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Proposition 6 and Local Debt Levels in Texas

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We recently [blogged](#) about a Columbia University study showing that there is a correlation between rising water rates and utility debt levels. The study found, by way of recap, that utilities across the country have increased water rates to pay off new infrastructure, and – somewhat unexpectedly – the higher rates depressed the demand for the very water that the infrastructure was supposed to provide.

Columbia is not the first to draw this connection. [Sharlene Leurig](#) at the Boston-based nonprofit Ceres is probably the leading [authority](#) on the subject and has advised a range of investors and utilities on the risk that this debt/rate feedback loop poses for traditionally sleepy and secure water infrastructure bonds.

This risk is particularly relevant to Texas, which next Tuesday will put Proposition 6 to voters. If successful, the proposition will appropriate \$2 billion from the state's Rainy Day Fund to the new State Water Implementation Fund (SWIFT).

The state intends to use SWIFT to kickstart infrastructure projects in the State Water Plan (SWP). Basically, the state estimates that it can leverage the initial \$2 billion capitalization to \$27 billion – a little more than half of the \$53 billion worth of capital costs for SWP projects. The political subdivisions sponsoring individual projects – such as municipalities, water districts, and river authorities – would have to foot the remaining costs.

The political and business establishments have lined up behind Proposition 6, but certain Tea Party activists and politicians have criticized it for, among other things, creating more debt. This criticism is not precisely accurate but has an element of truth.

Proposition 6 would not, by itself, create more debt. It would simply move monies that the state has already collected through tax revenues into the SWIFT. To leverage these monies, the agency responsible for SWIFT, the Texas Water Development Board ([TWDB](#)), will have to issue bonds.

These could be general obligation bonds that the TWDB already has the authority but has not had the reason to issue, or they could be revenue bonds secured by payment streams from the projects that are being provided with financial assistance.

To cover their share of project costs, political subdivisions will also have to issue bonds. For the most part, these will be revenue bonds repaid through utility charges like rates and connection fees. At least some political subdivisions will probably also use some sort of general obligation financing for some projects.

General obligation debt is backed by the full faith and credit of the entity that issued it and could affect credit ratings and the funding of other policy priorities. Revenue bonds are generally secured only by the revenues from the projects they finance. The type of debt that the TWDB and political subdivisions use to finance SWP projects could thus influence the fiscal implications of that debt.

So could the political and economic context in which the debt is issued. Since the Great Recession, municipal finance has come under its greatest scrutiny since New York City's disco-era [flirtation](#) with bankruptcy.

Several local governments, Detroit being the largest, have either filed for bankruptcy or come breathtakingly close. ([See also](#): Vallejo, Stockton, Los Angeles, San Bernardino, Harrisburg, and Jefferson County.) Pundits and foundations have warned of a looming ["pension bomb."](#) The Securities and Exchange Commission has stepped up its muni enforcement and [sanctioned](#) Harrisburg and South Miami for inadequate disclosure practices.

For several years, the Obama administration has been exploring the possibility of capping or even eliminating federal income tax exemption on municipal bonds. Last fall, the New York Times [quoted](#) Georgetown professor John Buckley as saying "[t]his is the most serious threat to tax-exempt bonds since Roosevelt, in the late 1930s, tried to repeal the exemption across the board."

Texas, meanwhile, is a state that – for all the bluster of its leaders about its low-tax economic miracle – depends heavily on public financing. [Comptroller](#) Susan Combs has adopted local debt as one of her key issues, warning in a Wall Street Journal [op-ed](#) that "debt excess lives even in Texas."

Combs' office has published a series of reports on the subject. [One](#) found that local debt levels in Texas were \$7,983. By this measure, Texas was the second most locally indebted large-population state, trailing only New York and ahead of the supposed fiscal train-wreck known as California.

Although local governments had issued much of this debt to keep pace with breakneck economic and demographic growth, statewide local debt had increased by more than 120 percent between 2001 and 2011 while population increased only 20 percent.

The Texas Municipal League has pinned the blame on unfunded mandates and the failure of the state to pay its share of infrastructure costs. The conservative Texas Public Policy Foundation has [said](#) that "soaring local debt threatens to derail the Texas model." The American Spectator has [sounded](#) the same alarm, claiming debt could undermine "the Texas boom."

Though these critics have pointed disapprovingly (and anecdotally) to expenditures on lavish high school football stadiums, much of the debt risk stems from unfunded pension liabilities that must be paid through general obligation bonds. Revenue bonds, by contrast, are somewhat insulated from pension fallout since they are structured to be repaid from designated fees, often for essential services.

That does not mean that water revenue bonds are without risk. In fact, as Columbia and Ceres have shown, issuers, underwriters, analysts and investors may frequently underestimate the risk in water revenue bonds. But the concerns surrounding the municipal market in general should be attributed to all of the individual muni sectors or offerings.

The comptroller's report found that, as of 2011, water districts and authorities accounted for about 16 percent of Texas' outstanding local debt. Of that, about 35 percent was tax-supported, with the remainder revenue-supported. Additionally, between 2001 and 2011, tax-supported debt had grown more quickly than revenue-supported debt.

These are, to be sure, aggregate figures. They reveal statewide patterns but not the financial positions of particular water districts. Still, they hint at the current circumstances, the music that will be playing when SWIFT enters the room.

Proposition 6 could compound existing trends by encouraging local governments to take on debt that, but for the state subsidies provided through SWIFT, would be prohibitively expensive. Conversely, SWIFT could ease the burden for local governments and save them from having to shoulder the full burden of debt that they would have issued regardless of whether the state came to their assistance.

Bottom line: Local debt levels will be high with or without SWIFT; the exact impact that Proposition 6 will have is difficult to predict; but the debt-rate cycle could make many infrastructure projects less cost-effective than the SWP implies.

[Proposition 6](#)[Texas](#)

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