SPECIAL REPORT

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TEXAS MUNICIPAL UTILITY DISTRICTS (MUDs) Provide Funding For Infrastructure Improvements; Roads, Drainage, Water And Sewer

Municipal Utility Districts (MUDs) are political subdivisions authorized under the Texas constitution to levy taxes, charge for services and issue debt for infrastructure such as water, sewer and drainage, within limited geographically defined areas. The Texas Commission on Environmental Quality (TCEQ) regulates and provides ongoing supervision of MUDs and other special purpose districts. There are over 500 active "typical" MUDs in the 5 county area surrounding Houston. MUDs exist in and around other large Texas cities (Austin, Dallas and San Antonio), but not to the same extent they are utilized in Houston's real estate markets.

Since the early 1960s, land developers, whose projects were located in various areas outside Houston's city limits, have used Municipal Utility Districts (MUDs) and other special purpose districts as the means to partially finance the water, sewer, drainage and other utilities normally required for residential and commercial development. Houston and other local municipalities support the use of these special districts to avoid having to extend existing utilities to developments outside the cities limits or in some cases, to areas within the boundaries. Instead of cities issuing bonds or utilizing available cash, the burden of providing the initial capital for infrastructure development is shifted to a private developer. The primary advantage to the developer is that they control the pace of construction and development in their projects without having to continuously deal with municipal bureaucracies. Once sufficient assessed value is in place to support debt service payments, the developer typically requests reimbursement for the water, sewer and drainage costs associated with the land development. The MUD district files a bond application with the TCEQ. After review & approval the MUD bonds are issued.

The primary source of revenue for a district, from which debt service on the MUD bonds are paid, are the ad valorem taxes levied on all taxable property within the district and water & sewer revenues. In the bond resolution, the district promises to levy a direct annual ad valorem tax, without limit as to rate, on all taxable property in the district sufficient to pay principal and interest on the bonds as they become due. The bonds are a general obligation of the district and are not obligations of the state of Texas, the city or the county. The investment quality of the bonds depends on the districts ability to collect taxes levied against the taxable property within the district and in the event of foreclosure of the districts tax lien, on the marketability of the property and the ability of the district to sell the property at a price sufficient to pay taxes levied by the district and by other overlapping tax authorities. The levy of ad valorem taxes by the district constitutes a lien in favor of the district on parity with the liens of all other state and local taxing authorities on the property against which taxes are levied. Average tax collection rates for Houston area MUD districts exceeds 97%.

Before 1980 some developers had abused the MUD process by issuing bonds for developments that had not even been started. This combined with the Houston recession of the mid 1980s resulted in about 5% of the 310 active MUDs defaulting on their debt service payments. Accordingly, the Texas Legislature gave the Texas Water Commission (the predecessor to the TCEQ) more authority to regulate MUD bond sales. In turn, the TCEQ required that the utilities being funded by bonds be constructed prior to issuance of the bonds. Also, before bonds can be sold, the developer is now required, in most cases, to pay 30% of the underground utilities and to finance and construct all of the roads in the subdivisions being developed from MUD bonds. This has generally resulted in the creation of significant assessed value prior to the first issuance of bonds by a district. Since the TCEQ imposed these stricter requirements on MUDs, over 2,400 MUD bond issues totaling over $10 billion in debt have been issued by MUD districts located in the five county area surrounding Houston. None of these 2,400 plus issues has ever defaulted on a principal or interest payment.

While the TCEQ took steps to strengthen the requirements placed on issuers of MUD debt, other factors also contributed to the overall improvement of the quality of MUD debt.

1. Improvements in the local real estate market. As Houston emerged from its 1980s recession, builders and investors began purchasing, at bargain prices, some of the vacant developed lots from the large inventory existing in the MUDs. By the mid 1990s, with few exceptions, all of the vacant developed lots that existed within districts in 1988 had been absorbed by homebuilders. Because of the cost advantage of acquiring existing developed lots over creating newly developed lots, development occurred rapidly, increasing the tax rolls of many districts and significantly improving their financial conditions.

2. A steady decrease in interest rates. The recovery in Houston's real estate markets from the mid 80s to 90s would not have been nearly as robust if interest rates in the U.S. credit markets had remained as high as they were in the 1980s. In 1982 government treasury bills and bonds were yielding over 14%. By 1992 they were yielding

6.50%. Not only did this help the local housing market in general, but it also allowed MUD districts to finance their current infrastructure needs at lower interest rates as well as refinance its existing bonds at lower rates. This in turn allowed MUD districts to lower property tax rates.

3. Relaxation of the City of Houston's refunding ordinance for MUDs. In 1991 the city of Houston passed an ordinance that allowed MUD districts greater opportunity to refund their high interest rate debt. Prior to 1991 MUD districts located within Houston's Extra Territorial Jurisdiction were not allowed to issue refunding bonds to lower borrowing costs or extend the maturities of its debt. The 1991 Houston (MUD) refunding ordinance addressed those issues. The result was that every creditworthy district that had issued bonds during the 1980s refunded their debt at least once between 1991 and 1993. A second wave of refundings occurred in the mid 1990s. The change in the Houston ordinance allowed MUD districts to capitalize on the ongoing drop in interest rates which resulted in lower debt service obligations and improving financial conditions for most districts.

Bond insurers discover MUD bonds.

As interest rates decreased and the local real estate markets improved, bond insurance agencies became attracted to the local MUD bond market. For a premium the insurance company would guarantee that the debt service of

HIGHLIGHTS OF MUD TAX FREE BONDS

• MUDs are political subdivisions authorized under the Texas constitution to levy taxes, charge for services and issue debt for infrastructure such as water, sewer and drainage facilities within geographically defined areas.

• The capital for infrastructure development is provided by the developer who is later reimbursed from the proceeds from a bond sale.

• Once sufficient assessed value is in place to support debt service payments, the developer requests reimbursement for costs associated with the developer.

• The MUD district files a bond application with the Texas Commission on Environmental Quality (TCEQ). After review and approval by (TCEQ) the municipal bonds are issued.

• The primary source of revenue for a district from which debt service on the MUD bonds are paid, includes ad valorem taxes levied on all taxable property within the district. MUDs have unlimited taxing power to pay principal and interest on the bonds they issue.

• The (TCEQ) requires that the utilities being funded by bonds be constructed prior to the issuance of the bonds. Also, the developer in most cases is required to pay 30% of the underground utilities to finance and construct all roads in the subdivision being developed from MUD bonds.

• The levy of ad valorem taxes by the district constitutes a lien in favor of the district on parity with all other state and local taxing authorities. Current tax collection rates for MUD districts average higher than 97%.

• Subsequent to the TCEQ rule changes in the late 1980s, over $10 billion in debt (bonds) have been issued by districts located in the five county area surrounding Houston, TX. ***Not one of over 2,400 bond issues has ever defaulted on principal and interest payments.***

• The yields are relatively high on MUDs, creating an excellent alternative for the tax free investor.

the bonds being issued, would be paid to the bondholders in the event the district was unable to make its bond payments. By purchasing the insurance the MUD district would issue bonds with a lower rate of interest, lowering their annual debt service payments. By 2000 58% of the MUD bonds issued since 1988 were insured by one of the major municipal bond insurers. Between January 2000 and January 2006 over 85% of all MUD bonds were insured. While bond insurance has been beneficial to MUD districts because of the modest savings in interest costs, it has been particularly advantageous to insurers. No municipal bond insurer has ever had to make a principal or interest payment for any Houston area MUD bond.

More recently municipal bond insurers have been plagued with their own set of problems stemming from their involvement in the CDO/ mortgage markets. As several of the insurers are losing their AAA rating, more and more MUD bond issues are being underwritten without the bond insurance. This, in our view, is creating an opportunity for investors as the yields on new MUD bonds are higher today compared to yields on treasury bonds and other high grade municipal bonds, than they have been in many years. So while the economic fundamentals of most MUDs are better than they have ever been, the yields are relatively high creating a very good alternative for the tax free investor.

While other types of local special purpose districts have been or may be utilized to aid real estate developers in providing the utilities in their subdivision projects, there is no doubt that MUDs will continue to play an important role in the growth of the Houston metro area. The problems that plagued the industry in the 80s have disappeared but have not been forgotten. Developers now base their projects on solid economics instead of tax law or the ability to acquire questionable loans. With intense oversight from the state (TCEQ) and ongoing population growth, the issuance of MUD bonds will continue to be an important factor in Texas land development.

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