Hunting Hill Metropolitan District

Finance Subcommittee Report

September 13, 2017

Members

Al Sullivan, HHMD Board Member and Chair, and Verona Resident
Dave Hoffman, HHMD Board Member, and Verona Resident
Tom Hickey, Former HHMD Board Member, and Verona Resident
W. Kay Johnson, Verona Resident
Tom Hendricks, Verona Resident
Greg Fulton, GVC Capital, and Verona Building Company
Kevin Collins, Clifton Larson Allen, LLP (CLA), Accountant for HHMD
Jennifer Ivey, Icenogle Seaver Pogue, P.C. (ISP), Legal Counsel for HHMD

Introduction

The Hunting Hill Metropolitan District (District) faces shortfalls in funding its operations and maintenance budget because the Verona Development has not built out at the rate projected in the approved Service Plan. To date, there are 108 residential units completed whereas 418 were anticipated in the Service Plan. As a result property taxes are insufficient to support District expenses. Developer advances are normally used to fill the gap during the early stages of new developments, and such advances have supported the District for several years, resulting in a large sum of accumulated principal and interest. By the end of 2017, the total developer advances and accumulated interest will be just under $1 million. Interest on developer advances accrues at 8%. The District's adopted budget for the current year totals $174,931, of which $143,000, or 82%, is projected to be funded by developer advances.

It is likely to be several additional years before property within the District is fully developed and producing its potential tax revenue. Some taxpayers and Board members have questioned whether we should continue to take developer advances, even if available, or consider other means to support the budget. This subcommittee was formed to gather information about the District's financial prospects, investigate budgeting alternatives, and make recommendations to inform the full board in preparing and adopting the 2018 budget.

Subcommittee Goals

- Gather facts and parameters within which the District must operate.
- Make the most realistic projections possible about continued development and future revenue streams.

- Examine alternatives for funding the District's budget shortfall, considering the pros and cons of each.
- While the immediate concern is the 2018 budget, look ahead into an uncertain future as best we can. This can help taxpayers and future boards better see what might be needed later.
- Present recommendations at the September District Board meeting for discussion with the full Board and taxpayer community.

Facts, Issues, Parameters and Constraints

Listed below, in bullet form, are many important pieces of information. These are put here, "in one place," for reference and to inform board and taxpayer discussions. While the list may be a bit tedious, we think it is important to present this information as completely and succinctly as possible.

- In addition to legal, accounting, and management expenses that are necessary for the District to exist, the District's budget supports snow removal, landscape maintenance, and irrigation. These services are funded and provided by the District rather than the Verona Homeowners' Association.
- The District has to make decisions in the face of considerable uncertainty, and has no real control over the schedule of future development on the property.
- There is no legal obligation for the developer to continue making advances to the District.
- The Advance and Reimbursement Agreement in effect between the developer and the District states, "The District shall make payment for the Advances, subject to annual appropriation and budget approval, from funds available within any fiscal year and not otherwise required for operations, capital improvements and debt service costs and expenses of the District."
- A draft 2018 budget is legally required to be provided to the District's Board of Directors by October 15, 2017.
- The final 2018 budget must be adopted by the Board by December 15, 2017 in order to certify a mill levy.
- The District Service Plan allows a maximum mill levy for operations and maintenance of 15 mills, and that for debt service of 45 mills. But, taken together, these two cannot exceed 50 mills.
- The 2007 bonds issued by the District require a debt service mill levy on all taxable property of the District in an amount sufficient to pay the principal and interest on the bonds, subject to some limitations. Practically speaking, at this time the 2007 bond indenture requires the District to impose 45 mills for debt service. (The District is not in default under its bond documents and the existing bondholders do not have a claim of default against the District as long as the District continues to impose the required mill levy and remit such revenues for payment on the 2007 bonds, even if the District is not fully paying interest and principal as originally projected.)
- As a consequence of the two bullets above, the District is currently limited to 5 mills for operations and maintenance. The District's accountant indicates that most districts

require 15-20 mills to operate as we do. If debt service can be reduced in the future, we can go up to 15 mills for operations without a Service Plan amendment.

- In order to exceed any of these mill levy parameters listed above, a Service Plan amendment would need to be processed through Douglas County. A Service Plan amendment could cost as much as $75,000. The amount will largely depend on the extent of the amendments and what process Douglas County requires. The process to amend the Service Plan could take anywhere from two to six months depending on the County's process and willingness to amend.
- The District's legal counsel has contacted the Douglas County Attorney's Office to inquire about the possibility of an administrative (or otherwise abbreviated) amendment to the Service Plan which would remove the 50 mill overall cap, leaving in place the 45 mill cap for debt service and 15 mill cap for operations and maintenance, while saving the District the expense of a full-blown "material modification" amendment process. The County's response is that this question must be reviewed and decided by the Board of County Commissioners (BOCC), and that this can be done at one of the BOCC's work sessions. If the District Board approves such an action, this can be scheduled with the Douglas County BOCC for consideration at minimal expense to the District. If removing the 50 mill overall cap can be accomplished by an administrative amendment, this would give the District Board flexibility to increase the operations and maintenance mill levy up to 15 mills without the very burdensome expense of a material modification amendment process and would not require an election.
- An operations and maintenance fee assessed by the District against the properties in the District to cover the operating shortfall does not require a Service Plan amendment. It can be accomplished by Board action alone.
- Under current tax law, taxpayers who itemize deductions can deduct taxes paid for the mill levy, but not an assessed fee.
- Under the current elector authorization, tax revenue for operations and maintenance cannot exceed $400,000 annually. In order to change these parameters, an election would need to be held in November of any year or May of even numbered years. The cost of an election varies depending on how it is conducted, the number of ballot questions, etc., but a ballpark estimate would be $100,000 for legal fees and election costs. Ballots must be certified 60 days in advance of the election and ballot drafting and preparation takes at least 30 days.
- The District currently has no capital reserves for things such as road and bridge repair.

Future Development – Nearer-Term

The latest information we have about the development of Lot 1 north of the Highline Canal by the Richmond American Company is that they hope to start constructing homes by August 2018. They plan to build at a rate of three homes per month with delivery starting five-six months after that. There is a lien currently in place on Lot 1 which requires payment of a capital recovery fee by Richmond in the approximate amount of $7,100 per home as each building permit is obtained (the exact amount will vary depending upon timing, due to interest calculations). This is significant because if they build two or three homes per month, that will generate $14,000 to

$21,000 in capital recovery fees to the District. That matches nicely with the current funding shortfall (the 2017 shortfall being funded by developer advances is budgeted to be $143,000, which is $11,917 per month). Richmond is planning a total of 53 houses on Lot 1, so a rate of two to three units per month will cover the shortfall in the District's operations and maintenance budget for around two years once house construction starts. Of course, once development on Lot 1 is complete, there will be no further capital recovery fees coming to the District; this funding is a welcome potential bridge, but not a permanent solution.

Future Development – Longer-Term

The latest information on the vacant property south of Primo Road is as follows:

- Evergreen Company is interested in 5.9 acres on the west side of the vacant property, which makes the most sense for access from Primo Road and/or Pisa Lane. They are planning on building approximately 140 apartments. The use of this property for apartments may require Evergreen to obtain a waiver from Shea Homes on the 2005 Deed Restriction that applies to this portion of the site.
- Century Communities is looking to take the east portion of the site to build roughly 100 to 125 condominiums and townhomes
- The contract language with these buyers is still being finalized. Their six-month due diligence period does not begin until after the contracts are executed.
- There should be much more detailed information available after October 15th. The sale contracts may be in force by then.
- Greg Fulton and Katie Walker are still waiting to hear what services the buyers will be requesting from the District, and which they propose to do themselves. For example, will Evergreen provide snow removal and landscape maintenance for their apartments, which otherwise would be provided by the District?

The Way Forward

The Subcommittee approached this task with open minds. In the end, particularly for the next year or two, there seemed to be one basic recommended plan to carry forward. Beyond those years, until there is more certainty about development and valuation of property within the District boundaries, the picture is less clear. Nonetheless, we take a stab at that future which should be helpful to future boards as they determine annual budgets. And this should help District taxpayers understand the District's circumstances and what may be necessary.

First, here are some things we considered but are not recommending at this time (depending on future events, a future board may find it necessary or desirable to revisit some of these):

- Bankruptcy (technically Chapter 9 reorganization) of the District. Our District accountant cautioned that in his experience, it may not be possible to do this in the foreseeable future, since the District isn't in that bad of financial shape. Specifically, the District would have to certify that a mill levy of 100 mills is necessary to meet the

District's obligations (versus the current 50) before a Chapter 9 reorganization would be allowed. In addition, it will severely impact the resale potential of the properties within the District.

- Seeking additional developer advances. Verona Building Company is not obligated to do this, and it is contrary to the goal of the Subcommittee.
- An operations and maintenance fee assessed by the Board against existing properties. This would represent a hardship to many of the District residents, and potentially cause issues with the Richmond, Evergreen, and Century developments, which would also be subject to this fee. In addition, it could impact the resale potential of properties within the District.
- A material modification amendment to the Service Plan and/or election to allow a higher operations and maintenance mill levy. The required timeframes make this unworkable to address the 2018 operations and maintenance budget shortfall of the District, since insufficient time remains to accomplish this by the end of 2017. (However, it is worth pursuing with the BOCC the elimination of the 50 mill total cap by an administrative or otherwise abbreviated process that would save the District significant expense while offering future flexibility.)
- Cutting back services provided by the District. The feeling of the group was that keeping the current level of service is desirable to maintain the quality of life, safety for residents, and to protect property values and prospects for future resale.
- Shifting the cost of some services to the various HOA's within the District. This is possible, but will simply result in a corresponding increase in HOA fees. Taxes paid by property owners to the District are deductible from federal and state taxes, whereas HOA fees are not.

Funding 2018 and 2019

The Subcommittee recommends funding the 2018 operations and maintenance budget, and likely the 2019 and part of the 2020 operating and maintenance budgets, largely from the capital recovery fees expected from Richmond's development on Lot 1. As they plan to start construction in August of 2018, there should be fees coming in as permits are pulled. There remains the question of how to fund this shortfall for the first part of 2018. Assuming the start date of August 2018 is correct for Richmond to begin making capital recovery fee payments, there are sufficient funds in the District's General Fund to cover the early 2018 shortfall, which should be in the range of $90,000 to $100,000 assuming no extraordinary expenses. The General Fund has roughly $384,000 left in it, after paying off the 2013 bonds and paving the walking path north of the Verona villas.

There are capital projects that have been anticipated for some time that were intended to be funded from the General Fund. The highest priority is lighting along the pathway north of the Verona villas. This work has been budgeted at $140,000. Ron Harris of Advance HOA Management, who manages the operations of the District, obtained a quote for this work a year ago in the amount of $90,000, so this $140,000 budget seems to be sufficient. The District will

also have to escrow funds for a possible traffic signal at Primo and County Line Roads when Richmond's planning documents are approved by Douglas County. The amount of $33,740 will be held by Douglas County to be used in the event studies show a traffic signal is warranted. Assuming the District only has to cover the operations and maintenance budget shortfall for a limited period of time until the Richmond payments begin, there should be sufficient funds to do the lighting project, submit escrow funds for a possible traffic signal, cover the shortfall, and still have funds left over for other expenses. The Board will have to make a tradeoff between using the remaining funds to cover operating and maintenance expenses versus using the money for capital improvements in the future.

If Richmond falls behind on their planned construction schedule, the Board will have to revisit funding the budget it will establish for 2018. The assumption in the funding projections assumes the Board will include the anticipated capital recovery fees from Richmond in the 2018 budget.

Funding 2020 and Beyond

While budgets this far out are not eminent, the Subcommittee addressed the question of being able to fund the ongoing operations and maintenance of the District once the payments from Richmond are complete, which is anticipated to be sometime in 2020. The question is whether there will have been sufficient new construction and additional tax revenue by that time from the Richmond, Evergreen, and Century developments, as well as additional tax revenue from increased property valuations in Verona to cover the District's operating and maintenance expenses. One point to note is that Evergreen and Century will not be paying capital recovery fees because these have already been paid by Verona Building as part of their land transaction. This is what enabled the District to retire the 2013 bonds.

Even in the face of uncertainty, it is vital to make the best possible projections. The information on Richmond's development on Lot 1 is a bit more certain. There is more speculation associated with what will happen with Evergreen and Century. Nonetheless, using the best information we can gather, projections were developed and attached as Exhibit A. Exhibit A uses existing mill levy parameters and satisfies the District's legal requirements regarding the 2007 bonds and developer advances. It represents "where we are" without changes to the Service Plan or developer advance agreement. It is important to note that Exhibit A does not recommend a specific action now; it is presented to illustrate what future boards will have to consider, based on the best estimates we can make today. Of course there will usually be differences between projected and actual results because events and circumstances frequently do not occur as projected.

Exhibit A shows that beginning in 2021 a fee assessment or increased mill levy will be necessary to meet annual general and administrative, and operations and maintenance costs, even if no developer advances are repaid. The amount needed per residence is highest in 2021, at $678/unit. As more development occurs and residences come on line, the amount per residence decreases, and lies in the range of $402 to $532/unit. If developer advances are repaid, fees or mill levies would need to increase by the amounts paid to the developer. However, on the

positive side, the projections in Exhibit A show that at the current 45 mill levy (adjusted as needed via the Gallagher amendment to account for the reduced valuation of residential properties), the 2007 bonds and all previously unpaid interest will be retired on schedule in 2037.

The subcommittee then discussed options of how to cover future projected budget shortfalls and/or to improve the District's financial situation.

A first option is fee assessments or increased mill levies on taxpayers in the years 2020 (or potentially earlier) and beyond. While understanding that this will place a hardship on the taxpayers and decrease the attractiveness of the properties for future resale, such action may be necessary in order to maintain the current level of services provided by the District, protect property values, and ensure adequate reserves for future repairs and replacements. In the event this becomes necessary and a future board must deal with this, we note that, unless tax laws change, there would be federal and state tax advantages to most taxpayers (any who itemize deductions) by the mill levy over a fee assessment. Of course the District would have to cover the cost of the Service Plan amendment and possibly an election to accomplish that. If BOCC allows an administrative (or otherwise abbreviated) amendment, the expense will be minimal.

A second option, and something that should be considered in any event, is refinancing/restructuring the existing 2007 bonds to get a lower interest rate and reduce the District's debt service expense. This could significantly reduce the projected budget shortfall. With the retirement of the 2013 bonds, the District now has some flexibility to do this. Exhibit A shows the current 45 mill levy will be able to repay the 2007 bonds and accumulated interest on schedule by 2037, but it means only 5 mills will be available to fund the operations of the District until that time, which is insufficient. In addition, by the end of 2017, the total developer advances that funded shortfalls in previous years along with accumulated interest will be just under $1 million.

The District is in this position because the Verona development did not build out as was originally planned, causing a shortfall in tax revenue. The question arises as to which party or parties are the appropriate ones to bear the risk of this timing. At this point, the risk of financing the District because of the slow pace of development is being borne by the District and its taxpayers. The developer and bond holders have assumed different kinds of risk that can be realized when developments do not go as planned.

At the time of refinancing/restructuring, it is reasonable for the District to negotiate concessions from the 2007 bond holders and the developer so that the realization of all these risks is shared. The District's leverage would come from offering a reduced total payout right then, perhaps based on a recalculated lower interest rate, as opposed to waiting a potentially very long time to get paid. The District's original Service Plan projected that principal repayments on these bonds would begin in 2012; whereas Exhibit A projects that principal repayments will not begin until December 1, 2028. Regarding developer advances, the District's repayment obligations are subject to annual budgeting and appropriations by the Board, subordinate to all other debt, and to be made only after funding of the District's other expenses and obligations.

Refinancing/restructuring the 2007 bonds should be done “when the iron is hot.” That will not occur until much more is certain about the proposed Evergreen and Century developments. To get the best possible interest rate on the new bonds, potential bond buyers will need to see development occurring rather than vacant land, and it will be necessary to know the details of the proposed Evergreen and Century developments prior to a new bond sale so this information can be included in the bond prospectus. This is an important “to-do” for the Board that is in office when events favor refinancing/restructuring.

In the event the District can refinance/restructure the 2007 bonds and issue new bonds with a lower interest rate, it may be possible to service this new debt with less than a 45 mill levy, which will free up tax revenues to cover operating and maintenance expenses. If these operating and maintenance expenses can be covered by 15 mills, no Service Plan amendment or election would be required. But if more is needed, as some districts require, we would need to do a Service Plan amendment, and possibly an election, and incur the related cost.

Developer Advances

The developer requests a renegotiation of the Advance and Reimbursement Agreement that gives comfort to Verona Building Co., LLC that advances will be repaid while still being subject to annual appropriations. This is a matter for full District Board consideration.

A Final Suggestion

The Board should consider establishing a standing subcommittee to monitor the District’s financial picture. There are a lot of moving pieces here, accompanied by considerable uncertainty. Such a subcommittee could make periodic reports to the full board, providing for open discussion. To align with open meetings law, the subcommittee could consist of two Board members. The subcommittee would not need to meet on a regular schedule, but only as matters arise or as instructed by the full Board. These members would be empowered to meet with resource people as deemed desirable, such as the District’s legal counsel and accountant, District taxpayers, or others, but not to include other Board members.