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The Credit Quality Of Colorado's Metro Districts Remains Strong Despite The Housing Slump

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The Credit Quality Of Colorado's Metro Districts Remains Strong Despite The Housing Slump

Very few areas across the U.S. have been spared the effects of the housing market decline, and Colorado is no exception. Governmental entities that rely primarily on taxes based on assessed value (AV) have been especially vulnerable, but the effects were delayed and the pain is ongoing. This is especially true for recreational areas of Colorado, such as towns surrounding ski resorts.

In Colorado, special districts -- quasi-governmental units that exist separately from local governments -- continue to help bridge the gap between what residents need and what state or local municipal governments are able or willing to pay for. Of the state's 1,947 special districts, 1,314 are designated as metropolitan districts. With voter authorization, these districts have the ability to issue tax-exempt debt for sewers, parks, and street improvements, as well as for an array of other services, typically in residential developments. The AVs of some metro districts, especially those surrounding recreational areas, have dropped by up to 30% in collection year 2012, forcing many to increase their tax rates. Standard & Poor's Ratings Services rates 49 metro districts, all of which are currently investment grade.

Overview

- Many Colorado metro districts have been raising their tax levies to service their debt and maintain reserves in light of AV declines.
- In general, the subsector's credit quality has remained strong despite the effects of the Great Recession.
- Colorado's housing market is recovering more quickly than the nation's, though metro districts could experience additional financial strain if AV continues to fall.

Despite these AV declines, our ratings on the metro districts themselves have been largely stable during the past three years. Because Colorado reassesses value biennially, however, some areas could still experience additional AV declines. Standard & Poor's remains cautiously optimistic about the future of Colorado's metro districts. Still, we believe that another significant dip in the housing market could strain some metro districts' finances.

What Is A Metro District?

A metro district is typically formed by a real estate developer under Title 32, Article 1 of the Colorado State Statutes, when the developer submits a service plan to the jurisdiction in which it's located. These plans establish the purpose of the district, as well as its governing laws, including the extent and nature of its taxing authority -- which is unlimited property tax in many instances -- and its ability to collect fees. Every special district has a five- or seven-member elected board of directors and must hold public meetings and make public its regular, audited financial reports. With a limited staff, some metro districts contract with third-party accounting or financial firms for assistance with budgeting, financial reporting, investment decisions, and day-to-day operations. Unlike single-purpose special districts, metro districts must by law provide at least two of the following services:

- Fire protection,
- Mosquito control,
- Parks and recreation,
- Safety protection,
- Sanitation,
- Solid waste disposal facilities or collection and transportation of solid waste,
- Street improvements,
- Television relay and translation,
- Transportation,
- Water, and
- Covenant enforcement.

Creating a metro district can be beneficial to developers for multiple reasons, most of which are financial. A district can raise funds by issuing municipal bonds for public infrastructure with more favorable interest rates than could a corporation or private entity. In addition, a district, as a public entity, is exempt from sales, use, and other taxes. Once a district issues debt for the improvements, it will then collect property taxes to service that debt. Districts may also levy fees to offset operational costs for such projects as water and sewer operations or recreation centers. The property tax levy, or mill levy, is the tax rate that applies to the AV of property within the district. A mill is one-tenth of one cent of AV, collected annually. A homeowner with an AV of $100,000 and a mill levy of 25 mills would pay $2,500 [(25/1,000) x $100,000 = $2,500] specifically to the district.

Overall Tax Rates Are An Important Credit Factor For Metro Districts

Oftentimes overlapping entities, such as a city, a county, or a school district, levy other property taxes. Total tax payments can become a credit risk in Standard & Poor's view if we consider them to be burdensome relative to wealth and income indicators, to the extent that some property owners might fall behind on their payments. Because metro districts are typically smaller in size, a few delinquencies in a metro district will have a greater impact on revenues than in a city or county that has a larger tax base.

Debt service payments in metro districts are typically structured in tiers to correspond with rising levels of development. If broader economic trends or other factors cause development to slow or AV to stagnate, mill levies must increase correspondingly to generate more revenue. As a result, property owners have to pay higher taxes as a percent of AV. In addition, should delinquencies increase, the actual total tax burden per the tax-paying homeowners would rise to make up for the delinquencies.

Mill Levy Trends Are Up For Many

AV changes in Colorado typically lag the effects of the national economy by about 18 months. So AVs for many metro districts were still growing in 2008 and 2009 when property values in much of the country had fallen. But the reverse is also true: Properties in Colorado metro districts started to experience significant AV declines in 2010 and 2012, when most of the national housing market had already begun to bottom out. And while the national housing market reached its lowest point in March 2012, according to the Case/Shiller 20-City Index, some areas in Colorado expect to still see declines in AV in the next reassessment collection year of 2014. But among the 49 metro districts Standard & Poor's rated in collection year 2012, 61% demonstrated modest decreases of no more than 5% each. Many of the Colorado districts that experienced double-digit declines in AV were in resort towns with large concentrations of second homes.

According to preliminary numbers, many metro districts are expecting fairly stable AV in collection year 2013. However, AV reassessments occur every other year in Colorado, and the next reassessment collection year is 2014. Therefore, some areas, such as Eagle County, Colo. (in which four districts' AVs declined by more than 25%) that experienced large AV declines in collection year 2012 and are predicting relatively flat AVs in 2013 could still experience AV declines that won't show up until 2014.

Metro districts typically receive preliminary AV for the upcoming calendar year in August and have until Dec. 15 to set the next year's mill levy rate. Declining valuations can often prompt a district to increase its mill levy rate to compensate for lower anticipated tax revenue. We find that most rated metro districts will proactively do so at this time to raise the property tax revenue they need to meet their upcoming financial obligations. Most districts were able to adjust their mill levy rate to account for the recent housing market decline in collection years 2010 and 2012. Moreover, we've seen that highly rated districts have been able to keep their mill levy rates low while maintaining very strong general fund reserves. However, another significant dip in the housing market or significant hits to AV because of the assessment lag could potentially strain metro districts' finances if metro districts don't offset them with additional mill levy rate increases.

On a positive note, recent data indicate that the housing recovery is stronger in Colorado than in the nation as a whole. The S&P/Case-Shiller 20-City Composite Home Price Index reports that while national home prices rose only 2% year-over-year through August 2012, prices in the Denver area increased 5.5%. (The Denver MSA has roughly half the state's population.) Similarly, year-over-year home prices for the entire state rose 7.4% through September of 2012, versus only 5% nationally, according to CoreLogic. However, the districts that are primarily tourism or second home communities have responded differently from the rest of the Denver MSA. Of the nine metro districts whose AV declined by more than 15% in collection year 2012, six are located in either Eagle County or Grand County, which are primarily tourism- or second home-based economies. And while the rest of Colorado's housing recovery could grind to a halt, or even reverse itself, we don't see that as likely at the moment when comparing Colorado's historical trend to the nation's.

District Ratings Are Generally Stable

The number of special districts in Colorado has increased over the years as residents and developers have found them an attractive way to pay for infrastructure or services. From the mid-1980s through the early 1990s, Colorado had roughly 875 special districts. Since then, the number of special districts has jumped to 1,947, 1,314 of which are considered metro districts. This significant increase demonstrates residents' and developers' perceived gap between what state and local municipal governments are able or willing to pay for and what residents need.

Standard & Poor's maintains long-term ratings on 49 of Colorado's 1,314 metro districts. All 49 carry investment-grade ratings, and all but nine are in the 'A' or 'AA' categories (see table 1). Our outlooks on 45 of the 49 ratings are stable.

Table 1

Rating Breakdown

Current Number of Underlying Ratings	Rating
1	AA+
1	AA
2	AA-
9	A+
14	A
12	A-
6	BBB+
3	BBB
1	BBB-

Principal Metro District Rating Factors

Despite their similar characteristics, each metro district is unique, and we consider multiple factors when assigning our ratings to a district's debt. When they're first established, metro districts generally have high property tax rates, sparse or nonexistent development, and only a handful of taxpayers. Districts in this initial period are generally unrated, and we view districts with these characteristics as speculative. However, as districts mature and their creditworthiness improves, issuers often seek to save money by refinancing their debt. Metro districts that are relatively large or those whose development is nearly complete, or both, are among the districts with higher ratings.

Strong reserves can also help support credit quality. Based on our observations, larger, higher-rated districts tend to have proportionately higher reserves (see table 2) than their smaller counterparts.

For further information on Standard & Poor's ratios concerning unlimited infrastructure districts, please refer to our criteria. Consistent with these criteria, Standard & Poor's takes these key factors into account when analyzing metro districts:

Limited versus unlimited taxing authority

When a service plan is initially submitted (typically by developers) for the creation of a metro district, officials determine whether the mill levy rate will be an unlimited property tax or a limited property tax. We believe the unlimited property tax will provide the district with more revenue flexibility should management need to continue to raise the mill levy rate to offset potential AV declines. Metro districts with limited taxing authority are viewed as potentially having less flexibility and could be rated lower than the unlimited districts.

Mill levy rates

The average overlapping mill levy rate among rated metro districts is approximately 100 mills, with a direct average rate of 26.44 mills. Districts that still rely on growth will often have higher direct and overlapping mill levy rates than will more mature districts. Moreover, we've seen that highly rated districts have been able to keep their mill levy rates low while maintaining very strong general fund reserves.

Status of development

We can better estimate each district's tax burden when we know how close the district's infrastructure and lot development are to completion. In a district that isn't fully built out, the properties that are already developed will bear more than their apportioned share of taxes. But when development is complete, each property pays only for its apportioned share. However, we would consider a credit risk a fully developed district with an already high debt burden that needed to issue more debt due to the lack of AV growth potential.

Concentration

The top taxpayers can be either a strength or a weakness for a district. When metro districts are first created, the top 10 taxpayers have historically been highly concentrated, with the developer owning most of the taxpayer entities and being the predominate taxpayer. As the district grows closer to completion and properties are sold, the taxpayer base typically becomes more diverse, creating more stability. But if the developer falters at an early stage of development, the district can and frequently does come under fiscal pressure.

Available fund balance reserves

In the event that a district's revenues are lower than budgeted, having sufficient reserves to cover operations and debt service is key. And while reserves don't necessarily result in lower tax rates, they do provide financial flexibility to a district experiencing delinquencies. Our ranges for metro districts' reserve adequacy as a share of expenditures are higher than those for state or local government general obligation debt given metro districts' often relatively small operating budgets and limited powers and responsibilities. According to our criteria, even though reserve levels may be considered "good" to "very strong" on a percentage basis, the nominal dollar amounts might be small, ultimately tempering financial flexibility.

Debt burden as a percent of market value

In less mature districts, the ratio of debt to market value can be high due to relatively low AV. The AV is typically lower due to the lack of development of the vacant land, which therefore requires a relatively large initial debt issuance. As the district completes infrastructure and develops lots, the ratio of debt to market value will decline.

Table 2

Metro Means and Medians

Ratings	Current Number of Underlying Ratings	% of Total Acreage Developed	AV ($000)	Total Overlapping Mill Levy Rate	Unreserved General Fund Balance (% of Operating Expenditures)
Means					
AA category	4	70	4,027,891	103.0	171.0
A+	9	93	1,950,372	70.7	374.6
A	14	91	641,590	132.6	188.4
A-	12	73	625,747	103.8	235.7
BBB+	6	75	206,336	120.9	259.1
BBB	3	66	220,810	127.9	50.7
BBB-	1	80	287,176	140.0	25.5

Table 2

Metro Means and Medians (cont.)					
Total number of ratings	49				
Medians					
AA category	4	78	1,523,578	108.0	131.0
A+	9	99	734,518	60.6	135.1
A	14	96	423,142	125.5	136.0
A-	12	75	605,239	106.6	167.1
BBB+	6	68	171,071	113.7	25.6
BBB	3	56	155,300	132.4	50.7
BBB-	1	80	287,176	140.0	25.5

Defaults

From the mid-1980s through the early 1990s, Colorado had roughly 875 special districts (including metro districts), and their track record of servicing debt was strong. In this period, only a dozen (1.4%) of them defaulted, usually because residential growth proved slower than anticipated, and the taxes or fees needed to meet debt obligations failed to materialize. The likelihood of default also increased if reserves proved insufficient, which is still the case today.

While we view the credit quality of this sector as stable overall, one rated metro district, the Poudre Tech Metro District, defaulted this past spring. We attribute the default to two major internal errors by district management. In December 2010, the district set the mill levy for collection year 2011 too low. As a result, the district's pledged revenues were inadequate to support debt service due Dec. 1, 2011. In addition, Poudre Tech had insufficient reserves to cover the shortfall in property tax revenues due to accounting errors discovered in the fiscal year ended Dec. 31, 2010, which erroneously showed a balance of $514,905 rather than the actual $25,345 deficit.

In our experience, both situations -- the insufficient mill rate and the accounting errors -- are uncommon in rated districts, and it's even less common for these situations to occur at the same time. Nevertheless, the default highlights the importance of a district's fiscal and debt management, and reserve strength.

The Forecast For Colorado's Metro Districts Is Mostly Sunny

Overall, property tax collections in metro districts have remained healthy despite recent declines in AV, allowing the districts to maintain general fund balances similar to those before the recession. In our opinion, this will remain the case as long as neither the state economy nor the housing recovery falters. Districts have generally raised their mill levies as needed, and the ability to continue to raise taxes remains a significant source of budgetary stability and flexibility, in our view. Most districts that have experienced AV declines have increased property taxes with no significant rise in tax delinquencies or severe reduction in accumulated cash reserves.

As Colorado metro districts continue to develop and diversify, we expect to see their general credit quality improve and believe they will remain stable as a whole. We are cautious about declaring a widespread return to growth in property values in the immediate future, since AV reassessments for collection year 2014 could capture additional AV declines. However, should districts experience stable reassessments in 2014, we would view this as an ongoing stabilizing credit factor for the overall metro district sector.

Related Criteria And Research

USPF Criteria: Methodology And Assumptions: Rating Unlimited Property Tax Basic Infrastructure Districts, March 17, 2009