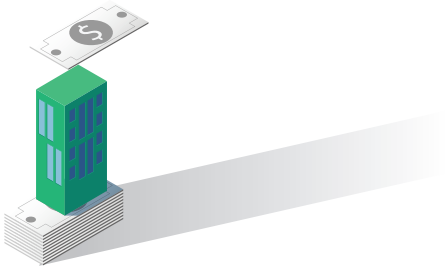
Economic Development Financing: Incentivizing Growth in Texas

JULIE PARTAIN, *Partner, Bracewell LLP, Dallas, Texas*



Local governments face competing challenges as they seek to encourage development while providing the infrastructure needed to accommodate growth. This article discusses some mechanisms available to local governments and developers in one of the America's fastest growing states: Texas. While the specifics may vary by degree, analogous tools are available in many jurisdictions across the country.

Texas municipal bond issuers have only limited tools in their toolbox to incentivize economic development. In Texas, property value is king because Texas municipalities receive a majority of their tax revenue from the levy of an ad valorem tax on the assessed value of taxable property within their jurisdictions. For many Texas cities, all taxable assessed value is not equal. The higher the taxable assessed value, the more revenue the municipality receives, and for cities, which must provide basic services such as fire and police, incentivizing higher quality development minimizes the chance that the revenue received from a property is less than the value of the services provided by the city.

It isn't lost on anyone that Texas has been a hotbed of development for the past several years. Most of this is demand for residential housing, which will eventually spur commercial development. The explosion of people moving to Texas and buying homes has left many cities with multiple developers at their door asking for incentives to bring their housing development within the city's borders. Ten or fifteen years ago, developers came to cities, developed their project pursuant to the city's zoning, dedicated the public infrastructure to the city and then developed their property. Today, those same developers line up at City Hall to ask for incentives and for the city to pay the costs of the public infrastructure that will be necessary for the development or to provide other incentives for that developer to provide housing and commercial development within the city.

For many Texas cities, getting ahead of this development and shaping it in a way that manages growth and results in residential housing that fits within the city and will at least pay for the level of service it receives with the tax dollars generated from it, has led them to use several economic development tools. While cities in Texas have limited avenues for attracting and retaining development, they are not without certain financing mechanisms. Three of the most common tools used by Texas cities are (i) public improvement districts, (ii) tax increment reinvestment zones, and (iii) economic development grants or incentives.

Public Improvement Districts

One of the tools that cities have begun to utilize extensively in the last ten to fifteen years is a public improvement district, or "PID." Established pursuant to Chapter 372 of the Texas Local Government Code, as amended, a PID is not a separate political subdivision, but rather, a designated area within the municipality or within its extraterritorial jurisdiction, that allows a city to finance public improvements that benefit the property owners within the designated area.

Creation:

A PID is created pursuant to a petition of (i) the owners of taxable real property representing more than 50% of the appraised value of taxable real property liable for assessment in the proposed PID or (ii) more than 50% of all record owners of property liable for assessment in the PID or those owning more than 50% of the area of all taxable real property that is liable for assessment in the PID. The majority of PIDs are formed when all the property within the proposed

PID is owned by a single developer or landowner, but there are some instances where a developer owns less than 50% of the property and can convince the owners of the remaining property to sign the petition prior to the developer's purchase of the land.

Purpose and Assessment:
The purpose of the PID is to levy assessments on the property owners within the PID to pay the costs of public infrastructure within that area. The amount of assessment paid by each property owner is proportional to the benefit they receive from the public infrastructure being financed. How the assessments are distributed among the properties within the PID is determined by a benefit analysis conducted by a special assessment consultant. The assessment levied by the city acts much like a tax and is enforceable by the city in the same manner as an ad valorem tax, including subjecting the property to foreclosure by the city in the event of non-payment of the assessment. PID assessments are superior in lien priority and are subordinate only to ad valorem taxes levied by the city and other taxing jurisdictions who levy an ad valorem tax within the boundaries of the PID. Once levied, however, the assessment has superior lien priority to a mortgage, and the city can foreclose on a property for nonpayment and subsequently sell the property, still subject to payment of the assessment lien in future years. Assessments are paid in annual installments and nonpayment of any annual installment can subject the property to foreclosure.

A city can issue revenue bonds backed by a pledge of the assessments levied to fund the public improvements the property owners are assessed for. Assessment revenue bonds issued by a city are city bonds but are non-recourse such that bondholders cannot demand payment from any other source of city revenue. PID bonds are typically non-rated and are sold to a limited number of buyers. The annual payment of assessments must be sufficient to pay debt service on the PID bonds being issued, and a city's only obligation with respect to the bonds is the enforcement of collection and a continuing disclosure obligation.

Continued on page 18



Julie Partain focuses on public debt offerings and business transactions involving cities, counties, school districts, universities, economic development corporations and water districts. She serves as bond counsel, underwriter's counsel and disclosure counsel in financing transactions for all types of public entities. Julie also works on financings and debt issuances for special districts, including special legislatively created districts. In addition, she advises clients on their economic development initiatives and incentives for public/private projects.

PiPR INDEX

The PiPRIndex Quantifies the 124% Growth in Public Records Complexity

Introducing the data-rich Peers in Public Records Index — the **ONLY** Index that tracks trends in public records for state and local governments.

Visit **www.GovQA.com/index** to see what trends you can expect.

GovQA

www.govqa.com | peers@govqa.com

Financing the Assessments:
While assessment revenues may be collected annually and the cash received can reimburse a developer for public improvement costs, most developers want to leverage the assessments into a bond issuance by the city which delivers cash to them on a much faster timeline. The statute allows for the assessments to be financed with bonds and there are a couple of different structures, or a combination of the two, that are utilized by cities:

(i) Upfront Financing: The city may issue bonds payable from the assessments before construction of the public improvements has begun. At the time of assessment, the property on which the assessments are levied is undeveloped. In these financings, the proceeds of the bonds are used to pay the construction costs of all or a portion of the public improvements. The city controls those proceeds and their payment for the costs of the public improvements. While this type of financing may contain more inherent risk, cities mitigate the risks through contractual arrangements with the developer by putting parameters around when and how much debt they will issue. For example, cities will often establish a minimum "lien to value" ratio for the assessment such that the property being assessed is at least three times more valuable than the amount of the assessment levied on it so that in the event of a foreclosure, the land would sell for a price high enough to pay off the assessment due. In addition, cities often require evidence of developer private financing before "up front" bonds are issued, to ensure that the developer has the financial ability to fully develop lots within the development. These "up front" financings are valuable to developers because they reduce the amount of capital developers must raise, and most developers request this method. However, depending on the size of the development, the value of the property, and the developer's experience and financial ability, up front financings are not always the best option for a city. Making this determination requires the city's financial advisor, development staff, and bond counsel.

(ii) Reimbursement Financing: Where "up front" financing is not possible, whether because of market conditions, the nature of the specific development, the developer, or just as a result of politics, a city can levy assessments within a PID and either (i) provide an annual cash flow from those assessments to the developer to reimburse the costs of the public improvements or (ii) after construction of the public improvements, leverage the assessments into a bond financing, the proceeds of which are used to reimburse the developer for the costs of the already-constructed public improvements. Reimbursement financing requires the developer to finance the construction costs of the public improvements privately, but it does add value to the property which then raises the "lien to value" ratio. Cities may often require more than mere construction of the public improvements in these types of reimbursement financings. Cities may require a certain amount of value to be on the ground or a certain number of homes to be constructed or building permits to be issued before reimbursements. All of these parameters reduce risk of an unsuccessful development and require the developer to significantly invest into the project before the city issues debt.

In an up-front financing, the issuer holds the proceeds of the bonds and will oversee the construction of those public improvements by the developer who makes periodic draws on the bond proceeds to pay for construction of the public improvements that have been assessed. In reimbursement financing, the developer constructs the improvements and the city levies assessments before land is sold to homebuilders and the annual payment of the assessment funds are reimbursed to the developer for the costs of the public improvements. Deciding which type of bond financing to utilize depends on the facts and circumstances of each development and of each developer, the value of the land and the financing costs. In general, PID bond financings are more costly than the issuance of other types of city-issued debt. The financings involve multiple consultants and their fees, as well as reserve funds and delinquency funds to ensure that there are monies to draw on in case of late payments or when foreclosure proceedings are ongoing. In addition, in an up-front financing, a developer may be required to deposit cash at bond closing if the bond proceeds are not sufficient to fully pay for the costs of the public improvements. In that event, the developer must bridge the gap with cash to ensure that there are sufficient funds available to fully construct the public improvements.

Benefits of PID Financing:
Initially, PIDs were passed into law and utilized as an annual cash flow tool primarily for downtown urban areas. These "cash-flow" PIDs developed an annual budget for things like annual plantings, security patrols, sidewalk improvements, and so on. In the early 2000's, the PID started

to become a tool to enable residential housing developers to be reimbursed for public improvement costs they expended or to use the proceeds of PID bonds to construct the public improvements necessary to serve a residential development. Historically, public improvements installed and constructed by developers in a residential subdivision were dedicated to a city free of charge. In the last fifteen years, developers have begun asking cities to pay for these improvements as a way to increase their internal rate of return and to mitigate their own financing costs.

For a developer, PID financing (especially bond financing) for all or a portion of the costs of public improvements reduces the amount of private capital needed for a development. A few million dollars of cash up front for the developer can make a very big difference in the financing and rate of return. Even in the instance of a reimbursement financing where the developer constructs the public improvements and the city reimburses the costs, such reimbursement can be a part of the developer's capital stack they can leverage into financing and reduce their construction or development loan. For a city, there are several reasons why a PID financing is attractive. First, it can allow the issuer to achieve a higher standard of development than zoning alone would allow, which in turn can lead to higher home values. With a PID financing, the issuer has leverage to entice the developer to agree to a higher quality development in exchange for the PID bond financing. Second, for certain troubled properties within a city, a PID bond financing may be a useful incentive to attract development that would not otherwise occur. Third, a PID financing places the payment obligation for an improvement only on the property owners benefitting directly from the improvement, as opposed to all citizens having to bear the cost of the improvements even if they don't benefit directly. Finally, a PID is often more attractive to a city than a municipal utility district or other water district formed and operating within the city or its extraterritorial jurisdiction. A water district is a separate sovereign entity with the power to tax and issue debt, where a PID is merely a financing vehicle used by the city, and the land within the PID remains under the city's control. Using a PID, a city can maintain control of development.

As a part of a PID financing, a city should consider the additional benefits to the city from incentivizing the developer with the creation of a PID and the levy of assessments for financing public improvements. In Texas, zoning can only regulate certain matters with respect to development. A PID gives a city the opportunity to add requirements and standards that they would not otherwise be able to require through their land use regulation process alone. Items such as additional park improvements, connectivity to a

Continued on page 20



city trail system, additional set back requirements, oversized or additional neighborhood amenities or the regulation of building materials are all items a city can require from a developer contractually before the city will pursue a PID financing. Many cities have developed a policy for the use of PIDs as a financing tool in order to be transparent with developers and consistent in the types of development they incentivize.

Cities often use PIDs to incentivize development that is above the normal standard they would receive through zoning alone. Higher value, more amenitized housing and retail development generates more ad valorem tax revenue to the city and attracts similar development. Cities should only incentivize those developments, residential, mixed use, or commercial, that add value to the city beyond what they would normally achieve through zoning alone. Some cities use PIDs as a way to attract developers who would otherwise utilize a water district to provide services. This allows a city to control its own destiny and not be subject to another political subdivision operating within its boundaries. While water districts absolutely have their place in development and development financing, they are not always the best vehicle for development within or surrounding a city and can sometimes impede a city's growth. PIDs can be especially helpful when they are within a city's extraterritorial jurisdiction (a ring of land around a city which the city can annex into its corporate limits). As an inducement to be annexed into a city via a petition by the developer landowner, a city can offer a PID for financing purposes in exchange for a voluntary annexation.

Risks of PID Financing:

PID bonds are payable solely from assessments levied within the PID, and a city is never required to pay debt service on PID bonds from any other sources of revenues. A city's general fund is not at risk. Because PID bonds are often issued before development occurs in an upfront bond issuance, or before all lots have been delivered to builders, including in a reimbursement financing, these issuances do carry additional risk that is not present with a city's general obligation debt or water and sewer revenue debt. The risks associated with issuing PID bonds can be mitigated by a cities in a series of ways, such as: (i) requiring a higher lien to value ratio; (ii) limiting the amount of bonds issued; (iii) requiring the developer to disclose his financing to ensure that lots are developed; (iv) requiring that the developer have lots already under contract with homebuilders; (v) requiring that the developer already have tenant commitments in place or contracts for sale for commercial development; or (vi) issuing the bonds as reimbursement financing after all of the infrastructure is on the ground and vertical development has reached a certain point.

The riskiest period for the PID bonds with respect to a default is the time period when the developer owns the property and is responsible for all or a majority of the assessments. Generally, when bonds are sold, the developer will have to disclose his private sources of financing, both to the city and to the market, in order to give assurances that the developer has the funds necessary to fully the develop the property, including private costs, and is able to deliver developed lots to builders. If a developer cannot complete lots and sell them to builders, then the developer would remain responsible for paying all of the assessments on the property. In that scenario, if a developer did not or could not pay its assessments, either (i) the developer's lender with a mortgage on the property would step in and pay the assessments in order to preserve their lien; (ii) the city would foreclose on the property and use the proceeds to pay off the PID bonds; or (iii) if the foreclosure proceeds are insufficient or not timely, the PID bonds would default and the reserve fund would be drawn upon to pay debt service.

Many cities' financial advisors advise issuers that a default of assessment PID bonds is not a default that affects the city's general obligation debt capacity or rating. In the event of nonpayment by a developer and/or a default on the bonds, while the city's credit rating may not be affected, the issuer would not get the development it bargained for but, because the city controls the proceeds of the PID bonds, it should at least be able to complete the public infrastructure that would hopefully work for a new property owner and developer. The PID bonds are often issued in the name of the city, however, and in the event of a default, while not legally responsible for the payment of the PID bonds, a series of city bonds would be in default and disclosed to the market as such.

Tax Increment Financing

Texas has adopted a statute that identifies a geographic area within the city that may be designated as a "Tax Increment Reinvestment Zone" or "TIRZ." The purpose of the statute is to incentivize an underdeveloped area within the city to be developed by providing a source of revenue to achieve that development. Within the boundaries of the TIRZ, the taxable assessed value of all the property is frozen as of January 1 of the year in which the TIRZ was designated by the city. Increases in assessed valuation after that year are designated "tax increment" and a city may allocate a portion of its tax revenue from the tax increment to pay for or reimburse projects within the TIRZ, including public improvements and to a certain extent, economic development projects. Other taxing

jurisdictions that levy taxes within the TIRZ may also participate by allocating a portion of their tax increment to projects within the TIRZ. Revenues from the tax increment are often used as incentives to developers, allowing for reimbursement for public improvement costs within a TIRZ, or even for economic development incentives in certain circumstances.

While a city may issue revenue bonds with a pledge of its tax increment, those bonds can be difficult to market, especially on a newly formed TIRZ without a long revenue history. As such, the most common use of tax increment revenues is a reimbursement to developers within the TIRZ for the costs of public improvements. However, cities can also use tax increment revenues within a PID context. In these instances, the PID and TIRZ are typically coterminous and the projects assessed within the PID must also be projects that qualify under the TIRZ statute. In a PID financing, the city uses its tax increment revenues to essentially subsidize or buy down the assessments levied on properties within the PID, applying those tax increment revenues to pay debt service on PID bonds or as direct reimbursement to the developer. Utilizing TIRZ revenues can allow for a higher initial assessment, despite the underlying land value and provide additional bond capacity for the PID bonds.

While popular with developers, the use of a TIRZ should be closely analyzed by a city. Tax increment revenues are not additional taxes, but rather are a siphoning of future tax revenue growth to provide financing to a developer for qualifying projects within the TIRZ. The theory is that this investment by a city in its TIRZ will facilitate development; however, a city will still be required to provide basic city services within the TIRZ, including fire and police, but will have reduced tax revenues to provide such services because it is diverting those future revenues to a developer or to a PID bond financing. Understanding of a city's costs of service and the nature of the proposed development is important in determining how much of its tax increment a city should contribute to a TIRZ.

Economic Development Funding

Texas Local Government Code Chapter 380 authorizes a city to create programs, including programs for loans and grant of public money to promote state or local economic development and to stimulate business and commercial activity in the city. Cities often enter into economic development agreements with developers to reimburse both public and private costs of development or simply to incentivize job creation and growth.

Continued on page 22

American Legal Publishing

IMLA Codification Consultant • Founding Sponsor IMLA International Committee

ORDINANCE CODIFICATION SERVICES

The Preferred Codifier of America's Leading Cities

Los Angeles • Chicago • New York • Philadelphia • Dallas • San Francisco • Boston

- Serving 3,400 Local Governments Across the Nation
- Rapid Updates of Online Codes
- Employee Owned
- Largest Staff of Attorneys

(800) 445-5588 www.amlegal.com sales@amlegal.com

Economic Development *cont'd from page 21*

Cities in Texas cannot use ad valorem taxes to fund such agreements without a vote, and bonds can only be issued for economic development capital projects with a vote and a permissive city charter provision. However cities often pledge other surplus revenues or their sales tax revenues to economic development agreements. The city should receive a benefit for such grants and loans of money to a developer. Requiring job creation, or value on the ground or a certain amount of sales tax revenues are typical measures of the "benefit" the city receives for entering into an economic development agreement.

Conclusion

Development deals involving a combination of PID bonds, TIRZ tax increment revenues and economic development grants are often used to attract larger scale and higher quality development within a city. Like all tools, they are not without risks, but with careful thought and consideration and the involvement of experienced professionals, a city can effectively utilize a PID, a TIRZ and/or economic development funding to obtain a development that it would otherwise not be able to achieve with zoning. Issuers may want to create thorough policies and procedures for using public improvement districts and Tax Increment Reinvestment Zones as an economic development tool. Once a PID or a TIRZ is utilized, the issuer may be inundated with developer requests for this financing vehicle. Identifying what types of development the issuer wants to incentivize and in what instances the issuer will consider a PID and/or a TIRZ will help focus the issuer's economic development program and hone in on those developments that bring something "extra" or "special" to the issuer or its residents. ML



Take advantage of the best value for IMLA's acclaimed distance learning CLE offerings. Register now for our 2022 Kitchen Sink program!

One Kitchen Sink subscription will provide your entire office with at least **30 distance learning programs,** for all of its CLE needs. These 30 programs are in addition to the **10 free webinars** IMLA offers to all members. Kitchen Sink subscribers will continue to receive at least **40 distance learning programs** for one small price!

Please visit the Kitchen Sink page under 'Webinars" on the **IMLA.org** website to get registered!