Fiscal Impact of Incorporation of The Woodlands, TX: 2016 Update

Prepared for Montgomery Harris Business Alliance

Fall 2016

TXP, Inc.
1310 South 1st Street #105
Austin, Texas 78704
www.txp.com

Overview

As the conversation around when and how to move toward incorporation continues in The Woodlands, the Montgomery Harris Business Alliance (MHBA) has asked TXP to update (2016 Update) the Township's 2012 incorporation impact study (2012 Study). Designed to support policy analysis at both the State and Township level, this updated incorporation impact study estimates the change in costs and revenues since 2012, based largely on secondary information derived from comparable communities and then applies this information to existing state law and the current situation in The Woodlands. By the same token, capital costs are adjusted from 2012 estimates by indices such as Texas Department of Transportation's Highway Construction Cost Index (TXDOT Index). Also, all estimates are predicated on current State laws, and do not presume either future legislative changes or future spending decisions by the Township. In this last regard, The Woodlands currently enjoys unrestricted use of some "revenue sources" which are not allowed for incorporated entities; if the Township became a municipality, then under existing state law, the Township's loss of this general fund revenue would have to be replaced with revenue from another source. Finally, if the decision was made to move quickly toward incorporation, the Township would be required to conduct its own tax rate study that builds on this methodology, including cost estimates based on primary data developed department by department.

Context

Adopted from the 2012 Study

The Woodlands is a master-planned, privately-developed community in north-metro Houston that was designed to offer a superior quality of life in a suburban setting. Approaching its build-out, The Woodlands is now home to over 110,000 residents who typically work for local major employers concentrated in the energy, healthcare, education, and professional services sectors.

Following a lengthy review and public discussion a community consensus was developed in 2006 that The Woodlands should ultimately be released from the extra-territorial jurisdictions of the City of Houston and the City of Conroe and no longer be subject to annexation by either city; and that in consideration The Woodlands would enter into Regional Participation Agreements (RPAs) with each respective city and would financially contribute to mutually agreed upon regional improvement projects. Then per state legislation passed in 2007, the Township was authorized to call an election to be held on November 6, 2007, within the boundaries of the entire unincorporated area of The Woodlands to determine whether the boundaries should be expanded to include all of such territory, to establish the effective date of the RPAs as of November 16, 2007, to give effect to the change of name of the Town Center

Improvement District to The Woodlands Township, to authorize the imposition of the Township's previously approved sales tax and hotel occupancy tax within the expanded boundaries of the District, and to authorize the imposition and collection of a property tax, without limit to rate or amount, throughout the expanded boundaries of the Township. Voters overwhelmingly supported all of the propositions. Additionally, a key provision of the RPAs and state legislation allowed The Woodlands 50 years (until 2057) to incorporate.

As a result of the 2007 election, the Township entered into a Transition Agreement with all three community associations and their affiliated service companies to consolidate the assets, liabilities, functions, facilities and services into the Township. Since January 1, 2010, The Woodlands Township has served as the community's local governmental organization utilizing a hybrid delivery system to provide services from the Township, County and local MUDs.

In 2011, Economic & Planning Systems (EPS) was hired by the Township to determine the fiscal impacts of incorporation including service provision, necessary capital investments, existing and new revenue sources, and impact on the property tax rate. That analysis (released in February 2012) focused solely on the fiscal impacts of the Township becoming a City and did not estimate the potential impacts to other taxing entities, including the County and School Districts.

Fiscal Impact of Incorporation

2012 Study

The fiscal impacts of incorporation are estimated by comparing the costs and revenues associated with governance under the current Township structure with the anticipated costs and revenues associated with governance as an incorporated city in the State of Texas. Existing costs in the 2012 Study were estimated based on the FY 2012 budget for the Township, Montgomery and Harris Counties, and for all applicable special districts. This process included an analysis of four peer communities to gain an understanding of comparable city roles and expected levels of service. EPS then assigned roles to each entity based on a future incorporation scenario. EPS also estimated potential revenue sources. The following tables summarize the revenues and operating costs from the 2012 Study as a township and under a municipality scenario.

Table 1: Revenues as a Township and Municipality: 2012

Revenues	Township	Municipality	Net Change
	From 2012 Study		
Property Tax	$40,498,958	$40,498,958	$0
Sales Tax	$31,517,667	$31,517,667	$0
Mixed Beverage Tax	$0	$127,000	$127,000
Franchise Fees	$0	$5,349,000	$5,349,000
Hotel Occupancy	$5,053,654	$3,930,620	-$1,123,034
Event Tax	$50,000	$0	-$50,000
User Fees	$2,940,050	$2,940,050	$0
Permits/Licenses	$347,100	$2,440,000	$2,092,900
Fines	$0	$1,548,000	$1,548,000
Grants/Contributions	$32,000	$56,000	$24,000
Interest Income	$589,334	$589,334	$0
Other	$920,453	$920,453	$0
Total General Fund Revenue	$81,949,216	$89,917,082	$7,967,866

Sources: EPS, TXP

Table 2: Annual Operating Costs as a Township and Municipality: 2012

Operational Costs	Township	Municipality	Net Change
	From 2012 Study		
General Government	$8,458,960	$12,164,527	$3,705,567
Police	$10,621,870	$20,864,653	$10,242,783
Municipal Court	N.A.	$2,895,647	$2,895,647
Neighborhood Services	$462,319	$387,342	-$74,977
Fire	$17,964,297	$18,444,411	$480,114
Public Works	$4,465,006	$10,754,056	$6,289,050
Parks & Recreation	$12,917,688	$12,917,688	No Change
Planning & Development Services	$2,345,338	$4,529,782	$2,184,444
Economic Development	$788,688	$1,032,670	$243,982
Solid Waste Services	$5,084,055	$5,084,055	No Change
Other	$2,371,082	$2,371,082	No Change
Transfers Out	$16,013,311	$16,013,311	No Change
Total General Fund Costs	$81,492,614	$107,459,224	$25,966,610

Sources: EPS, TXP

2016 Update

The 2016 TXP Update to the 2012 Study also estimates changes in costs and revenues based largely on secondary information derived from comparable communities that is then applied to the situation in the Woodlands. The level of property and sales taxes, major sources of revenue available to The Woodlands, would be unchanged under incorporation. The updated level of franchise fees, permits & licenses, and fines is expected to be substantially larger, though that likely is more due to growth than incorporation per se. However, these gains are significantly offset by the loss of hotel occupancy tax revenue due to Texas law; not only is the 2% surcharge currently levied not allowable, but the remaining 7% cannot be used for general fund purposes. On balance, the total updated annual 2016-17 net revenue figure is a gain of $5.5 million, compared to almost $8 million in the 2012 Study, yielding approximately $2.5 million less on net than the 2012 Study.

Table 3: Net Increase in Annual Revenues: 2012 Study and 2016 Update

	2012 Study	*2016 Update*
Property Tax	No change	No change
Sales Tax	No change	No change
Mixed Beverage	$127,000	$548,017[1]
Franchise Fees	$5,349,000	$7,077,724[2]
Hotel Occupancy	-$1,123,034	-$8,200,026[3]
Event Tax	-$50,000	-$158,706[4]
Permits/Licenses	$2,092,900	$3,999,073[5]
Fines	$1,548,000	$2,219,399[6]
Grants	$24,000	$33,812[7]
Interest Income	No change	No change
Other	No change	No change
Transfers	No change	No change
Total Net Change in Annual Revenues	$7,967,866	$5,519,292

Sources: EPS, TXP

[1] Based on the per capita average of peer cities, absent McKinney

[2] Based on per capita average of peer cities

[3] Municipal lodging tax revenue is not permitted for General Fund uses under current State law

[4] Based on 2012 Study, assumes 10% of budgeted revenue is lost

[5] Based on per capita peer cities average, absent Frisco

[6] Based on the per capita average of peer cities, absent McKinney

[7] Based on per cities overall average growth in grants from 2011-12 to 2016-17

Table 4: Net Increase in Operating Costs: 2012 Study and 2016 Update

	2012 Study	*2016 Update*
General Government	$3,705,567	$5,200,399 [a]
Police	$10,242,783	$14,209,178 [b]
Municipal Court	$2,895,647	$3,995,940 [b]
Neighborhood Services	-$74,977	-$105,223 [a]
Fire	$480,114	$666,032 [a]
Public Works	$6,289,050	$8,678,773 [c]
Parks/Rec Operations	No change	No change
Planning & Zoning	$2,184,444	$3,698,765 [d]
Economic Development	$243,982	$342,405 [a]
Solid Waste	No change	No change
Other	No change	No change
Total Net Change in Annual Operating Costs	$25,966,610	$36,686,270

Sources: EPS, TXP

[a] Based on per capita average of peer cities general government spending
[b] Based on per capita average of peer cities public safety spending
[c] Based on per capita average of peer cities public works spending
[d] Based on per capita average of peer cities planning & zoning spending

Annual operating costs were estimated to increase by almost $26 million in the 2012 Study, a figure that rises to $36.7 million in the 2016 Update. As indicated previously, the methodology in general is to look at the change in per capita spending by category in peer communities since the 2012 Study, with gains in the range of 25%. When combined with The Woodlands population growth of almost 12%, the translation (with compounding) is an increase in most COST categories of around 40%. When the operating cost increase is combined with estimated annual revenue gains of $5.5 million, the net annual operating figure for 2016-17 is a shortfall of $31.2 million ($36.7 million in increased costs minus $5.5 million in increased revenue).

Capital Costs of Incorporation

2012 Study and 2016 Update

The transition from a Township to a municipality would require City investment in a number of items that were previously provided through the capital assets of other entities, including the counties and the Development Company. Where new significant capital expenses are projected, the 2012 Study assumes the City would fund these improvements through general obligation or revenue bonds. Based on the Township's guidance, bond terms are assumed for a 30-year term at a 4.75% interest rate. The primary capital expenses to be considered include a new vehicle fleet, Public Works facility, Road Capital Projects, Police Department, Municipal Court. Some of these capital items are annualized and included as new annual operating capital in each department. These include vehicle and equipment purchases and police start-up costs.

Items that will require bond issuance are included in whole as one-time capital expenditures and will be funded out of a Capital Fund (Other Funds). These items include the land for the new police facility, the new Municipal Court facility, the new Public Works facility, and major Road Maintenance capital projects.

The largest category of estimated capital costs is road maintenance, accounting for over 85% of the total capital expenditures estimated in the 2012 Study. This figure is adjusted to current figures using the TXDOT Index referenced at the outset, an increase of 43.9%. Since there is no clear adjustment factor that would adequately capture regional cost increases, the remaining categories are adjusted by the estimated growth in general government operating costs, an increase of 26.3%. Based on recent financing activity in the area, a 30-year term remains appropriate, but the interest rate is set at 3%.[1] The results are outlined in Table 5 below; based on a new estimated capital cost total of $128.8 million and the revised terms, annual debt service rises to just over $7 million.

Table 5: Capital Cost Estimates: 2012 Study and 2016 Update

	2012 Study	*2016 Update*
Police	$3,267,000	$4,124,707
Municipal Court	$4,000,000	$5,050,147
Road Maintenance	$78,163,785	$112,500,745
Street Lighting	$4,342,058	$5,482,007
Total Capital Costs	$91,411,228	$127,157,606
Annual Debt Service	$5,780,898	$6,913,728[1]

Sources: EPS, TXP

[1] Annual Debt Service includes a 2.5% cost of issuance, reflective of recent local market transactions.

Water Service

Multiple MUDs or Consolidate Into A City Service

Water, waste water, and storm water management are currently delivered to Township residents via 14 separate Municipal Utility Districts (MUDS). Of these MUDs, 12 are located in Montgomery County (11 are managed by the JPA) and two are located in Harris County. Each MUD assesses residents a property tax for both outstanding debt service associated with the upfront capital investments in water and sewer systems and a portion of ongoing operations costs. The costs of debt service and operations are specific to each MUD; thus, each MUD has a different property tax rate.

Upon incorporation, all MUDs in the Township could either be dissolved and consolidated into a citywide service, or the MUDs can continue to operate independently. A small portion of homes in Grogan's Point are located within The Township boundaries but in a MUD (WCID/MUD No. 1) that is predominately outside the Township boundaries and not managed by JPA. The portion of debt ($1.7 million in the 2012 Study) associated with these homes would need to paid off before these homes could be consolidated under the City's Utility Fund.

2016 Update

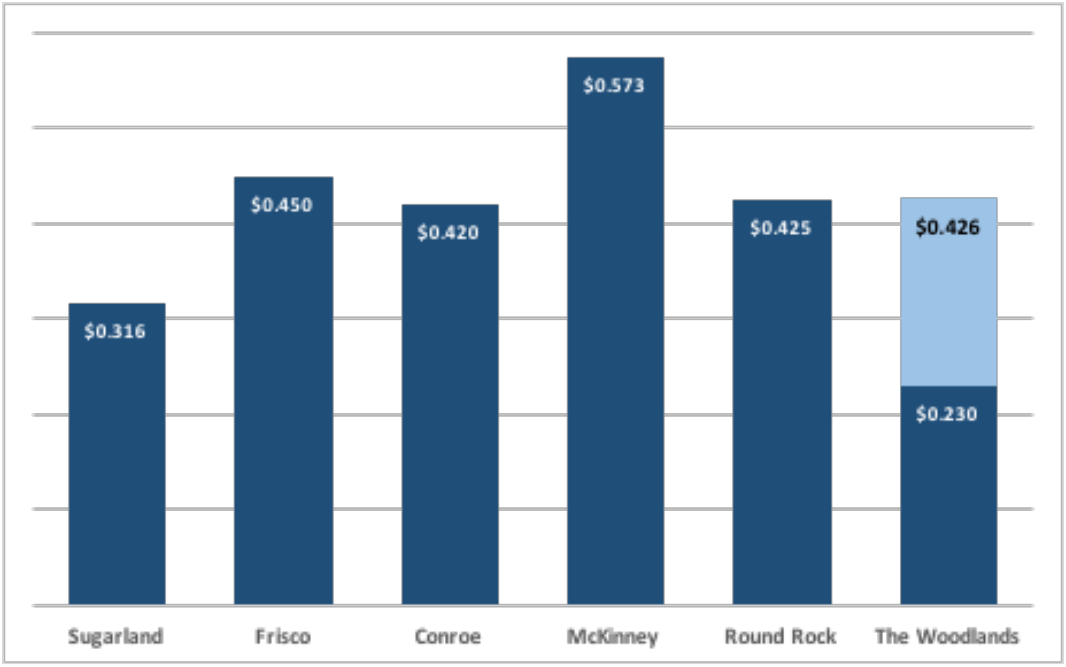
The focus of the 2016 Update is on the implications of incorporation for General Fund-related revenue and spending. In addition, this analysis assumes no policy change or direction by the Township, which would be necessary to create viable assumptions around MUD consolidation. The possible changes in MUD-related property tax rates under consolidation, therefore, are not part of the impact calculations of this update.

If consolidation were to occur, the capital debt from all MUDs is assumed to remain at the same terms. Thus, annual debt payments under incorporation are estimated to total $25.7 million. The consolidated payment from operations can either continue to be funded with property tax or can be incorporated into user fees on the water and wastewater utility bill. This analysis assumes the continued use of property tax to pay for a portion of operations. Therefore, O & M costs would likely continue to average $7.3 million, resulting in a total of $33.1 million in annual MUD expenses under incorporation. Based on a 2017 taxable value of $19.4 billion, a newly established City Utilities Fund would need to levy approximately $0.171 per $100 of assessed value. This rate would represent an increase in property taxes for property owners in several of the MUDs that no longer have outstanding debt and a decrease for property owners in MUDs that currently charge higher property tax rates.

2016 Update Results

The operating cost shortfall of $31.2 million and the annual debt service of just over $7 million to pay for about $127.2 million in needed capital projects upon incorporation means that The Woodlands would need $38 million in additional annual revenue to cover the gap. Because The Township sales tax is already at the State-legislated maximum, the principle source of revenue to pay for the estimated shortfalls under incorporation would likely be a property tax increase. In the 2016-17 Budget, the current property tax rate of $0.23/$100 of assessed valuation yields $44,593,740, or the equivalent of $1,938,858 per penny of tax effort. When that figure is divided into the shortfall, the translation is a property tax rate increase of $0.196/$100 of assessed valuation, an 85.4% increase that creates a new estimated rate of $0.4264/$100 of assessed valuation. This new rate would put The Woodlands squarely in the middle of its' peer community set, as the following chart shows.

Figure 1: 2016-17 City Property Tax Rates (per $100 of Assessed Valuation)



Source: TXP

2016 Update Conclusions

Blessed with an exceptional quality of life, residents of The Woodlands historically have enjoyed the mix of basic services and amenities they desire at a very competitive "price," as the Township's tax rate is well below peer communities. Municipalities typically combine rule-making/regulation with service-provision (including recreational and cultural amenities); the unique structure of The Woodlands has allowed the community to put greater emphasis on the later in a highly-cost-effective manner. The impact is clear; with one of the lowest current "city" tax rates in Texas, The Woodlands is attractive for not only residents, but as a site for corporate relocation and expansion. With incorporation, the balance between regulation and service-provision will likely shift, bringing new powers, new requirements, and increased costs. This analysis provides an order of magnitude to estimate what those costs will be, and uses the current property tax base to illustrate the potential tax rate implications. The overall finding is that, as a municipality, The Woodlands would lose at least some portion of its competitive advantage (at least in terms of its current low property tax rate) compared to its peer communities. As the community continues to discuss the how and when of incorporation, the path that minimizes the tax rate implications would seem to deserve careful consideration.