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October 16, 2006

The Honorable Royce West
Senate Intergovernmental Relations Committee
P. O. Box 12068
Austin, TX 78711

Re: Special Districts

Dear Chairman West:

It was an honor to have the opportunity to testify before your Senate Intergovernmental Relations Committee of September 13, 2006. I enjoyed the experience, and was pleased to be able to offer our thoughts on the issue of developer-created local governments within the extraterritorial jurisdiction of existing municipalities.

During my testimony at the hearing, I hoped to make several points. Of those, perhaps the most important is to convey the message that no one I'm aware of wishes to in any way inhibit the continued expansion of the City of Houston, or any other city which voluntarily, with balanced positions of all parties, negotiates a successful agreement with a developer to develop a portion of the ETJ through the use of a special district. The critical issue is the "even" nature of the negotiations.

My testimony did include a sincere and severe concern that the current status of the law is neither balanced, nor fair, with respect to the creation of a district in the ETJ. It is clear that legislation originally started with the recognition that cities should be able to prevent the creation of special districts within their ETJs, for a host of logical and appropriate reasons. It's equally clear that over a period of time the Local Government Code, and the Water Code, have been modified slightly so that while the city may initially turn down the developer's creation of a district, the developer may then press for the city to provide all of the services to the proposed area for the proposed district that the special district was intended to provide. The problem here is that the proposed project may bear no relation of any kind to any of the

thoughtful, and in many cases extraordinarily expensive, plans for the ETJ developed by the municipality.

We do recognize and understand that the City of Houston and some of its neighbors have chosen to reject and avoid the benefits of municipal planning, and zoning. While this has no doubt allowed developers to maximize profits, the vast majority of citizens of the State of Texas have decided that planning for purposes of water delivery, sewer treatment, roads, schools, fire, police, ambulance, parks, libraries, and all other municipal services does indeed make an extraordinary amount of sense. And, for at least those local governments I have had the privilege to work with over the years, there is not, despite the developers' protestations, an evil desire to strangle beneficial development. On the contrary, the vast majority of cities in Texas have grown through an amiable relationship of developers purchasing farms, annexing them into cities, developing in accordance with planning and zoning, creating long-term, sustainable city growth as a result.

This is in an extreme contrast to the "new" style of special district development. Instead of voluntary annexations and negotiation over zoning rights, the special district development is far too often proposed by the developer as a radical departure from what decades of planning may have intended for the area to be developed, whether that means eight residential units per acre, where four was contemplated, or it may mean apartment complexes where commercial or retail was anticipated. In virtually every case, the developer intending to finance his project through a district is doing so first for direct personal benefit as a result of special district financing, and second, to allow, primarily through the provision of additional sanitary sewer services, to construct a far higher density of development upon the land than otherwise would be the case.

In the North Texas example, the provision of sanitary sewer services was a primary limiting factor. Today, however, growth and development, not through districts but through municipalities, has pushed water resources in areas such as Collin County, Texas to the limit. This is not an indictment of the planning which has taken place. It is to say that had the area grown, as has Houston, with an unregulated, unplanned, even higher density, the water problem would be dramatically increased. Water supplies in most of Texas are not simply a matter of drilling a water well in the center of the special district, as might be the case in Harris County.

I have a number of specific statutes and the provisions of same which I would urge your committee to consider amending. It would be my pleasure to present those to you specifically,

if you, or perhaps someone on your committee, would be interested in reviewing those ideas in the form of proposed legislation. Our goal is to keep the playing field level. Again, there is no desire on anyone's part to prohibit cities from voluntarily entering into agreements with developers who wish to develop through the use of special districts. There is extreme opposition to developers forcing their way either into the ETJs, or properties immediately adjacent to the ETJs, with projects bearing no logical relation to the reality of the provision of water, sewer, or city services necessary to the development long after the developer is gone.

I have recently had one significant special district developer advise me, through their attorney, that they had no desire to do any development in one city I represent without the use of a special district. This was in response to the city's offer to provide water and sewer to the site, in the normal subdivision development fashion. It is clear that the real purpose of special districts, insofar as they are used in the North Texas arena, and I suspect South Texas as well, is financing, not utilities. No doubt you have been provided a fiscal example of the difference to the developers' profits with, and without, financing his project through the creation of a local government, and using that local government to provide tax-free funding for his development. This is in contrast to the developer obtaining his own funding either through investors, lenders, or other means.

In extreme summary fashion, the fundamental difference of developing in a city, in a normal development project, is the developer expends necessary funds from his own sources to provide water lines, sewer lines, roads, drainage lines and other infrastructure necessary prior to construction of buildings. His costs in doing so are, if the project has been well planned, simply a cost of developing the land, to be recovered, presumably with some profit in addition thereto, upon the sale of the lots or the project itself.

The same scenario may take place in the special district, with a major addition, which explains the mania for developers to use local governments (special districts) to finance their projects. That difference is when the developer has invested in and/or developed roughly 25% of the funds necessary to develop the project, he can request TCEQ to approve the developer-created special district to sell tax-free bonds with which to finance the construction of, or reimburse the developer for, roughly 70% of the same water lines, sewer lines, roads, drainage and other infrastructure requirements that otherwise the developer would be paying for himself.

The difference is dramatic. Presume a 500-acre project needs $20 million worth of infrastructure improvements. In the normal real estate development project, $20 million is a cost of the development, allocated among the various parcels of land within the development.

The same is true in a special district development, with the exception that if the developer's plans for his special district are approved through the state, and the bonds sold, the developer may be reimbursed 70%, or more, of that $20 million, upon the sale of the bonds. That $14 million of cash benefit flowing directly to the developer from the special district explains, despite any protestations to the contrary, why special districts are as popular as they are with developers. While there may be those who portray special district development versus municipal development as a land use and control fight, the truth of the matter is cold, hard cash flowing directly to the developer through a twisting of the law relative to special districts. While the developer can rejoice upon the sale of the bonds by his district, pocketing millions of dollars of proceeds from the sale of the bonds, he also still gets to enjoy the sale of the lots which may, or may not, be any less expensive as a result of the tax-free financing of the developer's project.

One of the best municipal bond lawyers in the state and I have discussed this apparent twisting of the law relative to special districts. If you review the provisions of the Texas Constitution providing for special districts, you will find that districts were created originally to allow residents of cities and counties to develop districts with which to finance projects to "preserve and protect" the natural resources of the state. Many districts were created by citizens to provide water, sewer, drainage or other services to their homes and areas where the need was apparent for a collective effort on the part of the citizens to remedy infrastructure issues. In those situations, the creation of a special district for the good of the residents made sense for the good of the area. Personal profits were not part of the equation. The exact number and kind of special districts has grown an amazing degree. They are intended, and limited, by the legislature for specific activities (roads, drainage, water, etc.) with the apparent and wise intent of the legislature to recognize districts for what they are: special, in most cases very limited purpose, entities. It is probably unconstitutional, for any of the districts, through the sale of tax-free government bonds, to be created, used and operated for what has become the direct personal financial benefit of the developers involved. These types of district usages stand in stark contrast to what the framers of the constitution intended for tax-free financing, and/or special districts. Certainly the creation of a high-density housing project in the middle of a former cotton field has nothing to do with the preservation of the state's resources. Precisely the opposite.

I would enjoy and deeply appreciate the opportunity to discuss this with you, and/or members of your committee, at any time convenient for you. I hope this letter, and the brief bullet points attached, are of assistance to you. I have also attached an excellent summary of special

districts and their uses in Texas I have obtained from the Texas Municipal League, which points out perhaps more clearly than I have in this letter the issues involved.

Please contact me if I may be of any assistance to you in the future. We would deeply appreciate the opportunity to work with you on new legislation, promoting some fairness and some balance, to special district development either in the ETJs of cities, or in unincorporated portions of counties.

Sincerely yours,

James E. Shepherd

Attachments:

"Special Districts - Municipal Consent to Formation in the Extraterritorial Jurisdiction"
"Special Districts" by Shanna Igo, Texas Municipal League

Special Districts – Municipal Consent to Formation in the Extraterritorial Jurisdiction

In North Texas, developers have proposed massive special districts in the extraterritorial jurisdictions (ETJ) of small cities. The population of the surrounding district will often exceed the population of the city many times over. Many cities oppose the creation of these special districts because the districts: (1) compete for citizen support and taxing authority; (2) serve as an obstacle to annexation, denying the city its ability to expand its tax base to meet the demands for services from increasing populations; and (3) attract thousands of new residents to the fringes of cities, straining the streets, parks, and other resources of nearby cities.

The most common response to city complaints about special districts is that a developer must obtain a city's "consent" prior to the formation of a special district in the city's ETJ. In reality, the current consent provisions in Texas law often prove meaningless. The process looks something like this:

- Texas Local Government Code Chapter 213 authorizes any city to adopt a "comprehensive plan." The purpose of the comprehensive plan is to "promote sound development of municipalities and to promote public health, safety, and welfare." A comprehensive plan may include "provisions on land use, transportation, and public facilities," and it may govern development both in the city limits and in the ETJ. For example, a city's comprehensive plan may provide, in accordance with the wishes of the citizens, that residential home sites be no smaller than 12,000 square feet. In the city limits, the city may enforce such a requirement through a zoning ordinance. In the ETJ, however, the city may not enforce the requirement.

- A developer decides to build a residential subdivision on property that abuts the city's limits. To maximize profits, the developer proposes to form a special district (which will pay the costs of the infrastructure for the district through the sale of bonds to be paid by an ad valorem tax levied on future homeowners in the district) and to offer homes on 5,000 square foot lots. Under Texas Local Government Code Section 42.042 and Texas Water Code Section 54.016, the developer is required to obtain the "consent" of the city prior to forming the district. The city council denies consent because they wish to preserve the character of their community in accordance with their comprehensive plan.

- Notwithstanding the city's lack of consent, the developer knows he can move forward with his project. That is because Local Government Code Section 42.042 and Water Code Section 54.016 authorize the Texas Commission on Environmental Quality (TCEQ) to "overrule" the city's objections and mandate the creation of the district.

- The Local Government Code and Water Code provisions provide that, if a city refuses consent, the developer can request that the city provide the water and/or wastewater services that would have been provided by the district. Note that a city may have for years planned to provide services to the area in the future. However, the city's plans were made in accordance with the development foreseen by the city's comprehensive plan (which provides for fewer homes on larger lots). To the contrary, the law requires a city to provide service *for the number of homes planned by the developer*. If the city cannot provide that level of services, the city is overruled by TCEQ and the district is created.

The better practice, which would protect cities and homebuyers alike, is to tie a city's consent to its comprehensive plan. In other words, if a city refuses to provide services to a proposed development in its ETJ that complies with the city's comprehensive plan, TCEQ would still be authorized to overrule the city's refusal. On the other hand, TCEQ would be prohibited from overruling a city and creating a district solely because the city does not have the ability to provide service to thousands of homes, which were not contemplated by the city's comprehensive plan.

Special Districts

Shanna Igo

Special districts did not exist in Texas until shortly after the beginning of the Twentieth Century. The 1876 Constitution of Texas allowed only three types of entities to collect taxes and spend public money: the state, counties, and cities. However, all were severely limited in the rate of tax that could be levied, so that none could afford to undertake large scale water supply, water conservation, flood control, drainage, irrigation, or other conservation or reclamation projects. Accordingly, Article 3, § 52 of the Constitution was amended, and Article 16, § 59 was added, in the early 1900s to allow the creation of special taxing "districts" that could issue bonds and levy property taxes sufficient to pay off the principal and interest on the bonds.

In 1987, the Constitution was amended by the addition of Article 3, §52-a, which allows the making of loans and grants of public money to encourage economic development. Legislation authorizing certain special districts, particularly County Development Districts, often cites this amendment as authority, in addition to Article 16, § 59 and Article 3, § 52.

During the last three decades, special districts in Texas have grown significantly in two ways: in number and by increases in authority. Obtaining a precise count of the number of special districts in the state is difficult because: (1) there are many different kinds of districts with various purposes and powers, and (2) no single state agency or other entity maintains an exhaustive list of all types of special districts. By all accounts, there are well over 1,500. Hundreds of new districts came into existence in the Houston, Austin, and Dallas/Fort Worth Metroplex areas during boom times of the early 1980s and late 1990s.

Additionally, the powers of districts have expanded through judicial and legislative actions. Municipal utility districts (MUDs), for example, were originally created primarily to provide water and sewer services to developing areas for which city services were not yet available. As originally drafted, the legislation authorizing such districts envisioned that annexation by a city and provision of full city services were expected as soon as the city was able to expand its service area to the MUD. However, MUDs subsequently secured authority to have fire departments, secure solid waste service, build and maintain parks and recreational facilities, build and maintain streets and street facilities, and to exercise other authority that was traditionally municipal in nature.

Two special districts of particular concern to cities are MUDs and county development districts (CDDs). MUDs are created by the Texas Commission on Environmental Quality (TCEQ) pursuant to Chapter 54 of the Texas Water Code. Before a MUD can be created within city limits or in a city's ETJ, the city must consent to the creation. However, if a city fails to consent to creation in the ETJ, the TCEQ is authorized to override the city's refusal and create the MUD if it finds that the city either: (1) does not have the reasonable ability to serve the area; or (2) has failed to make a legally binding commitment with sufficient funds available to provide water and wastewater service adequate to serve the proposed development at a reasonable cost to the landowner.

CDDs are created by a county commissioners court pursuant to Chapter 383 of the Local Government Code and do not require city approval to be located in city limits or the ETJ. CDDs were originally created to allow a developer to fund a theme park in Palo Duro Canyon. The CDD enabling act,

designed to authorize a sales tax to fund projects that would attract visitors for tourism, was passed as an economic development tool in 1993. The theme park never materialized, and CDDs have been used over last several years for projects, including residential developments, that have questionable tourism connections. Some CDDs have attempted to impose ad valorem tax, which is not authorized, and some CDDs have used sales tax money to fund bonds for residential construction.

In recent years, some CDDs in the North Texas area have constructed substandard infrastructure. Neighboring cities were pressured to spend large amounts of money to upgrade the CDD's facilities. S.B. 420, which was endorsed by TML, was introduced in 2003 in an attempt to curtail these problems. The bill, which did not pass, would have remedied city concerns by allowing land within a city to be included in a CDD only if the city consents to the inclusion of the land in the CDD and by providing that the city has the right to inspect all facilities being constructed by the CDD.

Various problems or perceived abuses of authority have accompanied the proliferation of new districts. At the heart of the controversy is a concern that the popularity and easy creation of districts have supplanted the basic governmental framework intended by the framers of the Texas Constitution. That framework made the state, counties, and cities the triumvirate of governmental authority in Texas. However, some argue that that system has been supplanted by a patchwork of overlapping, confusing, and sometimes conflicting local governments with significant powers of taxation and regulation that should now be returned and limited to the state, counties, and cities.

In North Texas and other areas, developers have proposed massive special districts in the ETJs of small, rural, cities on the outskirts of major cities. The population of the surrounding district will often exceed the population of the city many times over. Districts that overlap cities or their ETJs compete for citizen support and taxing authority. They serve as an obstacle to annexation by or incorporation as cities, denying the city its ability to expand its tax base to meet the demands for services from increasing populations. Special districts attract thousands of new residents to the fringes of cities, straining the streets, parks, and other resources of nearby cities. Also, conflicts between districts and cities often result in litigation and other legal complications that must be financed with public funds.

During the 2004 interim, the House Urban Affairs Committee was charged with "reviewing the roles of special purpose districts; including justification, powers, and responsibilities, as well as relationships with local elected governing bodies." However, the committee's report focused on only two types of special districts, municipal management districts and tax increment reinvestment zones. Those districts are fairly limited is use. In addition, the House General Investigative Committee was charged with continued "review of the creation of special purpose districts and their use of tax dollars." That report yielded nothing of substance.

For 2006, the Senate Intergovernmental Relations Committee has been charged to:

> *Study and make recommendations regarding the relationship between cities and special utility districts, including the formation of special utility districts in the extraterritorial jurisdiction of cities, and the ability of those districts to meet the future service needs of residents; the number of special utility districts currently existing and their effect on the overall property tax burden; as well as the significant growth/creation of special utility districts and their effect on the provision of services to residents.*

The committee will make recommendations on possible legislation for 2007, and cities should be prepared to see legislation affecting city authority in this area.

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