

# ALLEN BOONE HUMPHRIES ROBINSON LLP

## ATTORNEYS AT LAW

PHOENIX TOWER  
3200 SOUTHWEST FREEWAY  
SUITE 2600  
HOUSTON, TEXAS 77027  
TEL (713) 860-6400  
FAX (713) 860-6401  
abhllp.com

## Texas Municipal Utility Districts: An Infrastructure Financing System

By: Joe. B. Allen and David M. Oliver, Jr.

### I. The History of Special Districts

#### A. Overview

Large population growth requires the development of new communities. Massive capital outlays must be made in order to provide quality water, sewer, drainage, and other municipal services to these new communities. General units of government (e.g., states, counties, and cities) historically have been unwilling or unable to finance these large capital outlays. In Texas, this inability has been due to legal restrictions in the Constitution on municipal debt and taxing authority, combined with the unwillingness of one constituency to incur debt for the benefit of another, especially when risks associated with new development are involved.

Private financing of these capital outlays failed in Texas because the infrastructure costs were recovered through the sale of land, resulting in higher lot prices and unaffordable housing. Attempts at private ownership of the needed facilities led to the construction of substandard systems because the fees required to recover the capital costs were excessive. In addition, because there are no periodic charges associated with drainage facilities, the cost of such facilities could not be recovered through user fees.

States like Texas, Florida, and California that have experienced rapid growth have addressed the shortcomings described above by using special district governments to finance all or part of the required utility and community support facilities. Special districts are local governmental entities that can be endowed with special powers to provide one or more specific services when general purpose governments cannot or will not provide a necessary service to an area. This flexibility makes special districts efficient tools for the

stimulation of urban growth and enables them to function in the development of commercial, industrial, and residential properties, and in projects ranging from small subdivisions to large master-planned communities. Among the types of special districts widely used in the United States are hospital, school, water, irrigation, drainage and flood control, urban renewal districts, river authorities, and developmental districts.

## **B. Texas Constitutional and Legislative Background**

Texas recognized the need for special districts as early as 1904 when it adopted Article III, Section 52, of the Texas Constitution, authorizing the Texas Legislature to pass laws permitting special districts. After struggling with the limits on indebtedness and other shortcomings in the 1904 amendment, Texas adopted Article XVI, Section 59, of the Texas Constitution in 1917, allowing water districts to operate with unlimited tax authority and bond indebtedness. Since 1917, the Legislature has authorized numerous types of special districts. Water districts were initially used to develop the state's agricultural lands and later to service small communities. After the use of water districts for urban residential development increased significantly in the 1950s and 1960s, Texas adopted Chapter 54 of the Texas Water Code in 1971 authorizing the creation of Municipal Utility Districts ("MUDs") to streamline the process. In 1995, Chapter 49 was added to standardize the administrative provisions for the numerous types of districts. Today, MUDs are the primary financing tool used by developers in Texas for new development.

## **C. City Involvement**

Texas cities are granted a sphere of influence outside their boundaries known as extraterritorial jurisdiction ("ETJ"). A city must consent to the creation of a MUD within its ETJ or its corporate limits. In its consent, the city may require the MUD to submit all plans for its infrastructure for approval and limit the length of maturity and interest rate of the MUD bonds. The city bears no risk for the development or the MUD, while controlling the quality of the infrastructure. The city has the legal option to annex the MUD, acquire all the assets and assume the debt, subject to certain procedural steps.

## **D. Special Districts in Texas Today**

A majority of the approximately 1100 special districts in Texas today were created over vacant land owned by the developer outside of city limits. Even after significant annexation by cities, over 2 million people populate these special districts, and it is estimated that there is in excess of \$6 billion in outstanding special district bonds. There is significant use of special districts in Austin and rapidly growing use in the Dallas metropolitan area. Most of the special districts in Texas, however, are located in the Houston metropolitan area. It is estimated that the approximately 500 special districts located in the Houston metropolitan area have in excess of \$4.5 billion in outstanding bonds. All of the major community developments in the Houston metropolitan area over the past thirty years have been developed using special districts. Some of these communities and

their approximate acreage include The Woodlands (27,000 acres), Clear Lake City/NASA (15,000 acres), First Colony (10,000 acres), Sienna Plantation (10,000 acres), and Cinco Ranch (5,400 acres). The use of special districts has enabled Houston to sustain quality growth while retaining the lowest home prices of any major metropolitan area in the United States. Houston has acquired a major portion of its land and population through annexation.

The development of the city of Sugar Land, Texas provides a compelling example of the benefits of using special districts. Sugar Land was a company town (sugar cane processing) on the Southwest side of Houston until the 1960's. Its population in 1970 was approximately 5,000 people. In the 1970's, the sugar cane fields surrounding the town were sold to developers who utilized special districts to develop the area. After the build-out of these communities was completed, the City of Sugar Land annexed all of the property by dissolving the special districts and assuming their debt. Today, Sugar Land has a population of approximately 70,000 people, has a low ad valorem tax rate, and is viewed as one of the most prosperous, high-quality communities in Texas.

## **II. Municipal Utility Districts**

### **A. Overview**

The objective of a MUD is to provide various services such as water, sewer, and drainage (including detention ponds) to certain areas where municipal services are not available. A MUD also has the ability to construct parks, street lighting, fire prevention facilities, and certain types of roads. The funds used to construct the MUD's facilities are obtained through the public sale of tax-exempt municipal bonds. The MUD provides for the payment of the principal and interest on the bonds through its unlimited power to levy and collect ad valorem taxes on all taxable property in the MUD. The taxes are then paid by homeowners and landowners in the MUD. In addition, homeowners and other users pay monthly water and sewer fees to pay for the costs of operating and maintaining the system.

### **B. MUD Benefits**

MUDs have been a highly effective and well accepted development tool in Texas because they benefit all of the represented interests: (i) bond investors, (ii) developers, (iii) consumers, and (iv) good public policy. In fact, the only current opposition to the use of MUDs comes from those opposed to the promotion of growth and the creation of affordable housing.

**1. Bond Markets.** The combination of several features has developed investor confidence in, and a ready market for, bonds issued by Texas MUDs. The most important of these features include (i) a MUD's ability to impose an unlimited ad valorem tax rate to support its bonds and (ii) the regulatory requirements imposed on MUD bond issues.

Although there are no constitutional or statutory limits on the amount of bonds that it may issue, a MUD must satisfy strict financial feasibility rules issued by the Texas Commission on Environmental Quality (the "TCEQ"). Before a MUD can issue any debt the TCEQ rules require (i) the completion of all water, sewer, and drainage facilities to be financed with the proposed bond issue, (ii) the completion of all streets and roads that provide access to the areas served by the utility improvements, (iii) the completion of at least 25 percent of the projected value of houses, buildings and/or other improvements shown in the projected tax rate calculations used to support the bond issue, and (iv) a showing that the land values, existing improvements, and projected improvements will be sufficient to support a reasonable tax rate for debt service payments for existing and proposed bond indebtedness while maintaining competitive utility rates. More than just a legalized disclosure of the risks, these standards are designed to protect the consumer against excessive tax rates and maintain the integrity of MUD bonds, resulting in better interest rates for future MUD projects.

Although the TCEQ limits the amount of bonds it may issue, a MUD is authorized to levy an unlimited annual ad valorem tax against all property in the MUD to pay the interest and principal on the bonds. A MUD's tax lien has first priority over mortgages and assessments, and has the same priority as county, city, and school district taxes. This priority is of great significance when considered in conjunction with the fact that only in extreme situations will a borrower or mortgage lender who has foreclosed forfeit property in order to satisfy taxes due on the property.

All MUD bonds must also be approved by the Attorney General of Texas.

The interest payments made by a MUD to a purchaser of its bonds are exempt from federal income taxation. Currently, the net yield on unrated Texas MUD bonds equals approximately the yield on ten-year U.S. Treasury Bonds.

**2. Developer.** MUD financing of such infrastructure enables the developer to quickly recover infrastructure costs that would otherwise be recovered by raising the selling price of subdivided units. During the first phase of a typical 500 acre development using a MUD, the developer finances the build out of infrastructure for the first 100 acres. After construction of the first phase is complete and the TCEQ feasibility standards are met, the MUD issues bonds to pay for the constructed facilities and reimburses the developer with the bond proceeds. The MUD levies an ad valorem tax on all taxable land, houses and other improvements in the District to support the bond issue. The developer uses the reimbursed funds to build out the second phase of development. This cycle is repeated until the entire development has been built out.

MUD financing of utility improvements enables developer capital to be redeployed more quickly and less expensively than other methods, resulting in a higher quality development over a shorter development period. A MUD's cyclical reimbursement feature also lowers the barrier to entry for developers by reducing the amount of required

capital necessary to begin development of new communities, thereby creating a more competitive housing market.

Developers choosing non-MUD financing will be subjected to higher private interest rates and longer reimbursement periods. Thus, if a developer privately finances infrastructure costs, the cost of the subdivided units will be inflated by the pro rata cost of the utility system and extra borrowing costs, resulting in significantly higher lot prices and higher housing costs. Moreover, private financing can slow the rate of development because traditional lenders will not finance a new development phase until the loans for the prior phase have been repaid.

**3. Consumers.** The costs of all MUD utility systems are ultimately paid by the consumer. As was discussed above, the use of MUDs allows the cost of site improvements to be paid for through public financing, thereby lowering lot costs and reducing the price of homes. The tax-exempt interest rates on the MUD bonds are lower than mortgage rates. In addition, payments of taxes to the MUD are generally viewed as deductible from the homeowner's federal income tax. Thus, the buyer's payments to the MUD are significantly lower than if the cost of improvements were included in the purchase price. The MUD's periodic water and sewer charges cover the operation and maintenance of the district's utility systems.

Sellers are required to have purchasers of land and houses within the MUD execute a "Notice to Purchaser" informing purchasers of the existence of the MUD, its tax rate and the amount of authorized bonds. MUDs are also required to file that same information in the real property records.

**4. Good Public Policy.** Several good public policy goals are achieved through the use of MUDs, including the development of quality infrastructure, the creation of affordable housing, and the creation of a governmental entity elected by MUD residents to provide for the long term management and financing of a community's infrastructure needs.