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Research Update: Simcoe County District School Board Ratings Affirmed At 'AA-' On Continued Provincial Support

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Credit Rating:
AA-/Stable/--

Rationale

On Feb. 24, 2006, Standard & Poor's Ratings Services affirmed its 'AA-' long-term issuer credit and senior unsecured debt ratings on Simcoe County District School Board (SCDSB), which continue to reflect a high level of provincial support for elementary and secondary education. In the current period of capital funding reform this characteristic is even more relevant to the ratings on SCDSB. The outlook is stable.

The ratings are also supported by current, and expected long-term, moderate population growth of four- to eighteen-year-olds within the school board's service area. This growth provides ongoing support to enrollment demand. Moreover, SCDSB has a demonstrated track record for successfully managing the growth in its service area within the constraints of the provincial funding formula, while successfully adjusting to any funding reforms presented by the province.

The ratings are also based on the school board's debt service coverage ratio (DSCR), which is in excess of a DSCR that is consistent with a 'AA-' credit rating for an Ontario school board. This coverage ratio includes C\$20 million that the school board issued in January 2005.

The ratings are primarily constrained by the issuer credit rating on the Province of Ontario (AA/Stable/A-1+). This is because the board's capital grants are entirely dependent on the new pupil places (NPP) grants provided by the province, and SCDSB's debt obligations do not carry a provincial guarantee. The ratings also reflect the enrolment, interest rate, and construction risks that are transferred to the board through the NPP grant mechanism.

The ratings are also constrained by the uncertainty and lack of clarity surrounding the province's capital funding reforms. The Ministry of Education announced its "Good Places to Learn" initiative on Feb. 17, 2005, proposing major changes to its existing capital funding process. The announcement provided broad policy direction for new school construction, school consolidations, and capital funding. In particular, rather than following its previous protocol of flowing grants to a school board with excess enrolment relative to its capacity, the province now requires a board to also demonstrate that construction on the project has either begun or been tendered.

Details on the funding of new schools and consolidation guidelines, however, have not been provided by the ministry and the future long-term school board capital funding methodology regarding existing debt obligations and approved capital plans is still unclear. Nevertheless, SCDSB has demonstrated its ability to successfully adjust to previous funding reform presented by the province, and the province has a demonstrated history of insulating school board credit

quality from its policy revisions.

Outlook

The stable outlook reflects the expectation that potential capital funding changes following the 2005-2006 fiscal period will not compromise SCDSB's ability to service its debt. Any changes to the capital funding variables described earlier that result in lower NPP grant allocations to school boards, are expected to be accompanied by commensurate offsetting financial support to maintain the ratings. Also, should school boards be required to make use of all their unused existing grants, after those reserves are depleted, it is expected that the province will continue to fully support, on a timely basis, all existing debt obligations of the board. The ratings are also based on the assumption that before issuing any future debt, SCDSB will solidify its funding source(s) for servicing the debt. Commensurate with this is the expectation that this potential debt would be supported by the new capital grant formula, and that the board's ability to service both its outstanding and any future debt obligations will be maintained. Failure to meet any of these expectations could trigger a downward ratings action.

Ratings List

Simcoe County District School Board
Ratings Affirmed
Issuer credit rating AA-/Stable/--
Senior unsecured debt AA-

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Simcoe County District School Board

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ISSUER CREDIT RATING
Simcoe County District School
Board
Issuer Credit Rating
AA-/Stable/--
Issuer credit rating history:
June 6, 2001
AA-

Rationale

Outlook

Enrolment

Capital Borrowing Program

Capital Grants

Debt Service Coverage Analysis

Capital Funding Background

Rationale

The ratings on Simcoe County District School Board (SCDSB) continue to reflect a high level of provincial support for elementary and secondary school education. In the current period of capital funding reform this characteristic is even more relevant to the ratings on SCDSB.

The ratings are also supported by current, and expected long-term, moderate population growth of four- to eighteen-year-olds within the school board's service area. This growth provides ongoing support to enrolment demand. Moreover, SCDSB has a demonstrated track record for successfully managing the growth in its service area within the constraints of the provincial funding formula, while successfully adjusting to any funding reforms presented by the province.

The ratings are also based on the school board's good debt service coverage ratio (DSCR). For an Ontario school board to be considered for a 'AA-' credit rating, it must have a DSCR of 1.0x or greater. SCDSB currently has a primary DSCR of about 1.6x and a secondary DSCR, which includes its pupil accommodation grant reserve, of approximately 2.8x.

This coverage ratio includes a C\$20 million debenture that the school board issued in January 2005, before the Ministry of Education announced its "Good Places to Learn" initiative on Feb. 17, 2005, and falls within fiscal 2004-2005 (year ended Aug. 31). It is SCDSB's understanding that the capital funding formula under the new pupil places (NPP) grant regulations for fiscal 2004-2005 would be unchanged from the previous fiscal year. Also, the issuance was in accordance with the provisions of the Education Act for incurring debt for permanent improvements. Furthermore, some of the proceeds of the January 2005 debenture were to fund capital projects for which construction had begun before the ministry's February 2005 announcement.

The ratings are primarily constrained by the issuer credit rating on the Province of Ontario (AA/Stable/A-1+). This is because the board's capital grants are entirely dependent on the NPP grants provided by the province, and SCDSB's debt obligations do not carry a provincial guarantee. The ratings also reflect the enrolment, interest rate, and construction risks that are transferred to the board through the NPP grant mechanism.

The ratings are also constrained by the uncertainty and lack of clarity surrounding the province's capital funding reforms. When the Ministry of Education announced its "Good Places to Learn" initiative on Feb. 17, 2005, it proposed major changes to its existing capital funding process. The announcement provided broad policy direction for new school construction, school consolidations, and capital funding. In particular, rather than following its previous protocol of flowing grants to a school board with excess enrolment relative to its capacity, the province now requires a board to also demonstrate that construction on the project has either begun or been tendered. Details on the funding of new schools and consolidation guidelines, however, have not been provided by the ministry.

The government also announced that although the 2003 moratorium placed on school closures was lifted, the capital funding would be permanently changed so that reductions in pupil places through school closures would not necessarily lead to a corresponding increase in NPP grants.

There is also a possibility that the province could require a board to use any existing NPP grants or capital reserves that it may have available before it receives any further provincial grants. Should the province require this, in the context of the new capital funding formula expected to take shape, after a board depletes its reserves it is expected that the province, recognizing its moral obligation to the board and that the board is entirely reliant on it for funding, will continue to fully fund a school board's capital needs and related debt obligations on a timely basis.

The future long-term school board capital funding methodology regarding existing debt obligations and approved capital plans, however, is still unclear. Nevertheless, SCDSB has demonstrated its ability to successfully adjust to previous funding reform presented by the province, and the province has a demonstrated history of insulating school board credit quality from its policy revisions.

Outlook

The stable outlook reflects the expectation that potential capital funding changes following the 2005-2006 fiscal period will not compromise SCDSB's ability to service its debt. Any changes to the capital funding variables described earlier that result in lower NPP grant allocations to school boards, are expected to be accompanied by commensurate offsetting financial support to maintain the ratings. Also, should school boards be required to make use of all their unused existing grants, after those reserves are depleted, it is expected that the province will continue to fully support, on a timely basis, all existing debt obligations of the board. The ratings are also based on the assumption that before issuing any future debt, SCDSB will solidify its funding source(s) for the debt. Commensurate with this is the expectation that this potential debt would be supported by the new capital grant formula, and that the board's ability to service both its outstanding and any future debt obligations will be maintained. Failure to meet any of these expectations could trigger a downward ratings action.

Enrolment

The growth of four- to eighteen-year-olds in Simcoe County is expected to be modest until 2008, and then flatten to a noticeable decline (by as much as 2%) until 2015, after which it is expected to rise again. This closely follows SCDSB's enrolment forecast, although declining to a lesser extent. The echo boom generation has essentially just completed elementary school, resulting in an expected modest decline in elementary school-aged children until about 2010. This demographic group is currently making its way through the board's secondary school system, expected to grow at about 2% from 2005-2006 to 2008-2009, and then gradually decline until about 2015. For the 2005-2006 academic year the school board is expected to take in about 34,450 elementary school students and about 18,330 secondary school students for a total enrolment base of about 52,780.

Simcoe County District School Board Enrolment And Grants						
	--For the year ended Aug. 31--					
	2005-2006*	2004-2005	2003-2004	2002-2003	2001-2002	2000-2001
Enrolment	52,779	52,927	52,672	52,552	52,215	51,437
% change	(0.3)	0.5	0.2	0.6	1.5	1.3
NPP capacity	40,809	40,809	41,131	42,371	42,371	42,371
% change	0.0	(0.8)	(2.9)	0.0	0.0	(2.9)
NPP grant (mil. C\$)	13.4	14.8	13.8	12.2	11.8	10.8
% change	(9.7)	7.6	12.7	3.1	9.9	31.0

*NPP capacity and NPP grant figures are estimates for 2005-2006. NPP--new pupil places.

Capital Borrowing Program

To build new schools and build additions to existing schools, SCDSB had issued a C\$20 million debenture in January 2005, maturing on Jan. 28, 2015. This is factored into the above-calculated DSCR and is less than the C\$50 million that was initially expected to be issued by the board in fiscal 2005.

Standard & Poor's Ratings Services understands that this most recent issuance reflects capital funding for approved and nearly completed projects and that the incurred debt is eligible for capital financing under the terms of the current funding formula and grant regulations. Despite the current funding uncertainty, school boards are legally able to issue debentures, and the January issuance had received a standard issuer legal opinion indicating that SCDSB had the necessary statutory authority to issue its debenture.

Since 1998, the only other debt issued by the board was a C\$100 million serial debenture in June 2001 to fund school expansion. The serial debentures provided an orderly, annual retirement of principal from 2002-2011 with a refundable bullet payment in 2026. The board indicated that it might issue up to C\$30 million in additional debt in 2007, largely dependent on the ministry providing clearer directive on the capital funding formula, and how that new formula might take shape.

Capital Grants

Capital grants (under the 2005-2006 capital funding system) are based on a school board's NPP, which is the difference between enrolment and, as established by the province, fixed student capacity (NPP grants are the primary source for Ontario school boards to fund capital expenditures and meet debt service obligations). SCDSB's NPP grant is estimated to be C\$13.4 million for 2005-2006. Although this is about 8% less than the previous year's NPP grant, the estimate is based on the ministry's "shovel in the ground" concept, representing NPP grants for school construction that has either been started or tendered at the time the ministry calculated its estimates. The ministry's estimate also underrepresents the actual NPP grant expected for 2005-2006 because it does not incorporate an adjustment to the capital funding formula for capping primary level class sizes, which is expected to provide the board with further NPP grant funding. The ministry's estimates are typically lower than the actual NPP grant flowed at the end of the fiscal year. In fact, NPP grants have increased by an average of 7.8% in each year from 2002-2003 to 2004-2005, while enrolment growth has averaged about 0.5% annually since 2002-2003. Under the capital grant formula preceding the Feb. 17, 2005, announcement, the school board's grant allocation could increase as a result of either enrolment growth or, through school closures, a reduction in student capacity. SCDSB's NPP grant increase can be predominantly attributed to the former situation and, to a lesser extent, the latter (since 1998 the board has closed five schools and currently has approximately 92 elementary and 15 secondary schools).

Debt Service Coverage Analysis

Standard & Poor's calculates two debt service coverage ratios (DSCR). One is the primary DSCR, which is the sum of the annual allocation of grants (NPP, capital transition, prohibitive repair, enrolment pressures grants, proceeds of disposition, and 20% of renewal funding) relative to principal and interest payment for the current period. Standard & Poor's only includes 20% of renewal funding in the coverage portion of this calculation, as the funding is primarily intended for rehabilitation and repair activities but can also be applied to debt service.

In addition, a second DSCR is calculated, including the balance of the school board's pupil accommodation grant reserve fund into which unused NPP and capital grants are placed. The monies in that reserve fund can only be allocated toward capital accommodation, including debt service and, therefore, represent a source of near-term debenture repayment funding for the school boards. As part of the province's capital funding reforms, however, there is a possibility that the province would withhold further funding to a school board until it uses all its reserves. For this reason, Standard & Poor's focuses mostly on the primary DSCR, which excludes the pupil accommodation grant reserve.

For the 2005-2006 academic year, the SCDSB is projected to receive about C\$13.4 million (a conservative estimate) in NPP grants, which sufficiently meets its approximately C\$10.9 million in total debt service obligations for the year. This grant, along with 20% of renewal funding and the proceeds from

sales of its old capital inventory, gives SCDSB a primary DSCR of 1.6x. Although SCDSB has some enrolment growth, additional growth, which would generate additional capital grants, is not required at this time to service debt outstanding. The SCDSB's secondary DSCR (including its pupil accommodation grant reserve that is composed of previous years' unused capital grants) is 2.8x. The excess of NPP grants and the pupil accommodation grant reserve fund provide the school board with a cushion against downside enrolment. Alternatively, they offer the financial flexibility to issue further debt for school construction or to begin to place funds in reserve to fund all or part of future construction.

Although the issuance is still uncertain, should the board proceed with issuing the full additional C\$30 million in debentures in 2007, its primary and secondary DSCRs are estimated to decline to 0.74x and 1.27x, respectively. This concerns Standard & Poor's because, as noted earlier, an Ontario school board must have a DSCR of 1.0x or greater to be considered for a 'AA-' credit rating. It does, however, provide Standard & Poor's with some reassurance that the proceeds of the funds from the potential debenture would be used to fund school construction projects that have been approved by the ministry on a needs-based assessment, and have either been tendered or already started, conforming to the ministry's "shovel in the ground" requirement (part of its previously described "Good Places to Learn" legislation). With the board conforming to these ministry requirements, Standard & Poor's expects that the ministry, recognizing the capital needs demonstrated by the board, the board's funding dependency on the province, and the province's moral obligation to the school board, will fully and on a timely basis fund any obligations outstanding that the board may have. Falling short of this expectation will likely lead to a lowering of the ratings on SCDSB.

Capital Funding Background

SCDSB's modest enrollment growth rate, coupled with its strong management team, has contributed to its success with adjusting to previous funding reforms presented by the province. In September 1998, the last time the education funding for Ontario school boards was significantly altered, the province revoked the ability of school boards to establish education tax rates to be collected through the local property assessment base. Ontario set annual local education tax rates and supplemented school boards with grants so that all boards would receive relatively common per-student operating funding.

In addition to constraining the revenue-raising ability of school boards, and making them entirely reliant on grants to support capital activities, this funding reform also transferred enrolment, interest rate, and construction risk to the boards. Capital grants were based on a school board's NPP, which is the difference between enrolment and fixed student capacity; the latter being established by the province. The excess enrolment above capacity is then multiplied by a factor that reflects the province's view of construction costs and implied amortizing financing rates during an assumed 25-year period, resulting in the amount of the grant to be allocated in a given year. Therefore, a school board's grant allocation could increase as a result of either enrollment growth or, through school closures, a reduction in student capacity.

Since 1998, SCDSB's annual grant allocations have increased every year often as a result of both variables. To maximize the resources available to its highest growth areas, the SCDSB has implemented five school closures since 1998. In 2003, a moratorium was placed on school closures, which has since been removed. Nevertheless, since 2003 school boards have not been able to procure additional NPP grants by generating excess enrolment through school closures. Although closures have contributed to SCDSB's NPP grant increases, the main cause of annual increases in its NPP grants was enrolment growth within the board's jurisdiction.

The province has incrementally begun to roll out a new set of grant regulations and Standard & Poor's expects a new formula to be introduced in 2006-2007.

Changes to the capital funding formula that adversely affect funding the debt

incurred under the existing capital funding formula (without offsetting financial support) would negatively affect SCDSB's DSCR. Standard & Poor's, however, is of the view that the province recognizes this risk, and because school boards have no capital budget revenue autonomy, it is highly likely that the government will decide to provide offsetting financial support for these obligations as part of its ongoing funding review. This factor is a key consideration for the ratings on SCDSB.

A provincial funding approach to neutralize construction work undertaken and debentures issued in good faith in the context of a known capital funding formula (before the province's Feb. 17, 2005, announcement) would also be consistent with past provincial practice, and reflect the strong financial and policy support generally accorded by the essential and publicly sensitive Ministry of Education.

The last time the provincial government materially altered its school board capital funding formula, in 1998, the province issued a clear and defined statement explaining how debt incurred before and after May 14, 1998, would be funded under the revised capital funding formula. That level of analytical and funding clarity is an important differentiator compared with the current policy environment, although it is not deemed material enough to be a constraint on the ratings on SCDSB at this time.

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