Date: December 8, 2020

To: Board of Trustees

From: Chris Johnston, Assistant Superintendent, Business Services

Re: 2020-21 First Interim Report Executive Summary

Introduction

The interim financial reports serve both statutory and management functions. Per the AB 1200 process, the Trustees must certify the 2020-21 First Interim report as positive, qualified, or negative. This certification attests to the district's fiscal solvency, or lack thereof, for the current and subsequent two fiscal years. As a management tool, the interim reports and included multi-year financial projections estimate future year deficits or surpluses. Projected deficits call for expenditure reduction planning. Projected surpluses indicate the availability of funds for new programs and other long-term financial obligations such as salaries and benefits increases.

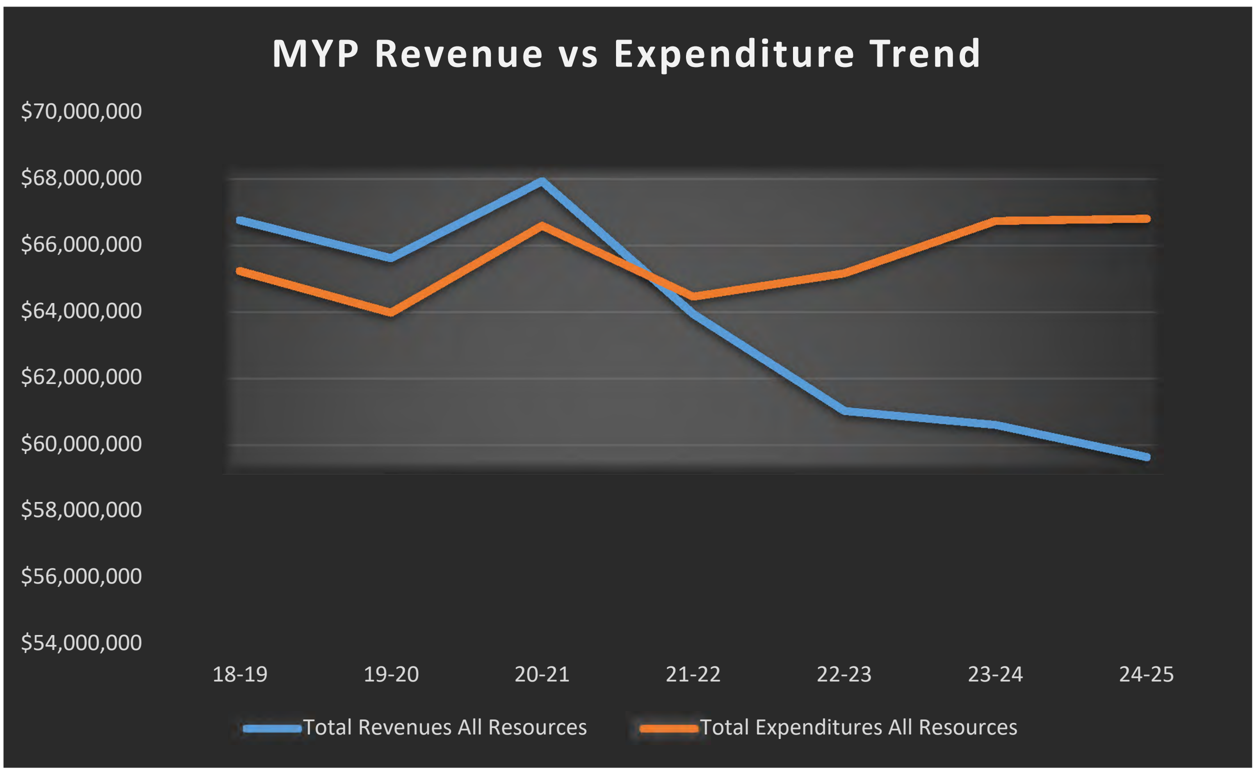
Positive Certification

This 2020-21 First Interim Report demonstrates, using conservative financial projections, that the district can meet its financial obligations this year and in the two subsequent fiscal years. For 2020-21 and 2021-22 the report projects modest budget surpluses. For 2022-23 the district has sufficient reserves to cover the projected budget deficit. Staff recommend, and the data support, a positive certification.

Management and Planning Considerations

Concerning the First Interim report's usefulness as a management tool, staff must emphasize the context of the pandemic environment. As detailed further in the discussion of assumptions below, operating schools in a pandemic environment is significantly more expensive than standard operations. Extra cleaning costs, PPE for staff and students, and extraordinary substitute costs to cover extended leaves – just to highlight three expenses – amount to more than $950K in projected additional costs. The degree to which the district will realize these, and other expenses, is contingent upon the duration and severity of the pandemic conditions. The district faces the question of whether it will be able to continue in-person instruction or whether surging infection rates will force a return to full distance learning. The answer to that question has the potential for a multi-million dollar impact on final expenditures. This brings us to the point that projected yearly expenditures are highly uncertain. In contrast to prior years when the First Interim report could be considered a useful management tool for understanding availability of funds for the fiscal year, this year's projections should be seen for what they are: a best estimate in a constantly changing environment.

Where this report and associated projections are useful management tools is in the identification of major trends and trajectories of the budget. Even if pandemic conditions alter total expenditures by $2M in 2020-21, the other 97% of the $66.6M budget is largely predictable. Two million dollars in expenditures, while not insignificant, can be absorbed on a one-time basis. Multiplying that cost over several years, however, creates a major obstacle. Please consider the graph below of the multi-year financial projection data:



This graph illustrates an alarming trend of declining revenues against growing costs. Understanding the drivers of this trend requires a review of the underlying assumptions of the MYFP.

Major Revenue Assumptions

This First Interim report uses School Services' "Dartboard" recommendations of 0% applied Cost of Living Adjustment (COLA) to Local Control Funding Formula revenues. Their recommendations are widely accepted as industry standard. Similarly, 0% COLA is applied to Federal funds and non-LCFF state funds. The First Interim update also recognizes more than $4M in Coronavirus relief funding, from both Federal and State resources. As Congress has enacted no further legislation, no further pandemic relief funding is projected in the model. For full details on the underlying revenue assumption numbers, please refer to the ProjectionPro multi-year financial projection report.

Compounding the issue of flat funding is PVSD's trend of declining enrollment. Prior to the onset of the coronavirus pandemic PVSD was facing a projected downward enrollment trend of approximately 1% per year. During the summer of 2020 hundreds of students dis-enrolled. Anecdotal data suggest that pandemic conditions were the primary driver of this loss. While the district saw some enrollment recovery in early fall, the net loss in enrollment from October 2019 to October 2020 was 294 students. This represents a 4.7% loss in enrollment. This new enrollment number is the baseline for the multi-year financial projection, with prior loss trends incorporated into future year estimates. While the district remains hopeful for post-pandemic re-enrollment, the district has no firm data that justify including enrollment recovery in the financial projections. Therefore, the budget model projects enrollment of 5927 in the current fiscal year are followed by 5883, 5823, 5757, 5722, and 5692 in subsequent years. Flat per-pupil funding rates multiplied by declining enrollment and attendance numbers create the downward revenue trend seen throughout the financial projections and illustrated in the graph above.

Major Expenditure Assumptions

To underline the obvious: changes in district operations drive changes in expenditures. Hiring more staff costs more money. Disinfecting classrooms every evening increases custodial supply and staffing expenditures. Financial projections, therefore, are highly dependent upon operational decisions. Operating in-person instruction in the COVID environment significantly increases costs in the following expenditure areas: cleaning supplies, personal protective equipment (PPE), utility bills (to run constant ventilation), cleaning personnel, substitute teachers, substitute classified employees, transportation, and campus supervision, and employee COVID testing. On the subject of substitute costs, as of the First Interim report the district had more than 20 employees on some form on long-term paid leave. The district incurs both the costs of the leave payments and the substitute employee wages. The First Interim report projected expenditures for 2020-21 assumes continued in-person instruction for the duration of the school year. Any forced change to these operations will change projected costs.

Regarding assumptions for multi-year expenditure trends, it worth highlighting three factors:

- Over the next four years the California Public Employees' Retirement System (CalPERS) school district employer contributions rate will escalate from 20.7% to 27.3%.
- Over the next three years the California State Teachers' Retirement System (CalSTRS) employer contribution rate will grow from 16.15% to 18.1%. The contribution increase from 2021-22 to 2022-23 is approximately $650K, ongoing.
- Step and Column salary increases for employees will cost approximately $500K per year.

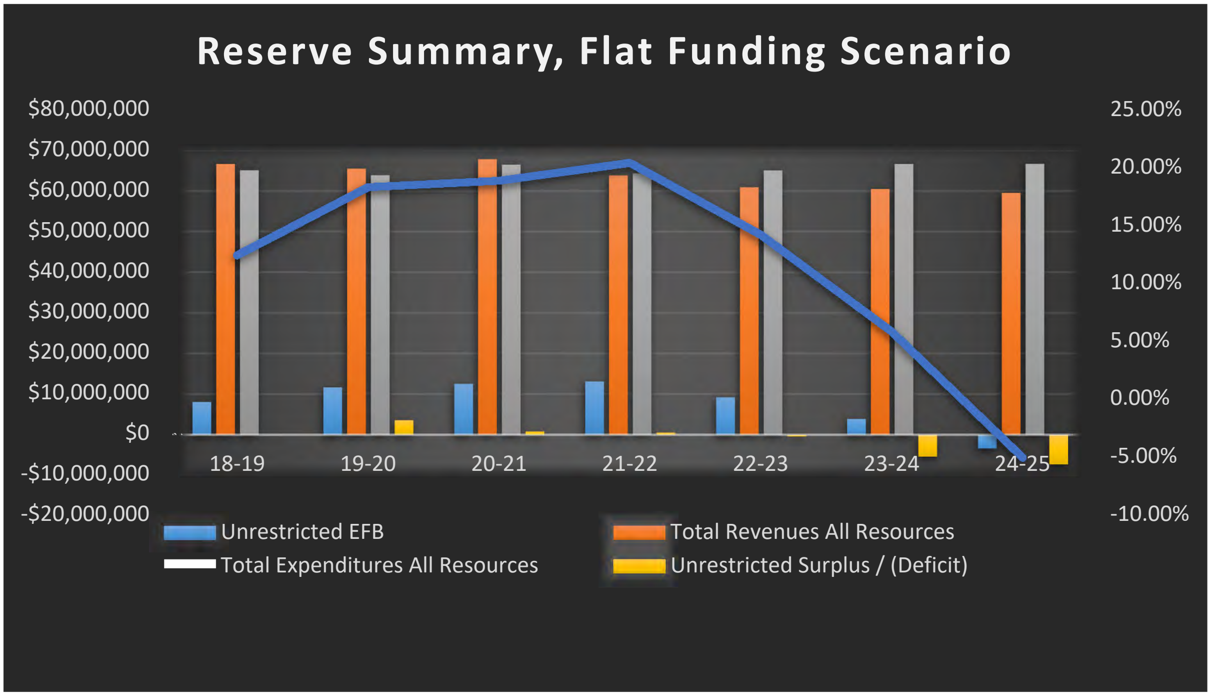
Combined with consumer price index-driven escalation in the cost of materials and supplies and contracted services, continually increasing personnel costs will result in year over year expenditure increases just to maintain the existing pre-pandemic level of services to the district's students.

Reserve Summary Graph

The graph below combines three factors: total revenues and expenditures; unrestricted deficit/surplus projections; and ending fund balance (EFB) percentage of total expenditures (commonly referred to as reserve percentage).

- The orange and grey pair of bar graphs shows the relative relationship between revenues and expenditures.
- The blue and yellow bars show unrestricted ending fund balance (reserves) and surplus/deficits, respectively.
- The overlaid blue line shows the percentage of reserves.

While this style of graph may take longer to digest than a separated format, viewing the juxtaposition of the various factors is worthwhile.



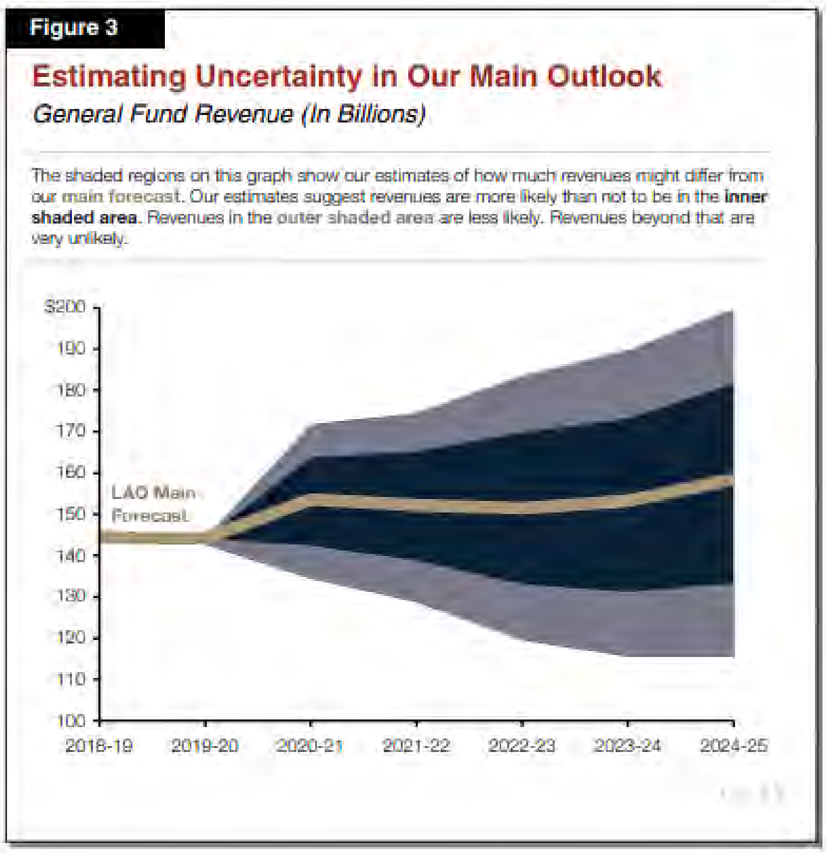
Fiscal Cliff

The projection shows a financial stumble in 2022-23 that quickly devolves into a plummet in subsequent years. This fiscal cliff and associated $5.4M budget deficit is a result of the convergence of three factors: flat funding, escalating costs to maintain the same services, and declining enrollment. While it is debatable that the assumptions underlying the projection will hold true for the next five years, that is not the purpose of a five-year projection. Instead, district leadership should consider the underlying trends, and the long-term risks created by those trends. It is worth emphasizing that multi-year financial projections are not a forecast of destiny, but a projection of where things would go without appropriate monitoring and course correction. The purpose of the projection is to highlight dangers such as these, so that advance planning is possible.

The flat funding projections, as noted above, are based on industry standard recommendations. The Governor's proposed budget, to be released in January 2021, will further inform the future of school funding.

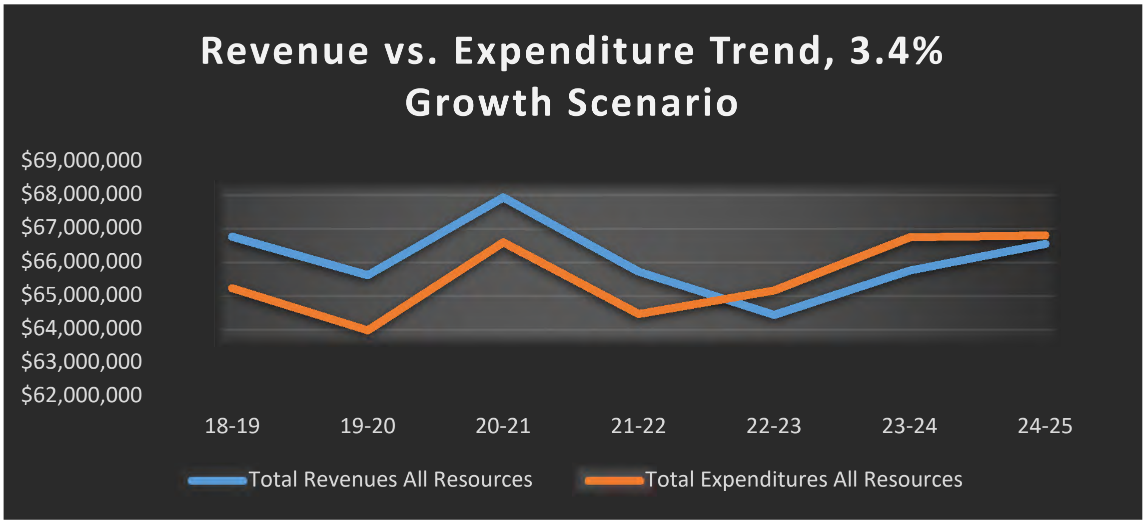
Alternative Budget Scenarios

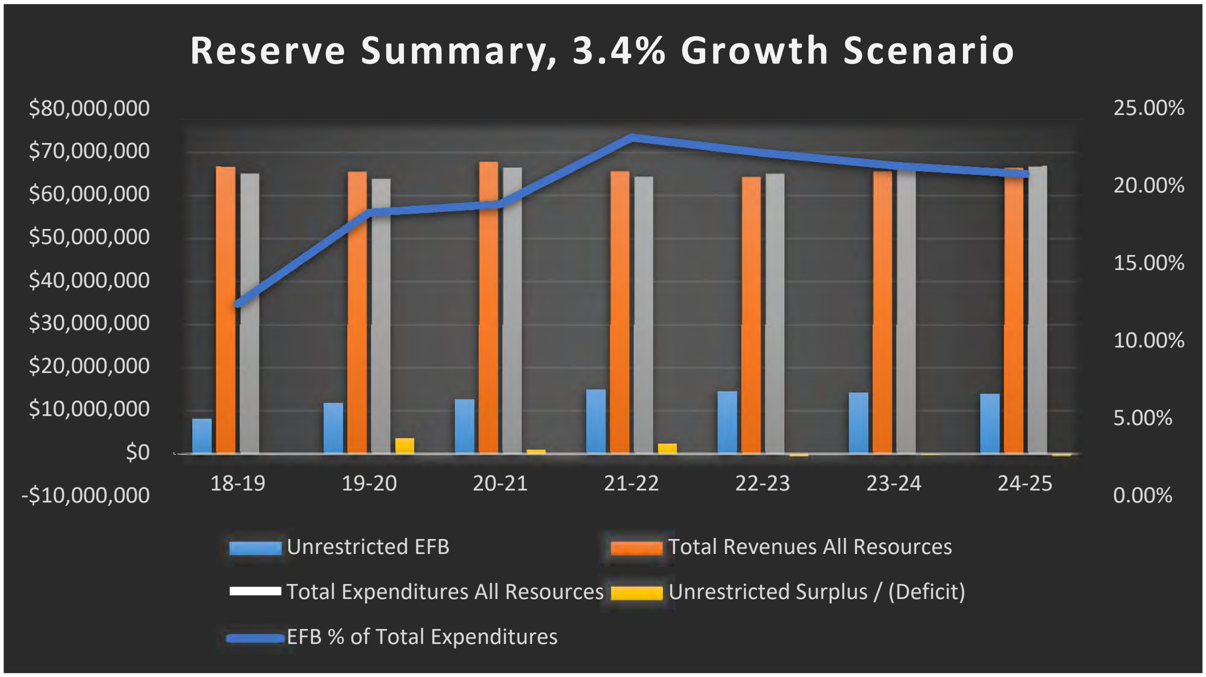
The November 2020 Legislative Analyst's Office report, *The 2021-22 Budget: California's Fiscal Outlook,* provides insight into alternative budget scenarios to consider. While the report's projected 2021-22 $26B "budget windfall" has garnered the most attention, staff would like to direct the Trustee's attention to the following graph, extracted from the report:



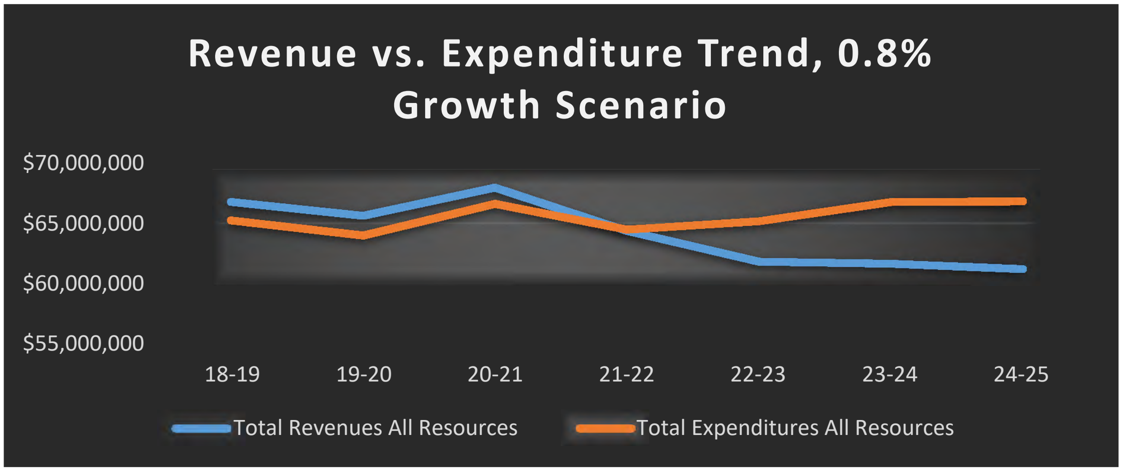
This graph emphasizes the volatility of the current financial environment and the inherent uncertainty of any projections developed during a pandemic. Public agency decision makers should consider this context before making any long-term decisions. Having established the background of uncertainty, let us consider what the LAO's main forecast could mean for education.

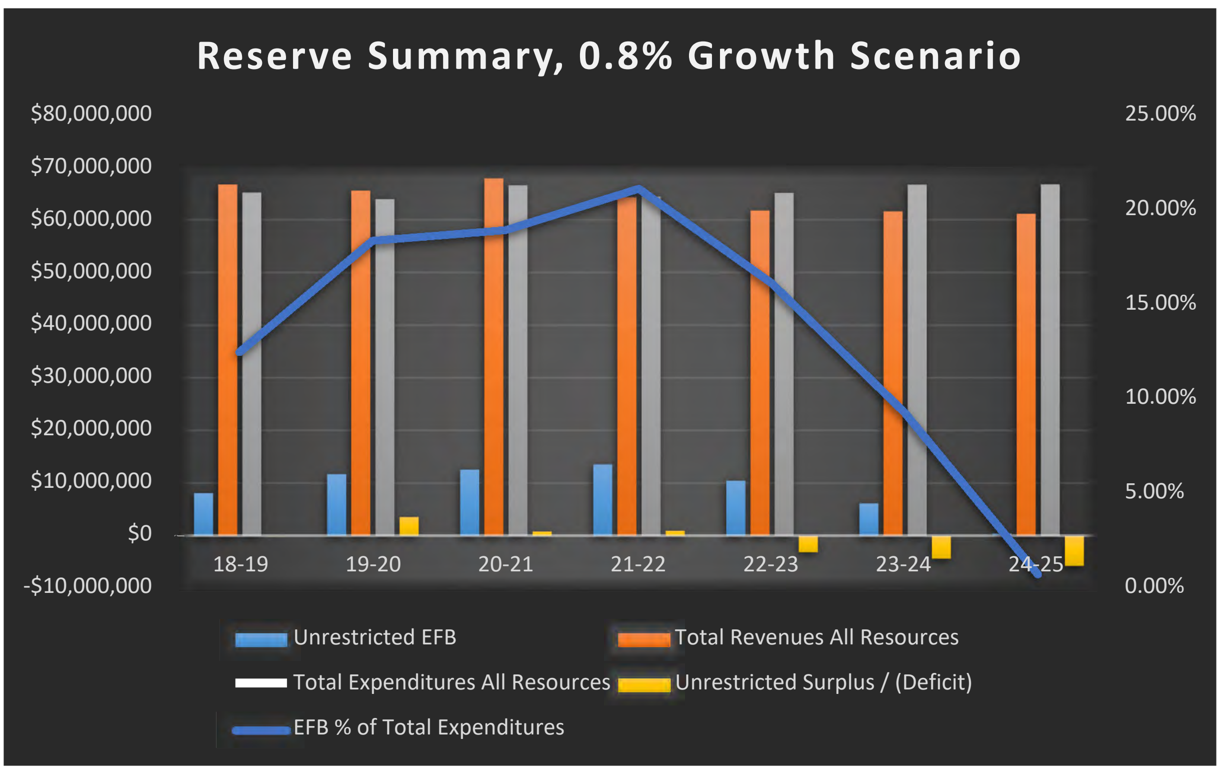
As the Trustees will recall, the state's adopted budget included a change to the Proposition 98 Test One minimum funding guarantee- raising the minimum percentage of the state general fund allocated to K-14 education up to 40% from 38%. According to the LAO report, under the main forecast, if this supplement to Proposition 98 is factored in, K-14 education could see an average yearly funding increase of 3.4%. The graphs below shows an alternative multi-year financial projection scenario with a 3.4% yearly increase to PVSD LCFF funding.





While the graphs above may inspire optimism, it is important to note that with the state general fund projected to run a deficit, the Proposition 98 Test One supplement could face repeal before it ever takes effect. If the Proposition 98 supplement is factored out, the LAO main forecast projects K-14 funding to increase by an average of 0.8%. The graphs below illustrate a multi-year scenario with 0.8% yearly increases to PVSD's LCFF Funding. Clearly, 0.8% funding growth does not offset the upward pressures on expenditures.





Conclusions and Recommendations

As noted above, the financial projections are contingent upon numerous assumptions. Each assumption contains a high degree of potential variability depending on the duration and severity of the pandemic. Furthermore, each of these assumptions, if changed, yields a significant financial impact. Multiplying numerous assumptions by significant financial impact, and compounding that with the uncertainty of the pandemic environment, one can easily imagine the magnitude of the volatility and financial uncertainty ahead. As such, while the First Interim report demonstrates that the district will be able to meet its near-term financial obligations and will likely see modest near-term budget surpluses, to make any long-term financial obligations based on this information would be akin to building on shifting sands.

As illustrated in the graphs of alternative budget scenarios, year over year increases to LCFF funding would be necessary to overcome the negative trends of declining enrollment and escalating costs. Strong reserves and pre-pandemic budget balancing activities have placed the district in a position of strength for navigating possible challenges ahead. Staff eagerly await the Governor’s January Budget proposals and May Revision. When that information becomes available, staff will develop and present updated financial projections. Until that time, a “wait and see” approach is most prudent.