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Fitch Rtgs: Chicago Teachers Settlement Preserves Expenditure Flexibility; State Aid Key

Fitch Ratings-New York-06 November 2019: Last week the Chicago Public Schools (CPS) and the Chicago Teachers Union (CTU) tentatively agreed to a five-year contract ending an 11-day strike. The contract is expected to be ratified by union members via secret ballot referendum on Nov. 14 and 15 and approved by the Chicago Board of Education (CBOE) on Nov. 20. Annual contracted cost increases start at \$115 million in fiscal 2020 (2% of fiscal 2018 spending) and reach \$504 million (9.1% of fiscal 2018 spending) by the end of the contract — for a cumulative estimated increase of \$1.6 billion. Fitch's 'BB'/Stable rating on CPS assumes management will be able to incorporate the additional contract costs without impairing its recent financial progress — namely the achievement of structural balance and the restoration of reserves to positive but still narrow levels.

The new contract commitments appear manageable within the scope of the fiscal 2020 CPS operating budget, but the additional costs represent a potential pressure on credit quality in the out years should projected state aid increases not materialize. CPS expects to fund the new contract costs from a combination of increased revenues estimated at \$200 million-\$250 million annually (including \$60 million-\$70 million of assumed increased state funding to full statutory levels), and, to a lesser extent, the reallocation of existing spending in the range of \$30 million-\$40 million. CPS has benefited from a new state funding framework enacted in 2018 that has significantly increased its recurring revenue and improved the stability of its cash flows. However, CPS's ability to accommodate the contract costs while maintaining its current level of financial flexibility would be challenged if the state school funding environment were to weaken.

The bulk of the contract cost increases are tied to cost-of-living adjustments, with annual wage increases of 3% in each of the first three years and 3.5% in each of the final two years. The annual increase in cost associated with high-needs school programs, class size initiatives, and additional nurses, social workers, and case managers is projected to reach nearly \$103 million by fiscal 2024. Another component of the contract increases, totalling about \$50 million or 10% of the fifth-year annual cost increase, relates to the normal cost contributions to the Chicago Teachers' Pension Fund, which will be paid by the state pursuant to the new state funding model enacted in 2018.

The new contract introduces new mandatory staffing requirements for some types of support staff, limiting CPS' ability to make cuts to those positions. However, CPS maintains the ability to enact reduction-in-force savings or to close schools, if necessary, to address future budget gaps, which is important to our view of CPS' credit quality given its already limited expenditure flexibility and its reliance on uncertain state funding increases in future years to pay for the increased contract costs.

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