Board of Education – City of Chicago

22 May 2015

Structural deficit discussion document

Preliminary DRAFT

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Scope of services

EY was engaged by CPS to assist in analyzing its financial situation and projected deficit, with the aim of addressing the following key issues:

- Does CPS have a structural deficit?
- If it does have a structural deficit, what are the main drivers?
- What is the projected deficit between now and FY 2020?
- What factors may exacerbate or mitigate the deficit in the future?

The findings arising from the above scope of services are summarized in this Report.

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Executive summary

Executive summary overview

1. Based on comparable data, CPS has made significant strides in enhancing students' proficiency and graduation rates over the last decade. It appears that CPS performs as or more efficiently than its peers in several operational areas such as students per teacher, central office, transportation and maintenance costs but lags its peers in certain metrics such as average ending teacher salary and students per school.

2. CPS has effectively been running a deficit for the past four years of ~$500 million annually, which has been mitigated by non-recurring revenue and deferral of pension payments.
   - Since FY 11, per pupil operating expenditures have increased whereas per pupil revenues have decreased thereby contributing to the deficit.

3. Absent significant intervention, the deficit is expected to increase to a run-rate deficit of ~$1.0+ billion annually culminating in an accumulated deficit of ~$5.4 billion by FY 20.
   - Even with a UAAL pension holiday for another five years, there remains an estimated accumulated deficit of $2.4 billion by FY 20

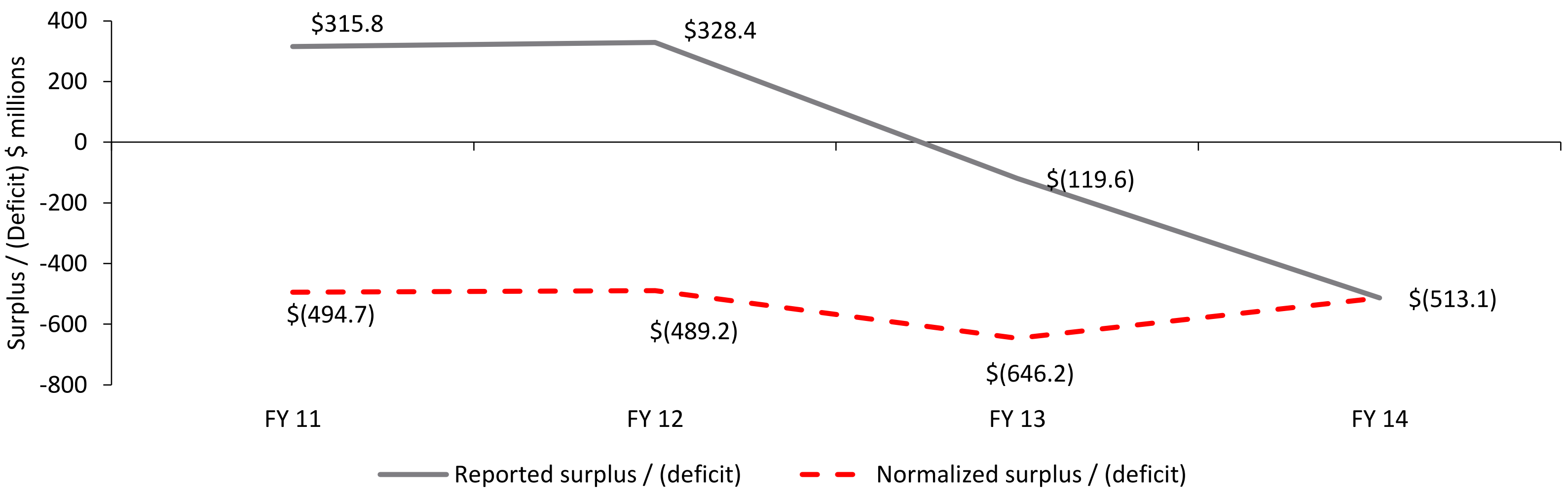
4. Absent new revenue, a greater proportion of the budget is expected to be diverted from operational costs to the funding of debt service and pension costs through FY 20.
   - GSA available for operational funding is expected to decline $500 million by FY 20 as compared to FY 14 primarily due to increasing debt service and loss of other debt service revenue sources (Capital Development Board grants).

5. Although the magnitude of annual projected deficits through FY 20 is concerning, the anticipated immediate and medium term liquidity shortfalls are even more critical. CPS is projecting a cash shortfall of ~$1.9 billion at the end of FY 16 and absent material cost deferral or third party intervention CPS is projected to run out of cash as early as this summer.
   - Even with a UAAL pension holiday in FY 15 and FY 16, CPS will still be facing a $1.0 billion cash shortfall in FY 16 that will likely have to be funded through incremental debt borrowings and significant budget reductions.
   - A critical analysis of the forecast assumptions and the cash impact of cost cutting initiatives is needed, given the severity and timing of the anticipated liquidity shortfall.

6. Implementing a comprehensive, long-term plan that provides adequate funding to educate students without increasing future per pupil indebtedness will likely require a combined CPS, City and State solution.

CPS has effectively been running a $500 million deficit for the past four years, which has been mitigated by non-recurring revenue and deferral of pension payments

General Operating Fund surplus / deficit FY11 – FY14



Source: Chicago Public Schools FY11 – FY14 CAFR; Management discussions; unaudited Management information; Segal Actuarial Valuations (FY11-FY13)

- Over the past four years, CPS has benefitted from a number of one-time revenue/expenditure items, which have understated the full extent of its underlying operating deficit (refer to page 18 for detail), including the following:
  - UAAL pension payment holiday;
  - Federal stimulus funding;
  - Changes to the due date for property tax payments; and
  - Atypical TIF distributions .

Despite cost reduction efforts, per pupil revenue has declined while per pupil expenditures (excluding pension UAAL) have grown resulting in an incremental annual deficit of ~$400 million

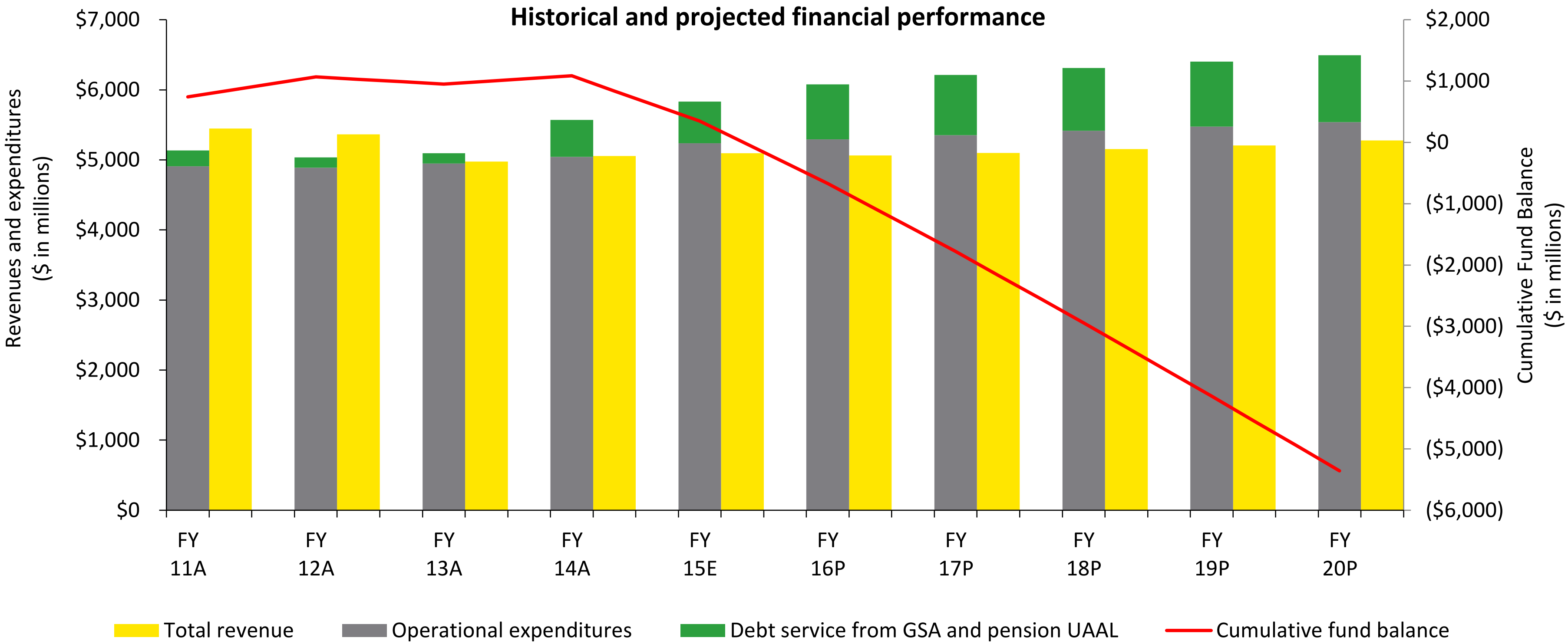
Illustrative Expenditures at FY 11 Levels

$ in millions (unless otherwise noted)	FY 11A	FY 12A	FY 13A	FY 14A	CAGR
Operating revenue	$ 5,226	$ 5,217	$ 4,827	$ 4,937	
Operating expenditures (excluding UAAL)	(4,910)	(4,888)	(4,946)	(5,044)	
Operating surplus / (deficit)	316	328	(120)	(107)	
Pupils	*378,959*	*379,919*	*378,954*	*376,874*	
Operating revenue ($ per pupil)	$ 13,790	$ 13,731	$ 12,737	$ 13,100	-1.7%
Operating expenditures (excluding UAAL) ($ per pupil)	(12,956)	(12,867)	(13,053)	(13,384)	1.1%
Operating surplus / (deficit) ($ per pupil)	833	864	(316)	(285)	
Illustrative expenditures @ revenue CAGR ($ per pupil)	$ (12,956)	$ (12,737)	$ (12,521)	$ (12,308)	-1.7%
Pupils	378,959	379,919	378,954	376,874	
Implied operating expenditures	(4,910)	(4,839)	(4,745)	(4,639)	
Less: actual operating expenditures	4,910	4,888	4,946	5,044	
Illustrative reduction in expenditures	$ -	$ 49	$ 202	$ 406	

Note 1: The revenue per pupil has not been normalized to exclude the one-time benefits identified on page 18.
Note 2: Enrollment excludes pre-K students.
Source: CPS management information

- CPS introduced a number of cost-cutting initiatives from FY11 – FY14, which identified $740 million in expenditure reductions (refer to Appendix E for summary). Despite the implementation of these initiatives, the net benefit of these reductions has been offset by escalating costs in other areas.
- While the growth in pension UAAL is a major driver of CPS' financial position, the growth in other expenditures from FY11 – FY14 (CAGR +1.1%) has outpaced revenue (FY11 – FY14 CAGR -1.7%)
  - Declining revenue over the period is largely attributed to the loss of Federal stimulus funding, declining State aid and the increasing use of GSA for debt service.
- Stimulus funding and UAAL pension deferral have enabled CPS to maintain its per pupil expenditures at a similar level from year to year.

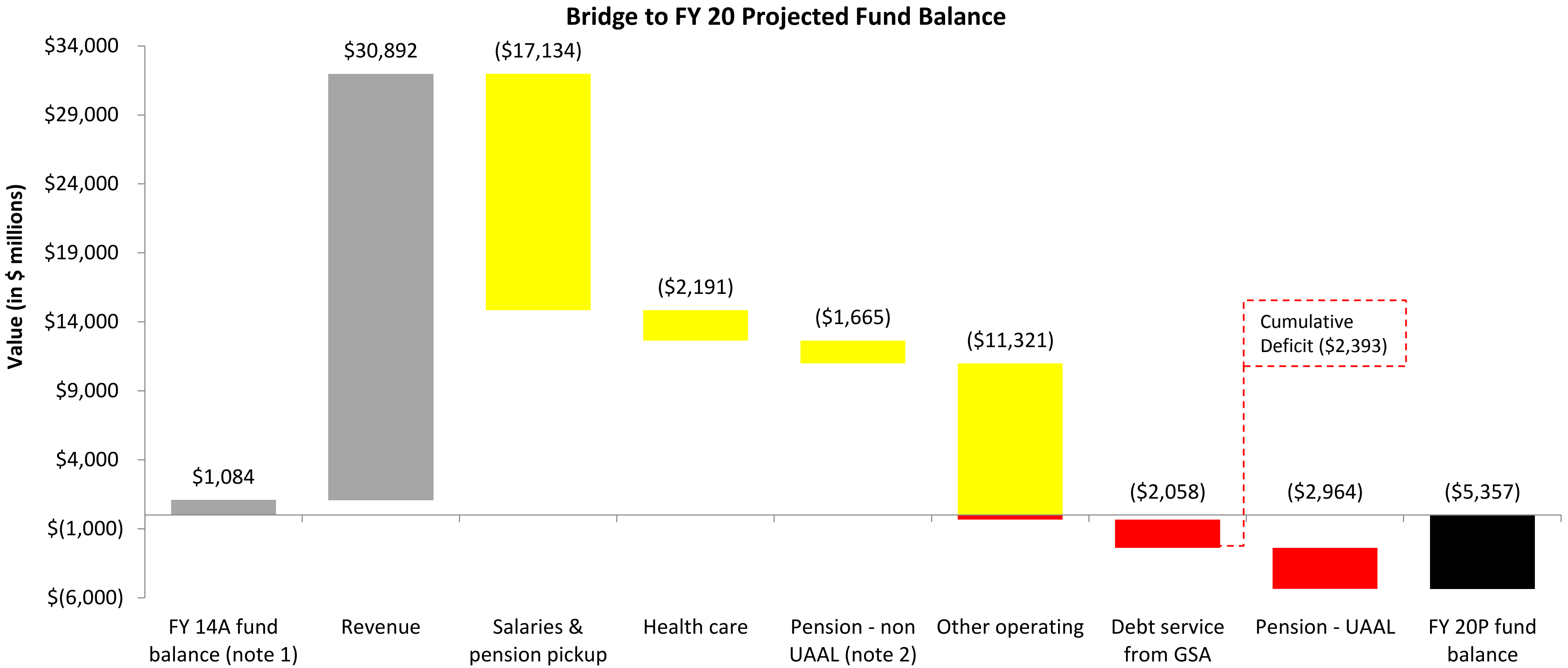
Based on Management projections, CPS is facing an estimated $5.4 billion accumulated deficit by FY 20 as expenses continue to exceed revenues



Source: Chicago Public Schools FY11 – FY14 CAFR ; FY15 Management estimates as of May 15, 2015; FY16 – FY20 Management Projection as of May 15, 2015

- The current annual deficit is projected to increase over the next five years, primarily driven by rising expenditures.
  - Absent additional revenue and cost saving initiatives, CPS projects an accumulated deficit of $5.4 billion.
- Major assumptions include:
  - State aid remains flat
  - Property tax raised to the cap annually
  - 0% COLA for CTU salaries and ~$35 million annually in steps and lanes increases
  - Debt service includes payments on both new and existing debt issuances funded by GSA
  - Pension contributions are based on the Segal actuarial valuation June 30, 2014

Even if CPS were to receive a UAAL pension holiday for the next five years, CPS could still have a ~$2.4 billion accumulated deficit by FY 20



Source: Chicago Public Schools FY14 CAFR; FY15 Management estimates as of May 15, 2015; FY16 – FY20 Management Projection as of May 15, 2015

Note 1: FY14 fund balance includes an adjustment of $648m relating to change in revenue recognition policy

Note 2: Pension- non UAAL consists of normal CTPF pension cost, and the City of Chicago and Federal pension pass-through for career service employees

- The projected $5.4 billion deficit (~$1+ billion annual deficit) is driven by expenditures consistently exceeding revenues and significant legacy liabilities.
- The chart above illustrates that CPS will not have adequate funding to meet its pension and debt service obligations absent cost reductions or new sustainable revenues.

The underlying drivers of the structural deficit will continue to challenge CPS in the near future, making it difficult to achieve fiscal sustainability

Structural deficit drivers

Funding

- Proration of General State Aid ("GSA")
- Decline in revenue sources
- State aid – lack of pension parity

Long-term liabilities

- Pension - escalating UAAL contributions
- Increasing debt service consuming State aid

Compensation

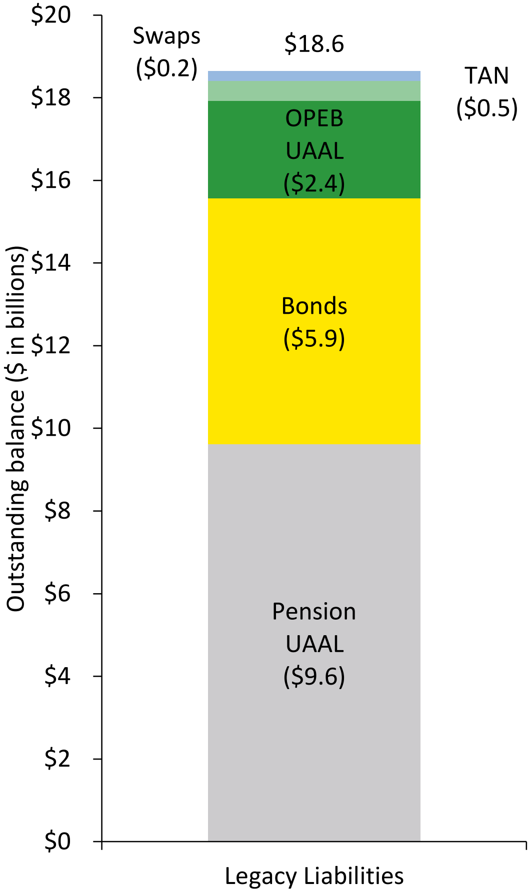
- High personnel costs
- 7% pension pick-up
- Salary COLA, steps and lanes outpacing revenue growth
- Significant employer contribution for health care costs

Operational

- Budgeting practices – budget cuts not in line with decline in revenue

The increase in the deficit has resulted in legacy liabilities of approximately $19 billion which are expected to increase in the future

Legacy Liabilities FY 14



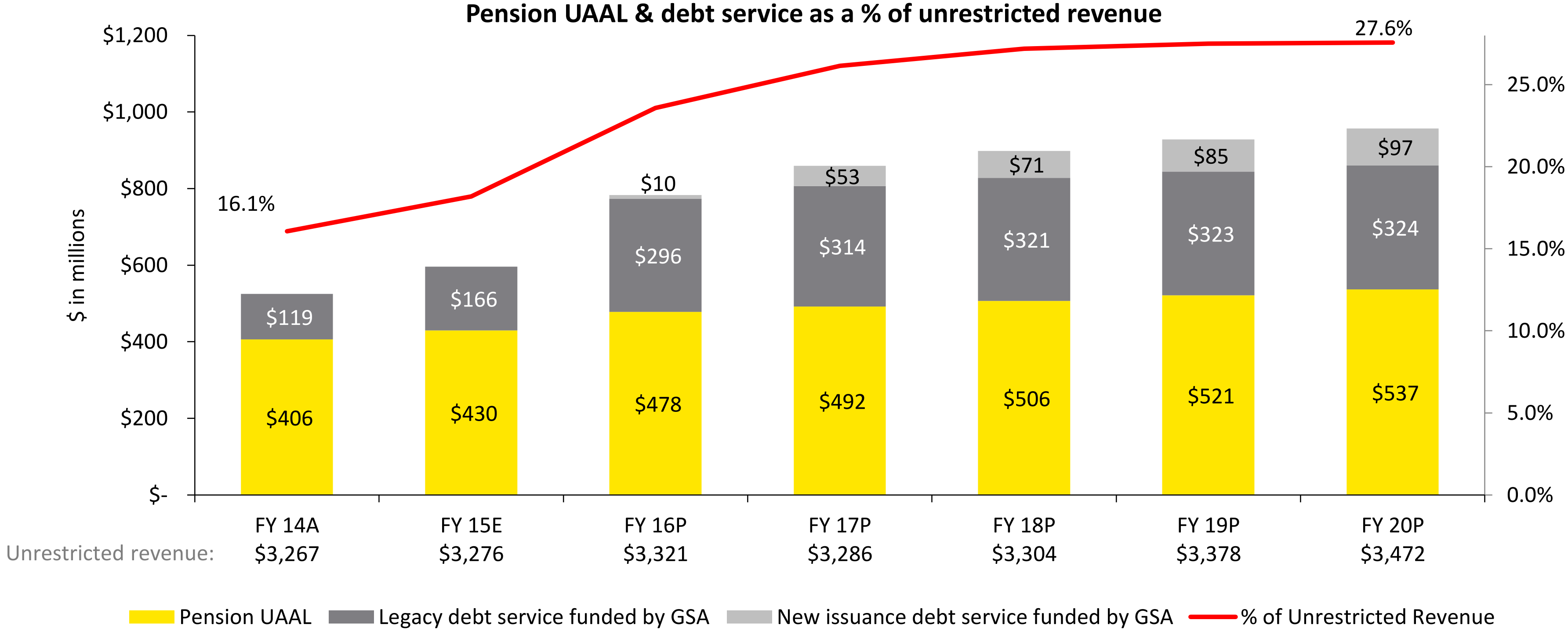
Source: Chicago Public Schools FY14 CAFR; unaudited Management information

	Considerations	Opportunities

Pension UAAL (52%)	▸ CTPF funded status was 100% in FY 01 and 52% in FY 14, decreasing due to:
	  ▸ Contributions below UAAL growth and pension holiday
	  ▸ Asset underperformance
	  ▸ Change in actuarial assumptions
	▸ An additional Pension holiday would result in an increase in pension UAAL and future required contributions.
	▸ Long term asset return assumptions of 7.75% may require additional review.
		▸ Pension reform
		▸ State funding of pension

Bonds (32%)	▸ Consists of $3 billion of capital improvement bonds and $3 billion of refunding bonds. ▸ Legacy debt service from FY 16 – FY 20 totals $2.7 billion ($1.6 billion from GSA). Total debt service (including proposed new issuances) is $3.1 billion ($1.9 billion from GSA).	▸ Pre-funding of annual debt service ▸ Dedicated funding source for future capital issuances
OPEB UAAL (12%)	▸ Funded from pension fund and expenditures on retiree healthcare are capped at $65 million annually.	▸ Evaluate options provided by Affordable Care Act
TAN (3%)	▸ Seasonal line repaid from property tax receipts. ▸ Facility expires at the beginning of October 2015.	▸ Renewal of facility
Swaps (1%)	▸ In negotiations with majority of counter-parties following credit rating downgrade, resulting in a call on the outstanding liability.	▸ Negotiate with swap counter-parties

At the current pace, CPS may have to dedicate ~28% of unrestricted revenues to pension UAAL and debt service thereby reducing funds available for educating students

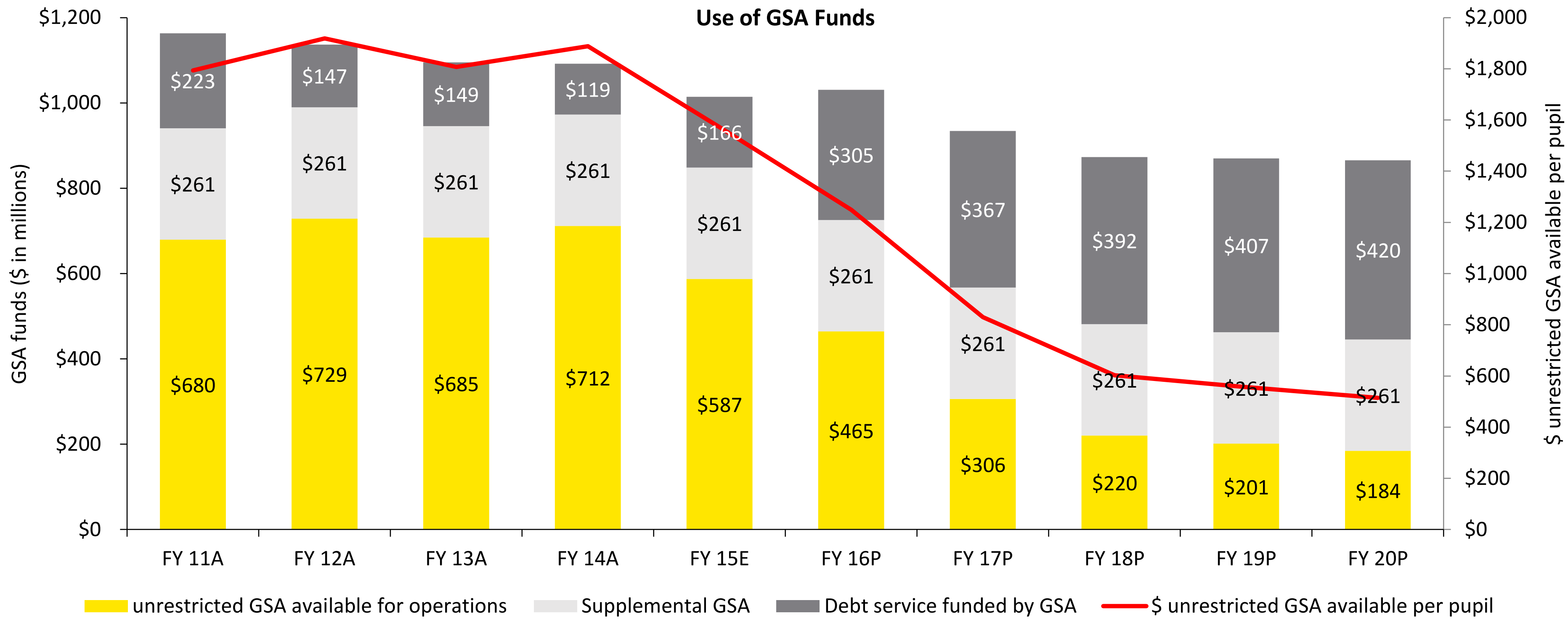


Source: Chicago Public Schools FY14 CAFR; unaudited Management information; FY15 Management estimates as of May 15, 2015; FY16 – FY20 Management Projection as of May 15, 2015,

Note1 : Unrestricted revenue includes local revenues and GSA funds, excluding SGSA and excludes TAN and PPRT debt service. Debt service is based on the FY15 – FY19 approved capital plan

- Debt service and pension UAAL costs are projected to increase at a significantly higher rate than revenue, which will have a negative impact on the ability to balance the budget in the future without structural changes.
  - In 2014, pension UAAL costs and debt service funded by GSA comprised 16.1% of revenue; this is projected to increase to 27.5% by FY 20, which represents an additional use of ~$1.8 billion in unrestricted revenue over a five year period.
  - The annual growth rate for costs associated with long-term liabilities is projected to be 10.5% compared to revenue growth of 1.1%.
- New debt issuances will fund future capital expenditures. Management believes the projected level of capital expenditures is insufficient to meet CPS' needs but is constrained due to the lack of an associated debt repayment source and immediate liquidity needs.

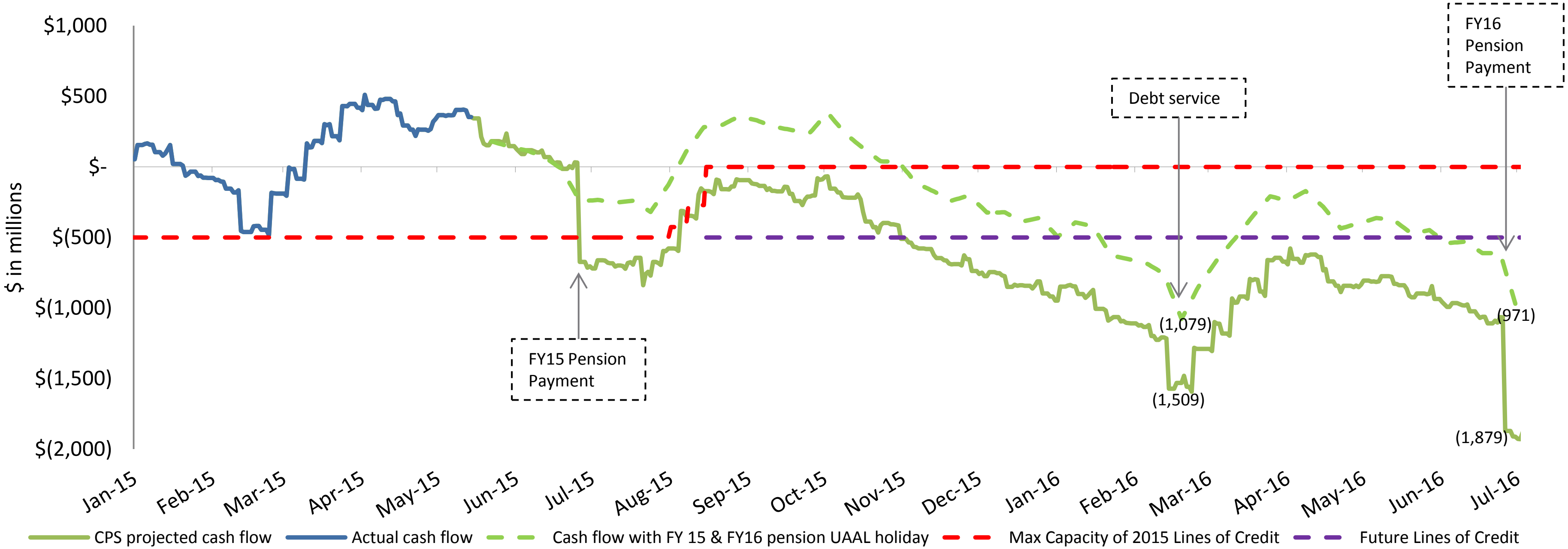
Based on current run rates, GSA available for student education is likely to decrease ~$500 million by FY 20 due to increasing debt service requirements and declining overall GSA funding



Source: Chicago Public Schools FY 11 – FY 14 CAFR; FY 15 unaudited management estimates as of May 15, 2015; Management projections as of May 15, 2015
Note: Debt service is based on the FY15 – FY19 approved capital plan

- CPS has historically used GSA revenues to cover debt service payments on alternative revenue bonds used for capital expenditures, reducing the amount of GSA available for operations.
- The absence of a dedicated debt service revenue stream results in a substantial amount of GSA being diverted to fund debt payments.
- Per Management, the State requires CPS to spend Supplemental GSA on students eligible for free or reduced-price lunches or breakfast, and must be used in a manner that is supplemental to the district's general per-pupil funding.
- Due to declining enrollment and other factors, CPS has projected that GSA will decline approximately 15% from $1.0 billion in FY 15 to $866 million in FY 20.
- The GSA used for debt service is projected to increase from $166 million in FY 15 to over $420 million by FY 20.
- The amount of unrestricted GSA available per pupil will decline from $1,888 in FY 14 to $515 in FY 20.

While forecasted deficits continue to be a major concern, CPS faces a $1.9 billion cash shortfall by the end of FY 16 and absent immediate action, an imminent liquidity crisis



Source: Management cash flow forecast and projected future line of credit as of May 15, 2015

- Based on current estimates and absent immediate action, CPS may not have sufficient liquidity to fund its upcoming obligations.
  - A UAAL pension holiday alone in both FY 15 and FY 16 is not sufficient to resolve the overall liquidity challenges.
- Absent a UAAL pension holiday from FY 11 – FY 13 and the issuance of new debt, CPS would likely have faced a cash shortfall much earlier than the current estimates.
- CPS will require a combined approach to implement a feasible, long-term plan. Such a plan would likely include securing new revenue sources, addressing existing obligations, implementing aggressive cost-cutting measures and seeking appropriate legislative support.

While CPS' liquidity projections would benefit from additional pension holidays and incremental debt financing, these strategies are unsustainable in the long term

Driver	Structural Change
Pension holidays	✗
New capital spending without dedicated revenues	✗
Restructuring the timing of debt obligations	✗
New debt borrowings that increase long term total cost for CPS	✗
Cost reduction in excess of revenue reduction	✓
New dedicated revenue stream for capital spending	✓
Pension reform reducing pension costs	✓
Compensation changes	✓
New taxes dedicated to CPS	✓

$ in millions

FY16 ending cash - base case	**$**	**(1,879.0)**
Recurring operating improvements [1]		500.0
FY 15 & FY 16 pension holidays [2]		907.9
New debt to fund capital		350.0
FY16 ending cash - adjusted	**$**	**(121.1)**
FY 17 illustrative cash burn [3]		(1,113.9)
Recurring operating improvements [1]		500.0
FY 17 pension holiday [2]		492.0
FY17 ending cash - illustrative	**$**	**(242.9)**

Notes:

(1) Recurring operating improvements could include cost reductions and additional revenue sources

(2) Estimated UAAL pension contributions

(3) FY 17 projected deficit

Source: CPS Management cash forecast as at May 15, 2015 and Management discussions

Implement a comprehensive plan that allows for a sustainable funding plan for educating students over the long term without increasing the per pupil indebtedness for future students

Tactical next steps

Funding required for educating students over the long-term

- Financial and operational plan
  - Revenue enhancement measures that require either State or City approval
  - Right size the cost structure
  - Other measures that require further review including charter funding, programmatic reviews, facilities, transportation, capital funding and purchased services costs
  - Financing strategy to address swaps and debt
- Cash flow planning
  - Develop detailed cash flow forecast and cash contingency plan

Approach with key stakeholders

Ensure the "ask" of key stakeholders is sustainable

- State of Illinois
- City of Chicago
- Active employees
- Retirees
- Financial creditors

Implementation

Long-term feasible plan

- Comprehensive proposal for all stakeholders
- Scenario planning

Structural deficit

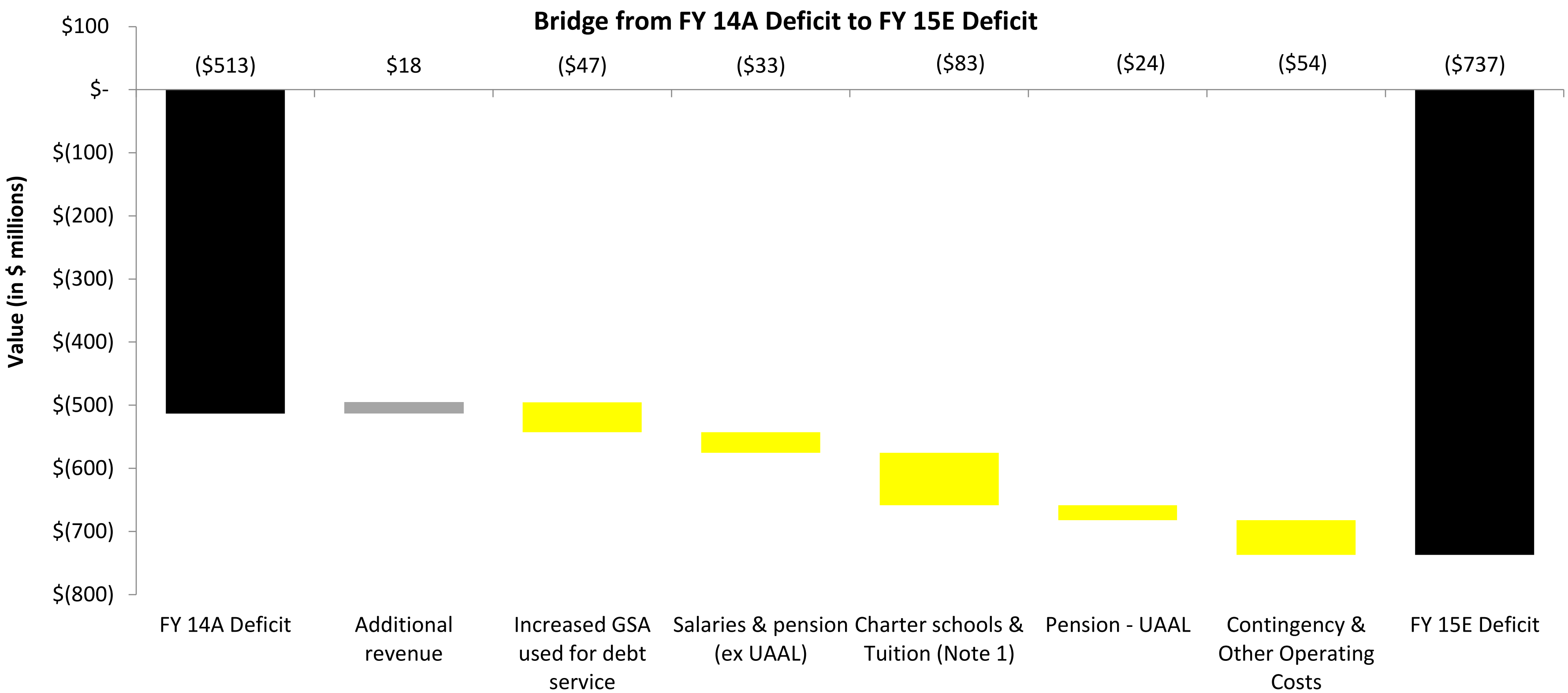
Over the last four fiscal years (ending FY 14) CPS has sustained a normalized annual operating deficit of approximately $500 million

($ in millions)	FY 11A	FY 12A	FY 13A	FY 14A
Reported surplus / (deficit)	**$ 315.8**	**$ 328.4**	**$ (119.6)**	**$ (513.1)**
Adjustments for one-off items:				
Property tax	-	(244.0)	-	-
Replacement tax	(47.0)	-	-	-
State aid (payment delays)	(53.9)	(102.1)	(49.6)	-
Nonrecurring Federal aid (ARRA)	(293.8)	(84.8)	(4.6)	-
TIF surplus (abnormal increase)	(110.0)	-	-	-
Deferred UAAL pension contribution	(305.8)	(386.7)	(472.4)	-
Total adjustments:	(810.5)	(817.6)	(526.6)	-
Normalized surplus / (deficit)	**$ (494.7)**	**$ (489.2)**	**$ (646.2)**	**$ (513.1)**

Source: Chicago Public Schools FY 11 – FY 14 CAFR; Management discussions; unaudited Management information; Segal Actuarial Valuations (FY 11-FY 13)

- Over the past four years, CPS has benefitted from a number of short term revenue / expenditure impacts, which have obscured the full extent of the underlying operating deficit.
  - Cook County change to the second property tax payment date (from November to August), which had the effect of bringing forward into the fiscal year taxes not normally collected until the following year (FY 12 $244 million).
  - Replacement tax increased in FY 11 as a result of a State tax amnesty, which secured an additional $20 million for CPS and the distribution of unutilized funds set aside for corporate refunds ($27 million).
  - An improvement in State aid payment delays, resulting in the collection of amounts outstanding from previous years.
  - Federal stimulus (ARRA) funding - $383 million (excluding GSA replacement funding) from FY 11 – FY 14, which has since elapsed.
  - A significant increase in TIF distributions from the City of Chicago in FY 11 ($110 million increase over FY 10).
  - Deferral of $1.2 billion in UAAL pension payments for FY 11 – FY 13 (based on the relevant Segal actuarial valuation for each year).

The deficit for FY 15 is expected to be more than $200 million higher than the deficit in FY 14



Source: Chicago Public Schools FY11 – FY14 CAFR; FY15 Management estimates as of May 15, 2015; Management discussions

Note 1: Increase Is net of $22m in admin fees and pension charges. Charter school funding model warrants further examination but was outside of the scope of this report. FY 15E deficit has been adjusted for anticipated budget variance. Refer to Appendix D for budget variance detail.

- The CPS annual deficit is projected to increase approximately $224 million, based on unaudited management projections as of May 2015.
- Cost increases across most categories, including charter school funding, personnel costs and an increase in the use of State aid to fund debt service, continue to be contributors to the deteriorating financial outlook.

Although CPS has undertaken some measures to curtail the deficit increase, there are several additional drivers causing the recurring and increasing deficits

FUNDING

Driver	Comment	FY 14 Impact	Future Trend
GSA proration (see Appendix A.1)	• Proration has resulted in a significant decrease in funding for CPS compared to its calculated GSA entitlement. • Cumulative funding impact since FY 11 has exceeded $325 million.	~$138m	Negative
Decline in revenue sources (see Appendix A.2)	• The loss of Federal stimulus funding (ARRA) has resulted in $383 million less revenue since FY 11. • Non-GSA State aid funding has decreased by $94 million since FY 11 due to State budget cuts.	~$477m (change from FY11)	Constant
State aid – lack of pension parity (see Appendix A.3)	• CPS is the only school district in Illinois that is not part of the State - funded TRS pension plan. • The State pension code set a goal of providing CTPF with 20%-30% of what it provides to TRS. In FY14, it provided ~0.3% (~$12 million).	~$601m	Constant

LONG -TERM LIABILITIES

Driver	Comment	FY 14 Impact	Future Trend
Pension costs: Unfunded Accrued Actuarial Liability (see Appendix A.3)	• Due to a UAAL funding holiday in FY11 – FY13, asset underperformance and the 3% COLA for the vast majority of members, projected contribution costs have skyrocketed .	~$400m	Negative
Increasing debt service consuming available State aid	• The absence of a dedicated debt service/capital revenue stream results in a substantial amount of GSA being diverted to fund debt payments, reducing funds available for operations. • In 2014, 11% of GSA was diverted for debt service; it is projected to increase to 49% by 2020.	~$119m	Negative

Source: Chicago Public Schools FY14 CAFR; Management Discussions

Although CPS has undertaken some measures to curtail the deficit increase, there are several additional drivers causing the recurring and increasing deficits (continued)

COMPENSATION

Driver	Comment	FY 14 Impact	Future Trend
Teacher salaries (see Appendix A.4)	• Due to COLA and negotiated step and lane increases, teacher's salaries increase approximately 4%- 5% per annum on average, a much higher rate than revenue growth.	\$50m - \$100m	Negative
Pension pick-up (see Appendix A.5)	• In addition to the normal employer pension contribution and the UAAL, CPS pays 7% of the ~9% of salaries that employees are mandated to contribute.	~\$166m	Constant
Health care costs (see Appendix A.6)	• On average, based on preliminary review of third party information, it appears that CPS employees contribute less to health care premiums than the national average and significantly less for dependent coverage plans (CPS 9%-10% vs 28% national average). • Additional cost saving opportunities may exist through network restrictions, management of prescription drugs, etc.	~\$22.5m - \$54m	Negative

OPERATIONAL

Driver	Comment	FY 14 Impact	Future Trend

Budgeting practices (see Appendix A.7)	• Budget cuts have not been sufficient to offset declining revenue.
	• Budget expenditure variances have been commonplace but have narrowed over recent years.
	• In recent years, the hold harmless practices adopted by CPS has had the effect of increasing costs:
	  • In FY 14 and FY 15 where actual enrollment was lower than projected enrollment, CPS allowed schools to retain the SBB overfunding initially allocated to them, while schools with higher than projected enrollment received a top-up.
	  • Charter schools also received a subsequent top-up payment to make them whole for the retained funding.
		Undetermined
		
		~\$54m
			TBD

Source: Chicago Public Schools FY14 CAFR; Management Discussions

CPS five-year projections

If no action is taken, CPS projects an accumulated deficit by FY 16 and a deterioration to a negative balance of $5.4 billion by FY 20

($ in millions)		FY 14A	FY 15E	FY 16P	FY 17P	FY 18P	FY 19P	FY 20P
Revenue								
Property tax		$ 2,161.2	$ 2,227.3	$ 2,254.3	$ 2,308.2	$ 2,377.8	$ 2,449.0	$ 2,543.4
State aid	(1)	1,631.8	1,505.2	1,366.5	1,304.9	1,279.9	1,264.5	1,251.7
Federal aid		864.5	863.6	838.6	813.6	788.6	763.6	738.6
Replacement tax		131.1	139.7	134.8	142.9	152.0	157.7	161.7
TIF surplus		19.9	46.1	25.0	25.0	25.0	25.0	25.0
Other local revenue		123.9	147.4	137.4	137.4	137.4	137.4	137.4
Investment income		4.5	-	0.1	0.1	0.1	0.1	0.1
Other financing sources		0.2	-	-	-	-	-	-
Operating revenue		4,937.0	4,929.3	4,756.8	4,732.1	4,760.8	4,797.4	4,857.9
General state aid used for debt service	(2)	119.0	166.2	305.4	367.0	392.0	407.4	420.2
Total revenue (incl. GSA used for debt service)		**5,056.0**	**5,095.6**	**5,062.1**	**5,099.0**	**5,152.8**	**5,204.8**	**5,278.1**
Expenditures								
Salaries	(3)	(2,541.4)	(2,576.4)	(2,615.4)	(2,654.4)	(2,693.4)	(2,732.4)	(2,771.4)
CTPF Pension - normal	(4)	(195.2)	(204.5)	(210.0)	(216.2)	(222.5)	(229.0)	(235.8)
Other pension including pass through	(5)	(75.1)	(57.8)	(57.8)	(57.8)	(57.8)	(57.8)	(57.8)
Pension - pick-up	(6)	(166.2)	(171.7)	(175.5)	(179.5)	(183.6)	(187.9)	(192.3)
Health care	(7)	(343.3)	(338.6)	(348.8)	(359.3)	(370.1)	(381.3)	(392.8)
Other operating		(1,723.1)	(1,887.7)	(1,886.7)	(1,886.7)	(1,886.7)	(1,886.7)	(1,886.7)
Operating expenditures		(5,044.2)	(5,236.7)	(5,294.2)	(5,353.9)	(5,414.1)	(5,475.1)	(5,536.7)
Pension - UAAL	(4)	(405.9)	(429.9)	(478.0)	(492.0)	(506.4)	(521.3)	(536.5)
Debt service from general state aid		(119.0)	(166.2)	(305.4)	(367.0)	(392.0)	(407.4)	(420.2)
Long-term expenditures		(524.9)	(596.1)	(783.4)	(859.0)	(898.4)	(928.7)	(956.7)
Total expenditures (incl. debt service - GSA)		**(5,569.1)**	**(5,832.8)**	**(6,077.5)**	**(6,212.9)**	**(6,312.5)**	**(6,403.8)**	**(6,493.5)**
Net surplus / (deficit)		**$ (513.1)**	**$ (737.3)**	**$ (1,015.4)**	**$ (1,113.9)**	**$ (1,159.7)**	**$ (1,199.0)**	**$ (1,215.3)**
Beginning fund balance		$ 949.1	$ 1,084.0	$ 346.7	$ (668.7)	$ (1,782.5)	$ (2,942.3)	$ (4,141.3)
Estimated change due to revenue recognition		648.0	-	-	-	-	-	-
Net surplus / (deficit)		(513.1)	(737.3)	(1,015.4)	(1,113.9)	(1,159.7)	(1,199.0)	(1,215.3)
Ending fund balance		**$ 1,084.0**	**$ 346.7**	**$ (668.7)**	**$ (1,782.5)**	**$ (2,942.3)**	**$ (4,141.3)**	**$ (5,356.7)**

Source: Chicago Public Schools FY11 – FY14 CAFR ; FY15 management estimates as of May 15, 2015; FY16 – FY20 Management Projections as of May 15, 2015

Notes:

(1) Assumes overall State Aid is flat. Balance reflects increases in debt service funded by GSA

(2) Increase in GSA used for debt service assumes CDB @ $0, DSSF @$0, capitalized interest for 2015 bonds. Debt service is based on FY15 - FY19 approved capital plan

(3) Assumes 0% COLA and $35m steps and lane changes for CTU.

(4) Based on Segal actuarial reports; FY14 UAAL contributions estimated. The projected split of future payments between UAAL and normal has been estimated.

(5) Reflects City of Chicago & federal pass through payments for non CTPF members plus any State contributions. Historic period includes ad-hoc contributions.

(6) Pick-up includes contributions for both teachers (CTPF) and career service employees.

(7) Assumes a 3% health care inflation rate.

Mitigation of the deficit cannot be addressed by CPS alone due to overlapping issues with the other constituencies that are outside of the control of CPS

Opportunities	Potential Considerations	Estimated annual impact	Key constituent(s)

Pension Reform/Funding	• Some combination of:
	  • Increase State funding of pension
	  • Consolidate TRS and CTPF
	  • Reform current pension benefits
		~\$200 - \$500 million	State of Illinois,
			Unions,
			Retirees

State aid	• Increased State aid funding for K-12 education	~\$50 - \$100 million	State of Illinois
State School Construction program	• Potential for the State to renew the State School Construction program to administer capital improvement programs	~\$50 million	State of Illinois
Budget cuts	• Cut operating expenditures back to 2010/2011 levels	~\$150 million - \$200 million	CPS
Benefits	• Increase share that employees contribute to health care benefits • Benefit plan changes	~\$50 - \$75 million	Unions
Pension pick-up	• CPS limits or stops paying the pension pick up for all employees	~\$100 - \$175 million	Unions
Capital improvement tax	• Property tax for capital projects and debt service • Grows at rate of inflation	~\$50 million	City of Chicago
New property tax levy	• Property tax levy – to effectively replace the GSA used for debt service	~\$100 - \$400 million	City of Chicago

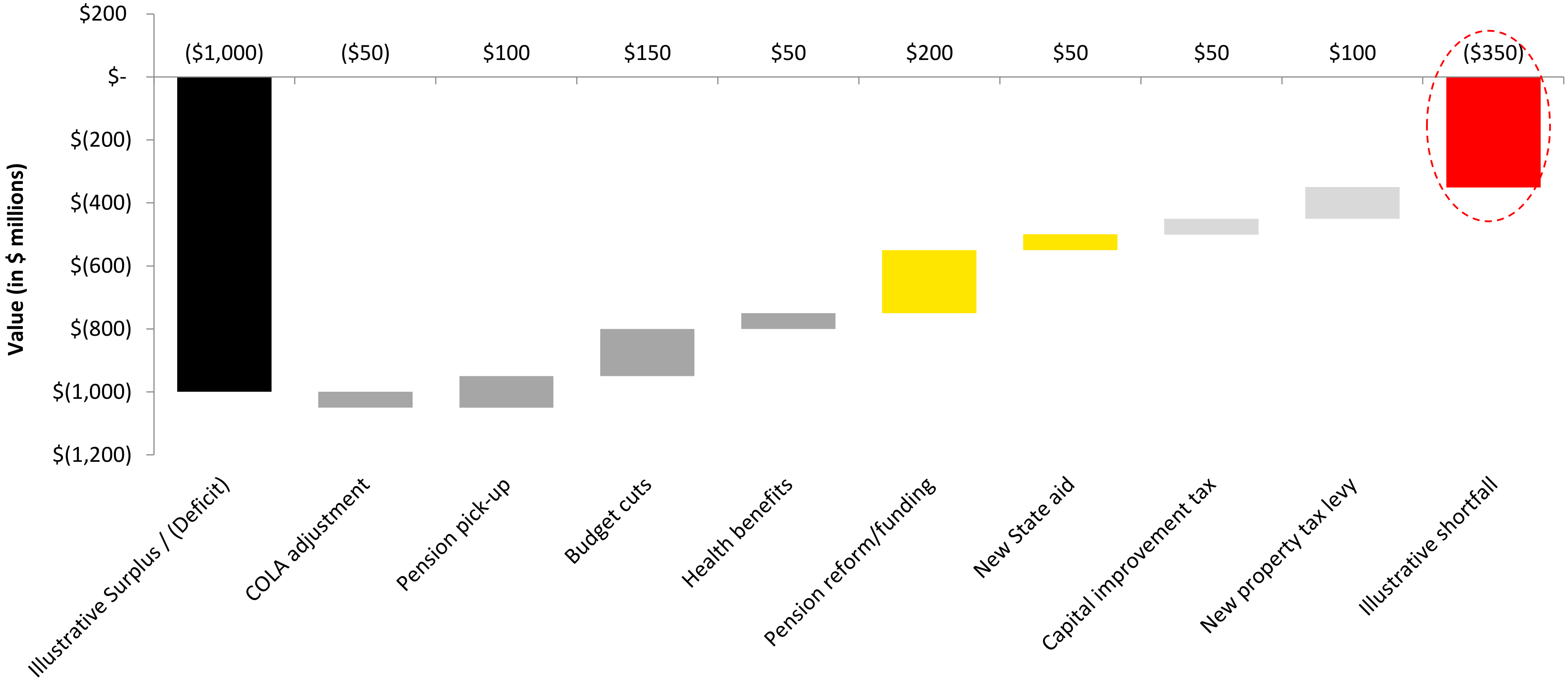
Source: Management discussions

The CPS projections may have additional downside risks that could further increase the estimated deficit going forward

Risk	Concern	Estimated annual impact	Key constituent(s)
State Aid funding	• Projections assume flat State Aid over the forecast period. Decline in GSA is assumed to be offset by other unidentified increases in non-GSA State Aid	Undetermined	State of Illinois
CBA COLA adjustment	• Projections assume no COLA adjustment for CTU. Current CTU CBA (expiring June 2015) has 2% COLA	~$40 - $60 million	Unions
Pension ROI assumption of 7.75% reduced	• The assumption on return on investment ("ROI") for the pension is higher than the ten year actuarial value average (6.0%) and may not be achieved	Undetermined	CTPF
Health care inflation assumption	• The projections assume 3% inflation, which is lower than CPS has historically incurred	Undetermined	CPS
Cost of debt service	• Ratings downgrade could result in higher costs for future borrowings.	Undetermined	Financial creditors
Swap termination	• The FY15 budget did not contemplate the settlement of the swap terminations • A portion of the swap payments could be paid from the debt service reserve	Up to $228 million (one-time)	Financial creditors

Source: Management Discussions

The combined effect of multiple mitigation opportunities may not be sufficient to cover the projected $1 billion annual funding gap



Source: Management discussions

- CPS has to develop a plan that exceeds the estimated $1.0 billion budget shortfall to cover for the potential decrease in achievable savings, inflationary costs and factors outside CPS's control.
- Shared sacrifice will be necessary from key stakeholders as there is no single solution to resolve the projected deficit.
- Identified opportunities need to be recurring since one time fixes exacerbate the deficit in future years.

Appendices

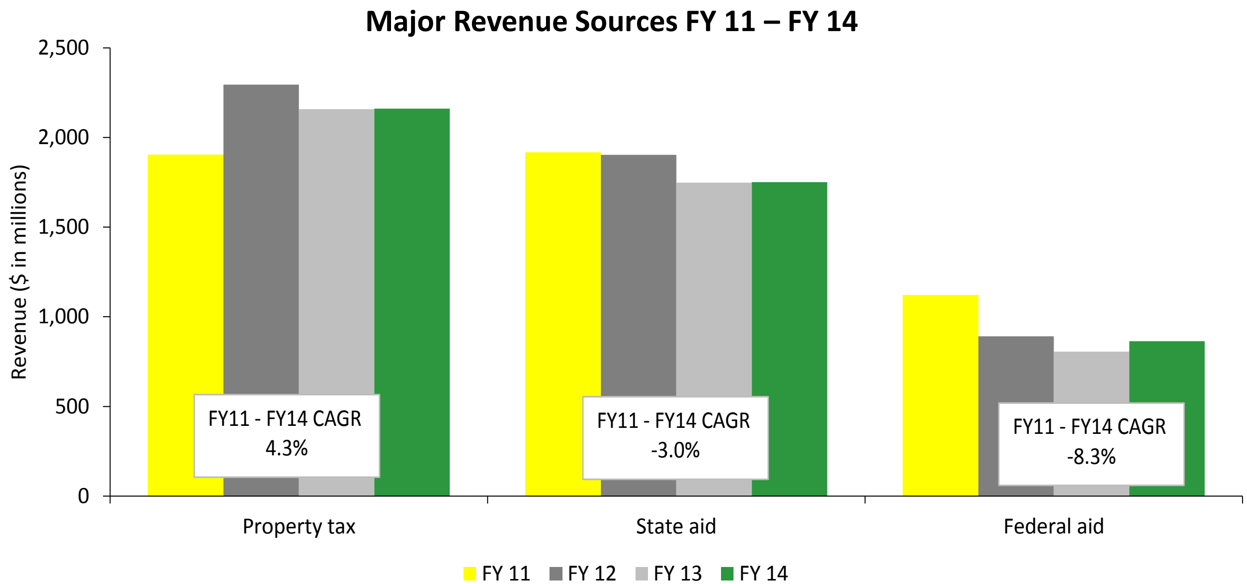
Appendix A.1 - GSA has declined due to a number of factors, but most significantly because of proration, which impacted CPS by approximately $138 million in FY 14

($ in millions) unless otherwise noted	FY 11A	FY 12A	FY 13A	FY 14A
GSA Entitlement				
Foundation level per pupil (FL) - $	6,119	6,119	6,119	6,119
Available local resources (ALR) per pupil - $	4,744	4,915	4,936	5,032
Average Daily Attendance (ADA)	349,196	347,845	349,470	348,975
Foundation claim (FL - ALR) * ADA	$ 480.1	$ 418.8	$ 413.4	$ 379.2
Supplemental Low-income grant	667.0	741.0	796.1	840.8
Gross GSA entitlement	**$ 1,147.2**	**$ 1,159.8**	**$ 1,209.4**	**$ 1,219.9**
Prior year property tax adjustment	16.3	16.3	16.3	16.3
Adjusted gross GSA entitlement	$ 1,163.5	$ 1,176.1	$ 1,225.7	$ 1,236.2
Proration	100%	95%	89%	89%
Net GSA Payment	$ 1,163.5	$ 1,118.5	$ 1,094.7	$ 1,098.5
Shortfall in State aid due to proration	**$ -**	**$ 57.6**	**$ 131.0**	**$ 137.8**

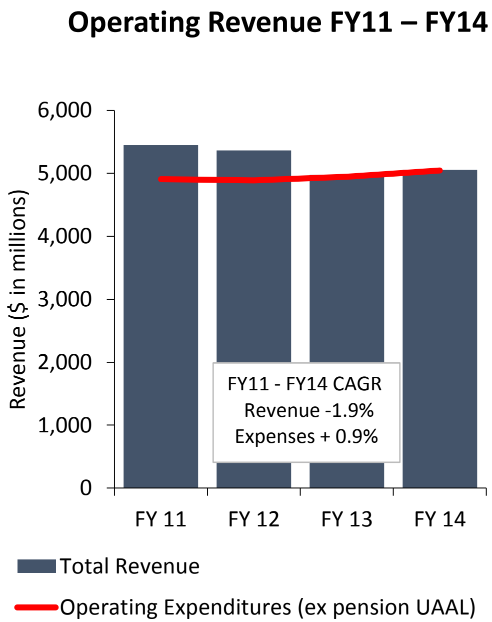
Source: http://www.isbe.state.il.us/funding/html/gsa.htm

- For each of the last three years, the State has not appropriated enough to fully fund the foundation level.
  - This has resulted in a cumulative funding impact exceeding $325 million.

Appendix A.2 - Since FY11, revenue has declined due to the loss of Federal (ARRA) funding and reductions in State aid

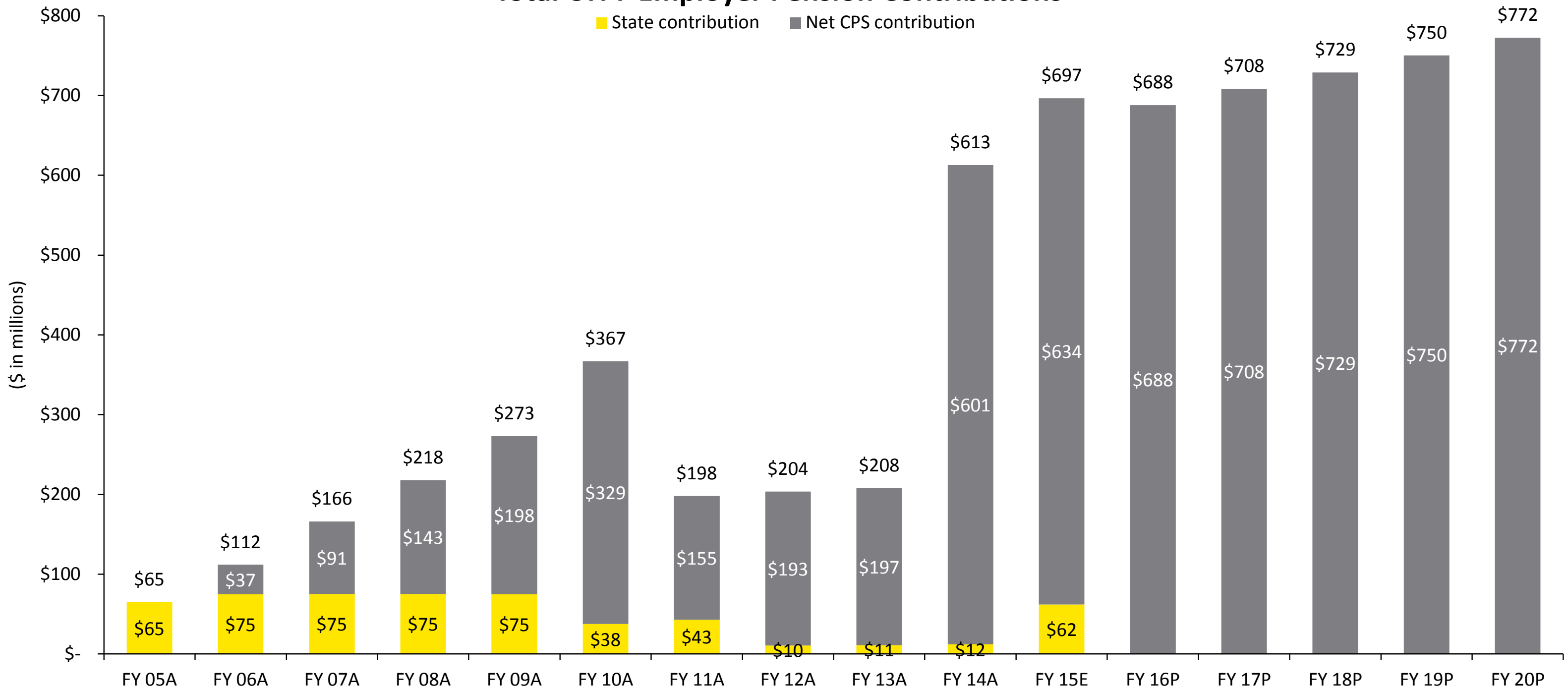


Source: Chicago Public Schools FY11 - FY14 CAFR



- Total general operating revenue has declined from FY11 – FY14, driven by reductions in the major revenue sources of Federal and State aid.
  - Federal revenue included substantial stimulus funding (ARRA) in FY11 – FY13, which is no longer available to CPS.
  - Since FY 2011, GSA funding has declined (-2.8% CAGR) as well as non GSA State funding (-2.4% CAGR), as a result of the state's decline in resources for these funds.
- CPS is limited in the property taxes it can levy (through tax caps and rate limits). Over the past four years, property tax revenues have grown consistently (CAGR 4.3%), however, the benefit of this has been entirely offset by declines in other revenue sources.

Appendix A.3 - Due to a combination of the pension holiday and the lack of adequate State funding, CPS' pension contributions are expected to increase ~$171 million from FY 14A to FY 20P



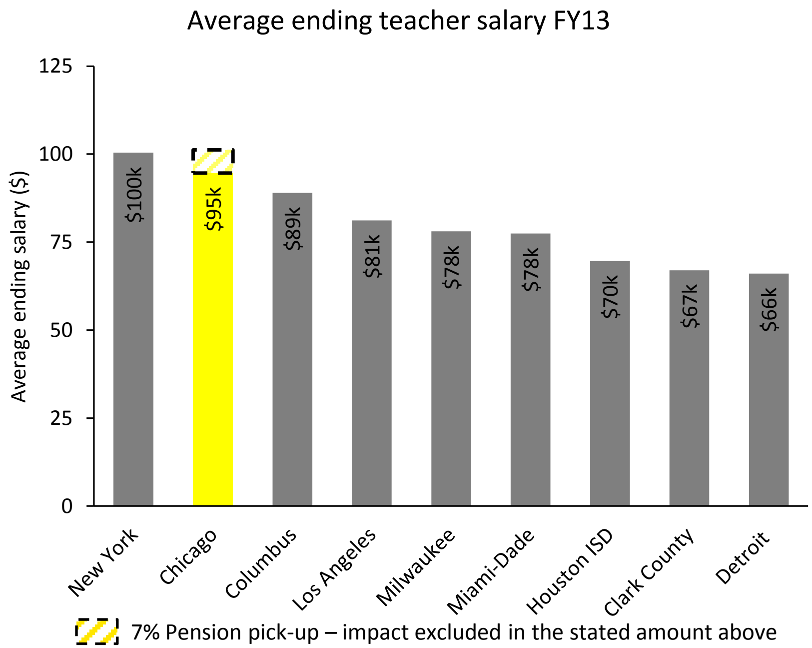
Source: Unaudited Management reports.
Note: Pension pick-up not reflected in figures above

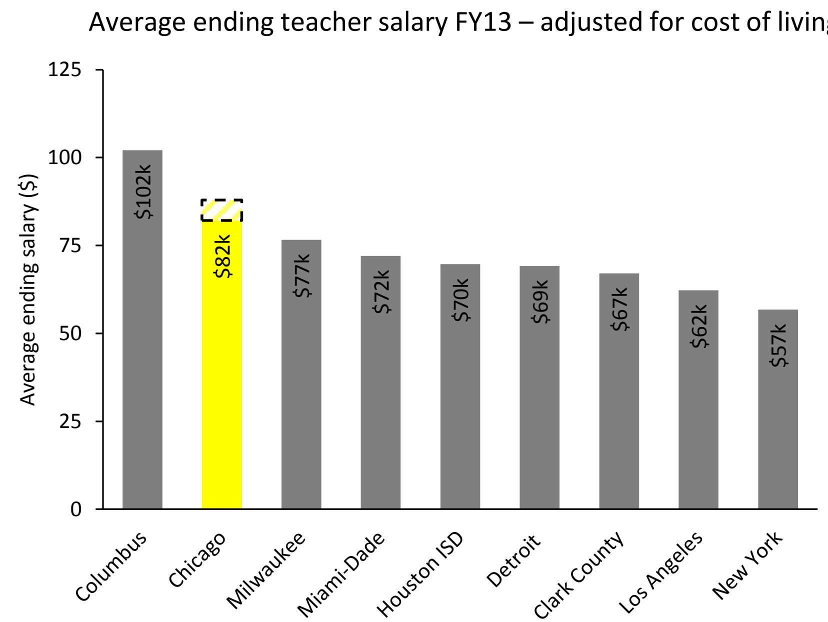
- The above contribution requirements would dramatically increase in the event more conservative actuarial assumptions are applied, such as asset investment return, liability discount rate, etc.
- The State pension code includes a goal to fund the CTPF pension fund at 20% - 30% of the funding it provides to the TRS pension in which all other Illinois school districts are members. Over the past five years, this contribution has varied from 0.3% - 2% of equivalent TRS funding and there is no certainty regarding future funding.

	FY 05A	FY 06A	FY 07A	FY 08A	FY 09A	FY 10A	FY 11A	FY 12A	FY 13A	FY 14A	FY 15E
State contribution - TRS	$ 907	$ 534	$ 738	$1,041	$1,452	$2,081	$2,171	$2,407	$2,704	$3,439	$3,413
State contribution - CTPF	$ 65	$ 75	$ 75	$ 75	$ 75	$ 38	$ 43	$ 10	$ 11	$ 12	$ 62
CTPF as % TRS	7.2%	14.0%	10.2%	7.2%	5.2%	1.8%	2.0%	0.4%	0.4%	0.3%	1.8%

Source: Management report.
Note: The State contribution to TRS excludes debt service on pension obligation bonds issued by the State

Appendix A.4 - Based on third-party data, CPS teachers generally have higher earnings potential, as compared to other school districts





Source: NCTQ Benchmarking Report, December 2014

- A NCTQ benchmarking report on teacher salaries indicates that on average, CPS teachers are well remunerated compared to their peers in other large US/midwest school districts.
  - The 7% employee pension payment paid by CPS on the employee's behalf ("pension pick-up"), further improves the relative position of CPS teachers.
- Over the past five years, total salary expenditure has reduced 4% /$93 million, through reductions in headcount in response to declining enrollment, budget cuts and lower average teacher tenure. The full extent of these savings has been offset by annual salary increases for continuing employees, including COLA and step adjustments.
  - On average, the salary of a CPS teacher in FY15 increased 5% over the prior year [1], compared to estimated flat / declining revenue.

Note 1: Based on the average increase in base salaries from 31 March 2014 to 31 March 2015 for teachers employed by CPS on both dates (source: www.cps.edu).

Appendix A.5 - CPS' current practice of funding a 7% pension pick-up costs approximately ~$166 million annually

State / District	Employee Contribution	Cost of living adjustment
CPS	2.0% [1]	Yes
California	8.0%	Yes
New York [2]	3.0-6.0%	Yes
Wisconsin	6.8%	Yes
Michigan	DB Plan [2]: 3.0-6.4% DC Plan: Min 2.0%	No
Nevada	12.3%	Yes
Florida	3.0%	No
Texas	6.7%	Yes - Ad hoc
Ohio	11.0%	Yes

Source: www.nctq.org
Note 1: 7% of the 9% required employee contribution is paid by CPS
Note 2: Dependent on salary

- State legislation mandates that 9% of salary is contributed by employees to the teacher's pension (8.5% for CPS employees in the MEABF pension). Currently, CPS is contributing 7% of the 8.5% - 9% on behalf of its employees. In FY14, this cost CPS ~ $166 million.
- Based on a preliminary review of third party information, it appears that compared to other multi-employer State teacher retirement plans, the CPS employee contribution is low. Of the three closest State/district plans in employee contribution terms (New York, Michigan, Florida: 3%+), there is no COLA component to two of these plans, which reduces the overall liability.

Appendix A.6 - CPS employees contribute less to dependent coverage health care premiums than the national average, equivalent to an additional $54 million annually in expenditures

Average employee contribution to healthcare costs

Average Employee Contribution	HMO		PPO		All plans		
	CPS	National	CPS	National	CPS	National	State / Local Government
Employee only	12%	19%	18%	18%	16%	17%	13%
Employee + child	8%	n/a	13%	n/a	10%	n/a	n/a
Family	7%	30%	12%	28%	9%	28%	24%
% CPS employees in plan	45%		44% [1]		100%		

Source: CPS Management information; The Kaiser Family Foundation & Health Research & Education Trust, Employer Health Benefits Survey 2014

Note 1: BCBS PPO (33%) + UHC PPO (11%)

- CPS currently offers five health care plans to employees through BCBSIL and UHC, with 89% of employees covered by the HMO (BCBSIL) and PPO (BCBSIL and UHC) plans. There are three tiers of coverage offered: Employee only; Employee + child; Family.
  - In FY14, CPS incurred $342 million in health care expenditures, an average of ~$10,000 per enrolled employee, representing an increase of 7% over the previous year.
  - Based on a preliminary review of third party information, it appears that 54% of employees are enrolled in a dependent coverage plan, in which CPS employee contributions are considerably below the national average. If employees contributed to dependent plans at the national average, CPS would reduce its health care expenditures by $54 million.
- Additional cost saving opportunities may be evaluated to reduce overall health care costs, such as managing networks, prescription drugs, etc.

Appendix A.7 - Management's decision not to reduce funding to schools where enrollment is lower than budget resulted in additional appropriations of $54 million in FY 14 and $46 million in FY 15

$ in millions unless noted	FY14		FY15	
	Projected	**Actual**	**Projected**	**Actual**
Enrollment (total students)[1]	380,574	376,874	377,106	373,946
SBB funding required	$1,743	$1,709	$1,814	$1,796
Hold Harmless		$54		$46
SBB funding approved [2]		$1,763		$1,842

Source: CPS Management information – unaudited

Note 1 – Enrollment excludes pre-K students

Note 2 – Represents SBB per pupil allocation before adjustments for salary increases, program support, etc. Enrollment excludes

- SBB was introduced in the CPS budget process in FY14 with the purpose of allocating the same amount of base funding for core education, per enrolled student (weighted based on grade), to each school.
- In FY14, where actual enrollment at a school was lower than the budgeted enrollment, the overall funding allocated to the school was not reduced to reflect the lower enrollment (i.e. school was "held harmless"). This decision resulted in additional appropriations of $54 million for schools in FY14 above the level implied by the per pupil funding formula.
- In FY15, schools were again "held harmless," resulting in additional appropriations of $46 million.

Appendix B - Glossary of Abbreviations

ADA	Average Daily Attendance
ARRA	American Recovery and Reinvestment Act
BCBSIL	Blue Cross Blue Shield of Illinois
CAFR	Comprehensive Annual Financial Report
CAGR	Compound Annual Growth Rate
CBA	Collective Bargaining Agreement
COLA	Cost of Living Adjustment
CTPF	Chicago Teacher's Pension Fund
CTU	Chicago Teacher's Union
DSSF	Debt Service Stabilization Fund
EAV	Equalized Assessed Value
FY14A	Fiscal Year 2014 Actual
FY15E	Fiscal Year 2015 Estimate as of May 15, 2015
FY16P	Fiscal Year 2016 Projection as of May 15, 2015
GSA	General State Aid
HMO	Health Maintenance Organization
MEABF	Municipal Employees Annuity and Benefit Fund of Chicago
NCTQ	National Council on Teacher Quality
PPO	Preferred Provider Organization
SBB	Student Based Budgeting
SGSA	Supplementary General State Aid
TIF	Tax Increment Financing
TRS	Illinois Teacher's Retirement System
UAAL	Unfunded Accrued Actuarial Liability
UHC	United Healthcare

Appendix C – Methodology and Project Details

The scope of work was undertaken over a four-week period and involved the analysis of internal CPS Management information, publicly available CPS information and external sources of data. These data sources, in addition to a list of meetings and discussion topics held with CPS Management, are outlined below.

Materials Analyzed

- FY11 – FY14 Comprehensive Annual Financial Report
- FY11 – FY15 Budget Books
- Five-year general operating fund projections
- Debt service projections
- Cash flow projections
- FY15 actual results to date and FY15 estimate
- CAFR and budget detail by fund and account code
- Historical revenue source data FY05 – FY14
- Revenue projections FY16 – FY20
- Revenue and cost saving initiatives
- Pension and health care analysis
- Enrollment data SY06 – SY15
- School-Based Budgeting allocations FY13 – FY15
- Employee roster/vacancy reports

External sources of data

- Moody's Reports
- CTPF annual reports
- Actuarial reports
- National Center for Education Statistics
- National Center for Teacher Quality
- School district websites
- School district Comprehensive Annual Financial Report
- Illinois State Board of Education Report Cards
- Civic Federation reports on Cook County property tax system
- City of Chicago EAV and new EAV estimates: 2013-2017

Meetings conducted – topics and CPS personnel

CPS background	Chief Financial Officer, Controller
GSA	Budget Manager 1
Property taxes	Consultant
Schools budgeting	Budget Manager 2
Grant funding	Exec Director Grant & Federal Programs, Budget Manager 3, Claims Manager
Debt and cash overview	Senior Treasury Analyst, Debt Manager
Discussion of CAFR detail files and data	Accounting Manager, Office of Budget & Management
Discussion of CPS projection assumptions	Chief Financial Officer
Cash flow forecasting	Treasurer, Senior Treasury Analysts, Controller, Chief Financial Officer

Appendix D – Reconciliation of FY 15 budget to FY 15 estimate

$ in million	FY15 Budget	Estimated Budget-to-Estimate Variance: General Fund	School Specific	Grants	Variance (excl. Grant) (1)	FY15 Estimate
Revenues						
Property tax	$ 2,178	n/a	n/a	n/a	$ 49	$ 2,227
Replacement tax	133	n/a	n/a	n/a	7	140
State aid	1,508	n/a	n/a	n/a	(2)	1,505
Federal aid	861	n/a	n/a	n/a	2	864
Interest and investment earnings	0	n/a	n/a	n/a	(0)	-
Other revenue from local sources	49	n/a	n/a	n/a	(3)	46
Other	162	n/a	n/a	n/a	(14)	147
Total revenues	4,892	n/a	n/a	n/a	38	4,929
Expenditures						
Teachers' salaries	(1,986)	35	0	6	35	(1,951)
Career service salaries	(626)	(2)	2	5	(0)	(626)
Teachers' pension	(795)	26	1	2	27	(768)
Career service pension	(101)	5	1	2	6	(96)
Hospitalization and dental insurance	(341)	1	2	6	3	(339)
Medicare	(40)	3	0	1	3	(37)
Unemployment compensation	(9)	1	0	0	1	(8)
Workers' compensation	(23)	(7)	0	0	(7)	(30)
Personnel costs	(3,921)	63	5	21	68	(3,853)
Charter schools	(650)	(12)	1	(5)	(11)	(661)
Tuition	(73)	(19)	1	1	(18)	(92)
Transportation	(100)	(6)	(0)	(0)	(6)	(105)
Food	(101)	(1)	(0)	3	(1)	(102)
Utilities	(113)	6	(0)	-	6	(107)
Textbooks, supplies & postage	(81)	(15)	(2)	(1)	(17)	(98)
Professional and special services	(321)	(22)	(1)	(28)	(23)	(343)
Other operating costs	(91)	(18)	(5)	(0)	(24)	(115)
Miscellaneous	(303)	40	74	170	113	(190)
Non-personnel operating costs	(1,833)	(47)	67	140	20	(1,813)
Total expenditures	(5,755)	16	72	161	88	(5,667)
Surplus / (Deficit)	**$ (863)**				**$ 126**	**$ (737)**

Source: Management estimates as of May 15, 2015 - unaudited

(1) FY 15 estimate is based on preliminary actual results through March 2015 plus an estimate for the remainder of the year and assumes no further delay in State aid block grant payments. Grant Funds variances have been excluded from adjustments as the net surplus / (deficit) impact should be zero (i.e. any reduction in grant expenditures will result in a similar reduction in grant revenue).

Appendix E – Summary of CPS expenditure Cuts FY 11 – FY 15

$ in millions	FY 11	FY 12	FY 13	FY 14	FY 15	Total
Administration	$ 17.2	$ 107.0	$ 12.0	$ 33.7	$ 12.3	$ 182.2
Operations	14.1	127.0	116.0	59.5	27.5	344.1
Programs	-	87.0	49.0	18.4	15.3	169.7
Debt Obligations	44.0	-	-	-	-	44.0
Total	**$ 75.3**	**$ 321.0**	**$ 177.0**	**$ 111.6**	**$ 55.1**	**$ 740.0**

Source: Unaudited CPS Management information.

Appendix F – FY 11 – FY 20 Financial results and projections

($ in millions)		FY 11A	FY 12A	FY 13A	FY 14A	FY 15E	FY 16P	FY 17P	FY 18P	FY 19P	FY 20P
Revenue											
Property tax		$ 1,904.2	$ 2,295.2	$ 2,157.8	$ 2,161.2	$ 2,227.3	$ 2,254.3	$ 2,308.2	$ 2,377.8	$ 2,449.0	$ 2,543.4
State aid	(1)	1,694.6	1,757.2	1,599.4	1,631.8	1,505.2	1,366.5	1,304.9	1,279.9	1,264.5	1,251.7
Federal aid		1,121.5	891.0	806.0	864.5	863.6	838.6	813.6	788.6	763.6	738.6
Replacement tax		172.4	126.8	128.2	131.1	139.7	134.8	142.9	152.0	157.7	161.7
TIF surplus		123.3	39.0	26.3	19.9	46.1	25.0	25.0	25.0	25.0	25.0
Other local revenue		98.1	103.2	106.4	123.9	147.4	137.4	137.4	137.4	137.4	137.4
Investment income		1.9	4.4	2.2	4.5	-	0.1	0.1	0.1	0.1	0.1
Other financing sources		109.8	0.1	0.4	0.2	-	-	-	-	-	-
Operating revenue		5,225.7	5,216.7	4,826.8	4,937.0	4,929.3	4,756.8	4,732.1	4,760.8	4,797.4	4,857.9
General state aid used for debt service	(2)	222.7	146.5	149.1	119.0	166.2	305.4	367.0	392.0	407.4	420.2
Total revenue (incl. GSA used for debt service)		**5,448.4**	**5,363.2**	**4,975.8**	**5,056.0**	**5,095.6**	**5,062.1**	**5,099.0**	**5,152.8**	**5,204.8**	**5,278.1**
Expenditures											
Salaries	(3)	(2,634.3)	(2,645.1)	(2,575.5)	(2,541.4)	(2,576.4)	(2,615.4)	(2,654.4)	(2,693.4)	(2,732.4)	(2,771.4)
CTPF Pension - normal	(4)	(133.2)	(194.9)	(196.9)	(195.2)	(204.5)	(210.0)	(216.2)	(222.5)	(229.0)	(235.8)
Other pension including pass through	(5)	(106.6)	(72.1)	(111.6)	(75.1)	(57.8)	(57.8)	(57.8)	(57.8)	(57.8)	(57.8)
Pension - pick-up	(6)	(168.5)	(168.7)	(168.4)	(166.2)	(171.7)	(175.5)	(179.5)	(183.6)	(187.9)	(192.3)
Health care	(7)	(353.9)	(324.9)	(319.8)	(343.3)	(338.6)	(348.8)	(359.3)	(370.1)	(381.3)	(392.8)
Other operating		(1,513.6)	(1,482.6)	(1,574.2)	(1,723.1)	(1,887.7)	(1,886.7)	(1,886.7)	(1,886.7)	(1,886.7)	(1,886.7)
Operating expenditures		(4,910.0)	(4,888.3)	(4,946.4)	(5,044.2)	(5,236.7)	(5,294.2)	(5,353.9)	(5,414.1)	(5,475.1)	(5,536.7)
Pension - UAAL	(4)	-	-	-	(405.9)	(429.9)	(478.0)	(492.0)	(506.4)	(521.3)	(536.5)
Debt service from general state aid		(222.7)	(146.5)	(149.1)	(119.0)	(166.2)	(305.4)	(367.0)	(392.0)	(407.4)	(420.2)
Long-term expenditures		(222.7)	(146.5)	(149.1)	(524.9)	(596.1)	(783.4)	(859.0)	(898.4)	(928.7)	(956.7)
Total expenditures (incl. debt service - GSA)		**(5,132.7)**	**(5,034.9)**	**(5,095.4)**	**(5,569.1)**	**(5,832.8)**	**(6,077.5)**	**(6,212.9)**	**(6,312.5)**	**(6,403.8)**	**(6,493.5)**
Net surplus / (deficit)		**$ 315.8**	**$ 328.4**	**$ (119.6)**	**$ (513.1)**	**$ (737.3)**	**$ (1,015.4)**	**$ (1,113.9)**	**$ (1,159.7)**	**$ (1,199.0)**	**$ (1,215.3)**
Beginning fund balance		$ 424.6	$ 740.4	$ 1,068.7	$ 949.1	$ 1,084.0	$ 346.7	$ (668.7)	$ (1,782.5)	$ (2,942.3)	$ (4,141.3)
Estimated change due to revenue recognition		-	-	-	648.0	-	-	-	-	-	-
Net surplus / (deficit)		315.8	328.4	(119.6)	(513.1)	(737.3)	(1,015.4)	(1,113.9)	(1,159.7)	(1,199.0)	(1,215.3)
Ending fund balance		**$ 740.4**	**$ 1,068.7**	**$ 949.1**	**$ 1,084.0**	**$ 346.7**	**$ (668.7)**	**$ (1,782.5)**	**$ (2,942.3)**	**$ (4,141.3)**	**$ (5,356.7)**

Source: Chicago Public School FY11 – FY14 CAFR ; FY15 management estimates as of May 15, 2015; FY16 – FY20 Management Projections as of May 15, 2015

Notes:

(1) Assumes overall State Aid is flat. Balance reflects increases in debt service funded by GSA

(2) Increase in GSA used for debt service assumes CDB @ $0, DSSF @$0, capitalized interest for 2015 bonds.

(3) Assumes 0% COLA and $35m steps and lane changes for CTU.

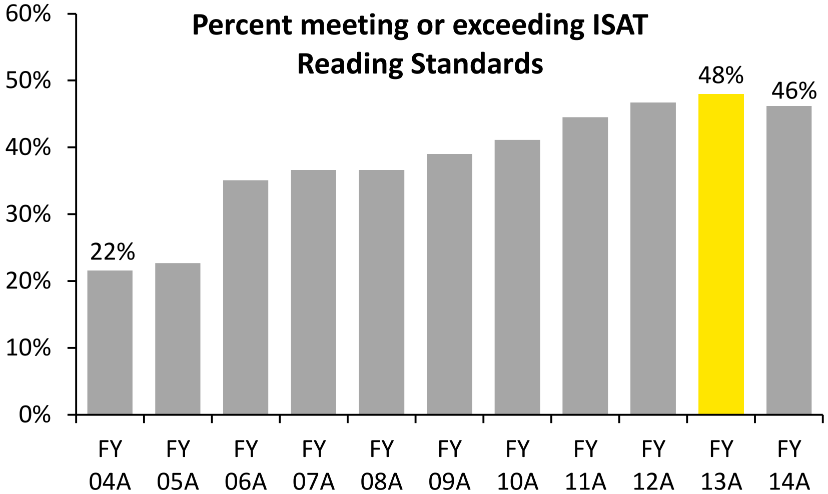
(4) Based on Segal actuarial reports; FY14 UAAL contributions estimated. The projected split of future payments between UAAL and normal has been estimated.

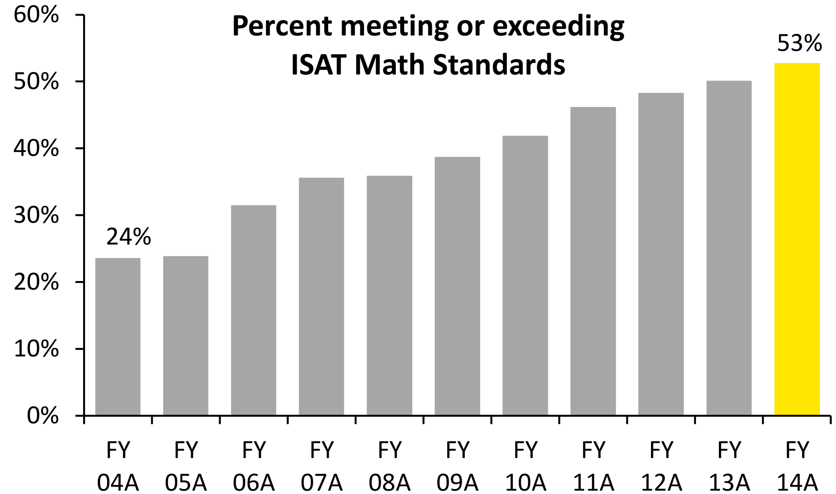
(5) Reflects City of Chicago & federal pass through payments for non CTPF members plus any State contributions. Historic period includes ad-hoc contributions.

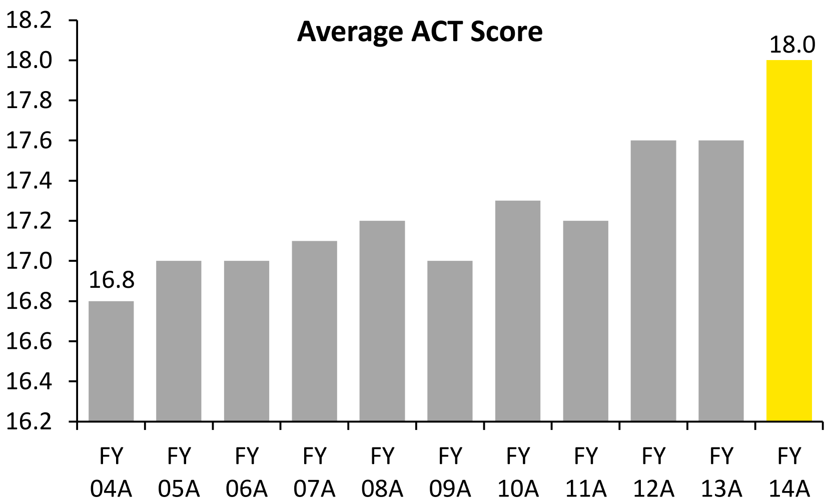
(6) Pick-up includes contributions for both teachers (CTPF) and career service employees.

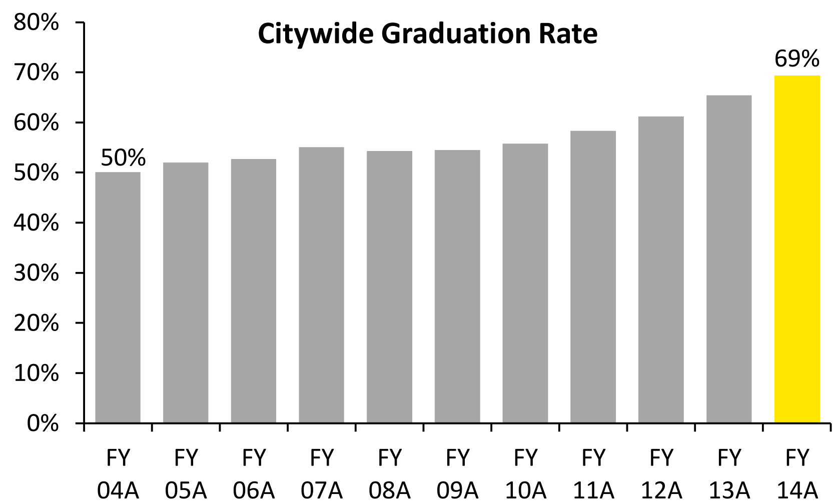
(7) Assumes a 3% health care inflation rate.

Appendix G.1 – CPS has made significant strides in enhancing students proficiency and graduation rates over the last decade



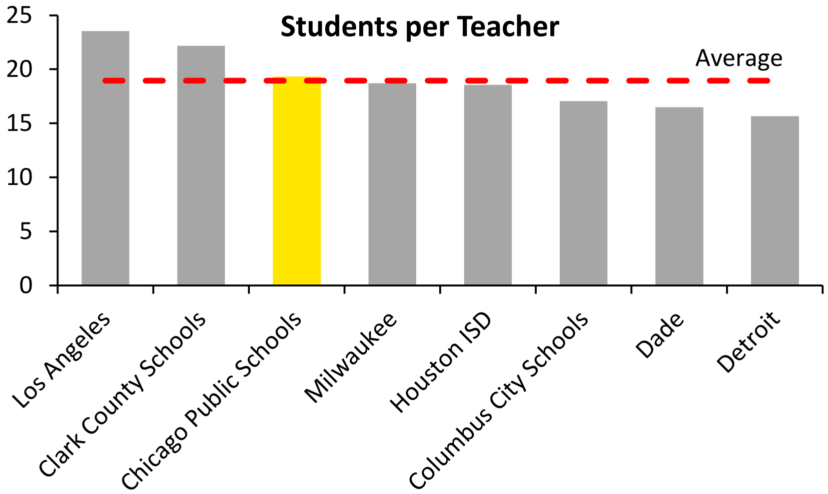


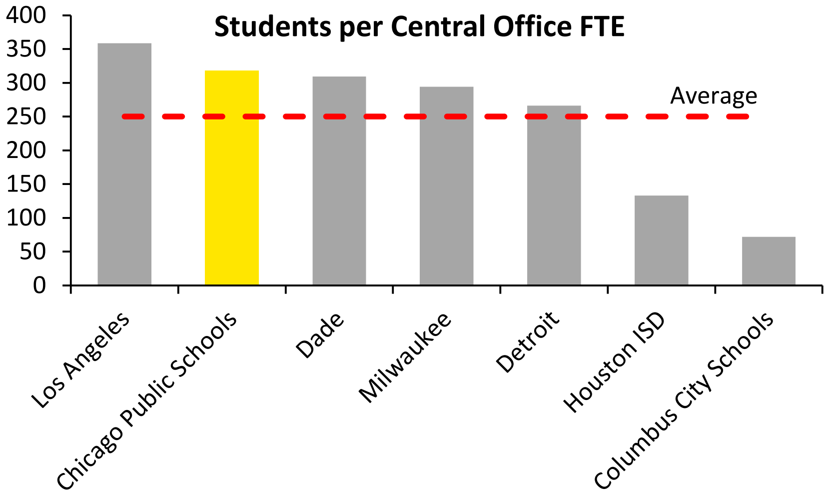


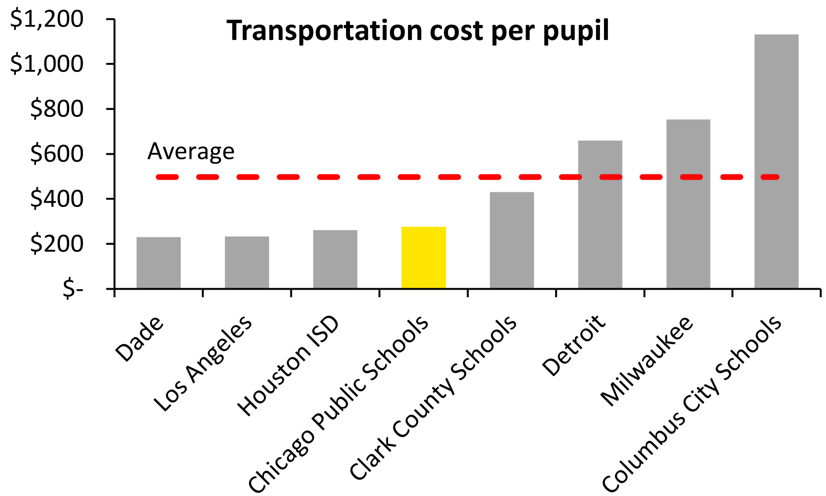


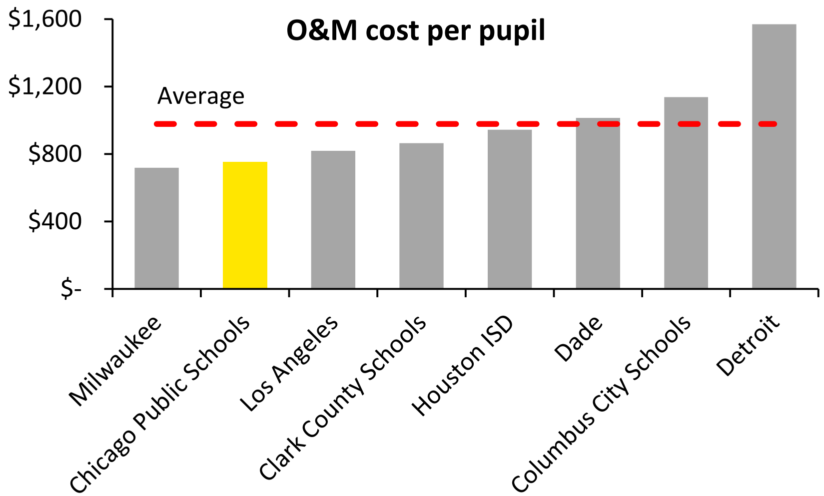
Page source: www.cps.edu

Appendix G.2 – CPS performs at a more efficient level than its peers in several operational areas that comprise a large portion of its budget

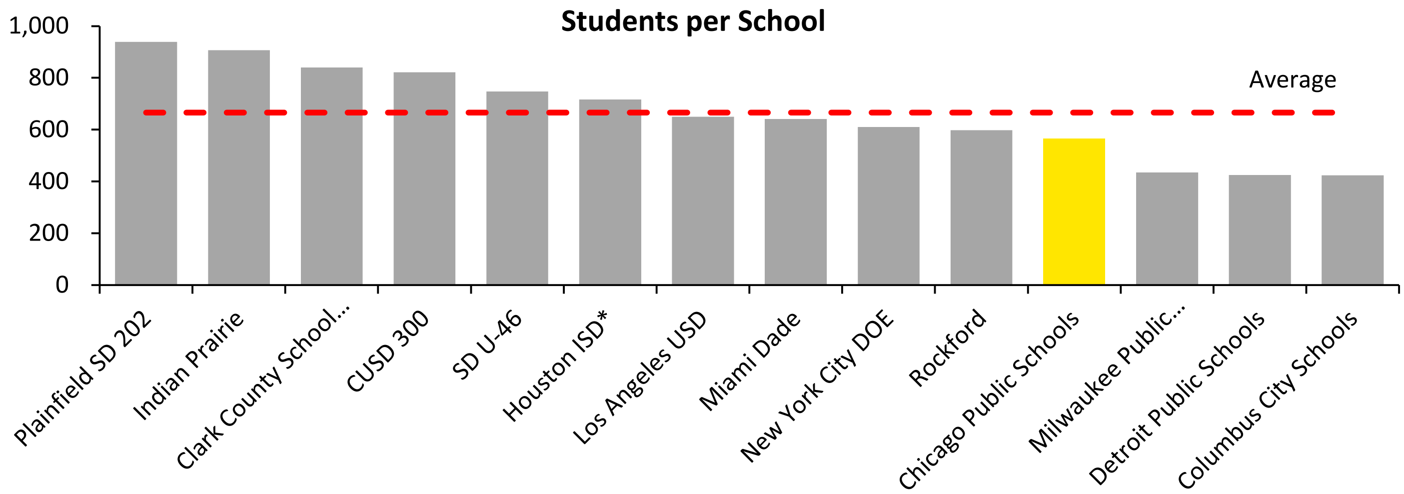


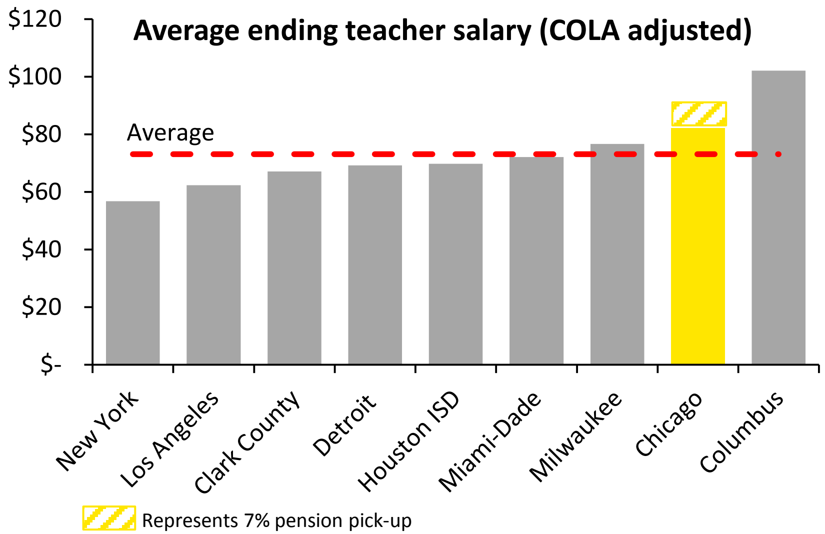


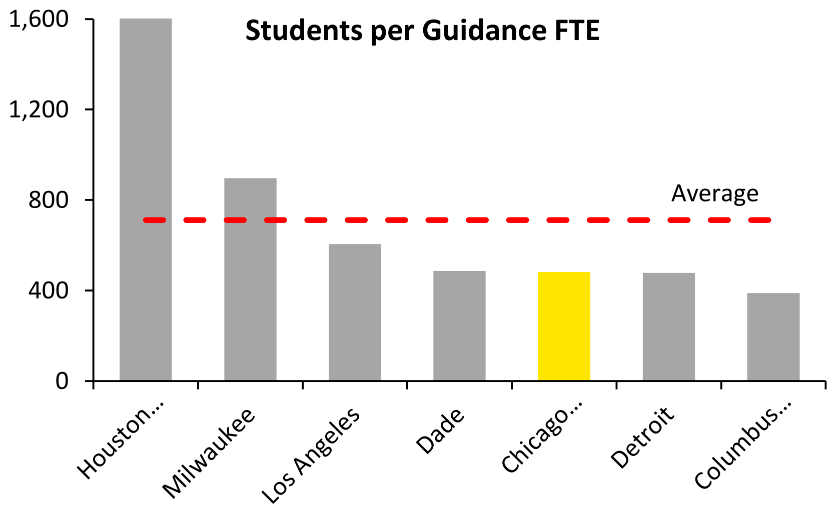




Source: CPS reports, National Center for Education Statistics, CAFR data available for school districts, National Council on Teacher Quality







Source: CPS reports, National Center for Education Statistics, CAFR data available for school districts, National Council on Teacher Quality

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