship requests for the School Facility Program (SFP).

BACKGROUND

At the February 2005 State Allocation Board (SAB) meeting, Board members requested information regarding the timing of financial hardship approvals and the equity of the funding distribution. It was requested that the Office of Public School Construction (OPSC) provide information on the trends in financial hardship requests.

AUTHORITY

Education Code Section 17075.15 (see attachment) and the SFP Regulation Section 1859.81(c)(1-4) outlines the requirements for a project to receive financial hardship status. This regulation states that a district must demonstrate reasonable effort to fund its matching share by levying the maximum developer fee justified by law and must meet at least one of the following criteria by having:

- Current school facility related indebtedness of at least 60 percent of its total bonding capacity;
- Accomplished a successful registered voter bond election for at least the maximum amount allowed under Proposition 39 within the previous two years from the date of request for financial hardship status;
- An application from a County Superintendent of Schools;
- Total bonding capacity at the time of the request for financial hardship status is \$5 million or less; or
- Other evidence of reasonable effort as approved by the SAB.

DISCUSSION

The financial hardship regulations have been in existence since the inception of the SFP. Originally, the regulations were less specific and had minimal requirements. As the program progressed and more data became available, it was apparent that the regulations required modification to provide more evidence of local financial effort. Those regulatory amendments were approved in December 2001 and were later codified (see attachment). Although these amended regulations and statutes were implemented, it appears that school districts continue to find creative avenues to meet the financial hardship criteria, which may be causing funding advantages.

Over the course of several years of financial hardship reviews, Staff has become aware of several trends as described below. Staff has also identified potential measures to ensure an equitable distribution of financial hardship funds.

1. **Observation:** Under current regulations after the initial request for financial hardship status is granted, no further encumbrances of existing capital facility funds are approved by the OPSC, and all prospective capital facility revenue is deemed available on the subsequent financial hardship review. The regulations provide for an exception to this requirement if the district does not file a financial hardship request for a period of three years from the date of the district's latest financial hardship adjusted grant apportionment.

Under this three-year provision, some districts receive SFP financial hardship approval for up to 100 percent State funding of their projects, and then later issue Certificates of Participation (COP) and other funding mechanisms that are not recognized as district contribution towards their previously funded SFP projects. These districts appear to simply wait to file subsequent SFP funding applications until after the three years lapse from the date of their last adjusted grant funding apportionment. As a result, the COP or other district funds are exempt from contribution to the previous or future SFP projects.

DISCUSSION (cont.)

Potential Measure: Extend the three-year time period currently specified in the SFP regulations to five or more years. This would not eliminate the concern but would minimize the districts' lack of financial contributions. Albeit districts can only manage so many construction projects in any given period of time, most districts could not wait several additional years to build and modernize their facilities. As a result, more funds would be recognized as available towards the districts' share of their projects, thus reducing the demand on State financial hardship funding.

- 2. Observation:** Existing law permits school districts to garner SFP new construction eligibility based on augmentations to their enrollment projections. The anticipated pupils that will reside in dwelling units indicated on approved tentative subdivision maps are used for this augmentation. This ability allows schools districts to plan ahead and build schools before or in time of the students' arrival. Because the districts can file for eligibility before the housing units are built, their SFP funding application and financial hardship review precedes the collection of developer fees which occurs later as the construction permits are issued. This results in the OPSC not being able to recognize the developer fees that could be used for the districts' matching share of their SFP projects.

Potential Measure: Offset the State's financial hardship apportionment to account for the developer fees collected and any other capital facility income received for a specified period of time. Given the SFP eligibility and funding is provided well in advance of the construction of the residential housing, the match period would likewise need to continue for a commensurate period of time.

- 3. Observation:** One of the ways to qualify for financial hardship is to have a current school facility related indebtedness of at least 60 percent of a districts' total bonding capacity. It has become an apparent pattern that some districts are securing a COP or other debt instrument in order to just meet the 60 percent threshold and then encumber those funds before submitting a financial hardship request. It would appear that this is occurring so those districts can qualify for financial hardship under the SFP.

Potential Measure: Increase the 60 percent bonding capacity to a higher percentage and do not permit districts to encumber recent indebtedness. Under previous State School Building Aid Fund programs, districts were required to have 90 to 95 percent bonded indebtedness in order to qualify for the State funding for the districts' matching share.

- 4. Observation:** At times when SFP funding is unavailable, districts are permitted to obtain temporary or so-called "bridge", financing to proceed with their building or modernization projects until State funds became available. The intent was to "bridge" the period of time without State funding and to retire the debt instrument once the districts receive reimbursement from the State. However, some districts are choosing to accept the reimbursement from the State but utilize the funds for other capital facilities purposes rather than retire the debt instrument used to fund the SFP project. The districts maintain the debt, so they continue to meet the 60 percent indebtedness and subsequently request financial hardship status for their other SFP projects without having to use the unpaid portion as district contribution.

Potential Measure: For purposes of determining eligibility for financial hardship funding, recognize the reimbursed amount as being applied to the debt and determine the corresponding revised percentage of indebtedness.

DISCUSSION (cont.)

5. **Observation:** Districts control the timing for their initial financial hardship submittal in order to encumber available funds prior to their review. As a result, the OPSC cannot recognize these funds as available for contribution towards their SFP financial hardship projects. This permits the districts to utilize available funds for other district priorities and then receive up to 100 percent State funding for their SFP project.

Potential Measure: Do not recognize any capital project related encumbrances within one year of the initial financial hardship request. Require districts to produce contracts and/or invoices dated one year prior to the financial hardship review in order for funds to be considered encumbered.

The OPSC suggests further exploration into these areas to determine if process, regulatory and/or statutory modifications may be appropriate.

RECOMMENDATION

Accept this report.

BOARD ACTION

This report was accepted by the State Allocation Board on May 3, 2005, with a request that the issues and potential solutions be discussed further by the SAB Implementation Committee. The discussion should also include the adequacy of financial hardship assistance for the construction of small schools.

ATTACHMENT

State Allocation Board Meeting, May 3, 2005

CALIFORNIA CODES
EDUCATION CODE
SECTION 17075.15

17075.15. Source and amount of funding; regulations

(a) From funds available from any bond act for the purpose of funding facilities for school districts with a financial hardship, the board may provide other construction, modernization, or relocation assistance as set forth in this chapter or Chapter 14 (commencing with Section 17085) to the extent that severe circumstances may require, and may adjust or defer the local financial participation, as pupil health and safety considerations require to the extent that bond act funds are provided for this purpose.

(b) The board shall adopt regulations for determining the amount of funding that may be provided to a district, and the eligibility and prioritization of funding, under this article.

(c) The regulations shall define the amount, and sources, of financing that the school district could reasonably provide for school facilities as follows:

(1) Unencumbered funds available in all facility accounts in the school district including, but not limited to, fees on development, redevelopment funds, sale proceeds from surplus property, funds generated by certificates of participation for facility purposes, bond funds, federal grants, and other funds available for school facilities, as the board may determine.

(2) The board may exclude from consideration all funds encumbered for a specific capital outlay purpose, a reasonable amount for interim housing, and other funds that the board may find are not reasonably available for the project.

(d) Further, the regulations shall also specify a method for determining required levels of local effort to obtain matching funds. The regulations shall include consideration of at least all of the following factors:

(1) Whether the school district has passed a bond measure within the two-year period immediately preceding the application for funding under this article, the proceeds of which are substantially available for use in the project to be funded under this chapter, but remains unable to provide the necessary matching share requirement.

(2) Whether the principal amount of the current outstanding bonded indebtedness issued for the purpose of constructing school facilities for the school district and secured by property within the school district or by revenues of, or available to, the school district, which shall include general obligation bonds, Mello-Roos bonds, school facility improvement district bonds, certificates of participation, and other debt instruments issued for the purpose of constructing school facilities for the school district and for which owners of property within the school district or the school district are paying debt service is at least 60 percent of the school district's total bonding capacity, as determined by the board.

(3) Whether the total bonding capacity, as defined in Section 15102 or 15106, as applicable, is five million dollars (\$5,000,000) or less, in which case, the school district shall be deemed eligible for financial hardship.

(4) Whether the application for funding under this article is from a county superintendent of schools.

(5) Whether the school district submits other evidence of substantial local effort acceptable to the board.

(6) The value of any unused local general obligation debt capacity, and developer fees added to the needs analysis to reflect the district's financial hardship, available for the purposes of school facilities financing.