MEMORANDUM

To: Greg Hoch, Director of Planning and Community Development, City of Durango

From: Andy Knudtsen and David Schwartz, Economic & Planning Systems

Subject: Evaluation of Public Financing Options; EPS #21873

Date: November 17, 2011

The Economics of Land Use

Introduction

The information provided in this memorandum addresses the options available to the City of Durango related to financing the Wilson Gulch Road extension. The purpose of this memorandum is to:

- Provide the City of Durango with background information related to public financing options,
- Help define the best financing vehicle available, given bond market conditions and the parameters surrounding the project, and
- Frame up terms for the debt that are reasonable for the City, the property owners, and the prospective developer.

Project Overview

The proposed extension of Wilson Gulch Road will provide a link between the existing road network in the Three Springs area and the Highway 550/160 interchange currently under construction. When the annexation and subdivision process is complete, the new right-of-way and road will serve several commercial and residential development sites, as shown below in **Figure 1**. The access and visibility created by the road will increase the value of the land substantially; however, the road must be funded and constructed before any major retailers will consider the location. At this time, the Growth Fund is under contract with the Crader family to purchase 37 acres of the 160 acres to be annexed and intends to develop the site as a retail shopping area. Establishing the appropriate revenue sources to fund the construction of the road is the focus of this analysis.

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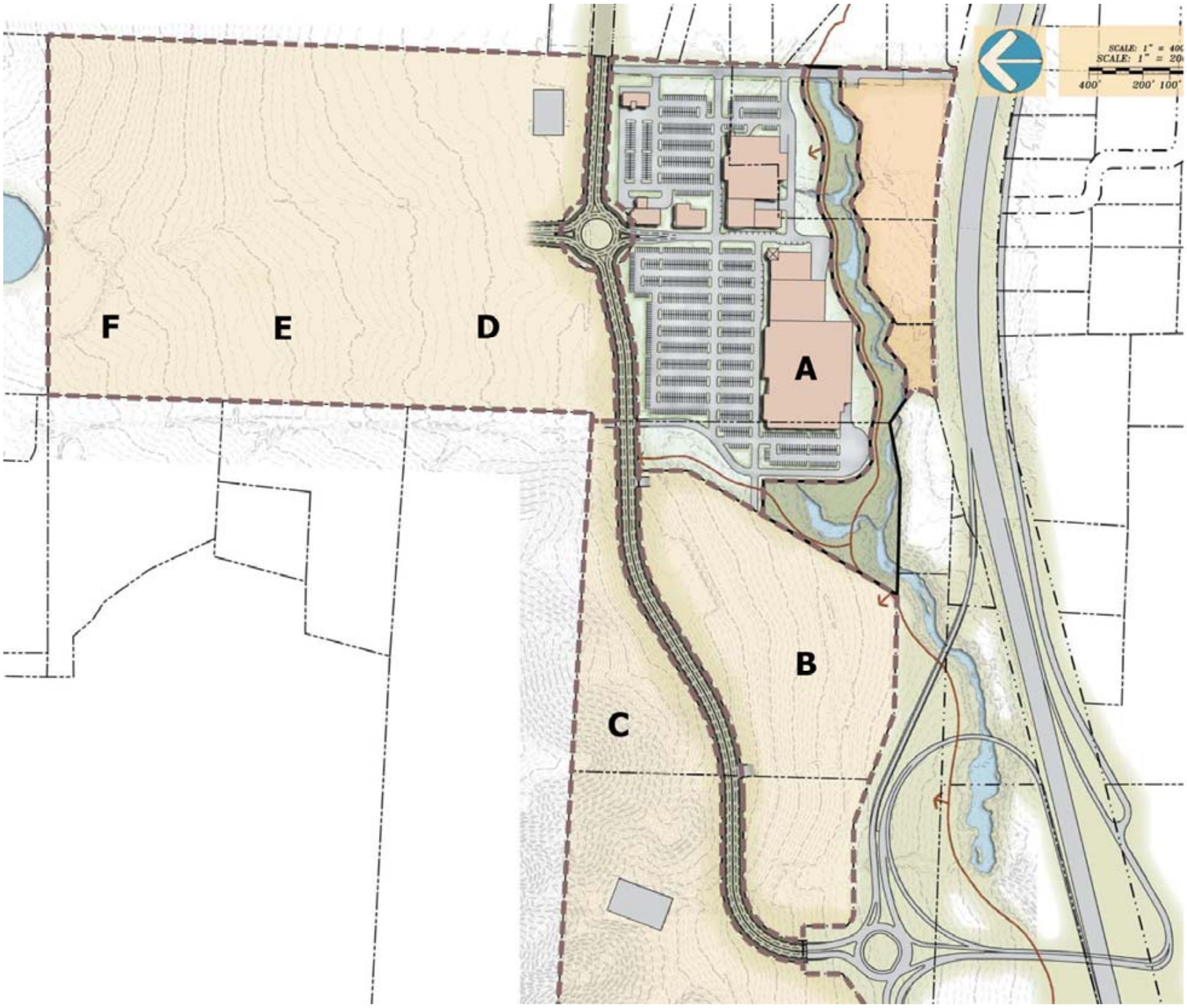
Figure 1



Optimal Financing Mechanism

The recommended financing mechanism for this project is a Title 32 Metropolitan District. With the formation of a metropolitan district, there are specific revenue streams that can be established to generate debt service. Through the service plan approval process, the City has the ability to define the purpose and extent of the metropolitan district. Once established, the metropolitan district would be autonomous from the City. As a legally defined entity subject to state regulations, it has legal standing to issue debt, administer revenues and expenditures, and must conduct annual audits, enabling the community to monitor its status.

Metropolitan districts are governed by a board elected by district property owners. The board, serving both the property owners' interests and the larger public interest of the City (via a City-approved service plan), can generate revenue and issue bonds only for public infrastructure. Revenues generated by the development in the district will be dedicated entirely to constructing and maintaining those improvements, as well as servicing the debt.

The most common form of revenue used to service debt by metropolitan districts is property tax; however, for this district, EPS recommends per-unit fees applied at time of construction (a benefit district impact fee) and a Public Improvement Fee (PIF). The City of Durango currently has development impact fees established for major street improvements that can be applied to residential and non-residential development. Because the proposed road section was not included in the total regional road network costs when city-wide impact fees were established, a separate fee can be established for this area, known as a benefit district fee. For modeling purposes, the current fees have been used, as it is estimated that the new fee will be comparable.

The second revenue-generating component of the district would be a PIF, common for districts with retail development. PIFs can either be additive (an additional layer of sales tax above the total rate) or replacement (a portion of the existing sales tax rate dedicated specifically to the District). Currently, the City of Durango's sales tax rate is 7.9 percent. The sales tax rate in the competitive retail market, specifically the City of Farmington, is 7.125 percent. As such, EPS recommends the District establish a replacement PIF so that the City retains its competitive position in the larger competitive retail market.

The metropolitan district has the potential to issue debt based on these forms of revenue. The district can work with conventional bond markets to secure adequate funds to cover the road construction costs. Alternatively, the district may seek a private placement. For reasons described in greater detail below, a private placement with the Growth Fund is expected to provide the most efficient, least costly alternative.

PIF based Metro District Examples

As detailed in a previous memorandum, EPS identified existing metropolitan districts formed using a PIF to fund improvements. In the three examples below, the districts draw from a variety of revenue sources. For each, the PIF represents a major source of revenue.

- **Centerra** – The 3,000-acre mixed use development in Loveland included a 500,000 square-foot lifestyle center. In addition to an Urban Renewal Authority that levied a property tax mill, five distinct metro districts were created within the URA to fund various public improvements. In addition to a deferral of Loveland's impact fees for seven years, the URA established a PIF of 1.25 percent to pay for approximately $80 million in public improvements. This was a replacement PIF, whereby the City waived 1.25 percent of its sales tax to ensure that Centerra would retain a competitive position in the retail market. Overall, including the PIF, the sales tax rate in the City of Loveland and at Centerra are effectively 6.7 percent.
- **Glenwood Meadows** – Two Metro Districts were established in the 300-acre shopping center in Glenwood Springs to finance approximately $15 million in public improvements. The Districts used an additive PIF of 1.5 percent, to fund the improvements. The PIF was applied to all merchandise and services, beyond the traditional definition of taxable goods. Overall, the sales tax rate in the City of Glenwood Springs is 8.6 percent, whereas Glenwood Meadows shoppers pay the City sales tax in addition to the PIF.
- **Colorado Mills** – Public improvements at this 130-acre shopping center are funded through a 1.4 percent PIF. Established in 2002, the City of Lakewood waived 1.0 percent of its sales tax for seven years. In 2009, however, the expiration of this waiver marked the resetting of the sales tax at Colorado Mills to the City's tax rate plus the 1.4 percent PIF. Overall, City of Lakewood shoppers pay a 7.6 percent sales tax. Shoppers at Colorado Mills currently pay this rate in addition to the 1.4 percent PIF.

Bond Market Factors and Constraints

The bond market today is not funding 'dirt districts.' Historically, cities and/or developers could go to the market and, with sufficient documentation regarding prospective market demand, issue land-secured financing bonds based on the future performance of the district. In some cases, developers could subordinate the land and provide recourse to the title as a form of enhancement.

Because many districts have not performed in the recent past, bond investors are now evaluating districts based on proven records of cash flow. Some look for 10 to 20 percent of buildings to be complete prior to bond issuance. Recourse to the land is no longer a consideration, given the substantial drop in values, particularly raw land.

Cities face similar challenges. Without the full endorsement of a General Obligation bond, options are limited. For examples, bonds backed by a General Improvement District require forms of endorsement as the market is unwilling to invest based on projected real estate performance alone. For the City of Durango to proceed with a GID, the bond market would require the City's commitment of a moral obligation. Even with a moral obligation commitment, bond terms will run 250 to 300 basis points higher than a metropolitan district alternative.

Developers also face challenges related to metropolitan district bonds. In recent transactions, Debt Coverage Ratio (DCR) requirements have been as high as 2.0. (The DCR is a multiplier on the development's revenue stream stipulated by an underwriter to serve as a debt service cushion. A ratio of 1.5, for example, would result in a 50 percent set-aside for debt service reserves. That is, the higher the DCR, the lower the cash flow available for debt service, resulting in lower bond proceeds.) Historically, DCRs have ranged from 1.3 to 1.4. The new levels reflect the extent to which investors want to mitigate risk.

Better terms can be achieved with some form of credit enhancement. Most often, this is provided as a letter of credit (LOC). Developers with a short track record and limited resources may have to provide a 1:1 commitment to secure a LOC. However, developers with a solid balance sheet and long-term commitment with an established lender have more options.

One way to work with these market constraints is to fund initial construction with equity or another debt source, establish a consistent cash flow, and then finance (or refinance) based on the consistent cash flow generated by the project. The refinance can result in much more favorable terms. The hurdle for the current financing structure may be viewed as a short term commitment (five to seven years), at which time a refinance could be completed. In some cases, developers will buy their own bonds. Provided that terms are reasonable, interest rates can be set on the upper end of the spectrum providing a form of investment that may not be available elsewhere.

Bonding Alternative

The optimal debt structure for this project is to partner with the Growth Fund to issue debt. Given the limitations of 'dirt bonds' in the current market, the City's interest in constructing the infrastructure and increasing the development options for retail and commercial projects can be best accomplished through partnership.

The debt would be serviced by impact fees and the PIF, which the City would establish and then provide to the metropolitan district. The district would operate within the stipulations of the city-approved service plan and would apply the impact fee and PIF proceeds to debt service.

Based on current assumptions, the Growth Fund (or related Southern Ute Indian Tribe (SUIT) fund) would front the construction costs by providing the full amount of the road construction cost to the metropolitan district. The metropolitan district revenues would be established to repay the SUIT.

This form of private placement eliminates many of the risk-mitigation costs that the bond market would otherwise apply. This structure provides the simplest route, with the least amount of cost (high debt coverage ratios, high bond reserves, etc.) Given the interest and ability for local investment of this magnitude, the City is advised to partner with the Growth Fund, developing terms that are reasonable for both entities.

Evaluation Criteria

Each community is unique and warrants a unique set of criteria to identify the optimal public financing structure. The factors shown in **Table 1** provide specific criteria that the City of Durango and its partners can use to review options. It also provides material that can be communicated to a broader audience to show how decisions have been made. At this time, it appears that the proposed metropolitan district fulfills each of these criteria, as further described below.

Table 1
Criteria for Evaluation
City of Durango Wilson Gulch Road Financing Analysis

Term	Definition	Measure
Governance	Simplicity and reasonable cost to City for district administration	Staff time and direct costs
Equity	Ability to ensure that benefits and costs are equally proportioned among property owners	Benefit analysis
Timing	Flexibility to treat current and future property owners consistently	Capability of district to establish present values
Protection of City Interests	Appropriate balance of risk and reward by City	Return on Investment and opportunity cost analysis
Fit	Complexity of district(s) is appropriate for scale and cost of public improvements	Steps required to establish district

Source: Economic & Planning Systems
H:\21873-Durango Retail Study & Infrastructure Financing\Data\[21873-Financing Options Durango Criteria.xls]Durango Criteria

A. Governance

In terms of time and cost to the City, a metropolitan district is one of the simplest options. The metropolitan district will need to coordinate with the City, as most rely on the City to collect the PIF as well as impact fees. While this adds a layer of responsibility for the City, once it is established, on-going time requirements are not substantial.

B. Equity

Equity involves two layers of analysis – within the proposed district and over the larger Durango community.

- Within the Crader Annexation Area

Within the Crader Annexation, the current plan calls for a distribution of costs across all parcels in the district. Based on an evaluation of trip generation by land use at build out, retail uses generate from 85 to 95 percent of all trips. Because the road improvements will largely benefit the retail uses in the annexation, EPS believes the most equitable allocation of cost is to uniformly distribute it by retail uses through the application of a PIF. Thus, all development will participate in the PIF. It is expected that projects on the 37-acre site under contract by the Growth Fund will occur in the near future, with development on other parcels following at some point in the future. Regardless, of the timing of construction, all property will pay into the PIF and will pay impact fees.

- Within the Region

Given the comparable sales tax rate in Farmington, it is recommended that the proposed PIF be a replacement PIF until the project is fully integrated into the Durango market. The replacement approach is needed to ensure full market support. Once established, it should be transitioned to an additive PIF, to enable the project to generate the sales tax revenue that benefits the larger community. The timing of this transition can be based on a number of factors. EPS recommends that it be done when 50 percent of the bond has been retired.

C. Timing

All payments dedicated to debt service (from all sites within the annexation) will be subject to a consistent interest rate. Thus, the ability of the financing tool to account for payments overtime is met. Moreover, all of the land within the annexation request will participate in the PIF and impact fee structure consistently, and will generate debt service at time of construction and tenanting uniformly throughout the set of parcels.

D. Protection of City Interests

As the metro district is autonomous from the City, as given that the City can shape the parameters for metro district responsibilities through the Service Plan, the recommended financing tool fulfills this criterion.

E. Fit

The recommended Metro District supported by PIF and impact fee revenue is the simplest and most effective public financing mechanism that can be applied to funding the Wilson Gulch Road improvements. This model has been applied successfully to numerous retail developments in the past to fund public improvements.

Potential Terms

Given the interest on the part of the Growth Fund to fund the improvements and structure the debt as a private placement, the City should recognize the benefit of the partnership. Securing debt through conventional routes used for the past few decades have been made substantially more complex currently due to the slow economic recovery. While the overall partnership has significant upside in the effort to construct the road and provide access to sites within the City for regional retail development, there are some issues that warrant additional consideration:

- *Concurrency of development* – the City should ensure that the debt service for the road starts only after the initial retail development has been completed.
- *Rate* – the City should recognize that the Growth Fund's commitment to fund the road involves risk. Accordingly, a return on that risk is reasonable. The rate at which the debt should be structured should reflect the degree of risk, which in today's market has a very broad spread. Additional research can be provided to hone the range which should be acceptable.
- *Sunset* – To ensure the City achieves its goal of expanded retail sales tax revenue, the replacement PIF should transition to an additive PIF approximately seven to ten years through the debt repayment. Based on preliminary modeling, the term will span from approximately 15 to 20 years. Accordingly, it is recommended to change PIF structure when 50 percent of the construction cost has been repaid (based on present value discounting).
- *Incentive* – The project works best and generates the most stable revenue streams with a critical mass of retail floor area. To the extent the land owners and developers are incentivized to ramp up development, the debt can be retired sooner, the PIF can be eliminated, and the risk eliminated.