

SPECIAL COMMENT

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Charter Schools Pose Growing Risks for Urban Public School Districts

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Analyst Contacts:

NEW YORK	+1.212.553.1653
Michael D'Arcy	+1.212.553.3830
<i>Analyst</i>	
michael.darcy@moodys.com	
Tiphany Lee-Allen	+1.212.553.4772
<i>Associate Analyst</i>	
tiphany.lee-allen@moodys.com	
Geordie Thompson	+1.212.553.0321
<i>Vice President - Senior Credit Officer</i>	
geordie.thompson@moodys.com	
Naomi Richman	+1.212.553.0014
<i>Managing Director - Public Finance</i>	
naomi.richman@moodys.com	

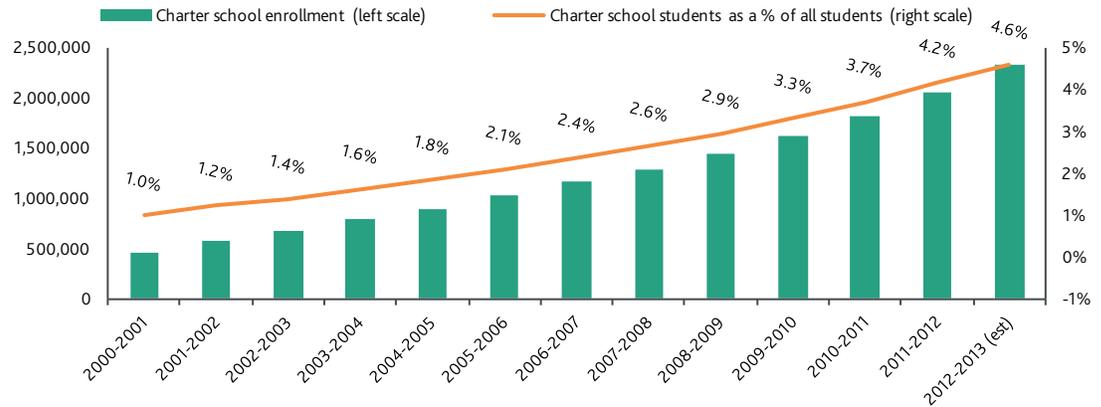
Summary

Charter schools are now significant competitors for public K-12 school districts (see Exhibit 1), particularly in older core cities, where they have achieved substantial, double-digit growth in enrollment. While the vast majority of traditional public districts are managing through the rise of charter schools without a negative credit impact, a small but growing number face financial stress due to the movement of students to charters. Four key credit risk drivers confront affected public school districts:

1. **Weak demographics and district financial stress**, which detract from the ability to deliver competitive services and can prompt students to move to charter schools
2. **Weak capacity to adjust operations in response to charter growth**, which reduces management's ability to redirect spending and institute program changes to better compete with charter schools
3. **State policy frameworks that support charter school growth** through relatively liberal approval processes for new charters, generous funding of charters, and few limits on charter growth
4. **Lack of integration with a healthier local government** that can insulate a school system from credit stress

EXHIBIT 1

Charter School Enrollment in the US Has Grown Steadily



Source: National Alliance for Public Charter Schools

Risk Factor #1: Weak Demographics and District Financial Stress

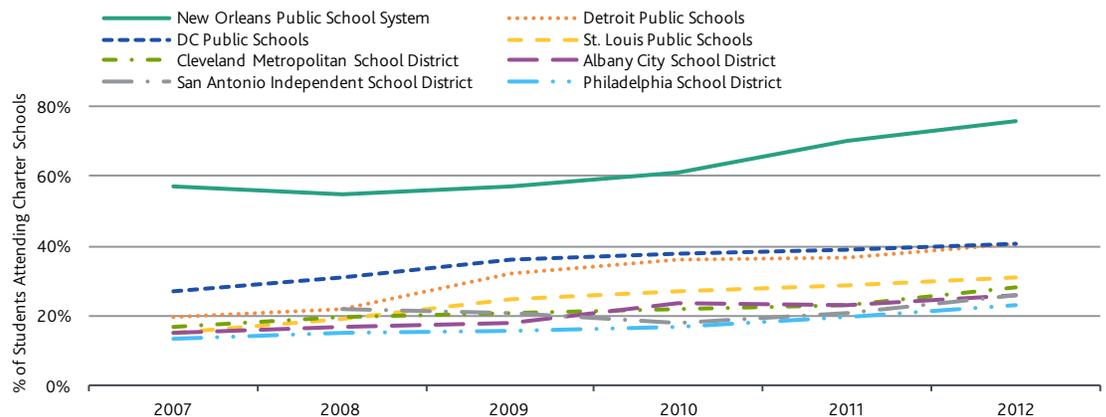
The nationwide increase in charter schools since 2000 is having an outsized effect on urban public school systems, particularly in the Northeast and Midwest. While charter schools exist in 42 out of 50 US states and operate in both suburbs and major cities, the majority of public school districts where charter schools account for 20% or greater of student enrollments serve major cities, including Cleveland, Detroit, Kansas City, St. Louis and the District of Columbia (see Exhibit 2), making charter schools a predominantly urban phenomenon.

Charter schools tend to proliferate in urban areas where local school districts already manifest a degree of underlying economic and financial stress stemming from population and tax base losses. Long-term demographic changes were placing credit stress on urban school districts long before the advent of charter schools. A combination of population declines and shifts in enrollment away from traditional public schools in favor of parochial, private or other educational alternatives have also reduced the number of school-age children enrolled in public schools in some areas. These patterns have led to declines in state revenues, as most state basic education formulas are closely linked to enrollment.

EXHIBIT 2

Growth in Charters Concentrated in Urban Districts

Districts with Highest Charter Proportion



Source: School District Annual Financial Reports and National Alliance for Public Charter Schools

Rapidly declining enrollments coupled with increasing expenditures pose serious operational challenges for traditional public schools, as they can trigger a cycle of financial stress - even in cases where management responds meaningfully to these challenges.

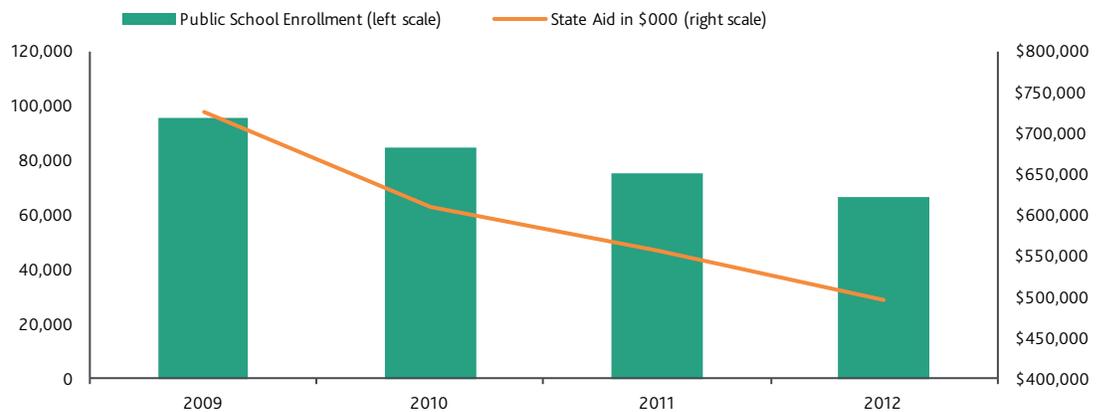
As districts struggle to reduce costs to balance out declining revenues, they often cut academic and other programs, reducing service levels and thereby driving students to seek education alternatives, including charter schools. The movement of students to charter schools can exacerbate the loss of state and local revenues, as portions of both will follow these students to charter schools per state charter-funding mechanisms. Continued program reductions can drive additional students to charters, worsening the financial impact on the district.

This phenomenon is an important factor in the stress faced by Detroit Public Schools (B2 negative). A 25% population contraction between 2000 and 2010 led to a drop in enrollment from nearly 160,000 students in 2002 to less than 67,000 in 2012, a 58% decline. These losses include a loss of students to charter schools and have resulted in a steady reduction in state aid. The district received \$1.2 billion in state aid in 2002, accounting for 75% of General Fund revenues; by 2012, it received \$495 million, or 55.4% of revenues. General Fund revenue overall fell by 44% over the same period. Although district management was proactive in reducing annual expenditures, the decline in revenue outpaced the decline in expenditures, resulting in the district running operating deficits for most of the past ten years (see Exhibit 3).

EXHIBIT 3

Declines in Enrollment Lead to Loss of State Aid

Detroit Public Schools, 2009-2012



Source: Detroit Public Schools Annual Financial Reports

Philadelphia School District (Ba2 negative) has also experienced credit deterioration in recent years due partly to charters. Philadelphia's population remained stable between 2000 and 2010, following five decades of declines. Unemployment (10.8% for July 2013) remains high, however, and income measures are below average (2010 MFI was 72% of the US). A loss of manufacturing has reduced the number of blue collar jobs in the city, and the poverty level is 24%. These demographic challenges were well-established in Philadelphia by the mid-1990s, and the district's credit rating was below investment-grade.

In 1997, four charter schools opened in Philadelphia. In 2000, the district began to authorize charters at a greater pace given pressure to provide educational alternatives and improve test scores. By 2012, there were 80 charter schools operating in the district, along with several online academies commonly known as "cyber charter" schools. Enrollment in charters began to increase rapidly after 2006. Pennsylvania requires school districts to use a portion of their revenues, including their basic aid

allocation, to fund charter school tuition on a per-pupil basis. As the result of this formula, the district's revenue outflow to charter schools grew from \$126 million, or 7.9% of General Fund expenditures, in 2003 to \$533 million, or 23.7% of General Fund expenditures, in fiscal 2012. With charter-related costs rising and state and federal revenues down, financial reserves turned negative.

Risk Factor #2: Weak Capacity to Adjust Operations in Response to Charter Growth

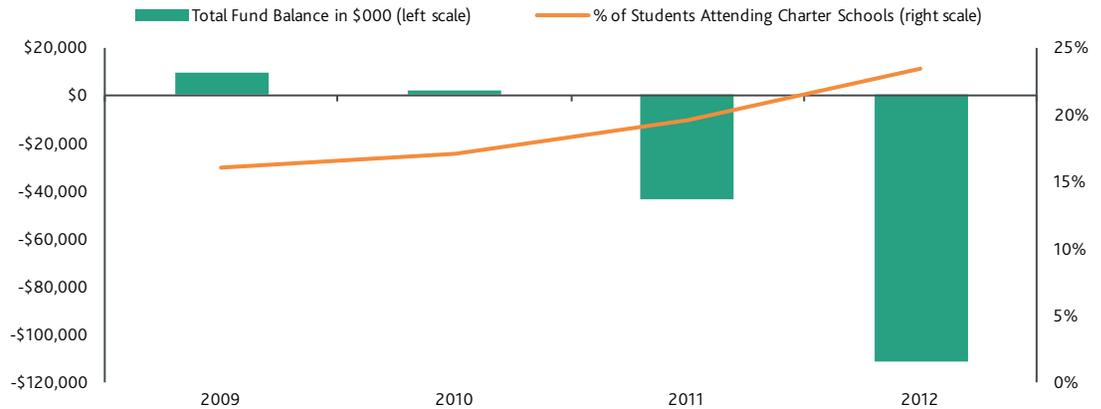
Shifts in student enrollment from district schools to charters, while resulting in a transfer of a portion of district revenues to charter schools, do not typically result in a full shift of operating costs away from district public schools. While districts can gain cost efficiencies by consolidating students and closing schools, many face significant logistical challenges coupled with public pressure to keep schools open. Districts may face institutional barriers to cutting staff levels, capital footprints and benefit costs over the short term given the intricacies of collective bargaining contracts - leaving them with underutilized buildings and ongoing growth in personnel costs.

The difficulty school districts face in realigning their operations in response to charter school growth stems from the piecemeal nature of charter-driven enrollment declines. The declines will typically be felt across many schools in the resident district that share grade levels with charter schools. For example, if a traditional school district with 2,000 students attending class in six buildings loses 5% of its enrollments to a charter school, those students will likely come from a variety of grades in several or all of six school buildings. The district will look to realign costs by consolidating buildings or eliminating classes, but will have a problem because there is no critical mass of empty classrooms or schools. The district will most likely employ the same number of teachers to instruct a shrinking student body, with costs maintained or growing in line with contractual bargaining agreements.

It can also be difficult to shrink staff sizes given highly unionized workforces in many states whose multi-year contracts may stipulate no layoffs prior to the negotiation of a new contract. There is also often strong community resistance to school closures, heightening the political challenge to school officials seeking to realign expenditures with revenues.

The rapid growth in the Philadelphia School District's revenue transfers to charter schools arose largely from a spike in charter enrollments that a gradual adjustment in per-pupil costs was unable to counterbalance, as the district could only reduce costs gradually in response to student outflows from dozens of schools. In fiscal 2008, 30,000 of the 200,000 member student body attended charters that were funded by \$269.7 million of revenue transfers. By fiscal 2012, charter enrollments had risen to over 50,000 and the transfers doubled to \$533 million, strongly impacting finances (see Exhibit 4). Although the district began implementing significant cost reductions in fiscal 2011, large numbers of school buildings were not closed until 2013, leaving it with high operating and per-pupil costs. As its per-pupil costs decline, management expects growth in charter school transfers to moderate.

EXHIBIT 4

Philadelphia School District Total Fund Balance and Charter School Market Share 2009-2012

Source: Philadelphia School District, Annual Financial Reports

A few districts that have been greatly affected by steep enrollment declines have turned to privatization of portions, or all, of their operations to manage the fiscal challenges. The emergency managers of Highland Park School District (not rated) and Muskegon Heights School District (enhanced rating of Aa2), both in Michigan and both facing extreme fiscal stress, recently decided to outsource all school operations to private charter school operators to prevent further financial deterioration and possible near-term defaults on debt obligations.

Highland Park turned its school operations over to a for-profit charter school organization, Leona Group LLC. Among other changes, the privatization included the laying off of the entire unionized staff and the hiring of new teachers who will earn annual salaries averaging \$36,000, well below the \$65,000 average teacher salary in 2011. Muskegon Heights' emergency manager decided to convert all of the district schools into charter schools after multiple years of deficits. Both districts will remain legal entities for the purpose of paying off their debt obligations¹; their property tax levies will remain in place until all debts mature.² If these strategies prove successful in the long term, they could become models for school districts unable to cut costs in step with enrollment losses.³ For example, the state-appointed receiver for Duquesne City School District, PA (Aa3/stable enhanced rating) opted for a similar course of action in 2012.

Risk Factor #3: State Policy Frameworks that Support Charter School Growth

State legal and institutional frameworks contribute greatly to the degree of charter school growth and the potential for that growth to negatively impact traditional public schools. Statewide legislation prescribes the rules governing authorization of new charters and their maximum enrollment and sets guidelines on curriculum, funding, and the number and types of charter schools the state will allow. These frameworks play a gatekeeper role by dictating the pace at which charter schools enter a state's public education market and compete with traditional public schools. Less restrictive frameworks tend to promote competition by lowering barriers to entry and allowing greater numbers of charter schools to enter the market. This can negatively impact school district credit quality when the factors mentioned earlier (i.e., population declines, shifts in enrollment) are present.

¹ Wall Street Journal: Michigan City Outsources All of its Schools

² <http://michiganradio.org/post/muskegon-heights-schools-emergency-manager-1-year-local-control-28-pay-debt>

³ Michigan Live: Emergency in the Heights: Charter school district seen as a risky, and only, option

When charter schools first emerged in the early 1990s, most states made local school districts the primary charter school authorizers. Over time, the type and number of such authorizers have proliferated as more institutions (e.g., regional and state bodies, public universities) have been given this power. States with multiple authorizers tend to see a larger charter school market share and more districts with charter enrollment penetrations above 10%. For example, state statutes in Colorado, the District of Columbia and Florida allow for multiple authorizers and place no caps on charter enrollments. Not surprisingly, ten Colorado school districts had greater than 10% charter enrollments for the 2011-12 school year⁴, Florida had five⁵, while a notable 41% of District of Columbia public school students attended charters in the same year. Other states with multiple authorizers include Michigan, Minnesota and New Mexico.

Approximately 20 states have laws limiting the number and/or type of charter schools, including Hawaii, Mississippi and Ohio.⁶ Despite its restrictions, Ohio was home to five districts with a greater than 20% share of charter enrollments in 2012. All were urban school districts serving major Ohio cities, more evidence that rapid growth in charter schools is a heavily urban phenomenon. The credit impacts, however, have varied by district. Columbus City Schools (Aa2) has maintained healthy finances, helped by the city's stable population and demographics. Cleveland Municipal School District (A2 negative) and Toledo City Schools (A1 negative) have struggled to contain the revenue impact of falling enrollments, with populations and demographics declining.

The National Alliance for Public Charter Schools annually ranks each state for how supportive their legal frameworks are to charter schools. In 2012, Minnesota, Florida, New Mexico, California, Colorado and Michigan were among the top 10 of 42 states ranked due to their relative lack of caps on charter school creation and enrollment, and the allowance of multiple authorizers.⁷ Among these states, only Michigan is home to a notable number of school districts under severe credit stress.

Why only Michigan? In our view, Michigan's statutory framework, particularly its emphasis on educational choice, has encouraged a high degree of student mobility, both between traditional public schools and charters, and among the traditional school districts. Multiple authorizers have facilitated steady growth in the number of charter schools, impacting financially weaker districts. In addition to Detroit Public Schools, Clintondale Community Schools (Ba3 negative), Mount Clemens Community School District (Ba3 negative) and Ypsilanti School District (Ba3) have experienced significant fiscal strain related to both growing charter enrollments and the free movement of students to districts of their choice. Suburban school districts appear to be benefiting from, or at least weathering this trend, while urban public schools are seeing the greatest challenges as revenues follow students away from the urban cores.

Funding frameworks are important, but details determine the impact

State policy frameworks also determine how charter schools are funded. The interplay between the policies governing charter school creation and funding, along with the sending district's ability to adjust operations, directly impacts the credit quality of traditional public schools. But generally speaking, the type of funding formula used is less important than the "fine print" of school funding legislation. When enrollment losses are recognized and how the associated revenue impact is

⁴ Out of 110 school districts with 10% or greater charter market share, 13 are located in Colorado. Source: National Alliance for Public Charter Schools, "A Growing Movement: American's Largest Charter School Communities," Seventh Annual Edition, 2012

⁵ Of note, Florida school districts are organized on the county level, making the greater than 10% figure more striking. While 14% of Lee County's students attended charter schools, this figure was equivalent to 11,712 students in the county.

⁶ "Measuring Up to the Model: A Ranking of State Charter School laws", Third Edition, January 2012, the National Alliance for Public Charter Schools

⁷ "Measuring Up to the Model: A Ranking of State Charter School laws", Third Edition, January 2012, the National Alliance for Public Charter Schools

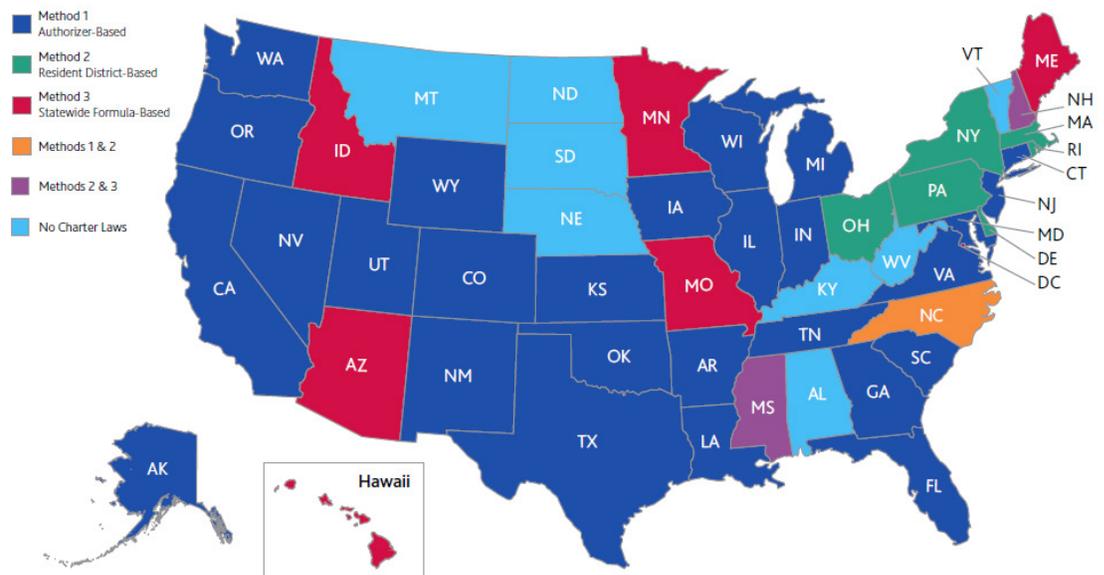
calculated has a greater impact than the overall framework. The baseline level of state funding for public schools is also a factor.

While differences among funding methods are important, our view is that these varying approaches ultimately lead to a similar outcome – reduced funding for traditional public schools through recognition of enrollment losses. In general, states are also given enormous latitude in allowing exceptions to these formulas, particularly in terms of what expenses can be deducted from the revenues passed on to charters.

Funding for charter schools is generally determined on a per-pupil basis based on a calculation that uses one (occasionally two) of three formula types: per-pupil funding based on the authorizer, per-pupil funding based on the student's resident district, or a statewide per-pupil formula (see Exhibit 5).

EXHIBIT 5

Charter School Funding Approaches by State



Source: National Conference of State Legislatures, National Alliance for Public Charter Schools, and state websites

The first and most common funding method, used in 29 states, is based on the per-pupil revenue of the authorizing entity, which in most cases is the local school district, but may also be a state body or not-for-profit organization. In cases where the authorizer is not the local district, charter schools typically receive the same amount of state and local per-pupil funding as the district in which the charter is located. The local funding component does not always follow the student to the charter school, however. For example, charter schools in Michigan, New Mexico and New York do not receive a share of local revenues, even while following this overall framework.

The second approach, used in eight states, bases charter school funding on the per-pupil revenue of the school district in which the student resides, irrespective of the authorizer, and is not based on the state formula.⁸ This method requires districts to pass along a portion of both state and local funds to the charter and the amount of per-pupil funding that follows the student can vary based on the features of the sending district.⁹ States use different methods to calculate per-pupil funding that will determine

⁸ Delaware, Massachusetts, New Hampshire, New York, North Carolina, Ohio, Pennsylvania (NCSL analysis based on Batdorff, Maloney and May, 2010, and state charter school laws.)

⁹ <http://www.ncsl.org/documents/educ/charterschoolfinance.pdf>

how much goes to a charter school, often based on per-pupil funding for the prior or current year. New York, Ohio and Pennsylvania use this approach to finance charter schools.

The third approach, used in five states and the District of Columbia, provides charter school students with level per-pupil funding regardless of where the charter school is located in the state or where a student resides.¹⁰ Differences exist even within this approach. Local revenues are not available to fund Arizona and Idaho charter schools under their variants of the formula, while Minnesota charter schools receive a share of local revenues under their state's interpretation of this framework.

Some Michigan and Pennsylvania districts pressured despite different approaches; Colorado districts resilient in spite of rapid charter growth

Negative credit pressure can arise under a variety of funding approaches. For example, Michigan and Pennsylvania are both states with a growing number school districts that are under credit pressure from charter schools despite their different funding methods.

Pennsylvania's application of the second approach requires local school districts to fund students attending charter schools at their per-pupil cost of the prior fiscal year, minus various deductions related mostly to federal funds received by the district. As a result, most of the revenues associated with a student, including state aid, move with the student to the charter school. The Pennsylvania approach recognizes enrollment drops in the subsequent fiscal year; a 10% shift in enrollments to charter schools would equate with a roughly 10% transfer of state and local revenues the next fiscal year – a rapid translation of enrollment losses into lost revenues.

Michigan's per-pupil funding method recognizes enrollment drops even faster, as state aid is adjusted shortly after the beginning of the school year when new enrollment figures are calculated and submitted to the state. Districts with falling enrollments lose a portion of their state aid within *the same* fiscal year, increasing the potential for negative budget variances if declines exceed expectations. Perhaps more critical to understanding how funding policy is contributing to credit pressure among southeast Michigan school districts is the fact that the state provided approximately 54% of revenues in 2012 – a much higher proportion than Pennsylvania's 36% in the same year. So, even while Michigan charter schools are unable to access local revenues, the fact that they receive a generous allotment of state funding makes up for this, placing strains on Michigan public schools comparable to, and arguably greater than, those in Pennsylvania.

Growth in charter school enrollment does not always correlate with significant lost revenues for school districts, however. Colorado charter funding is based on the authorizing entity, and charter schools typically receive 15% less revenue per pupil than traditional public schools. This is because state law does not require the entire local revenue portion of per-pupil funding to follow students that switch to charter schools, and also allows Colorado public schools to raise additional tax millage to help cover charter school expenses. In addition, the Colorado funding formula uses a three-year average of enrollments, as opposed to prior or current year figures, to allocate state aid, blunting the impact of sharp enrollment changes. Finally, it is important to note that population and enrollment patterns in Colorado districts, as in the American West generally, have tended to be stable or growing. The underlying stress factors so common in the "Rust Belt" are largely absent here.

¹⁰ Arizona, Hawaii, Idaho, Minnesota, New Hampshire, Washington, D.C. (NCSL analysis based on Batdorff, Maloney and May, 2010, and state charter school laws.)

Risk Factor #4: Lack of Integration with a Healthier Local Government

A high level of integration with a larger, healthier municipality can provide a school system with a degree of insulation from fiscal pressures related to charter school growth. Such integration allows for greater revenue diversity and balance sheet flexibility, often making a system better poised to deal with financial and operating fluctuation.

In the District of Columbia, charter schools account for 43% of total student enrollments. But the District of Columbia Public Schools are fully integrated into the DC municipal government (Aa2 stable). Public education accounted for 26% of expenditures in fiscal 2012 - \$1.6 billion out of \$6.1 billion—supported by the District's tax base and the same federal education grants received by states. Because the District of Columbia is not part of any state, its school system is not dependent on state aid, a common feature of urban school districts with high poverty, and thus avoids the diversion of state aid to charter schools. Instead, because education is funded through the District's general fund budget, charter funding represents a reallocation of overall public funding as opposed to a diversion away from traditional public schools.

The Boston Public School system has experienced some enrollment declines in grades 6-8 as a result of increased charter school growth. In 2014 the school system lost some state and federal aid (\$12.7 million) with a portion of the funding diverted to charter schools. The system's full integration into the City's of Boston's (Aaa stable) operations, however, has facilitated investment by the city into the system, evidenced by a plan to provide \$30 million for underperforming schools via the Quality Improvement Funds.

Case Studies of Selected School Districts With Significant Charter School Growth

The following brief case studies illustrate the diverse financial and credit impacts that charter schools are having on notable US public school districts.

Cleveland Municipal School District, OH (A2 negative): The district will continue to be pressured by declining enrollments, cuts in state funding, and elevated property tax delinquencies, but a new operating levy will provide some mitigation of these pressures over the near term. The district's largest revenue source is state aid, which comprised over 70% of fiscal 2012 operating revenues. The district has experienced declines in aid recently due in part to enrollment losses to charter schools. A projected 18,410 district students out of 44,000 attended charter schools in fiscal 2013. These enrollment losses resulted in a direct transfer of \$130 million in state aid to those charter schools in fiscal 2013, as per Ohio's charter funding formula.

After reserve declines through 2010, management responded by closing 23 schools, laying off 594 teaching staff and 565 non-teaching staff, wage concessions, and administrative reorganization. The cumulative effect of these cuts enabled the district to end fiscal 2012 with \$46 million in reserves, or 7.1% of cash receipts.

In November 2012, district voters approved a four-year, 15-mill operating levy that is projected to generate \$56 million to \$63 million at the current (76%) current collection rate. One mill of the new levy is designated specifically for new charter schools approved within the district. The remaining proceeds will be used to rehire some staff and stabilize the district's reserve reserves. Additionally, management is pursuing further expenditure reductions, including union concessions and program reductions, as well as the sale of five administrative buildings. The district expects to return to the voters for renewal or replacement of this levy in 2016.

Orleans Parish Public Schools, LA (Aa3 stable): The New Orleans public school system has the highest proportion of charter school students in the US – 70% as of the 2011-12 school year. Hurricanes Katrina and Rita devastated the majority of the system's facilities in 2005. In 2006, the State of Louisiana (Aa2 stable) passed Act 35, transferring control of the majority of the district's schools to the Louisiana State Department of Education, which created a Recovery School District (RSD) for academically failing schools (83% of the total). Academically troubled schools had contributed heavily to the district's financial stress pre-2006. The RSD operates 33 public schools and 37 charter schools, educating 25,000 students. The non-RSD public school district operates four schools, two program facilities, and oversees 12 charter schools, educating some 10,000 students. Unencumbered by large numbers of failing schools post-2006, the Orleans Parish district has re-established healthy fund balance (112% of revenues in fiscal 2012 versus -0.5% in fiscal 2005), reduced dependence on state aid (30.9% of revenues in fiscal 2012 versus 49.9% in fiscal 2005) and restructured its debt burden for cost savings.

York City School District, PA (Baa2 negative): Since 2003, total enrollments have fallen 19.7%, driven by charter school growth, as an estimated 2,500 students out of 7,900, or 31.6%, attended charter schools in fiscal 2012. From fiscal 2009 to fiscal 2013, charter school tuition expenses rose by \$18 million, while state aid rose less than \$6 million, creating a large structural imbalance. Management has cut 200 positions (20% of the workforce), closed 2 of its 10 schools and raised property taxes in response, and the budget has contracted by \$20 million since 2010, exclusive of charter school tuition costs. In December 2012, the state declared the district to be "in moderate financial recovery" under Act 141, allowing the Department of Education to appoint a chief recovery officer to devise a plan to stabilize the district's finances. Under Act 141, districts that agree to implement a recovery plan become eligible for interest-free state loans to help execute the plan. Act 141 also gives the state the power to place any district that rejects such a plan into receivership.

San Antonio Independent School District, TX (Aa2): In this sizable district serving an economically disadvantaged population (26.8% poverty level), charter schools have been a source of educational choice for students with income levels that are well below the US and Texas averages (PCI and MFI equal 58% of the nation). Enrollments have shown modest long-term declines, dropped by about 1% annually since 1998, and 9.6% from 2002 to 2012. Finances for the district are strong (17.7% of General Fund revenues in fiscal 2012) and state aid continues to be a major funding source for operations at 59.9% of the total for 2011-12. The pace of change for the district has been manageable, allowing management to adjust year-over-year to rising charter enrollments by instituting a variety of deep expenditure reductions. General Fund expenditures totaled \$360 million in fiscal 2012, down 10.1% from \$400.3 million in fiscal 2007. Deep cost reductions allowed the district to remain within structural balance for five consecutive years even as revenues declined in step with costs.

Moody's Related Research

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- » [Philadelphia's \\$50 million Commitment is Credit Positive for Stressed School District, August 2013 \(157583\)](#)
- » [Michigan School Districts Under Pressure: Outlook Remains Negative, November 2012 \(147479\)](#)
- » [All California School Districts to Benefit from New Funding Formula, But Some More Than Others, July 2013 \(156791\)](#)
- » [Vote to Close 23 Schools is Credit Positive for Philadelphia School District, March 2013 \(151543\)](#)
- » [Tight Liquidity and Competition Fuel Michigan School District Defaults, June 2013 \(154914\)](#)

Sector Outlook:

- » [Outlook Update: Why US Local Governments Still Have A Negative Outlook Despite Our Revised Outlook For States, August 2013 \(157557\)](#)

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- » [Charter Schools, November 2006 \(98173\)](#)

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 Report Number: 158801

Authors
 Michael D'Arcy
 Tiphany Lee-Allen

Associate Analyst
 Rebecca Rasis

Editor
 Robert Cox

Production Associates
 Miki Takase
 Joaquin Jimenez

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