CRC Memorandum

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Detroit Public Schools' Legacy Costs and Indebtedness

Introduction

The Detroit Public Schools (DPS) recently submitted its audited financial statement for fiscal year 2014-15 (FY2015) to the State of Michigan.[1] Because of recent changes to accounting and financial reporting standards, the report provides a much richer picture of the district's overall financial condition than previous reports. In addition to the liabilities associated with various debt instruments that routinely appear in financial statements, the most recent report includes, for the first time, an accounting of the legacy costs for unfunded pension benefits owed to current and former employees. As debate continues about crafting a financial plan to reduce the district's operating deficit and provide educational services to nearly 48,000 students, a key fiscal consideration concerns the district's liability for future payments.

[1] Public school districts operate on a fiscal year that runs from July 1 to June 30. The State of Michigan's fiscal year runs from October 1 to September 30.

As reported in **Table 1**, DPS has over \$3.5 billion outstanding in combined operating and capital liabilities. This includes nearly \$1.9 billion in employee legacy costs and cash flow borrowings and almost \$1.7 billion in multi-year bonds/notes and state loans.

The amounts in **Table 1** represent only the principal outstanding for many of the liabilities; however, liquidating these liabilities over the time schedules assumed when the debts were incurred will include interest and other costs. This adds to the district's total future payments. For example, retiring the nearly \$1.5 billion in general obligation bonds as currently structured will require \$1.0 billion in interest payments over the next 25 years. Payment on the total debt incurred for capital improvements will be spread out over decades and financed by a dedicated property tax. Other annual debt service obligations (under "Operating" in **Table 1**) will be financed from the district's general operating revenue. Financing

DPS Governance

In late 2008, State Superintendent of Public Instruction Michael Flanagan, acting under Public Act 72 of 1990, declared that a financial emergency existed in the Detroit Public School district and recommended to Governor Jennifer Granholm the appointment of an emergency financial manager. In early 2009, the Governor appointed the district's first emergency manager, Robert Bobb. Since that time, and through various iterations of the state's emergency manager law, the district has been under the control of a series of state-appointed emergency managers. Emergency managers assume all of the powers and responsibilities of a school district's elected board and appointed superintendent.

Under state law, state intervention in local school district affairs is premised on financial reasons. However, in addition to addressing a district's financial problems, emergency managers are tasked with improving the academic performance of students. In Detroit's case, a financial crisis prompted state intervention, but the district's academic performance has been consistently at, or near, the worst in the country among big city districts.[a]

[a] Robert Bobb (2009 to 2011), Roy Roberts (2011 to 2013), Jack Martin (2013 to 2015), and Darnell Earley (2015 to present).

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these liabilities with operational funds competes with other expenditures, including paying teachers, maintaining buildings, and buying supplies.

Furthermore, the amounts above only reflect a small portion of the district's reported accumulated operating deficit; the $81 million payable to the retirement system. For FY2015, the General Fund finished with a deficit of $215.9 million, up from a deficit of $169.5 million for FY2014. This amount is carried forward into the FY2016 budget and equates to roughly 28 percent of planned General Fund expenditures. Instead of paying down the accumulated deficit, the FY2016 spending plan will add to it. The FY2016 budget projects that the General Fund will have a $312 million operating deficit at June 30, 2016.

Each liability listed differs in material ways (e.g., its original purpose, how it is accounted for in financial statements, how repayment is structured and financed, etc.). Similarly, the consequences of failing to pay the obligations as they come due also differ. This is an important consideration as policymakers develop a plan to deal with DPS finances, both in the near term and the long term. In some cases of nonpayment, the financing responsibility could fall to the State of Michigan (all taxpayers). In other instances where DPS is unable to liquidate a debt, other school districts could be responsible for picking up the cost. For capital debts, there may not be any change in responsibility as Detroit taxpayers pledged to repay the liability with a dedicated local property tax. And for other obligations, it is unknown who would be liable for the district's nonpayment because either a similar default has never occurred or state law is silent on the matter.

Table 1
Detroit Public Schools Legacy Costs and Other Liabilities, 2015
(Dollars in millions)

Operating Liabilities	**Amount**
MPSERS – Pension Unfunded Actuarially Accrued Liability (UAAL)	$872.7
MPSERS – Retiree health Unfunded Actuarially Accrued Liability	443.8
Delinquent MPSERS payment (principal and interest)	80.9
Termination Incentive Plan – UAAL	16.6
Refinanced 2005 and 2011 cash flow borrowings	259.2
Refinanced 2014 cash flow borrowing	82.8
2015 cash flow borrowing	121.0
Subtotal – operating liabilities	*$1,877.0*
Capital Liabilities	
"Qualified" general obligation bonds	1,452.1
School Loan Revolving Fund loan (principal and interest)	198.7
Subtotal – capital liabilities	*$1,650.8*
Total	**$3,527.8**

Source: Comprehensive annual financial reports of Detroit Public Schools from multiple years, comprehensive annual financial reports of the Michigan Public School Employees Retirement System, official prospectuses for various borrowings by Detroit Public Schools, and State of Michigan sources. Information is reported for the most recent fiscal year (FY2015) when available.

Future Employee Costs

In 2014, the Detroit Public School district was the fifth largest employer in Detroit with just over 6,500 employees. As recently as 2005, DPS was the largest employer in the City with 18,600 employees. The shrinking workforce is a direct byproduct of the student enrollment losses, outsourcing, and program cutbacks over the last decade. The district enrolled approximately 141,400 students during the 2004-05 school, nearly three times the number it enrolled during 2014-15.[2]

The costs associated with current and retired employees are a part of the district's ongoing financial challenge. **Table 2** shows general fund expenditures associated with active and retired employees in FY2014.

As is the case for all Michigan school districts, the vast majority of spending is concentrated in personnel expenses; public education is a people-intensive endeavor. For DPS, this spending equated to over two-thirds of its total operating budget in FY2014. While the majority of personnel expenses are associated with active employees (salaries and insurance benefits), DPS must allocate current resources to pay for retirement benefits promised to current and former employees. In FY2014, the district spent $84.2 million (nearly 12 percent of the total operating budget) on retirement benefits. This includes contributions to defined benefit and defined contribution retirement plans for current employees as well as paying for legacy costs associated with unfunded pension and retiree health benefits.[3]

Retirement Benefits

Unlike the City of Detroit, which operates its own retirement systems for city government employees (the City operates two systems – General Retirement and Police and Fire), DPS participates in the Michigan Public School Employees Retirement System (MPSERS), a multi-employer, cost-sharing plan run by the State of Michigan. The system provides retirement benefits for covered employees of traditional public school districts and community colleges, as well as certain public school academies (charter schools), state universities, and public libraries. The system provides both a financial pension benefit, as well as health, dental, and vision insurance benefits for eligible retirees, generically called other postemployment benefits (OPEB).

As a multi-employer, cost-sharing plan, the assets and the obligations of all participating employers

Table 2
Detroit Public Schools Personnel Expenditures, FY2014
(Dollars in millions)

	General Fund Expenditures	Percent of Total
Salaries and Wages	$321.8	44.6%
Active Employee Insurance Benefits	44.0	6.1
FICA/Retirement/Unemployment/Workers Comp.	123.2	17.1
Other	$2.4	0.3
Total Personnel Expenditures	**$491.3**	**68.1%**
Total General Fund Expenditures	**$729.3**	**100.0%**

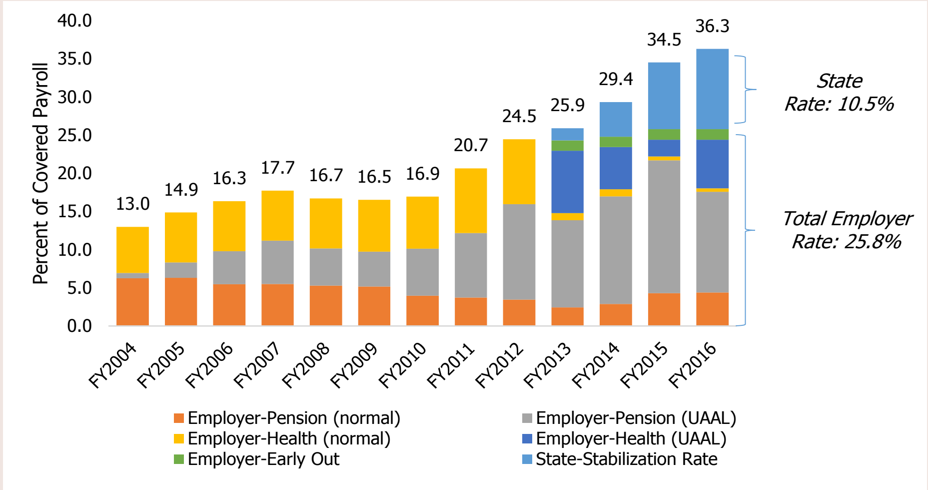
Source: Center for Educational Performance and Information, MI School Data

[2] The transfer of 15 DPS schools to the Education Achievement Authority (EAA) in the 2012-13 school year contributed to the student enrollment decline and the reduction in DPS staff. The EAA enrolled approximately 8,700 students in 2012-13, almost all of whom were former DPS students.

[3] This does not include the MPSERS rate stabilization payment ("state share") received from the Michigan Department of Education, which totaled approximately $20.7 million in FY2014. See discussion on page 4.

are pooled together rather than maintaining separate accounts for each employer. This means that the cost of providing these benefits is shared by employers that participate in the system.[4] Plan assets are used to pay the pensions of the retirees of any participating employer. Employer contributions to meet estimated retirement costs are determined annually by the state's Office of Retirement Services on the basis of an annual actuarial valuation of the retirement system's assets and accrued liabilities. The estimated cost is then charged to employers as a percentage of payroll for employees covered under the system.

Chart 1
MPSERS Employer Contribution Rates, FY2004 to FY2016



Source: Office of Retirement Services

The annual employer contribution rate charged to individual school districts is comprised of three component categories: 1) pension normal costs (the cost of future retirement benefits attributable to the current year of service); 2) retiree health normal costs (the cost of future health care benefits attributable to the current year of service); and 3) unfunded actuarially accrued liabilities (UAAL) for both the pension and retiree health benefits. This last component is commonly referred to as employee "legacy costs" and results when the previous amounts collected to cover the normal costs are not sufficient to cover the actuarially-determined value of benefits in the future. When the assumptions used in setting the annual contribution rate are not met, unfunded liabilities result for the system. Since employee contributions are fixed in statute, these unfunded liabilities must be covered through additional employer contributions (i.e., larger percentage charged against payroll).

Chart 1 presents the employer contribution rate for all employers participating in MPSERS, by major component, from FY2004 to FY2016 (current year). The total employer contribution rate in FY2016 is 25.8 percent of payroll. In addition to the various employer rates, the State of Michigan is responsible for funding some of the UAAL contribution annually. For FY2016, the state share amounts to 10.5 percent of payroll and results in a total (state and employer) rate of 36.3 percent of payroll. Stated differently, for every $1 paid in wages by a school district, MPSERS receives 36 cents.

Two trends stand out in **Chart 1**. First, the total contribution rate over the last 13 years has nearly tripled. Second, the driver of this growth is clearly the pension legacy costs (UAAL) component (gray portion of bar). Whereas these contributions amounted to less than 1 percent of payroll in FY2004, the contribution for pension legacy costs in FY2016 is 13.2 percent of payroll. Over the same period, the contribution rate for the system's pension normal cost fell from 6.26 percent of payroll in FY2004 to 4.39 percent today. This decline was largely the result of system reforms requiring larger employee contributions.

A second noteworthy development, was that beginning in FY2013, the State of Michigan started prefunding the retiree health benefit. Previously, the cost of these benefits were paid on a cash basis with current employer contributions financing the costs of

[4] In addition to employer contributions to the system, employees are required to contribute based on their date of hire and the benefit program selected. These contribution rates range from 3 percent to 7 percent and are set in state law (The Public School Employees Retirement Act of 1979, Public Act 300 of 1980).

health care services consumed by current retirees. With the switch to prefunding, two employer contribution rates are required, similar to treatment of the pension benefit; 1) normal cost (less than 0.5 percent of covered payroll in FY2016), and 2) UAAL (6.4 percent of covered payroll). These rates are reflected by the light orange and dark blue portions of the bar in **Chart 1**, respectively.

DPS's Funding of Legacy Costs

As a result of the 2012 MPSERS reforms, school districts' exposure to retirement funding is capped as a fixed percentage of their covered payroll. Controlling the employer contribution rate variable means that the actual amount a district pays each year towards unfunded liabilities is a function of its payroll. In DPS's case, its payroll has been declining rapidly for the past decade with workforce reductions caused primarily by student enrollment declines, but also by program eliminations and privatization of services. DPS's payroll dropped from $803 million in FY2005 to $340 million in FY2014, a 58 percent decrease.

Since the employer rate cap has been in place, the district's total annual UAAL payment has declined from $95 million in FY2012 to $71 million in FY2014. It is likely that its UAAL payment shrank again in FY2015 as a result of further staffing reductions caused by a 3.8 percent decline in student enrollment between FY2014 and FY2015.

Detroit is not the only school district with declining payroll; other school districts have experienced the same trend in response to declining student enrollments, program cuts, and privatization over the past 10 years. However, the total covered payroll of all traditional school districts (excluding DPS) declined by 12 percent between FY2005 and FY2014, far less than DPS's 58 percent drop over the same period. Since the employer UAAL rate cap has been in effect, the total payroll for non-DPS districts has declined by 1.7 percent. With the contribution rate fixed as a percentage of payroll, districts with shrinking payrolls have been able to reduce their annual UAAL payment in nominal terms.

At the same time that some districts' UAAL payments have declined, the total unfunded liability for the pension system has increased. In recent years, the pension liability rose from $24.2 billion in FY2012 to $26.5 billion in FY2014. The reduced employer UAAL payments combined with the increase in the total liability means that the State of Michigan is picking up a larger share of the funding responsibility for school districts' legacy costs. The state's contribution, paid from the School Aid Fund, has increased from $160 million (the equivalent of 1.6 percent of payroll) in FY2013 to $894 million (10.5 percent of payroll) in FY2016.

Because MPSERS is a multi-employer, cost-sharing plan and given the current mechanics of the employer rate cap, the ultimate responsibility for funding DPS's legacy costs falls directly to the State of Michigan and the portion of the UAAL paid through the state stabilization rate. Specifically, this portion of the pension liability is picked up by an annual appropriation from the School Aid Fund. In a practical sense, if DPS is unable to contribute to MPSERS, funding DPS's share of the system's legacy costs becomes the responsibility of every other school district. This is because with an increase in the state share paid directly by the School Aid Fund, there are fewer School Aid Fund dollars to distribute among all districts, either through the per-pupil foundation allowance or categorical grants.

Accounting for DPS's Share of Legacy Costs

Historically, accounting and reporting the legacy costs of school districts has not been very transparent or accessible to the layperson. While the State of Michigan has reported MPSERS unfunded liabilities for pension and retiree health benefits in the system's annual financial report for a number of years, this information was relegated to the notes and supplementary information sections of the report. The State of Michigan reported this information, despite the fact that it does not have any employees covered by MPSERS. Further, the reported information was aggregated for *all* participating districts combined. Individual employers were not required to present actuarial information about pensions, including any liability, in their own financial statements.

Recent changes in government accounting standards (GASB Statement No. 68) require that actuarial

Financing MPSERS Legacy Costs

Growth in the UAAL components (pension and retiree health) is generally the result of lower-than-anticipated investment returns for system assets.[b] The actuarial assumptions used by the system are based on an expected eight percent annual rate of return. Failing to meet this assumption in a number of years means that the system's pension unfunded liabilities have increased substantially since the early 2000s, rising from $7.5 billion on September 30, 2004, to $26.5 billion on September 30, 2014.[c] In effect, employer contributions have had to increase to "catch up" for previous years' underfunding. This growth is mirrored in the employer contribution rates discussed above.

To address these rising costs and to add some predictability to retirement funding for all participating employers (school districts), the state made significant changes to MPSERS in 2012. A number of the reforms addressed the growth in the unfunded liabilities and the corresponding employer contribution rates. Of particular note, the legislation eliminated the retiree health guaranteed benefit for new employees and required prefunding of the benefit beginning in FY2013, as noted. This ended the practice of financing the benefit on a cash basis.[d] This had the effect of creating two employer rates for the retiree health benefit – normal cost and UAAL.

Additionally, the reforms established a cap on the combined (pension and retiree health) employer contribution rate for unfunded liabilities. Beginning in FY2013, the cap is fixed at 20.96 percent of payroll (the combined rate charged for pension UAAL and retiree health in FY2012) in state law. Any amount above the capped employer contribution is provided by the state from an "off-the-top" allocation of School Aid Fund dollars, the state stabilization rate in **Chart 1** (light blue portion of bar).

[b] See www.crcmich.org/funding_public_education_drivers_policy_options-2013/

[c] Additionally, as of September 30, 2014, the UAAL for the retiree health benefit program was $11.2 billion, bringing the system's total unfunded liability to $37.7 billion.

[d] In addition to the switch to prefunding, the legislation redirected an existing 3 percent employee contribution towards prefunding the retiree health benefit and guaranteed each employee's prefunding contribution. Previously, this employee contribution was used to finance the annual costs of the retiree health benefit.

information, including legacy costs associated with pension plans, must be presented in the financial statements for *all employers* participating in the retirement system (see box discussion below). For MPSERS and Michigan school districts, this means that individual districts, for the first time, will carry pension long-term liabilities on their books. The new standards took effect for larger governments in the 2015 fiscal year.

As required under the new accounting standard, the State of Michigan did an analysis to determine each participating employer's proportionate share of the $22.4 billion MPSERS net pension liability.[5] Under the new GASB standard, the proportion for each employer is to be consistent with the determination of pension plan contributions. Contributions are based on a district's reportable payroll. Because DPS has the largest workforce and payroll, the district is responsible for the largest share of the MPSERS net pension liability. According to the state's calculation, DPS's share of the liability is 3.96 percent, or $872.7 million. This is reflected on the district's FY2015 financial statements.

MPSERS also has unfunded OPEB liabilities totaling $11.2 billion as of September 30, 2014. Under current accounting standards, these liabilities are not required to be allocated to individual employers and contained in the financial statements of these entities. However, GASB Statement No. 75 dealing with OPEB will require similar treatment as the pension liability under Statement No. 68. The new standard takes effect for fiscal years beginning after June 15, 2017. This means that Michigan school districts will have to carry their proportionate share of the MPSERS OPEB liability on their FY2018 financial statements.

[5] The new GASB statement required pension plans to determine the total net pension liability as of September 30, 2014 and then allocate this liability among participating employers. MPSERS net pension liability was based on the actuarial valuation as of September 30, 2013. The State of Michigan, Office of Retirement Systems then used each employer's proportionate share of reportable compensation to allocate the liability.

MPSERS Delinquency

Detroit Public Schools racked up an unpaid retirement bill of $80.9 million in FY2015.[e] Instead of paying its monthly retirement bill, the district used its state aid to meet other obligations during the year. In October, the district resumed paying a portion of the required monthly payment, but it has not budgeted the funds to repay even a portion of its MPSERS delinquency. In fact, the delinquency is projected to more than double by the end of FY2016. If this debt goes unpaid, the retirement system will have fewer resources to pay benefits to pensioners or to invest. While Detroit's delinquency represents a very small percentage of the total assets held by MPSERS, if unpaid, it will have to be factored into future actuarial calculations and could affect contribution rates.

For approximately seven months during FY2015, DPS failed to pay its monthly MPSERS bill. This included both the employer contributions as well as the funds provided to the district to cover the state's share of the UAAL payment (state stabilization rate). At one point, the district was not remitting the employee contributions, but this stopped during the year and these funds have been sent to the retirement system. The decision to withhold payment to the retirement system was based on the district's cash flow problems during the year.

State law requires school districts to remit their retirement contributions monthly to the Office of Retirement System (ORS). If a district fails to do so, the law allows ORS to request the State Superintendent of Public Instruction and the State Treasurer to intercept a district's state aid to satisfy its retirement obligations. After months of nonpayment and to avoid the potential loss of state aid, in August, the DPS Emergency Manager entered into an agreement with the ORS to begin paying a portion of its monthly retirement bill. Specifically, the district committed to timely remit all employee contributions and all pass-through amounts provided by the state. Additionally, the agreement requires the district to pay a portion of its employer contribution ($750,000 per month). The district resumed making retirement contributions in October 2015. As long as the district complies with the agreement, the ORS has indicated that it would not initiate a state aid intercept.

As noted, the agreement between DPS and ORS does not address the $80.9 MPSERS delinquency that existed at the end of FY2015. In fact, by agreeing to pay only a portion of the employer contribution ($750,000 per month) beginning in October 2015, the delinquency will increase going forward. It is estimated that the delinquency, along with additional interest and late fee charges, will increase to $165 million by the end of FY2016.

For perspective, participating employer contributions to MPSERS for pension and retiree health totaled $2.6 billion in FY2014 and the system had assets with a market valuation of $46.6 billion as of September 30, 2014. And while the nonpayment is not currently factored in, should the $165 million DPS delinquency remain unpaid, it would have to be incorporated into the actuarial valuation at some point. It is unlikely that the nonpayment would have a material effect on future contribution rates. However, the district's failure to pay its retirement bill clearly sets a bad precedent for all other districts in the state, including those facing financial difficulties.[f]

[e] This includes interest and late fees on the unpaid balance as of June 30, 2015, according to the State of Michigan, Office of Retirement Services.

[f] As of June 30, 2015, five other school districts had outstanding MPSERS balances with ORS: Flint ($10.9 million), Pontiac ($3.7 million), Hazel Park ($2.3 million), Muskegon Heights ($1.9 million), and Highland Park ($720,000), according to the Office of Retirement Services.

Using DPS's current proportionate share of the pension liability (3.96 percent), it is estimated that the district's share of the total OPEB liability is $443.8 million. If the OPEB liability was required to be presented in the district's FY2015 financial statements, DPS's total MPSERS liability (pension and retiree health) would be $1.3 billion.

Termination Incentive Plan

In 2009, then DPS Emergency Financial Manager Robert Bobb designed a plan to help ease the district's cash flow problems by reducing current employee paychecks and using the funds to cover other operational expenses. The program, called the Termination Incentive Plan (TIP), was included in the 2009-2012 collective bargaining agreement between the district and the Detroit Federation of

Teachers. Under this program, the majority of district employees had $250 deducted from each paycheck beginning in January 2010 and ending in December 2012. The deducted funds were deposited in a TIP account for each member to be made available upon their separation from the district. Upon separation, participating employees are entitled to a termination of service bonus equal to $1,000 for each year of service up to 9 years (cap of $9,000 per employee). The program effectively allowed DPS to receive a $9,000 interest-free loan from each employee.

Roy Roberts, the district's emergency manager appointed in 2011 suspended the program in 2011 prior to its scheduled 2012 end date. Over the life of the plan, $49 million was deducted from employee paychecks with the promise that these funds would be returned in the future. In effect, the TIP represented a postemployment benefit separate from the pension and retiree health benefits provided through MPSERS and entirely funded by the district (as opposed to the cost-sharing arrangement of MPSERS).

While the program was created to help the district with its cash flow for a couple of years, it also created another long-term liability. Based on the valuation report as of June 30, 2015, the TIP's unfunded liability is $16.6 million. The district is required to pay off this liability over the next three fiscal years using current revenues. In FY2015, the district contributed $2.3 million towards the liability.

Bonded Debt

Nearly every Michigan school district issues debt to fund capital improvements, major maintenance, and for other purposes. This debt is issued within limits established by the Michigan Constitution and state laws. The total amount of outstanding school district debt on December 31, 2014, was $15.4 billion. Districts vary in their use of long-term debt as a financing tool, but on average, this equated to approximately $12,629 per pupil in outstanding debt.[6] Bonded debt is secured by dedicated revenues from local property tax levies and is retired over a number of years (20 to 30 years). Long-term general obligation debt backed by property tax revenue must be approved by local voters. For the year ending December 31, 2015, school districts paid a total of $1.5 billion in debt service (principal and interest) on debt issued with the State of Michigan's backing through the School Bond Loan and Qualification Program.

Detroit Public School's Long-term Debt

Detroit Public Schools has borrowed money for a number of purposes, including to provide cash for operations, to finance its operating deficit, and to finance capital expenditures. Annually, the district issues short-term notes to help with its cash flow throughout the fiscal year. This borrowing requires repayment within a 13-month period from current-year resources (see box below). Additionally, the district has issued various forms of long-term debt, largely bonds payable over 10 to 30 years. "Limited tax" bonds are limited tax general obligation bonds repaid from the district's general operating funds; "unlimited tax" general obligation bonds are backed by the full faith and credit of the district and are repaid from unlimited property tax levies subject to voter approval. As of August 31, 2015, DPS had $1.7 billion in long-term debt outstanding (see **Table 3**).

Of the total, $1.5 billion is "unlimited" general obligation debt backed by a dedicated property tax and $259 million is "limited" debt repaid from a pledge of the district's state aid (primarily the per-pupil foundation allowance). For the current year, DPS will pay $191.3 million in principal and interest on its long-term debt (see **Table 4**). Of this total, $53 million will go towards meeting the annual debt service on general obligation limited tax notes issued in 2005 (refinanced in 2012) and 2011 to help with the district's cash flow problems. In these years, the district was able to convert short-term cash flow borrowing into long-term debt.

[6] Michigan Department of Treasury, Bureau of State and Authority Finance, School Bond Qualification and Loan Program, 2014 Annual Report, www.michigan.gov/documents/treasury/SBQLPAnnualReport_456025_7.pdf.

Table 3
Detroit Public Schools Bonded Indebtedness (as of June 30, 2015)
(Dollars in millions)

Date Issued	Series	Type	Maturity	Outstanding
11/1/98	Refunding, Series 1998C	Unlimited	5/1/25	$48.3
10/1/01	Building & Site, Series 2001A	Unlimited	5/1/29	183.7
10/31/02	Building & Site, Series 2002A	Unlimited	5/1/21	35.8
8/17/05	Refunding, Series 2005A	Unlimited	5/1/32	226.8
12/30/09	Building & Site, Series 2009A	Unlimited	5/1/25	74.9
12/30/09	Building & Site, Series 2010B	Unlimited	5/1/39	191.4
10/28/10	Building & Site, Series 2010A	Unlimited	5/1/29	144.1
10/28/10	Building & Site, Series 2010B	Unlimited	5/1/40	49.6
10/13/11	Amended and Restated Series 2011A Notes	Limited	6/1/21	165.0
3/27/12	Building & Site Refunding, Series 2012A	Unlimited	5/1/33	304.8
5/17/12	2012 Multi-Year Repayment Obligation (originally issued in 2005)	Limited	6/1/20	94.2
3/12/15	Refunding, Series 2015	Unlimited	5/1/25	192.6
				$1,711.3

Source: Municipal Advisory Council of Michigan

Table 4
Detroit Public Schools Annual Debt Service on Long-term Debt
(Dollars in millions)

Year Ending	Unlimited Obligation			Limited Obligation		
June 30	Principal	Interest	Total	Principal	Interest	Total
2016*	$53.5	$84.8	$138.3	$124.1	$15.5	$139.6
2017	56.5	82.0	138.5	43.5	9.5	53.0
2018	59.0	79.8	138.8	45.7	7.4	53.0
2019	61.5	77.5	139.1	47.9	5.1	53.0
2020	64.3	75.1	139.4	30.8	1.5	32.3
2021-2025	369.7	333.3	703.0			
2026-2030	460.8	219.1	679.9			
2031-2035	229.7	69.7	299.4			
2036-2040	97.1	19.1	116.1			
	$1,452.1	**$1,040.3**	**$2,492.4**	**$292.0**	**$39.0**	**$330.9**

* Includes repayment of $82.8 million 2014-15 cash flow notes by June 2016.

Source: DPS, 2014-15 Financial Report

Converting Short-Term Borrowing to Long-Term Debt.[7] Because of the differences between the timing of receipts and outlays each month, school districts sometimes need to borrow money to ensure they have sufficient funds on-hand when bills come due. To raise the funds, school districts issue short-term notes to manage their cash flow needs throughout the school year. Districts generally engage in cash flow borrowing early in the fiscal year (July 1) and are required to set aside some of their state aid revenue to retire the notes at maturity. Generally, districts repay the full amount borrowed, plus interest, by August of the following calendar year.

In August 2010, the district borrowed $420 million to help with its cash flow during the 2010-11 school year. Faced with other fiscal pressures and an inability to bring spending within the limits of available resources, it became apparent during the year that the district would be unable to repay some of the notes within the year. In order to avoid a default, the state through (the emergency manager) authorized the district to issue $231 million in 10-year notes to refinance a portion of the unpaid cash flow borrowing. This had the effect of converting short-term borrowing to a long-term liability, paid from future general operating revenues the district receives.

The state's Michigan Finance Authority issued the debt on behalf of DPS and required the district to pledge a portion of its state aid as repayment. This means that the debt service competes for resources that would otherwise go to general operations (classroom instruction, supplies, etc.). The notes carry an interest rate of 4.75 percent and will be fully repaid in 2021 (see **Table 3**).

The 2011 debt was not the first time the district converted short-term borrowing to long-term debt. In 2005, the district was under the control of the mayoral-appointed school reform board. To avoid defaulting on its cash flow borrowing, the district converted $210 million in cash flow borrowing to long-term debt in April 2005. To do this, the district issued special purpose bonds payable over 15 years. The plan required the debt service payments to begin in 2007 ($16 million in 2007 and $22 million each year after) and for the debt to be fully repaid by June 2020. This borrowing was part of the district's multi-year deficit elimination plan approved by state officials earlier in 2005.

By the end of FY2011, DPS still had $141 million of the original $210 million 2005 bonds outstanding; however, the district was now under the control of the state-appointed emergency manager. In May 2012, the emergency manager asked for approval from the Michigan Finance Authority to refinance the remainder of the original special purpose bonds to take advantage of lower interest rates. The Authority refinanced the debt but maintained the final maturity date of June 2020.

With the debt issued in 2011 and 2012 (originally in 2005), DPS was allowed to extend the repayment of its cash flow borrowings well beyond the years in which the original borrowed funds were used for school operations. At June 30, 2015, the district had a total of $259 million outstanding between the two issues.

As noted, the 2011 and 2012 notes were issued by the Michigan Finance Authority, not DPS. While the debt does not represent a general obligation of DPS, the Michigan Finance Authority, or the State of Michigan, it is a limited obligation of the Authority payable from pledged DPS state aid payments. The 2011 long-term notes represent a first lien obligation, meaning that the district is required to allocate a sufficient amount of its state aid to cover the debt service before making any other expenditure. Similarly, the 2012 notes represent a second line obligation. For the 2015-16 school year, total debt service for these borrowings is $53 million, which amounts to about $1,100 per student. In the absence of the DPS state aid payments, it is not clear how the Michigan Authority would pay bondholders as the Authority does not have taxing authority.

Converting cash flow borrowing to long-term debt is not a common practice. In fact, it was done only one other time. To facilitate the merger of the Ypsilanti and Willow Run school districts and to assist the districts with deficit reduction, the Michigan

[7] In a previous report, CRC examined the history of DPS's actions to convert its cash flow borrowing to long term bonded debt. See www.crcmich.org/PUBLICAT/2010s/2015/state_assumption_DPS_debts-2015.pdf.

Finance Authority issued $19 million of long-term notes in August 2013 to refinance the two districts' outstanding 2012-13 cash flow borrowings (due August 2013). The notes will be retired by 2026 and the annual debt service covered by a portion of the state aid the new, consolidated school district (Ypsilanti Community Schools) receives.

Unlimited General Obligation Debt. Per the state Constitution, voters must approve the sale of unlimited general obligation debt. Unlike limited tax debt, unlimited debt does not compete with a district's general funds because it is repaid from the proceeds of a property tax levy that is set at a millage rate that is recalculated annually to generate sufficient funds to service the debt.

Detroit Public School voters were last asked to approve unlimited general obligation debt in 2009. In November 2009, voters authorized the district to borrow up to $500.5 million for various capital investments.[8] The district issued the full amount of bonds under this authorization in 2009 and 2010. As of June 30, 2015, the district had approximately $1.5 billion in total unlimited general obligation debt outstanding (see **Table 3**).

All of the district's general obligation debt is "qualified" by the State of Michigan through the School Bond Qualification and Loan Program. This program provides a state credit enhancement and loan mechanism for school district debt issues. Districts that receive qualification from the state receive a rating on the bonds equal to the state's credit rating, which will often result in a lower interest rate and cost, and the ability to borrow from the state an amount sufficient to enable the district to pay principal and interest requirements on its outstanding qualified bonds in the short-run if its property tax levy is insufficient to pay the full debt service (a minimum debt millage of seven mills must be levied before a district can borrow from the State).

To service its general obligation debt, DPS levies a debt millage of 13 mills, the maximum rate that a district is allowed to levy under the School Bond Qualification and Loan Program.[9] The district has been levying its debt millage at the maximum rate since before 2009, when voters approved the $500 million bond sale. The proceeds from the debt millage levy, along with loans from the State of Michigan, are used to make the annual principal and interest payments. While the annual debt service payments have been level in recent years (approximately $139 million), the district has been forced to regularly borrow funds from the state to make the required principal and interest payments. This is because the yield from the 13-mill debt levy has declined with the reduction in taxable value in the City of Detroit. In recent years, the district borrowed $33.5 million (FY2013), $44.9 million (FY2014), and $28.4 million (FY2015). As of December 1, 2015, DPS owes the state $198.7 million (total principal and interest) for loans to provide sufficient funds to meet its general obligation debt payments.

Other Liabilities

The district is carrying other liabilities on its financial books, including nearly $83 million of restated 2014-15 cash flow notes and amounts owed to various vendors for providing services and goods. Additionally, the district issued $122 million in cash flow notes in September to provide the funds needed to make payroll and meet other obligations as they come due during the 2015-16 school year. Many of these other liabilities are due within the year and will compete with classroom instruction and ancillary services for the resources the district receives.

Refinanced 2014-15 Cash Flow Borrowing

For the 2014-15 school year, DPS issued $107.8 million in cash flow notes in August 2014. In May 2015, district officials notified the state that repaying the full amount borrowed by August 2015 would create cash flow problems later in the year. To avoid a possible default and to head off a cash shortage in the last months of the year, the Michigan Finance Authority issued $82.8 million in short-term notes to refinance a portion of the original borrowing. These

[8] See www.crcmich.org/PUBLICAT/2000s/2009/memo1095.pdf.

[9] Technically, the City of Detroit levies the millage on behalf of the school district.

proceeds, along with $29.5 million in state aid set aside during the 2014-15 school year, were used to repay the original $107.8 million notes. While this provided a financing mechanism for the original 2014-15 notes, it effectively pushed repayment of the borrowing into the 2015-16 school year.

The refinanced cash flow notes will have to be covered by the state aid payments the district receives during the 2015-16 year.[10] Repayment was scheduled to begin in October 2015 and the notes completely repaid by June 2016. This will have the effect of reducing the amount of state aid funding available for current operations (similar to the debt service requirements of the 2011 and 2012 notes). The difference being that the 2014-15 refinanced cash flow notes will be repaid within a period of 12 months as opposed to over a period of 10 to 15 years.

For the 2015-16 school year, DPS will have to pay $53 million to service the 2011 and 2012 notes and repay the $82.8 million notes ($87 million with interest) from the 2014-15 borrowing. In total, the district will pay $140 million, nearly $3,000 per pupil, to finance the costs of past cash flow borrowings (See **Table 4**).[11] Additionally, there are interest costs associated with the 2015-16 cash flow borrowing that will have to be paid from current revenues in the 2015-16 school year.

Conclusion

Detroit Public Schools has $3.5 billion in outstanding debt. Nearly half of this amount, $1.7 billion, is capital liabilities payable with a dedicated millage. The Michigan Constitution requires the state to provide loans to districts to help with debt service on capital debt. The School Bond Qualification and Loan Program ensures that property-poor districts are able to access capital financing without being overburdened by debt repayment obligations. The capital liabilities, along with the state loans outstanding related to the debt, will remain with DPS.

The balance of DPS's liabilities are related to legacy costs and repaying short-term borrowings converted to long-term debt by state-appointed emergency managers. This includes $1.3 billion that represents DPS's estimated share of the unfunded actuarial accrued liabilities for retiree pension and health care costs; $97.5 million of legacy costs unique to DPS; and $463 million of long-term debt being repaid from operating funds. Paying the debt service on the long-term debt will compete for resources the district receives to fund education services for today's students. For the current year, 40 percent of the district's per-pupil funding will have to go towards repaying past cash flow borrowings. No other district is saddled with this type of burden currently.

Efforts to address the debts unique to DPS would put the district on par with other school districts in the state. Depending on how such an effort is structured will determine whether putting DPS on par with other school districts comes at the expense of funding available to all other districts statewide.

It is clear that something must be done. Despite being under the control of a state-appointed emergency manager since 2009, Detroit Public Schools, the state's largest district, is failing academically and financially. It was recently reported that DPS ranked last in academic achievement (4th and 8th graders) among urban districts nationally on the National Assessment of Educational Progress. This was the fourth time in a row that DPS ranked at the bottom of all large city districts in the country.[12] At the same time, the district has been grappling with chronic operating budget deficits, growing liabilities and indebtedness, and challenges to meet payroll.

After years of state control of DPS, state policymakers are again being called to develop a new approach to deal with the district's problems. Whether this means a complete abandonment of the current

[10] The district also issued $121 million in 2015-16 cash flow notes in September 2015 to provide funds needed to pay bills as they come due during the year. Repayment of these notes will be made by August 2015.

[11] See www.crcmich.org/paying-for-former-students-education-with-todays-dollars/

[12] U.S. Department of Education, Institute of Education Sciences, National Center for Education Statistics, National Assessment of Educational Progress (NAEP), various years.

emergency manager regime is unknown at this time. What is clear is the fact that a policy response must be a first-order priority of state officials. And while policymakers' actions may be motivated by the longevity and sheer size of DPS's financial and academic problems, a call to action must be prompted by the nearly 48,000 Detroit schoolchildren and the fact that they are not currently receiving the quality education they deserve and are entitled.

Dealing with the myriad challenges will require a comprehensive approach. A plan that solves the district's money problems without addressing what is taking place in the classroom will not set the district up for future success. Similarly, any financial plan that only deals with the district's near-term fiscal woes (cash flow for example) will not prove lasting and will not support student learning over the long haul if current financial problems are shifted to future students. Financial and academic reforms will have to be packaged with governance reforms and build upon the litany of management reforms implemented under emergency managers.