Understanding New Bills That Limit CO’s and Other Non-Voter Approved Debt

House Bill 1869 (Rep. Burrows)

87R4691 TJB-F

By: Burrows H.B. No. 1869

A BILL TO BE ENTITLED

AN ACT

relating to the definition of debt for the purposes of calculating certain ad valorem tax rates of a taxing unit.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. Section 26.012(7), Tax Code, is amended to read as follows:

(7) "Debt" means a bond, warrant, certificate of obligation, or other evidence of indebtedness owed by a taxing unit that <u>has been approved at an election and</u> is payable solely from property taxes in installments over a period of more than one year, not budgeted for payment from maintenance and operations funds, and secured by a pledge of property taxes, or a payment made under contract to secure indebtedness of a similar nature issued by another political subdivision on behalf of the taxing unit.

SECTION 2. The change in law made by this Act applies only to a bond, warrant, certificate of obligation, or other evidence of indebtedness for which the ordinance, order, or resolution authorizing issuance was adopted by the governing body of the taxing unit on or after the effective date of this Act.

SECTION 3. This Act takes effect September 1, 2021.

Author's Legislative Intent

- Push began during the 86th Legislative Session House floor hearing on Senate Bill 2 (3.5% M&O Cap); HB 1869 builds on that push
- Provide taxpayers larger voice in bringing about property tax relief
  - Belief is that local governments will use non-voted debt to circumvent the 3.5% M&O cap
  - Circumventing the cap by moving expenses to debt issuances was allegedly discussed at a Texas Association of Counties Conference
    - *These discussions are out of line and as stewards of public funds, no finance professionals should recommend financing techniques that will harm the long-term financial health of their City*
- Give taxpayers more voice in what projects they want to see in their community
- Effective only for bonds issued after September 1, 2021
- **Does not take away any currently authorized financing instrument**

Legislative Update (as of April 6, 2021)

- Bill Tracking
  - Filed on February 11
  - Read for First Time and Referred to House Ways & Means on March 11
  - Scheduled, Heard, and Considered on March 22
  - Left Pending in Committee
- Unintended Consequences that Committee is Responsive To:
  - Refunding Bonds
  - Self-Supporting Debt (Double-Barreled Pledges)
  - State Program Issuances (TWDB, SIB, etc.)
  - Disaster-Related Issuances

Current Legal Requirements of COs

- Approved by the elected governing body for defined purposes (§ 271.045)
- May not have a maturity greater than 40 years
- May not be issued for contractual obligations if a bond proposition for the same purpose was submitted to voters and failed within the preceding three years
- Notices of the issuance must be posted for 45-days
  - Once per week for two consecutive weeks in newspaper of general circulation
  - Continuously on the City's website
- A petition of 5% of the registered voting population can make the issuance of COs be placed on the next election ballot
- Proceeds may only be used for purposes for which the certificates were authorized and issued
- All COs must be submitted to and approved by the Attorney General's Office

Positives of COs #1: Lower Interest Rates

- Pledging against a city or County's tax base, typically receives higher bond ratings and thus lowers Interest rates
- Interest earned on Certifications of Obligation is tax-exempt, which lowers the interest rate even further
  - Some cities paid interest rates as low as 1.5% interest last year
- Due to the low interest rates many cities use COs for their utility system
  - This is referred to as self-supporting debt
  - 54% of all COs have a self-supporting component
  - 35% of all COs outstanding are self-supporting from revenue other than taxes
- Typical savings on Certificates of Obligation over revenue bonds is 10 – 30 basis points or (0.10 - 0.30%)

*Statistics from the Municipal Advisor Council

Positives of COs #2: Lower Issuance Costs

- Additional savings are captured due to not having to issue separate revenue bonds for each type of utility
  - Lowers issuance costs through the consolidated issuance
- Certificates of Obligation have a less complicated legal and debt structure than revenue bonds, which results in additional savings
- Estimated savings to Texas taxpayers $123 Million in issuances cost by issuing self-supporting CO's

Positives of COs #3: No Fund Reserves

- Debt service reserve funds are typically required to be funded from bond proceeds when revenue bonds carry a rating below the AA rating category
- Reserve fund requirements can be as high as 10% of the principal amount of the bonds being issued,
  - Issuer may have to increase the amount of debt it has outstanding in order to fund a reserve fund.
  - This results in additional costs being passed on to the rate payer
- It is inefficient use of cash
  - Low interest rates over the last 10 years have causes the debt reserve fund to become costly
  - Example: borrowing at 2% and reinvesting at .25% is a losing proposition. This loss or negative arbitrage is an estimated $6 million per year on outstanding self-supporting COs.

Positives of COs #4: Coverage Requirements

- Certificates of Obligation require for cities to have enough revenues to cover the debt service payment
- Revenue bonds require the issuer to cover not only the debt service payment but additional debt payment as well
  - Investors and rating agencies measure credit quality in part by the amount of cushion that exists in the budget before having a shortfall on paying bond
    - Added coverage to protect against market fluctuations
  - If Cites were unable to provide the additional coverage
    - City would likely receive a lower bond rating
    - Resulting in a higher interest rates

Summary

- Certificates of Obligation
  - Result in Lower Interest Rates
  - Reduce Issuance Costs
  - Require Less Debt Service Reserve Funds
  - Have Lower Coverage Requirements

HB 1869 – Lubbock Impact

- Limiting Our Ability to Capitalize on Outside Funding Sources
  - Direct Developer Contributions for Projects
    - Lubbock's Milwaukee Avenue $20MM 7-Lane Thoroughfare Project
    - Initiated by a group of developers, who pledged $5MM direct assistance
    - Now home to over 100+ businesses and thousands of jobs
    - Generates $150MM+ in retail sales per year
  - Risks if HB 1869 goes into effect as filed
    - Developers must hold $5MM cash until election (opportunity cost and risk of election failing)
    - At today's low interest rate, the cost of the project as non-voted debt would add approximately $1.4MM in M&O costs
      - 3.5% cap for Lubbock adds approximately $1.6MM (equates to 0.7% General Fund budget increase)
      - That leaves $200k for Public Safety, Street Maintenance, Solid Waste Disposal, Libraries, Parks & Recreation, Engineering, Public Works, Street Maintenance, and much more (equates to 0.09% General Fund budget increase)

HB 1869 – Lubbock Impact (Continued)

- Putting our ISO Class 1 Rating at Risk
  - ISO Class 1 Rating provides insurance premium reductions to homeowners and businesses
  - Tax Note program to keep up with Fire vehicle replacements
    - Fire pumpers and ladders cost $800k and $1.2MM respectively
    - 7-year debt to fund equipment that will last approximately 15 years
    - Fund up to 3 apparatuses per year
  - Risk if HB 1869 goes into effect as filed
    - Increased cost to hold annual election to issue a critical need for public safety (adds $350k) – have never had any negative feedback or public comment related to these issuances
    - Could be forced to over-purchase vehicles to not trigger “defunding” of public safety if other legislation is enacted

Addison Impact

- Addison has used CO’s to fund public infrastructure of major development projects
  - Over the past decade these projects have added approximately $600M to Addison’s tax roll and contribute approximately $3.6M annually to the Town’s budget in ad valorem taxes alone.
- Refunding Bonds
  - Over the past decade Addison has refunded debt on four separate occasions creating gross savings of $7.1M and NPV savings of $6.1M
  - Under proposed legislation the Town would not have been able to take advantage of market conditions to create these savings without first receiving the approval of voters

Addison Impact (Continued)

- Addison has used CO’s to fund enterprise funds capital improvement program (Airport, Utility Fund, Stormwater Fund).
  - The debt service of these obligations is serviced by the revenues from these funds, but are supported by the taxing authority of the Town.
  - If CO’s were not an allowed funding mechanism these would have been required to be Revenue Bonds carrying in all likelihood a rating below Addison’s AAA (S&P) and Aaa (Moody’s) ratings costing Addison residents and businesses millions of dollars in additional financing charges.
  - Over the past decade Addison has issued CO’s for its enterprise fund capital improvement program on three separate occasions.
    - Total debt service as issued = $44.8M
    - Total estimated debt service as revenue bonds = $48.8M
    - Increase in total debt service of $4M or 8.75%

HB 1869 – Northlake Impact

- Town has issued two rounds of CO’s totaling $15,565,000
  - Financial advisors estimated impact is $2,170,931 or 14%
- Would have delayed construction due to the timing of the issuance. Estimated increases in construction costs are $1,000,000.
- Would have caused two separate elections estimated costs $30,000.
- Total impact estimated impact $3,200,931 if this legislation would have been in place.

How to Discuss Impact of Legislation

- Financial Impact
  - Analyze your City's debt-funded project plan in your CIP to calculate an approximate debt service
    - Understand and be prepared to defend your reason for debt financing plan
    - Factor in cost of elections
    - Understand the cost of changing the issuance type - Certificates of Obligation → Revenue Bonds
  - Analyze the impact of the debt payments if your City had to carry this on your M&O tax rate, subject to 3.5% cap
- Legislative Impact
  - Takes authority away from Locally Elected Officials
  - It is an additional unfunded mandate from the state