SOUTHERN LEHIGH SCHOOL DISTRICT

Budget Seminar

March 12, 2011

SOUTHERN LEHIGH SCHOOL DISTRICT

STATE OF THE DISTRICT'S FINANCES

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I. DESCRIPTION OF THE DISTRICT

Southern Lehigh School District is a school district of the third class, organized and existing under the laws of the Commonwealth of Pennsylvania. In 1950, the former school districts of the Borough of Coopersburg and the Townships of Lower Milford and Upper Saucon formed the Southern Lehigh School District. The reorganized School District has assumed all rights and obligations of the predecessor school districts.

Southern Lehigh School District is located in eastern Pennsylvania in the southern-most portion of Lehigh County, several miles south of Allentown, the county seat of Lehigh County. The School District encompasses approximately 45 square miles and is comprised of the Borough of Coopersburg and Lower Milford and Upper Saucon Townships. The District borders the following school districts:

East Penn SD (Lehigh County)
Salisbury Township SD (Lehigh County)
Saucon Valley SD (Northampton County)
Palisades Area SD (Bucks County)
Quakertown Community SD (Bucks County)
Upper Perkiomen SD (Montgomery County)

The governing body of the School District is a board of nine school directors who are each elected at-large for a four-year term. The daily operation and management of the School District is carried out by the administrative staff of the School District, headed by the Superintendent of Schools who is appointed by the Board of School Directors.

The District operates three elementary schools (K-3), one intermediate school (4-6), one middle school (7-8), and one high school (9-12). The original construction date and rated capacity for each building, for PA Department of Education reimbursement purposes, are as follows:

Hopewell Elementary	1969	450 students
Liberty Bell Elementary	1962	415 students
Lower Milford Elementary	1950	350 students
Intermediate School	2009	950 students
Middle School	1966	752 students
High School	1953	1236 students

II. BUDGET HIGHLIGHTS

A. Key Terms and Concepts

Act 1 – In 2006, PA Governor Ed Rendell called a special legislative session for the purpose of discussing, debating, and passing tax reform. The legislation that grew out of that process was Act 1 of Special Session 2006 (Act 1). Act 1 utilizes gaming dollars to provide tax relief in the form of a homestead/farmstead exclusion (see below) and an expansion of the Senior Citizens Property Tax and Rent Rebate program. Act 1 also required all school districts (except Philadelphia) to place on the ballot of the 2007 primary election a question concerning whether voters wanted to levy or increase an earned income tax or local personal income tax for the purpose of generating additional revenue to increase the homestead/farmstead exclusion in their district. Additionally, Act 1 establishes limits on annual school real estate tax increases and requires school districts to offer an installment plan for the payment of real estate taxes. Lastly, Act 1 imposes an accelerated budget approval process on districts that wish to take advantage of one or more exceptions (see below.) Instead of the traditional budget adoption of May (preliminary) and June (final), districts subject to Act 1 must pass their initial (preliminary) budget 90 days prior to the date of the primary election. This results in a series of budget approvals beginning in the month of February.

Act 1 Exceptions – Act 1 (see above) provides for ten exceptions to the basic rules that annually limit school real estate tax increases to an index (see below.) The exceptions are intended to reflect certain unusual circumstances or extraordinary factors, which may prevent schools from adhering to the regular tax limitations imposed by the index. Some of the exceptions must be approved by the PA Department of Education and others must be court-approved. Any district wishing to take advantage of one or more exceptions to levy a higher tax increase than otherwise permitted must apply for such exceptions by a date in early March that varies annually based upon the exact date of the primary election that year.

Act 1 Index – Act 1 (see above) establishes an annual limit on the real estate tax increase that schools may levy. The index is the average of the statewide average weekly wage for the preceding calendar year, as determined by the PA Department of Labor and Industry, and the employment cost index for the prior 12-month period, as determined by the Bureau of Labor Statistics of the Federal Department of Labor. The index for school districts with a market value/personal income aid ratio (see below) greater than .40 is adjusted to permit a higher tax increase.

Assessed Value – Depending upon which county a school district is located in, the tax base for calculating annual real estate tax levies may be equal to 100% of the district's real estate market value or some lower percentage of the market value. Market value adjusted by the applicable percentage used in a particular county produces the assessed value of real estate. Assessed value for any property is multiplied by the respective district's millage rate (see below) to produce the annual real estate tax bill for that parcel.

In Lehigh and Northampton counties, for example, assessed value is designed to be 50% of market value. In Bucks County, the ratio is 100%. Because there has been no county-wide reassessment in Lehigh County since 1990 or 1991, the actual relationship between assessed value – determined at the time of reassessment – and market value no longer approximates 50%. In reality, that relationship is closer to 32%. The County of Lehigh has begun work on a reassessment, which is due for completion in one to two years.

Basic Education Funding (BEF) – This term generally refers to the primary source of state funding for schools in Pennsylvania. It is also known as basic subsidy. Basic Education Funding reflects a complex set of variables, including each district's particular wealth – as measured by the market value/personal income aid ratio (see below), student population, and population density, among others. The Commonwealth of Pennsylvania chose to use federal economic stimulus money in 2009-10 and 2010-11 to supplant state dollars for BEF. The Commonwealth is not expected to have similar federal resources for 2011-12. Traditionally, Southern Lehigh SD has received close to half of its state support in the form of basic education funding.

Capital Projects – Major construction, remodeling, or renovation projects that, because of their scope and expense, are typically funded outside of the General Fund Budget (see below.)

Capital Reserve Sinking Fund – Section 2932 of the PA Municipal Code authorizes establishment of a capital reserve sinking fund for the purpose of capital improvements, for the replacement of and or additions to public works and improvements, and for deferred maintenance. Specific projects must be identified, together with the year of proposed completion. Southern Lehigh SD has maintained such a fund for more than 30 years. The General Fund Budget typically contains a line item fund transfer to the Capital Reserve Sinking Fund of $300,000 to $350,000 annually. Large projects are undertaken by the District and paid for out of the Capital Reserve Sinking Fund. Some years the work performed requires payments exceeding the amount of the District's annual fund transfer; in other years it is less. However, it has been the District's plan and practice to ensure a recurring balance in the fund of +/- $1M to be available for future projects.

Debt Service – Debt Service is the annual payment of principal and interest on general obligation bonds which the SD has issued to fund the very largest capital projects – typically the construction, addition to, or major renovation of a school building. It is comparable to one's mortgage on his/her home.

Deficit (or Operating Deficit) – If the expenditures of the General Fund exceed the revenues in a particular period, the difference is referred to as the deficit. Deficits reduce an entities' fund balance (see below.)

District's Fiscal Year – The District operates on a fiscal year of July 1 – June 30.

Fund Balance – Fund Balance is the cumulative total of annual deficits and surpluses (see below) over the life of the District. Stated differently, it is essentially the difference between Assets and Liabilities – the Net Worth – of the District at a moment in time.

GASB – Schools, municipalities, counties, states, and other governmental bodies adhere to accounting principles that are established by a national Governmental Accounting Standards Board (GASB). Financial statements and footnotes must comply with GASB statements.

General Fund – The General Fund budget is the primary budget for school districts. It includes all operating revenues and expenses of the district, including debt service (see above), transfers between funds of the district, and some capital expenditures (acquisition of or improvements to assets), as well.

Homestead/Farmstead Exclusion – This is the amount of school real estate tax relief that property owners are eligible to receive each year as a result of Act 1. This credit against school taxes is funded by gaming revenue and, as such, varies annually. The property must be a residence and/or farm to qualify for the exclusion and the owner must occupy the property. Since adoption of Act 1, homestead/farmstead exclusions in the Southern Lehigh SD have averaged slightly above $100 annually.

Market Value/Personal Income Aid Ratio – This measure of district wealth is used in calculating individual school district's state support and also serves to establish each district's Act 1 index (see above) for annual limitations on real estate tax increases. The ratio compares the real estate market value and personal income tax base of each district to that of other districts across the state. Ratios range from a mandated minimum of .15 to a high of 1.00. The greater the district's wealth, the lower the aid ratio, and the less state support. And conversely, the lower the district's wealth, the higher the aid ratio, and the greater the state support. The use of the market value/personal income aid ratio is the key component is the Commonwealth's primary way of attempting to equalize financial resources for students across the state. As the community has undergone change and become significantly wealthier – relative to neighboring districts and those from across the state - the District's aid ratio has declined steadily for over 30 years, from above .5000 to the current .1706.

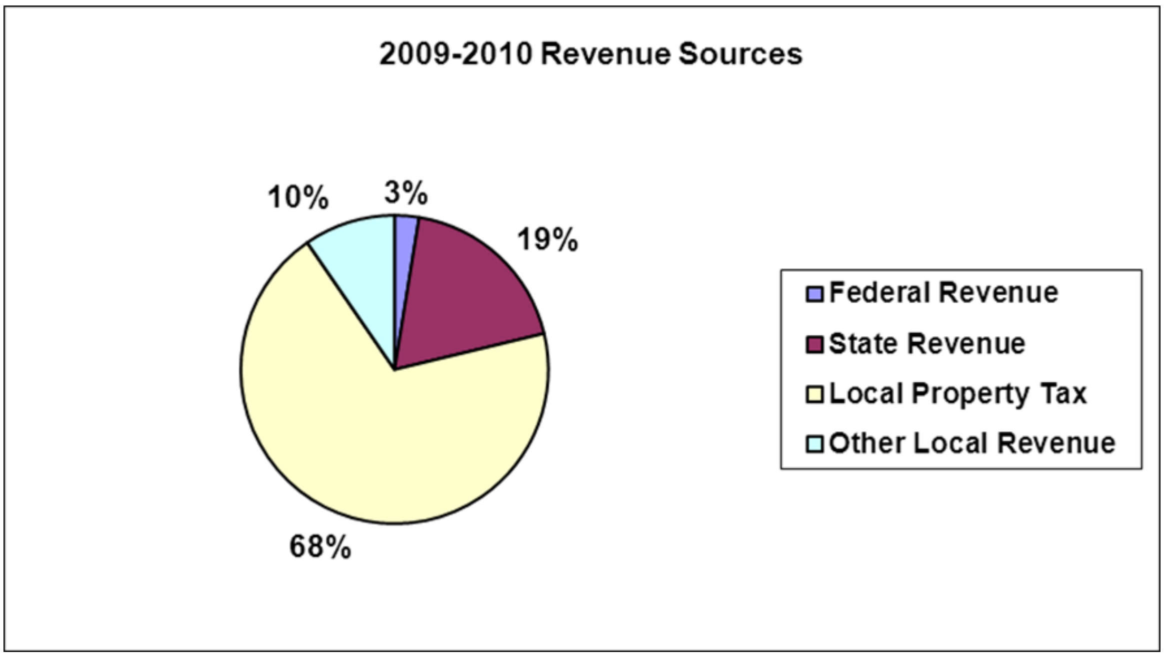
Millage Rate – Each property's assessed value (see above) is multiplied by the particular district's millage rate to generate the annual real estate tax bill. The same millage rate is applied evenly to all properties in a given school district. Millage is expressed as thousandths. Southern Lehigh's current millage rate is 45.3, or .0453.

Mill – A mill is a measure of taxation on real estate. Each mill is one-one thousandth, or .001. The average assessed value of all real estate parcels across the Southern Lehigh SD is approximately $93,000. Each mill of real estate tax costs the average property owner $93 ($93,000 x .001).

Surplus (or Operating Surplus) – If a district's General Fund revenue for a period of time exceeds expenditures, the excess revenue is considered a surplus. Surpluses increase an entities' fund balance (see above.)

B. Revenues

The District funds its General Fund operation with a combination of revenues from local, state, and federal sources. Like most districts in Pennsylvania, the majority of revenues come from local sources. However, due to the relative wealth of the community, there is even greater pressure placed on local taxes in this district than in most districts. And, like most districts, Southern Lehigh has recently benefited from an increase in federal funding attributable to economic stimulus packages that have been approved. It is most likely that federal funding for our District will return to a very low level in the 2011-12 year. Please refer to Section IV for additional information about federal funding.

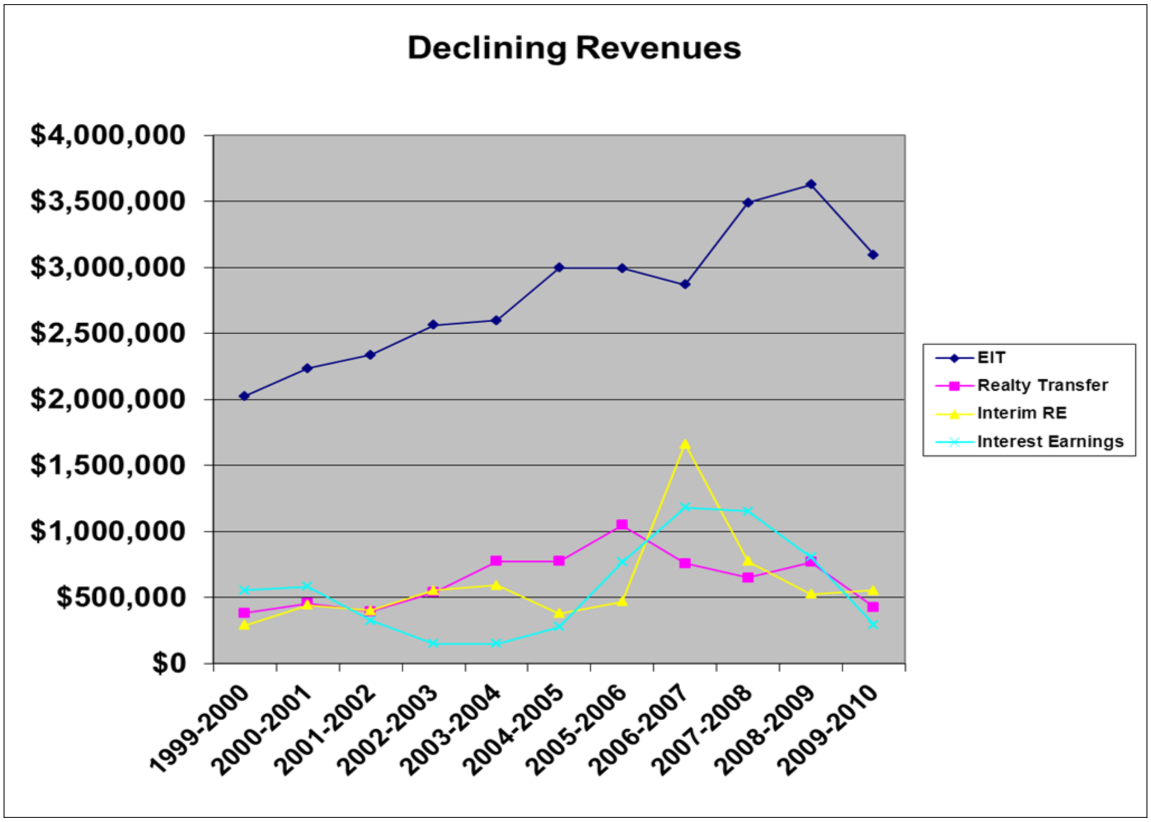


Real estate tax revenue is, by far, the major source of revenue for the District. It represents 68% of all revenue received in the 2009-10 year. Revenue from the real estate tax nearly tripled between 1999-2000 and 2009-2010, due to steady growth in the tax base (assessed value of the SD) and regular increases in the millage rate (see Appendix A).

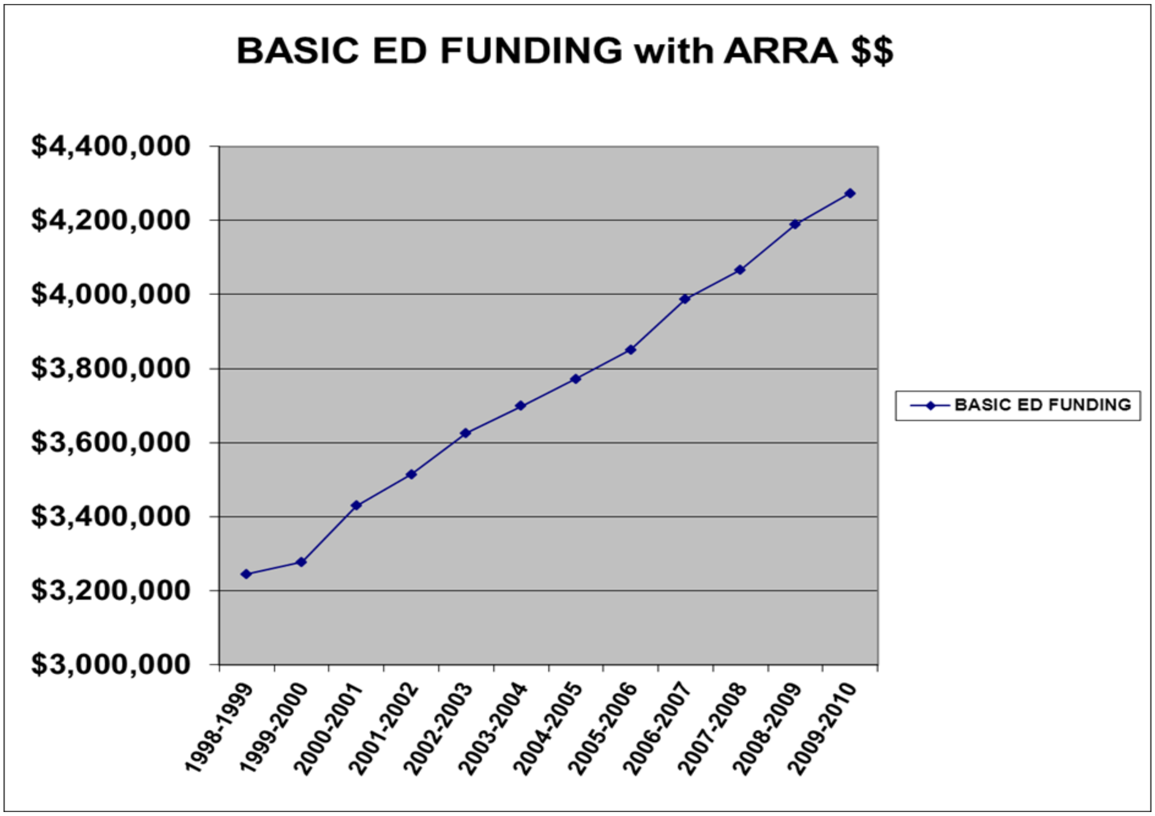
The total taxable assessed value of the District increased from $501M to $790M during that period (see Appendix A). Unfortunately, tax assessment appeals filed in the 2009-10 year and a lack of economic development for the past two years lead to little or no increase in taxable assessed value for the 2010-11 or 2011-12 years.

The next largest source of funding from local sources is earned income tax. The District levies an earned income tax of .5%, which generates over $3 million dollars in revenue annually. Due to increases in population, an influx of high income individuals, and salary and wage increases granted to residents in our community, revenue from the earned income tax grew by about 80% between 1999-2000 and 2008-09. Unfortunately, earned income tax revenue dropped sharply in 2009-10. Although it appears that the District will experience a small rebound from this 15% decline, it is likely that it will take multiple years before returning to the level of the 2008-09 year.

At the same time that earned income tax revenues plummeted during 2009-10, the District experienced a dramatic decrease in revenue from real estate transfer taxes. The continued decline in interest earnings from investments and interim real estate taxes that began in 2007-08 and 2006-07, respectively, has only compounded the problem.



Commonwealth funding for K-12 public education grew significantly during the last decade or so. Although the major emphasis of this infusion of money from the state was on poorer and urban districts, Southern Lehigh saw incremental increases in funding from the state each year during this period, until the 2009-10 year. Federal economic stimulus money from the American Recovery and Reinvestment Act (ARRA) was used in 2009-10 to replace a major portion of state funds for basic education. Although the District's revenue for Basic Education Funding (BEF) continued to grow, more than $500,000 of that revenue was from temporary federal funds. State funding for BEF actually declined by about $400,000, falling to the level the District received in 2004-05. The practice of the Commonwealth using federal funds to maintain funding levels for basic education continued in 2010-11. (See Section IV below.)

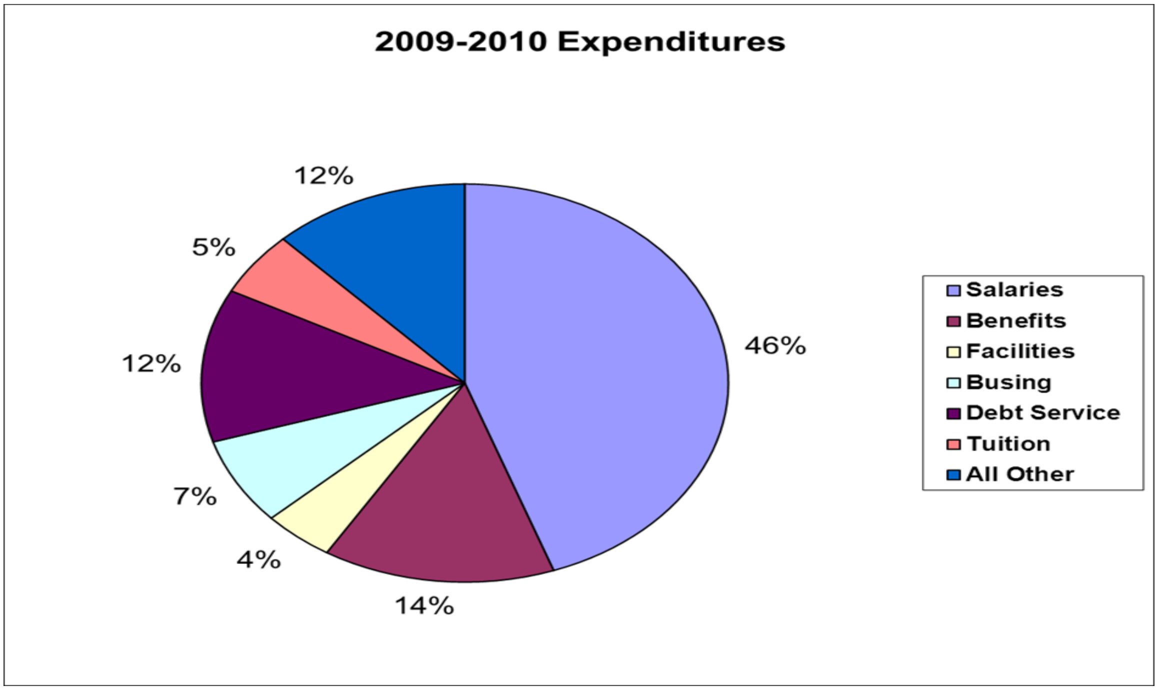


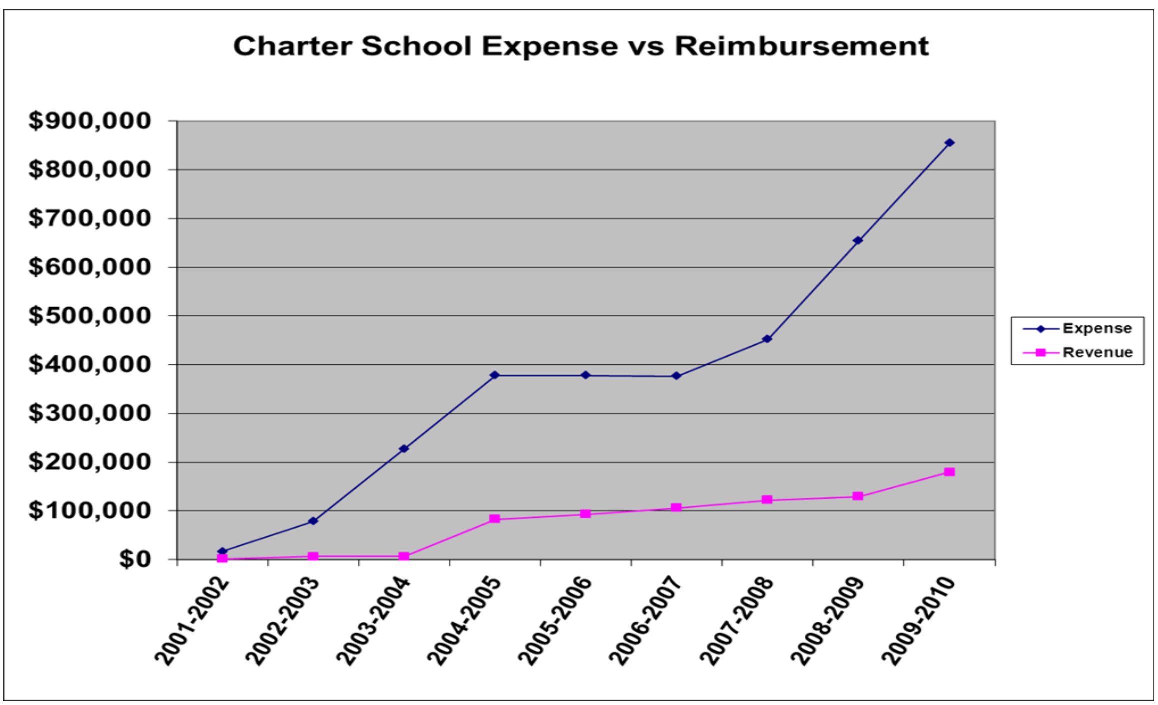
C. Expenditures

Education is labor-intensive, from the many teachers who educate students to the various employee groups that support that endeavor. Consequently, it is customary for the largest share of districts' budgets to be allocated to compensation – salaries and benefits. Southern Lehigh is no different. It was common in this District and elsewhere twenty or thirty years ago for salaries and benefits to represent approximately 70% of a district's General Fund budget. Today, salaries and benefits amount to nearly 60% of total District expenditures. With projected increases in health care costs and the certainty of significantly higher employer pension contribution rates (see Section V below), it is likely that compensation will return to being a higher percentage of overall budgets.

Following compensation, it is common across the state for districts to have significant amounts of their budgets dedicated to debt service, operation of facilities, bus transportation, and tuition for students to attend other schools (charter schools, cyber charter schools, community colleges, area vocational technical schools, special education programs, etc.) Again, Southern Lehigh is no exception to that rule. Renovations to several schools across the District, a major addition to the high school, a comprehensive energy management/conservation program, and the construction of an intermediate school which houses 4th, 5th, and 6th grade students have been funded by multiple bond issues and a municipal lease over the last 15 years. Annual debt service payments currently average just shy of $6.5M, or approximately 12% of the General Fund budget.

In addition to compensation and debt service – approximately 72% of budget – busing, operation of facilities, and tuition costs add another 15%, leaving approximately 13% of the budget for all other categories. Total expenditures in the General Fund have more than doubled in the last decade (see Appendix A).





III. DEVELOPMENTS SINCE PASSAGE OF 2010-11 BUDGET

- The Commonwealth budget was passed in early July. It contained:
    - Nominal increase in Basic Subsidy for SLSD
    - Substantial reduction in Employers PSERS Rate set by PSERS Board in December 2009.

- District completed a bond refunding in August which provided $700K savings over a period of several years, including a reduction in Debt Service for 2010-11 of more than $100K

- Completion of 2009-10 audit revealed an ending fund balance substantially in excess of the projected amount

- The Administration took measures to reduce expenditures, as follows:
    - 2010-11: Non-replacement of Cleaning Person and a Special Education Teacher/Facilitator and the replacement of a retiring Head Custodian with a regular Custodian
    - 2011-12: No increase in building budgets, a transition from in-house earned income tax collection to an private collector one-year earlier than required by law, and a switch in student information system software from PowerSchool to Sapphire

- The Administration negotiated and the Board approved a revision to the last year of the bus contract with First Student and a one-year extension that provided significant savings for both 2010-11 and 2011-12

- Two veteran teachers retired during the first-half of the school year, allowing the District to hire lower-salaried replacements and thereby reducing staffing costs

- The Administration continued to monitor natural gas prices and took advantage of a favorable market by locking in substantial percentages of the District's needs for 2010-11 thru 2012-13 at low rates, thereby saving money compared to budget estimates

- On September 13, 2010, the Board approved the recommendation of Mr. Dimmig to establish budget parameters for 2011-12 and future years. Those parameters are:
    - Limits on Total Expenditures of $54.9M (11-12) and $60.5M (14-15)
    - Limits on Tax Increases of .25 mills (11-12), .50 mills (12-13), .50 mills (13-14), and .50 mills (14-15)
    - Maximum deficit in 2014-15 of $1.8M
    - Ending fund balance in 2014-15 of 10-12%

- Extremely low interest rates across the market continued to plague fixed-income investors. No substantial increase in rates is forecast for the next six months. The Administration anticipates falling short of the Interest Earned budget by more than $200K, resulting in year-end revenue for this line item that is less than 20% of the comparable figure just two years ago.

- In November, Governor Rendell signed pension reform legislation. While not affecting District costs for 2010-11, the bill did establish estimates for PSERS rates for the next several years. These rates represent a more gradual climb in employer costs over the next four or five years than prior legislation required, but do not substantially alter the long-term trend toward tremendously higher pension costs for schools and the Commonwealth. Furthermore, barring extremely favorable investment returns for multiple years, the new legislation allows the PSERS system to drop to even lower levels of fully-funded status before that trend reverses in a decade or two.

- Also in November, the Administration recommended and the Board adopted a resolution limiting the District's tax increase for 2011-12 to .63 mills

- In December, Highmark Blue Shield provided the District with the projection of a premium increase for 2011-12 of 8-9%. The District had initially projected a 7.5% increase for 11-12 and then adjusted that estimate to 10% when the Administration learned that SLSD was the only member of the County Insurance Consortium to project anything less than 10%. The Consortium is in the midst of a Request for Proposal (RFP) for a new contract. It is possible that estimates for 11-12 (and beyond) will need to be revised further when the proposals are opened and reviewed and an award is made in March.

- In January, the Administration recommended and the Board approved participation in an Emergency Demand Response program through Comverge, Inc. This decision will generate in excess of $200K in a three-year period beginning this summer.

- In February, the Board approved the Administration's recommendation to settle the Center Valley Distribution Center (Aldi Foods) tax appeals case. As a result, the District will have successfully settled all but one of the nine key tax assessment appeal cases that the Board was informed about in the fall of 2009. Preliminary indications are that the District has been able to preserve approximately 60% of the potential lost revenue at stake in these cases. It is estimated that those results are substantially superior to what was likely to have occurred if the SD did not become an active participant in these cases and they are consistent with the Administration's estimates at the outset of the process.

- In mid-February, Phillipsburg-based chemical manufacturer, Avantor Performance Materials, Inc. announced that they will relocate 140 jobs to a currently vacant office building that is located in the Stabler Office Center. The company also indicated it had plans to hire 60 more individuals who would occupy the offices in Upper Saucon Township. The building was once considered by drug-maker Sanofi Pasteur for its headquarters. Since the property is currently assessed by the County of Lehigh as land only, it is expected that Avantor's occupancy will result in a reassessment of the property and potentially add $150,000 per year in real estate tax revenue to the District.

- The District anxiously awaits the March 8th release of the new governor's first Commonwealth Budget proposal. There is widespread anticipation that state funding for BEF will be reduced to the 2006-07 level, or lower.

- During six Budget & Finance Committee meetings, beginning with one as early as mid-August and one as recently as early February, the Budget and Finance Committee has continued to challenge and refine the assumptions used to generate long-term financial projections and explore opportunities for savings without substantially affecting students, staff, or programs in a negative manner.

IV. COMMONWEALTH BUDGET & FEDERAL STIMULUS FUNDS

Historically, funding for education has consumed a very substantial share of the annual budget for the Commonwealth of Pennsylvania, leading all other categories and representing more than a third of all PA General Fund expenditures. The next largest categories are Medical Assistance/Long-Term Living at about 22% and Other Department of Public Welfare Human Service Programs at 16%. Together, these three categories account for more than two-thirds of the Commonwealth's General Fund budget.

Rainy Day Fund – The Commonwealth has maintained a Budget Stabilization Reserve or Rainy Day Fund that grew to $750 M during the middle and latter part of the first decade of the century. It is widely understood that the Commonwealth was forced to use all or nearly all rainy day funds during the past year.

Federal Economic Stimulus – In 2009-10 and 2010-11 the Commonwealth used federal ARRA funds to offset shortages in state funds. The 2010-11 Commonwealth budget proposed by Gov. Rendell anticipated $2.8B in ARRA funds: two-thirds for Enhanced Federal Medical Assistance Percentage (FMAP) funding and one-third for State Fiscal Stabilization Fund purposes. Of the latter, approximately two-thirds of those funds ($655 million) were proposed to be sent to schools in the form of basic education funding. This past August, President Obama signed legislation that provides an additional total of $26B to states to shore up their Medical Assistance (Medicaid) programs and to save approximately 160,000 teaching positions across the country that would have been terminated otherwise. The latter portion – dubbed as "Edu-Jobs funding"- was $10B. It has been estimated that Pennsylvania will receive approximately $400M in Edu-Jobs money. Most recently, it was announced that Governor Corbett intends to use Pennsylvania's money to further plug holes in state funding for basic education for the current (2010-11) year. It is unclear what portion of the money allocated to Pennsylvania will be earmarked for Southern Lehigh SD, but it does appear that the money will not increase overall funding; it will simply take the place of Commonwealth dollars that were scheduled to be spent for the same purpose.

Increased Pension Costs – The Commonwealth is responsible for the employer share of pension contributions to the State Employees Retirement System (SERS) and over 50% of the employer share of pension contributions to the Public School Employees Retirement System (PSERS). Pension reform legislation that was passed in late 2010 ensures that employer pension costs are going to increase dramatically for the next five to ten years. The new law projects that PSERS employer rates will go from the current rate of 5.64% to something in excess of 25% before leveling off at that point. Similar increases in employer contributions will be necessary for SERS. These costs will consume very significant portions of the Commonwealth's budget annually.

Deficit – It is widely estimated that, after postponing pension reform for too long, draining the Rainy Day Fund, utilizing all available federal economic stimulus money, and exhausting all other one-time sources of funds, the Commonwealth faces a $4-$5B deficit for 2011-12. The current poor economic environment across the nation and the Commonwealth is expected to linger for another year or more. Although state revenues may have stopped declining, a complete recovery has clearly not occurred. It is quite conceivable that the problems facing the Commonwealth are not limited to simply the upcoming year.

Future State Funding for BEF – Although the Governor has not yet announced his proposed budget, popular belief is that the budget will call for a sharp reduction in funding for BEF, perhaps to the levels of 2006-07 or earlier.

SLSD BASIC EDUCATION FUNDING (BEF)

	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
PA $$$	3,987,000	4,067,000	4,189,000	3,766,000	<3,835,000	??????
ARRA $$$	0	0	0	506,000	494,018	0
EDU-JOBS $$$	0	0	0	0	???????	0
TOTALS	3,987,000	4,067,000	4,189,000	4,273,000	4,341,000	???????

V. PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM (PSERS)

A. Creation, Governance, & Funding

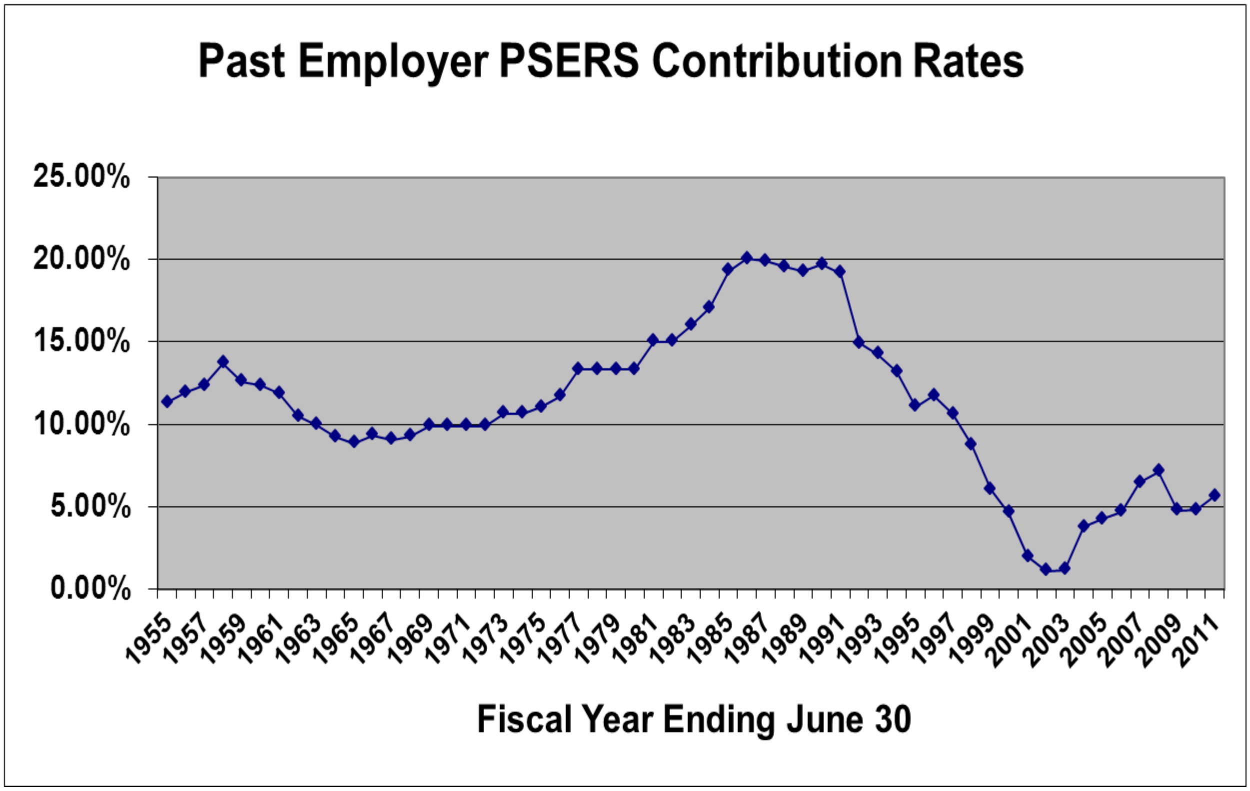
The Pennsylvania Public School Employees' Retirement Act of 1917 created the public education pension system we know as PSERS. The system is controlled and managed by a fifteen member board of trustees which is an independent administrative arm of the Commonwealth. The members have full fiduciary responsibility to the members of the pension system regarding the investment and disbursement of funds.

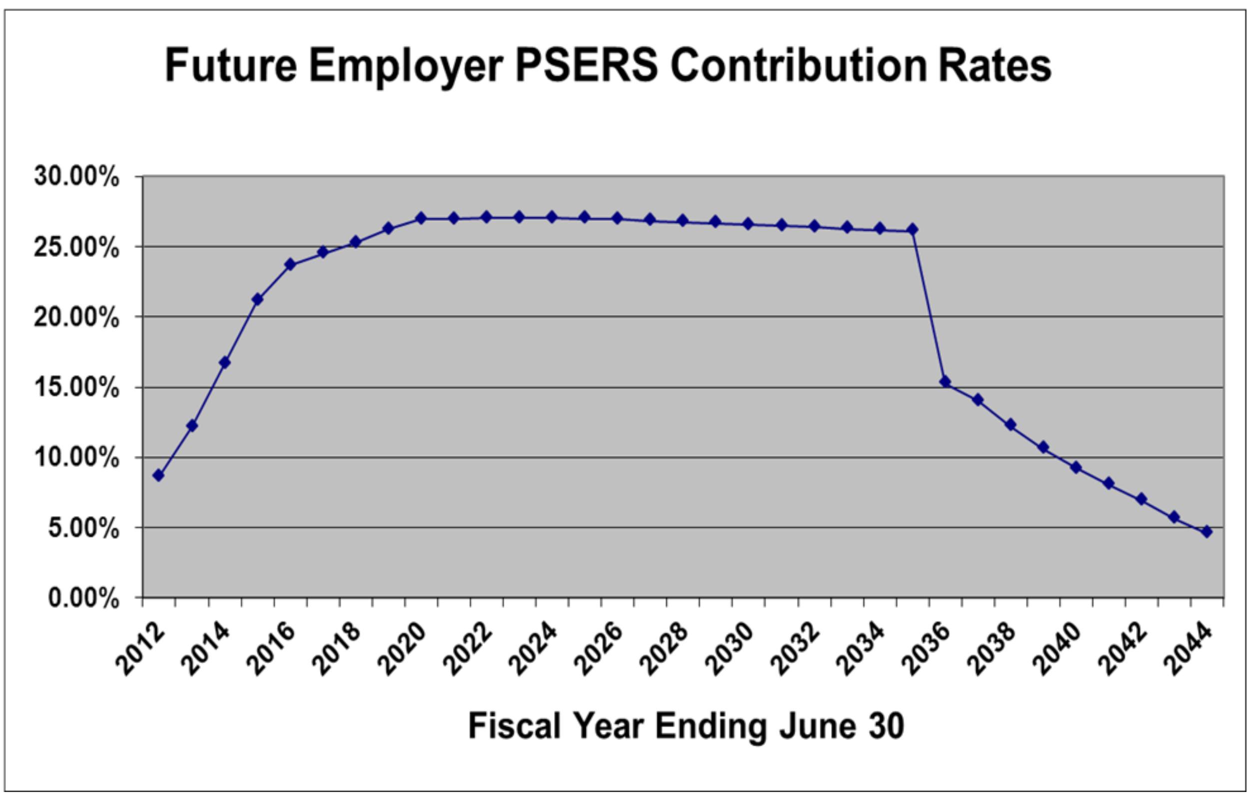
The Board also performs other functions as are required for the administration and execution of the Public School Employees' Retirement Code such as certifying contribution rates, authorizing the actuarial valuation and independent audit of the System, and publishing an annual financial statement of the condition of the Retirement Fund. In addition, the Board reviews the activities performed by the System's Executive Director and Chief Investment Officer.

PSERS currently covers in excess of a quarter million active members, another 95,000 individuals who are pending qualification, and nearly 200,000 annuitants, beneficiaries, survivor annuitants, and vested and inactive members. Altogether, the Board is responsible for the pension system of over half a million individuals.

The System is funded by employer contributions and employee contributions. The employer contributions are shared by the Commonwealth and the particular employer (school district, intermediate unit, vocational school, etc.) Generally, those employer contributions are shared equally by the school entity making the full employer contribution payment and filing with the Commonwealth for reimbursement of 50% of the payment. However, districts with an aid ratio above .5000 are reimbursed at their respective aid ratios, thereby shifting more of the burden to the state. This results in the overall split being approximately 54% Commonwealth and 46% local education agencies.

Employer contribution rates have varied wildly in cycles. We have begun the next cycle in which rates are projected to go from the current 5.64% to 27% by the early 2020's. Unfortunately, due to a decade of artificially low employer contribution rates, two prolonged and deep stock market declines, benefit enhancements, and accounting manipulations (specifically decisions with regard to the amortization of liabilities), the System has gone from one that was more than fully funded to one that currently has assets of approximately only 70% of the actuarial liabilities. And, the news gets worse. Even with very substantial increases in the employer contribution rate and an assumption of 8% annual investment returns, the System is projected to reach a low of 56.3% fully funded in 2017-18 before gradually returning to fully funded status nearly 30 years later.


Past Employer PSERS Contribution Rates
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
1955 1957 1959 1961 1963 1965 1967 1969 1971 1973 1975 1977 1979 1981 1983 1985 1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009 2011
Fiscal Year Ending June 30


Future Employer PSERS Contribution Rates
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
2012 2014 2016 2018 2020 2022 2024 2026 2028 2030 2032 2034 2036 2038 2040 2042 2044
Fiscal Year Ending June 30

The employee contribution rate was 5.25% or 5.50% of salary from the late 1960's until the mid-1980's when new members were required to contribute at 6.25%. The two-tiered employee rate of 5.25% (existing members) and 6.25% (new members) was increased to 6.50% and 7.50% almost a decade ago when legislation increased members' benefits. Beginning July 1, 2011, employee contribution rates for new employees will range between 7.5% and 9.5% for members who elect to have their pension benefits calculated based upon a service credit of 2% per year and will range between 10.3% and 12.3% for members who elect to have their pension benefits calculated based upon a service credit of 2.5% per year. Exact employee contribution rates for employees hired after July 1, 2011will be determined by PSERS' investment returns, but are guaranteed to be within the afore-mentioned ranges. Employee contribution rates for existing members will be unchanged.

Obviously tremendous sums of money flow into PSERS via the payment of employee and employer contributions. However, the most significant component of PSERS' funding is investment returns. For example, investment returns provided the following percentages of total funds to PSERS during the respective periods:

1985-2009 (twenty-five years)	65%
1999-2008 (ten years)	77%
2000-2009 (ten years)	59%

Although the precise portion of total funds represented by investment returns varied during these different periods, it is clear that investment returns have been the life-blood of the System. It is also readily apparent from this data that a particularly robust market or a serious market decline will affect PSERS significantly, causing the System to be much more or less fully funded. As stated above, PSERS actuaries currently assume an annual rate of return of 8%.

B. Pension Reform

On November 23, 2010, the Governor signed H.B. 2497 into law. The law is now known as Act 120 of 2010. Although the law truly represents major pension reform, it does not provide any immediate or short-term assurance that the System will be properly funded. In fact, PSERS actuarial assumptions suggest that it will take decades before the System returns to a solid financial condition. Since the legislation affects the contributions and future pension benefits of only new members, the reform will take many years before it makes a substantial impact. In the meantime, employers (the Commonwealth and local education agencies) will face increased pension costs of monumental proportion to prop up the System before the reform measures are projected to be sufficient to maintain the System at fully funded status. Southern Lehigh's pension costs are projected to increase from $1.3M this year to $6.3M in 2015-16. As the Commonwealth continues to experience budgetary pressures from all angles and react to demands within the K-12 community for more funding for basic subsidy and special education, some fear that it will no longer be able to maintain its share of employer contributions to PSERS. A change in the standard 50% (Commonwealth) -50% (district) split to something that more closely reflects the wealth of each school district, perhaps as measured by the market value/personal income aid ratio, would be disastrous to the District.

C. Pension Stabilization Fund

As a result of the above-mentioned concerns about rapidly rising pension costs over an extended period of years, some districts are beginning to consider methods to ensure adequate resources for this mandated expense. Such planning is being done in the face of complex finance issues and the certainty of having to make unpleasant decisions about future budgets.

One strategy that is being mentioned by some school business officials is the creation of a pension stabilization fund. Such a fund would receive regular or periodic transfers from the General Fund to establish a type of "rainy day" fund for future pension costs. Another approach that some districts are planning on doing is to commit or assign a portion of the entities' General Fund balance for this specific purpose. Depending upon a district's GASB 54 policy, a fund balance commitment might require Board action, whereas an assignment of a portion of fund balance could be done by the Business Manager or Finance Committee. This matter will require some further discussion prior to passage of the District's final budget in June.

VI. POST-RETIREE HEALTH INSURANCE BENEFITS

A. GASB 45

The Governmental Accounting Standards Board (GASB) released Statement 45 entitled, "Financial and Accounting Reporting by Employers for Postemployment Benefits Other Than Pensions" in mid-2004. GASB promulgated Statement 45 because of the growing concern over the potential magnitude of government employer obligations for post-employment benefits.

Statement 45 is intended to provide more complete, reliable, and useful financial reporting as it relates to post-employment benefits other than pensions (OPEB). Note: Earlier GASB Statements addressed the issue of pension benefits. Prior to Statement 45 governments generally accounted for and reported the cost of post-employment benefits after employees retired. This "pay as you go" approach understated financial obligations of governments and failed to provide decision-makers and users of financial statements with a complete picture of the entities' financial status. In a most general sense, GASB 45 requires governments to attribute the future cash flows for post-employment benefits to the employee's working career.

GASB 45 will:

1. Recognize the cost of OPEB benefits in the period when services are received.

2. Provide information about the actuarial liabilities for the promised benefits.

3. Provide information useful in assessing potential demands on future cash flows.

B. Actuarial Studies Performed for SLSD

Although not required to comply with GASB 45 until the 2008-09 year, the District elected to "early implement" a year earlier. GASB 45 requires governments to obtain reports from professional actuaries every two years. The District selected Conrad Siegel Actuaries, Harrisburg, PA to perform the initial actuarial report and a follow-up one that was done during the summer of 2010. Here is some key data found in the most recent actuarial study:

- The District's actuarial present value of total projected benefits is $13.8M. This is the present value of all benefits expected to be earned by current plan participants from their date of employment through their date of retirement. It includes $2.1M for current retirees and $11.7M for active participants. The latter portion assumes no changes in plan participation rules or benefit levels.

- The District's accrued liability is $6.6M. Accrued liability is the present value of all benefits attributed to the past service of current plan participants as of the date of the valuation. It is composed of the cost for current retirees ($2.1M) and a partially amortized amount for active participants ($4.5M). The second portion is based on a twelve-year amortization period.
- The District's normal cost is $480,858. Normal cost is the present value of benefits attributable to the year beginning on the date of valuation.
- The District's annual required contribution (ARC) is $1.2M. ARC represents the amount needed to both fund the cost of benefits attributed to the current year ($480,858) and an amortized portion of the unfunded liability ($725,377).

C. District Funds Earmarked for Purposes of GASB 45

The District has recognized the magnitude of its OPEB liabilities and, unlike many governments, has been fortunate to be able to take some measures to mitigate those costs. Over the last four years, the District has set aside $2.3M for this specific purpose. Accumulated interest during that period has enabled the total funds to grow to $2,344,558.

D. OPEB Trust

The District has annually made a fund transfer to a separate bank account for the purposes of funding OPEB liabilities. However, GASB 45 requires that OPEB assets be placed in a formal trust – a separate entity – in order for the financial statements to reflect the full or partial funding of the liabilities. The rationale behind this requirement is clear. If a governmental entity does not transfer control of the assets to a trust to be used for this specific purpose, the entity could decide in difficult times to utilize the assets for other expenditures such as salaries and benefits, debt service, or other ongoing costs to which the government is obligated.

The District decided that it was not economically feasible to create its own trust. A trust would require a board of trustees, substantial upfront as well as periodic legal services, annual audit services, ongoing professional investment advice, etc. No such trust existed specifically for school districts until the formation of the Pennsylvania OPEB Trust early in the 2010-11 fiscal year. Central Susquehanna Intermediate Unit 16, along with Public Financial Management and US Bank, N.A., created the trust for school entities across the state. The Trust currently includes six members. Other schools are in various stages of investigating the Trust. At some point prior to the end of the 2010-11 fiscal year, it is recommended that the Board and Administration consider joining the Trust and transferring assets that have been set aside for this purpose to the Trust or another similar trust, if one can be identified.

VII. DEBT SERVICE

A. Outstanding Debt

The District currently has $78.4M in outstanding debt with the final debt payments scheduled for the 2027-28 year. The debt was incurred in connection with renovation and expansion projects at Lower Milford (1991-92), Liberty Bell (2000), Middle School (2000), and the High School (2002-03) and the construction of the Intermediate School which was completed in 2009. All of the District's debt is tax-exempt, thereby resulting in lower interest rates than for comparable taxable bonds.

Although applicable borrowing laws permit a greater period for the debt to be amortized, the SD typically utilizes a 20-year schedule, with one exception about 10 years ago when a 25-year period was used. Although a longer period of amortization would reduce annual debt service costs to the District, it would increase total interest paid over the life of the bond issue.

The District's debt has been assigned a rating of Aa2 by Moody's Investors Service. The rating is assigned only to very high caliber debt and is highly desired by investors. It enabled the District to avoid incurring the cost of bond insurance in its most recent issuance in the summer of 2010 – a refunding (refinancing) issue that saved the SD in excess of $700K.

Total debt service payments range from $6.1 to $6.4 million annually. Debt currently represents approximately 12% of the General Fund budget. State support of $500K to $600K annually reduces net debt service payments to $5.6M to $5.9M annually. The District has traditionally utilized "wrap around" debt which keeps annual debt service payments from varying wildly from year to year. As an example, net debt service payments vary by no more than $13,000 between 2014-15 and 2026-27, one year before all current outstanding debt is retired.

B. Potential for Refundings

Schools and other governments refinance debt just like homeowners do when interest rates decline. In the public sector, the word refunding is typically used to describe the process of paying off old debt with the incurrence of new debt, generally at lower interest rates. In addition to these situations, entities often are able to save money by refunding debt in other scenarios. Unlike fixed rate home mortgages, it is customary for interest rates on debt to increase with the maturity of the bonds to compensate for the greater risk to the investor. It is typical for the bonds that mature in the first few years of an issue to yield 3 – 4% (even lower in markets like we are currently experiencing.) If, for example, those bonds yield 3.00%, the bonds that mature after 10 or 15 years may pay interest one or two percentage points higher, especially if conventional wisdom is that interest rates are likely to rise over time. This sliding scale of interest rates provides yet another opportunity for issuers to refund (refinance) debt at a savings, even in stable or flat interest rate markets. As a bond issue gets into the middle years of its life, the bonds that were initially issued as 10 year or 12 year bonds are now able to be refinanced at lower interest rates as shorter-term debt. The District regularly monitors opportunities for such savings with the help of its financial advisor, Concord Public Financial Advisors, Inc.

As mentioned above, the SD refinanced debt in the summer of 2010. The savings on that refunding were the highest – in absolute dollars and in percentage terms – the District has experienced throughout the many years of refinancing its debt.

VIII. CAPITAL PROJECTS/IMPROVEMENTS

A. Possible Projects

The Administration has identified and prioritized a list of capital projects that are either underway, on the drawing board, or are perhaps worthy of consideration. Some of the projects are ones that have already been discussed at the Board level; some have been requested by a particular group in the community; some have come to light as the result of a recent safety audit. Although there are rough cost estimates for most of the projects, there are a few that are listed without a price tag. The total cost for the items with cost estimates (excluding renovation of the administration building) approaches $6M. Please refer to Appendix C for a copy of the list.

B. Funding Sources

Funding for capital projects could come from multiple sources, including:

General Fund
Capital Reserve Sinking Fund (Capital Projects Fund)
Unspent Construction Project Bond Proceeds
Fundraising

Although the General Fund is permitted to make purchases of major equipment and pay for capital improvements, budgetary pressures for the foreseeable future suggest that there will be little or no funding available from the General Fund for such purposes. It is anticipated that Act 1 indices for at least the next couple years will remain very low, thereby restricting the District's ability to raise the real estate tax rate without seeking voter approval through a referendum. In addition, low increases in the local tax base, a widespread fear of reduced Commonwealth funding for education, and the expectation of substantial increases in certain expenditure categories – most significantly, pension costs – virtually guarantee that the District will be limited in its ability to rely on the General Fund for such expenditures.

The Capital Reserve Sinking (Capital Projects) Fund currently has a balance of approximately $1.1M with several projects in varying degrees of completion projected to require over $500,000 in funds. Historically, the District has transferred annual amounts from the General Fund into the Capital Reserve Sinking Fund for the purpose of capital projects and improvements. Most recently, the annual transfers have ranged between $300,000 and $350,000. Please note that the "cuts list" to be reviewed by the School Board at the March 12, 2011 budget seminar includes an item to reduce the annual transfer by $100,000. It is important that the Board align its plans for transferring money from the General Fund to the Capital Projects Fund– and replenishing funds being spent on projects – with the scope and cost of projects to be undertaken over the next 3-5 years.

The District was fortunate to complete the Intermediate School slightly under budget. Also, the initial borrowing for the construction project enabled the District to invest excess proceeds for a significant amount of time at interest rates that produced substantial earnings. As a result, there are unspent proceeds from the project. The exact amount of excess bond proceeds will be determined after some ongoing issues are addressed and final payments are made, but it is conceivable that the total could exceed $3M.

Because of the fierce competition for a limited amount of resources, some of the projects on the list located in Appendix C may require substantial fundraising efforts in order to be undertaken.

C. Options for Use of Funds

Money currently held in the Capital Reserve Sinking (Capital Projects) Fund and the excess bond proceeds in the Construction Fund must be used for capital expenditures. They may not be used for General Fund operating expenses. The one exception to this rule is that the excess bond proceeds may be used to make debt service payments, although that approach is not recommended by the Administration. Although the School Board is severely limited in how it may use these funds, there are some strategies to leverage these assets in a way that benefits the General Fund. Those strategies include:

- Transfer unspent bond proceeds from the IS Construction project into the Capital Projects Fund and reduce annual contributions from the General Fund to the Capital Projects fund for a series of years, thereby freeing up money annually for other General Fund purposes. If this approach is taken, the Administration would recommend structuring the relief in a way that avoids having to sharply increase the annual contribution from the General Fund in the one or two years that precede exhausting the money that is transferred into the Capital Projects Fund from the IS Construction project bond proceeds.

- Transfer unspent bond proceeds from the IS Construction project into the Capital Projects Fund and temporarily cease annual contributions from the General Fund to the Capital Projects fund for a series of years, thereby freeing up money annually for other General Fund purposes. Even more than in the scenario above, the Administration has concerns about the District's ability to reinstitute annual contributions from the General Fund to the Capital Projects Fund once the unspent bond proceeds are exhausted.

- Utilize the unspent bond proceeds from the IS Construction project to make payments of debt service. If this approach is selected, the Administration strongly recommends using the funds gradually over an extended period of time so that the District is not faced at some future date with a large increase in the General Fund Budget in the year when there are no more bond proceeds to utilize for the payment of debt service.

D. Feasibility Study

From time to time, school districts engage architects and engineers to provide a comprehensive, external evaluation of the condition and adequacy of the existing facilities and to identify and prioritize capital projects and improvements needed to meet stated goals or objectives of the organization. These studies typically include enrollment projections for the next 10 years or longer based on the current student population of the district, retention rates for students already in the system, and projections for students entering the system at kindergarten and other grades. As such, they rely heavily on projections for new housing starts and sales of existing homes to families with children. These studies are referred to by various names, including school facilities master plans.

The District received a School Facilities Master Plan in June 2001 from Ingraham Planning Associates of Butler, PA. Within a year of the plan being issued, the enrollment projections contained in that study were found to be invalid. As a result, the District engaged Breslin Ridyard Fadero Architects to provide another feasibility plan which was completed and presented in early 2004. It was that study that lead to the decision to build an intermediate school, install air conditioning at Lower Milford, replace a roof at the High School, and add storage at Liberty Bell.

In January 2008, the Administration recommended authorizing the Breslin firm to complete a new feasibility study which would include plans for renovating and/or expanding the Administration Building and the locker room facilities at the Middle School and also performing some work at Lower Milford. The Administration reported at the May 5, 2008 Board meeting that the feasibility study was temporarily put on hold while they interviewed at least two firms to provide the demographics study since the Breslin work did not include that dimension. Later that year, with signs of a worsening economy and a slowing housing market becoming clear, the Board decided to put the feasibility study and demographics study on hold.

The additional capacity created by the construction of the Intermediate School and the extended economic recession and housing slump have enabled the District to generally stay on top of its facility needs with only a few medium-sized capital projects the last few years. However, with projections of an economic turnaround in the next year or two and the possible residential construction – and additional students - that it will bring, coupled with aging facilities that will eventually require attention, it seems prudent to once again consider proactive planning in the form of a feasibility study. Perhaps the two best examples of the types of projects that will require attention in the next several years are the aging systems in Hopewell and the overall declining nature of the Administration Building.

IX. FIVE-YEAR BUDGET SCENARIOS

For nearly twenty years, the District has placed the highest possible emphasis on long-range budgetary planning and has used a five-year budget planning tool as the centerpiece for developing annual budgets, levying taxes, and making all sorts of decisions that have financial implications.

The five-year budgets are organized in a way that is meant to be useful to Board members and the general public, as opposed to simply following the accounting methodology required of public schools by the Commonwealth for formal budgeting and reporting purposes. Revenue and expenditure line items are defined in terms a layperson can understand and the various sections of the spreadsheet are linked to allow for interactive use in developing "what if" scenarios that reflect various levels of spending and taxation. The spreadsheets are structured to calculate an annual surplus or deficit and an ending fund balance for each year for any set of assumptions the user may select.

In September 2010, the Board adopted a series of General Fund budget parameters for the next four years (2011-12 through 2014-15). Those parameters are:

- Total Expenditures in 2011-12 not to exceed $54.9M
- Total Expenditures in 2014-15 not to exceed $60.5M
- Annual increases in real estate taxes not to exceed .25 mills in 2011-12 and .50 each year thereafter
- A maximum deficit in 2014-15 of $1.8M, and
- An ending fund balance in 2014-15 of 10-12% of the total budget

On February 9, 2011, the Administration presented a five-year budget that fully complies with all of the parameters above (see Appendix B), including the taxing and spending limitations for 2011-12. However, the planning document clearly illustrates that the parameters for 2014-15 can be met only if significant cuts in expenditures are made. Current projections suggest that $3.3M needs to be cut from the 2014-15 projected spending in order to fall within the stated limitation of $60.5M. The five-year document reflected a level of cost-cutting in 2012-13, 2013-14, and 2014-15 that, when combined, resulted in hitting the target for 2014-15.

Although the September Board action did not provide guidance for 2015-16, the Administration placed a 4.0% ceiling on expenditure increases for that year. That additional parameter results in the need for a 2015-16 cut of $750,000 on top of the previously mentioned $3.3M. On March 12, 2011, the School Board will review and discuss a list of 38 spending cuts or enhancements to revenues to bridge or eliminate the gap between the Board-approved spending targets and the current expenditure projections of the Administration.