Colorado River District
Protecting Western Colorado Water Since 1937

# MEMORANDUM
## FEBRUARY 11, 2019

**TO:** BOARD OF DIRECTORS

**FROM:** ANDY MUELLER, GENERAL MANAGER
IAN PHILLIPS, CHIEF ACCOUNTANT
AUDREY TURNER, ADMINISTRATIVE CHIEF
JOHN CURRIER, CHIEF ENGINEER
LUCI WILSON, ACCOUNTANT

**SUBJECT:** **CRWCD LONG TERM BUDGET DISCUSSION**

***ACTION:*** ***No Action, just Board direction with respect to budget actions.***

***STRATEGIC INITIATIVE(S):*** ***12. Financial Sustainability:*** ***The above strategic initiatives cannot be achieved without financial sustainability. The River District enjoys a diversified tax base for its Governmental Funds, which helps to reduce the impacts of dramatic downturns in its overall assessed valuation. Over the long-term, the Enterprise Fund is intended to be self-sustaining, managing the River District's Business-Type Activities.***

## I. INTRODUCTION

We appreciate your willingness to devote the better part of a day to a discussion of the District's long term financial health. As a starting point for the conversation, we want to stress that there is not an immediate financial crisis in the District and that the District is currently in solid fiscal health. As many of you are aware, since 2012 the District General Fund revenues have remained relatively flat while our expenses, have climbed at an average rate of approximately 3% per year. This presents what has been referred to as our District's own "structural deficit." Unlike the Lower Basin, we would like to correct our structural deficit before we create a crisis with significant consequences for the District and its constituents.

In the 2019 budget planning cycle, in an effort to prevent the structural deficit from running the District into immediate deficit spending, the District management team and Board instituted several cost saving budget measures:

1. The District temporarily put the grant program on hold, reducing expenditures between $150,000 and $250,000 per year;
2. The District instituted an early retirement incentive program aimed at reducing the number of full time employees by 3 to 4 positions before 2020 for a reduction in expenses of approximately $300,000 to $400,000;
3. The District reduced its fleet of vehicles by two vehicles seeking a 25% reduction in maintenance costs;

4. The District adopted a projected 2020 budget containing a 15% across the board reduction in expenses.

As will be discussed below, these efforts are needed but they do not present a long term fix to the District's financial issues. Should the structural issues discussed below not be remedied in the future, the District will need to make additional significant cuts in personnel, programs and services in the future. The reduction in force and a permanent cessation of the grant program will have a very real and significant impact on the District's ability to protect, conserve and develop the water resources of the District for our constituents.

## II. THE GALLAGHER AMENDMENT

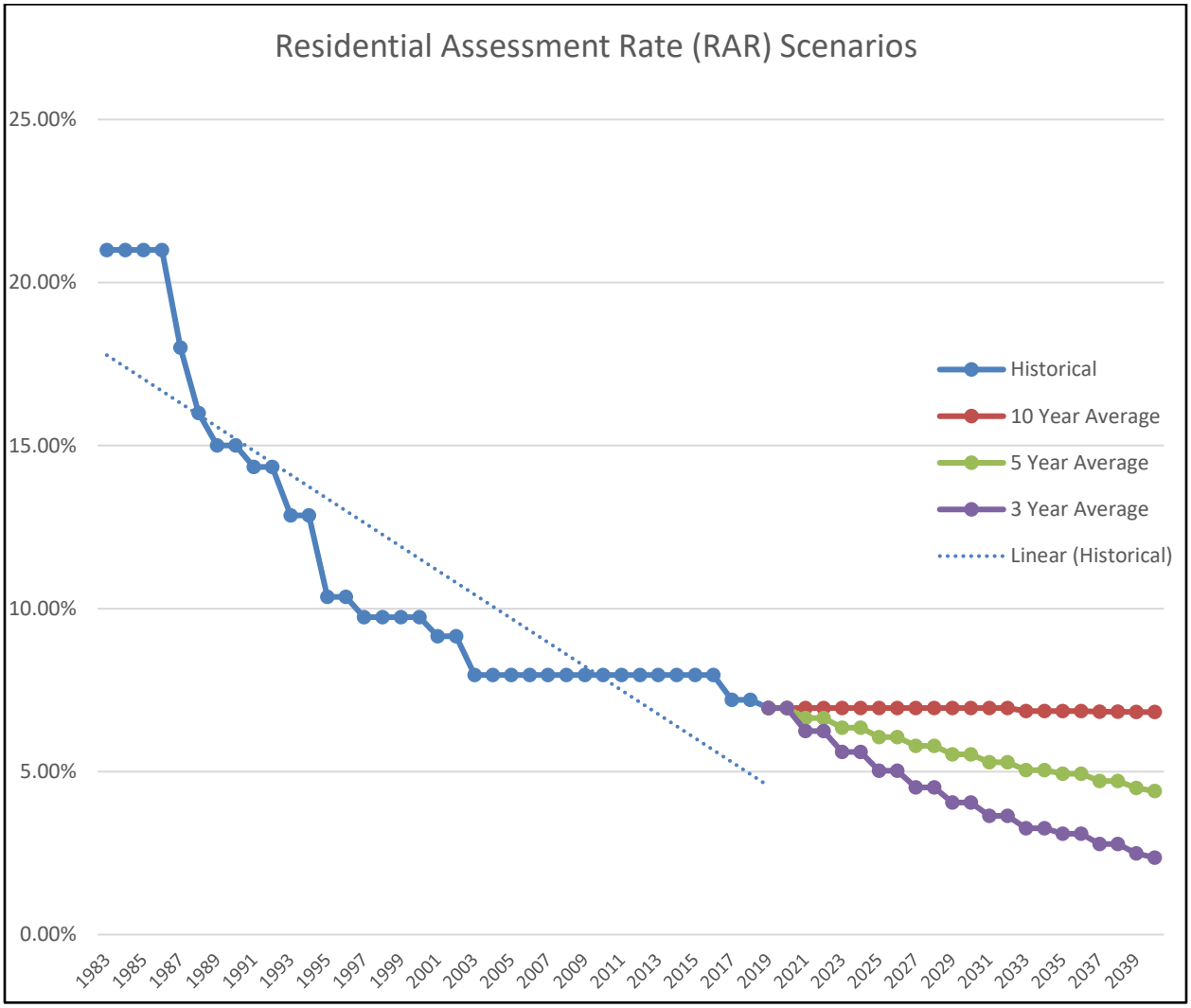
In 1982, the electorate of Colorado approved Section 3(1)(b) of article X of the Colorado Constitution (the Gallagher amendment). Pursuant to the Gallagher amendment the General Assembly enacted C.R.S. § 39-1-104.2. These two sections of law require a bi-annual adjustment in the state wide residential assessment ratio (RAR) in order maintain a consistent relationship between the total assessed value of statewide residential property compared to statewide non-residential property at a ratio of approximately 45% residential and 55% non-residential. In theory, this amendment was designed to keep the burden of state taxes equitably spread between residential and non-residential properties. However, since 1982 the growth in the value of residential properties has outstripped that of non-residential properties and in 1992 our electorate enacted the TABOR amendment which has been interpreted by our legislature to prevent it from raising the RAR. What has resulted is a significant downward trend in the residential ratio. In 1982, when the Gallagher amendment was enacted the RAR was set at over 21%; today the RAR sits at 7.2% (See, Figure 1 below).

For our District, the key to the RAR is that it is set every two years based upon the statewide relative growth between residential and non-residential properties. Since 1982 there have been several periods where the residential growth within our primarily rural district did not keep up with the statewide residential growth which is often fueled by the residential growth in the metropolitan Front Range. As has been widely noted, the economic recovery since the Great Recession has been concentrated in urban areas while the economies of many rural areas have lagged. Our District is no exception to this trend. Residential growth statewide during the last ten years has proceeded at a rate of 3.01% while within our District we have seen a growth rate closer to .093%. The net effect is that when the state lowers the RAR due to residential growth on the Front Range, our District usually experiences a significant reduction in revenue.

For most of 2018, based upon projections from the Department of Local Affairs (DOLA) we anticipated that the Gallagher Amendment would result in an annual reduction of revenue of approximately $370,000 or approximately 8% of our General Fund revenue due to a reduction in the RAR from 7.20% to a projected RAR of 6.11%. In January, DOLA revised its draft estimate and we now anticipate a reduction of approximately $77,000 based upon a projected RAR of 6.95% (DOLA cautions that this is only an estimate and that it is likely to change before the final number is determined in April). While it appears that the District and other similar local districts which are dependent upon property tax revenue will avoid a significant hit from Gallagher in 2020,

it is reasonable to predict that the Gallagher amendment and the declining RAR will continue to negatively impact the District in the future.

FIGURE 1:




In Figure 1, we have mapped the historic trend in RAR reduction and projected out three scenarios based upon the ten, five and three year average growth in state wide residential and non-residential valuations. You will note that the three year average decline in RAR is closest to the average historic trend which is shown as the dotted light blue line. We believe that the three year trend in RAR is the "most probable" future faced by our District if we do nothing. While we may avoid immediate irreparable harm in 2020, the future trends in the RAR portend significant harm to our District's revenue stream.

As you have read in memos from Chris and Zane over the past six months, our General Assembly did convene an interim committee to study remedies to the problem posed by Gallagher and the related impacts from TABOR. While the committee did study several solutions, none of them seem

realistic in today's political climate and one of the most promising (regionalization of the RAR) of them appears to pose an even greater potential to harm our District's revenue stream than the status quo.

The downward trend in RAR has recently had an even greater impact on our District due to the decline in valuation and tax revenue coming from fossil fuel extraction and the related decline in energy production. This issue is addressed in greater detail below, but it is important to point out that as the assessed value of energy production declines in our District, our residential property values become a greater percentage of our overall tax base and if the residential net valuation continues to decline due to the statewide reduction in RAR, the Gallagher amendment will have an exaggerated negative impact on our revenues.

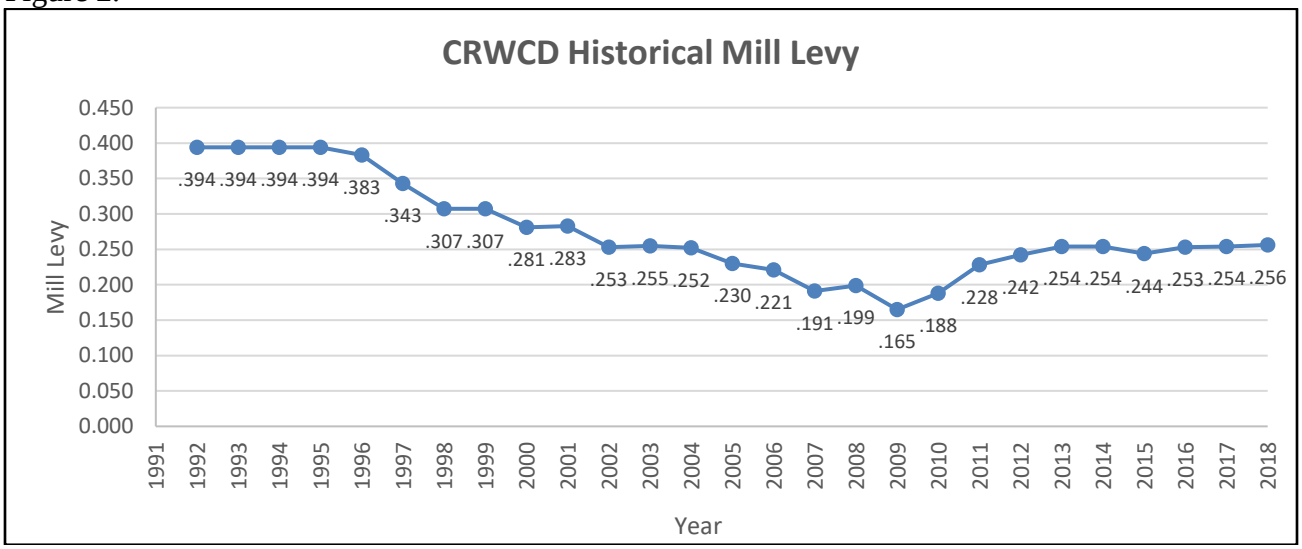
Many rural special districts have sought relief from the effects of Gallagher at the ballot box. The vast majority have been successful. Approaches have ranged from getting voter approval to freeze a district's RAR, to authorizing the district governing body to adjust its mill levy as necessary to offset the decline in the RAR, to raising the district's authorized mill levy.

## III. Taxpayer Bill of Rights (TABOR)

TABOR is a complex piece of constitutional law enacted by the electorate in 1992.[i] For the purposes of our discussion, we will try to focus on two limitations it contains: 1. The "tax rate limitation" or "mill levy limitation" and, 2. The "revenue limitation". Both of these caps have historically and will continue to impact the District's revenue stream.

The tax rate cap is probably the most well understood limitation on our District's finances. Pursuant to TABOR, our District cannot raise its tax rate without voter approval. Due to the revenue cap contained in TABOR, our revenues are not permitted to grow beyond a rate equal to inflation plus local growth. In times where the growth in net assessed valuation within the District grows greater than this permitted factor, the District has provided a credit to taxpayers in the form of a temporary reduction in its authorized mill levy. In 1937, the General Assembly gave the District Board the authority to set its mill levy up to 2.5 mills. Today, largely because of TABOR, our mill levy is capped at .252 mills. We have not been able to uncover the complete historical record of our District's mill levy rate, however, Figure 2 below depicts the District's effective mill levy rate since 1992.

Figure 2.

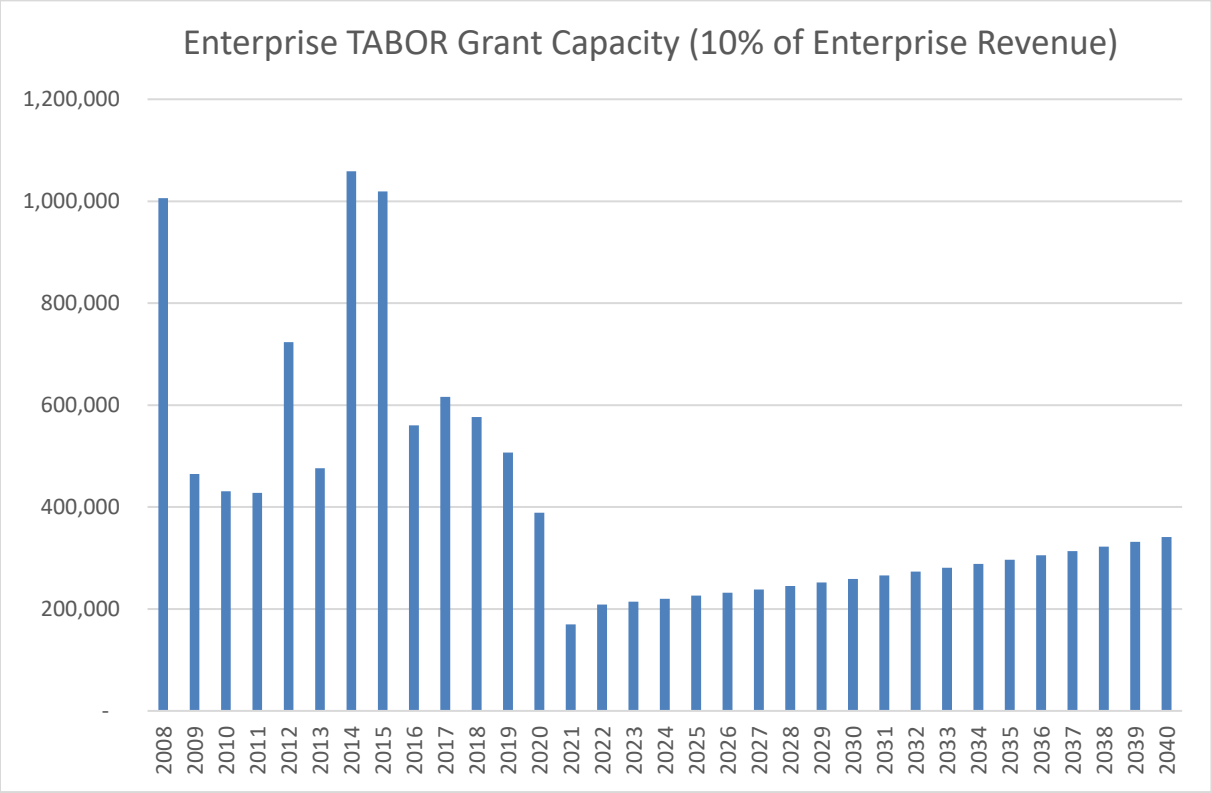



Between 1992 and 2005 the District reduced its mill levy from .394 to .252 in order to avoid violating the TABOR revenue cap. By permanently reducing its mill levy during these times, our District's tax rate was permanently ratcheted down and may not be raised above that rate without a vote of the electorate. In 2005, the District Board, in keeping with statewide interpretation of TABOR instituted the use of a temporary tax credit in order to prevent any further permanent reduction in the District's mill levy. That temporary tax credit was largest in 2010 and due to a slowdown in economic activity in the District was eliminated by 2014. Under TABOR, unless a majority of our electors vote to raise our mill levy it is capped at .252 (with only small temporary upward adjustments due to prior year tax abatements and/or refunds, which explains why the effective mill levy for 2018 was .256). This tax rate cap has impacts in years like 2014 when but for the tax rate cap, TABOR's revenue cap would have allowed our tax rate to increase by growth plus inflation to a rate of .291. The net effect of the TABOR tax rate cap is that in times of moderate to high inflation and growth, our District's revenues are prevented from growing with that inflation plus growth factor. The resultant effect of these caps has been and threatens to continue to be a diminishing of the District's ability to provide services to our growing population and to our ability to successfully achieve our mission of developing and protecting our District's water resources.

In addition to impacting our District's ability to truly keep pace with the growth in our District's net valuation, TABOR's revenue cap has an additional impact on the River District's ability to assist our constituents. Contained within the definition of "revenue" are grants from state and/or local governments. It is the revenue cap on our General Fund which keeps us in most years from accepting state or other local government grants into our General Fund. With respect to our Enterprise, we do have the ability to accept grants so long as the total amount does not exceed 10% of our total Enterprise revenue. (See, Endnote i). Over the past twenty years, primarily due to revenue from the Denver lease payments for Wolford, we have had reasonable "TABOR capacity" in our Enterprise and we have been able to accept state grants to assist our local constituent water users on major projects by doing so. Unfortunately the TABOR capacity of our Enterprise will be

greatly diminished as a result of cessation of lease payments from Denver in mid-2020. Figure 3 below depicts the historic and future Enterprise revenue and TABOR capacity.

Figure 3.




As the Board is aware, much of our District's best work in recent years has been performed by acting as a catalyst for our local water users. We have been able to create an outsize impact for our water users through leveraging outside funding, often state grants, to assist our water users in everything from the Gunnison basin selenium and salt reduction effort, to acting as fiscal agents for water plan funding grants in the Yampa, White and Green Basin Roundtable, to leading the charge in a cloud seeding program. Our ability to continue to lead through these types of partnerships is tremendously impacted by the TABOR revenue cap.

Local governments throughout Colorado have adopted a variety of mechanisms to modify the negative impacts of TABOR. Some governments have asked voters to for authority to raise their mill levy and exempt their revenue stream from the revenue/spending limitations contained in TABOR. Other government bodies have sought out and received voter approval to remove the revenue/spending limitations contained in TABOR and other governments have sought limited exemptions from TABOR to allow them to accept state and local grants that are in excess of the revenue/spending caps in TABOR.

## IV. DECLINE IN ENERGY RELATED REVENUES

Our General Fund at the District does not have a diversified income stream. Over 97% of our revenue is derived from tax on real property which includes the value of fossil fuel reserves and production as well as the value of the related coal fired power plants. Over the decades, this has meant that our District's assessed valuations, like many other public entities, has been subject to same variation as the local real property and energy sectors. Over the last ten years, we have seen a significant downward trend in the assessed valuation of oil and gas and coal within our District. See, Figures 4 and 5.

Figure 4.

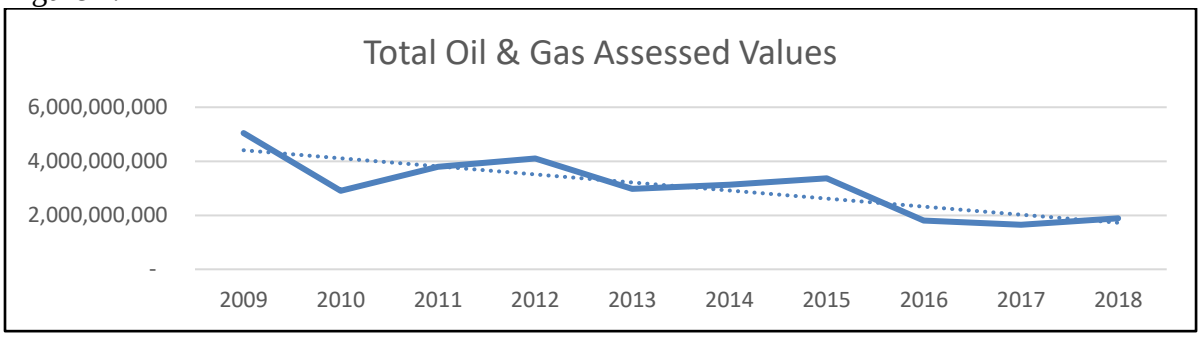
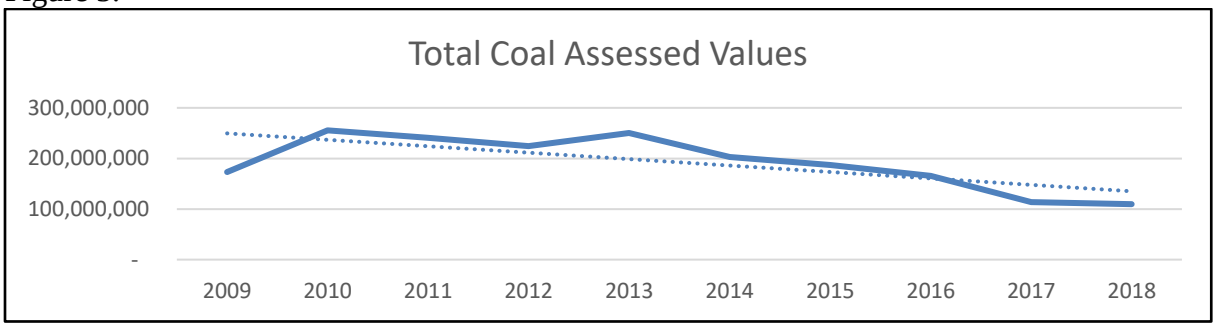



Figure 5.




Over the last ten years we have seen the contributions to the District's tax revenue from oil, gas and coal production go from a high of 24% in 2013 to a low of 11% in 2018. It appears that market forces have combined with a significant national, state and local trend toward renewable energy production that poses a risk to the long-term viability of coal fired power plants within the District. The Governor currently is calling for Colorado's electric energy sector to be 100% renewable by 2040, Xcel Energy is planning for a 100% renewable future by 2050, and even some of our local West Slope co-ops such as Holy Cross and DMEA are planning to be 100% renewable within a few decades. The owners of the Craig stations and the Hayden electric plants have all announced plans for partial or complete decommissioning of these plants in the foreseeable future.

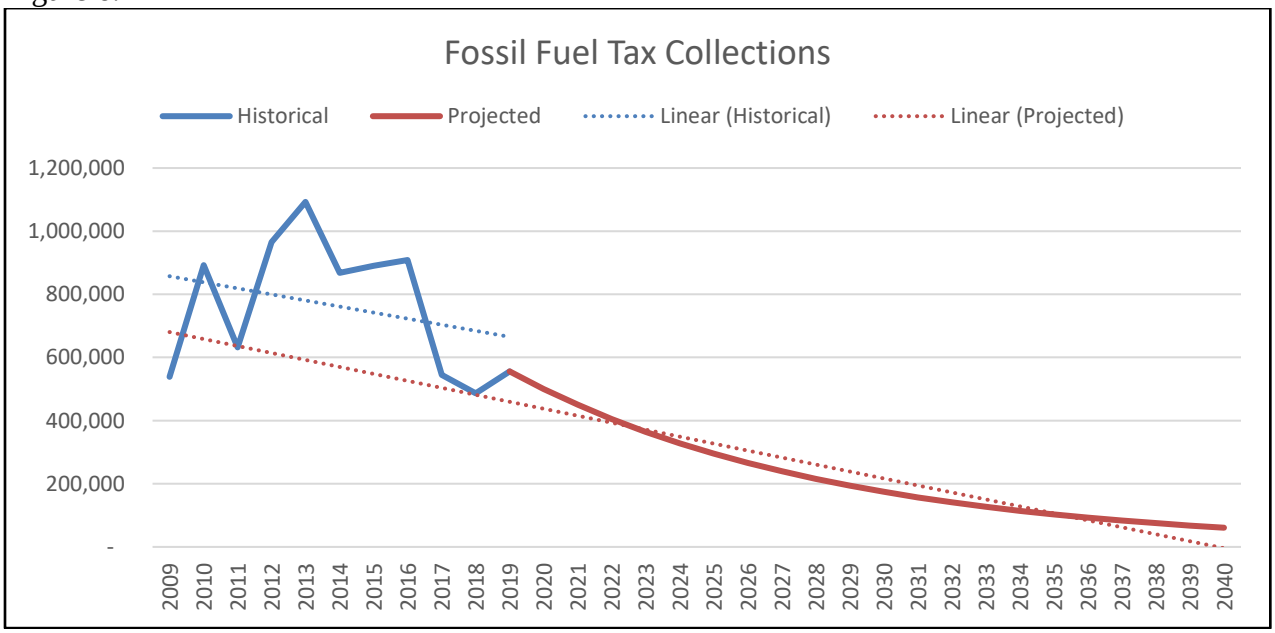
The Piceance Basin is the District's largest source of tax revenue from oil and gas production. The production in the basin largely comes from natural gas. The current and likely future supply of natural gas on the global market appears unlikely to decrease anytime in the near future and unfortunately, there have been major reserves, such as the Permian Basin in Texas and New Mexico which have come on line in the last few years that can get their product to market easily and produce natural gas at much cheaper cost than the Piceance Basin. There are major reasons to

be concerned that the downward trend in tax revenue coming from oil and gas production in the District will continue for the foreseeable future.

Without wading into the hotly charged political debate around climate change and the motivation for these power companies and governments to be setting goals around reduction in fossil fuel energy production, it is important for those of us who are charged with the financial stability and success of the District to recognize the potential if not likely impacts these discussions and actions will have upon our District's revenue. Essentially, we must plan for the worst case scenario from a revenue perspective. If we project the recent declining trend into the future, combined with pronouncements like those of Governor Polis and Xcel Energy, we can see a time in the relatively near future where we will receive very little to no significant revenue from this sector of our economy. See, Figure 6.

In light of the significant challenges to District's future tax and revenue picture created by Gallagher and TABOR the decline of a significant property tax sector, will likely compound existing revenue challenges at the District. If we were a private enterprise, our fiscal advisors would tell us that we need to consider diversifying our income stream in order to weather likely future economic storms.

Figure 6.



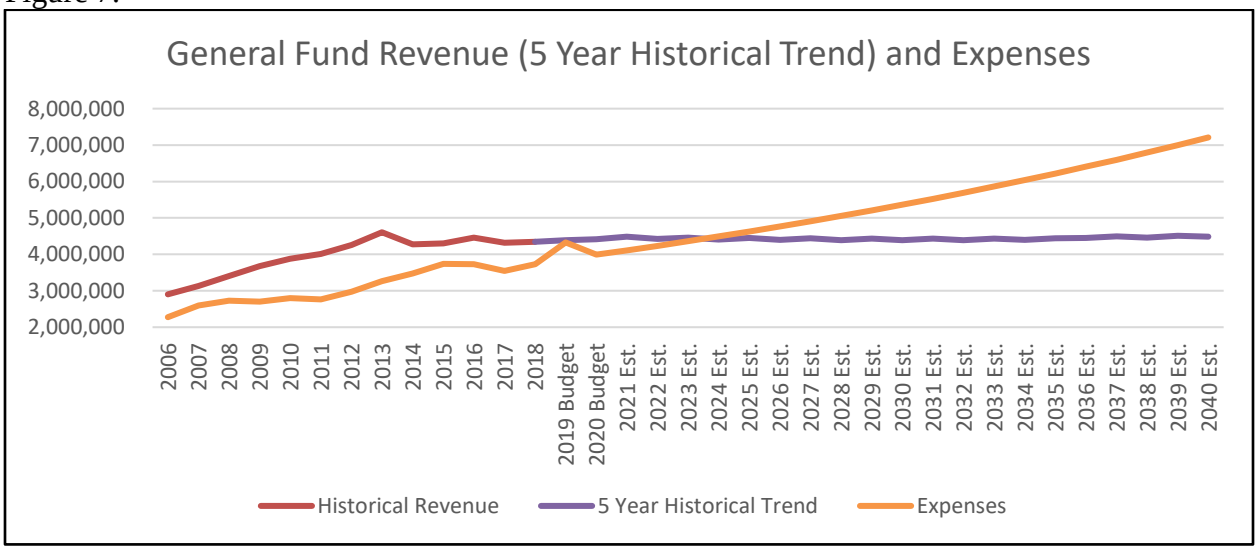

## V. EXPENSE TRENDS WITHIN THE DISTRICT

As referenced in the introduction, the District management team has kept growth in expenses to a rate of 3% over the last eleven years. The rate is only slightly higher than inflation over the same period (2.36%). The increase in expenses is driven largely by the increase in costs related to employee compensation including and especially the costs of non-monetary compensation including health insurance. The increase in expenses in our employee benefits has been between

4 and 5% during this ten year period, significantly below the national, state and local trends in the increase in the cost of health insurance. District management eliminated a position in 2018 (Deputy General Manager), and is pursuing the reduction of three to four more full time positions in 2019. While these reductions are necessary, they do not present a long term remedy due to the fact that expenses will continue to increase at a greater rate than revenues due to the combined impact of TABOR and Gallagher.

In Figure 7 below you will find what we believe to be the most probable scenario in terms of growth in District revenue versus growth in District expenses if no action is taken to seek relief from the combined impact of TABOR and Gallagher. Figure 7 uses our the historical five year growth rates for both state wide residential growth (6.10%) and local growth (.718%) and assumes a steady District mill levy of .252 mills to project out into the future. At our meeting on Friday, we can model different growth rates in revenue to show the impact of increased local growth and/or the potential relief offered by removing the constraints of Gallagher and/or TABOR on the District revenue stream.

Figure 7.



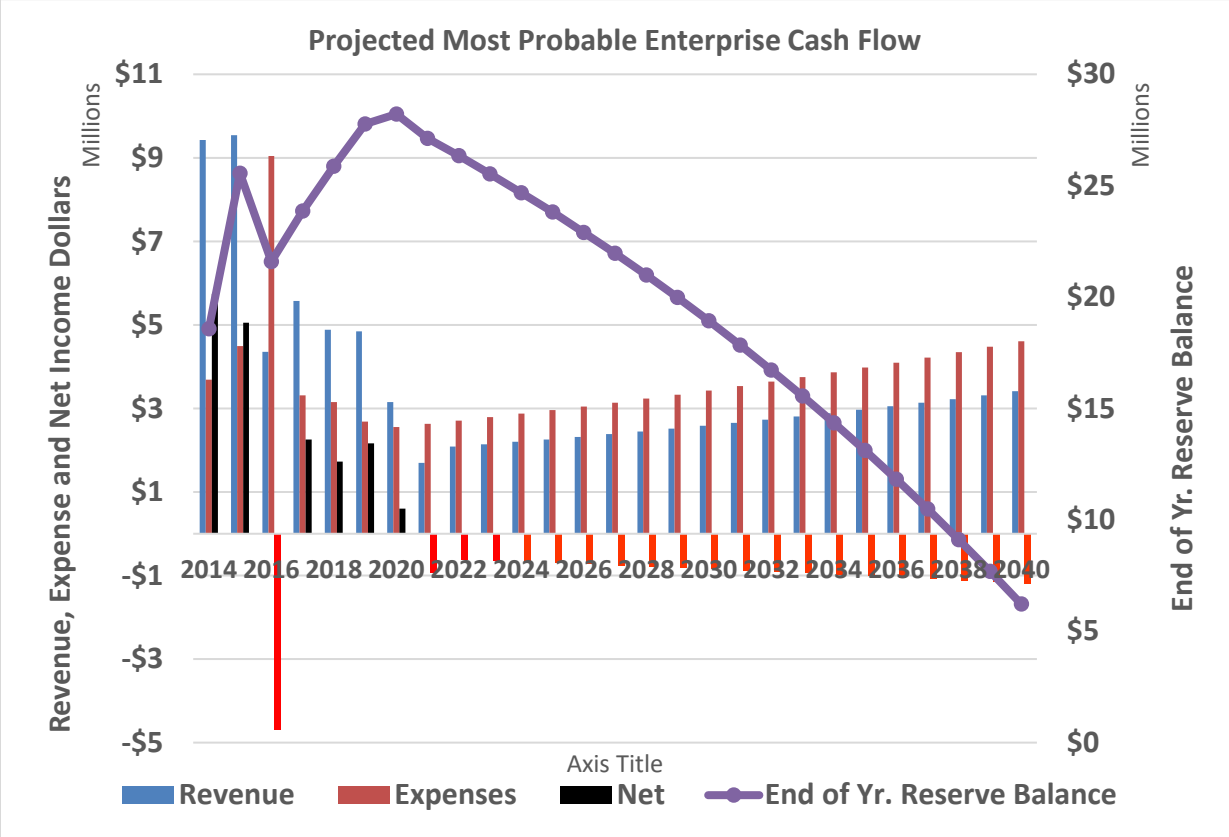

## VI. THE ECONOMIC FUTURE OF THE ENTERPRISE

**ENTERPRISE OPERATIONS.**

After Denver Water's final $1.5M lease payment in January 2020, without new revenue sources, Enterprise operations likely will start to run in the red and spending down cash reserves. This is dramatically depicted in Figure 8 where cash reserves are essentially depleted by 2040. In this figure the projections assume;

1. No growth in contracted M&I water volume,
2. 3% annual growth water contract revenue, and
3. 3% growth in Enterprise expenses.

**Figure 8.**




**What are the options for reversing this dire trend so the Enterprise operates in the black?**

1. Reduce operation, maintenance and replacement expenses.
2. Reduce personnel cost allocated to the Enterprise.
3. Creatively increase water marketing.

Each of these is discussed briefly below:

**Reduce operation and maintenance expenses.**
We will always be looking for ways to responsibly manage OM&R expenses. The fact, however, is that it is very difficult to significantly reduce these costs while striving to maintain fully functional, safe, permit compliant facilities.

**Reduce personnel cost allocated to the Enterprise.**
Currently most River District personnel costs are allocated 25% to the Enterprise and 75% to the General Fund. Certain personnel costs such as the Wolford caretakers are appropriately allocated

100% to the Enterprise. Overall, 30% of the River District personnel cost is allocated to the Enterprise. In the 2019 budget this totals $1.17M or, effectively, 7 FTEs, 2 caretakers at Wolford and 5 Glenwood staff. If the Enterprise were a standalone operation and effectively walled off from General Fund operation these personnel costs could and would likely be reduced.
**BUT** there is an obvious General Fund impact. Shifting personnel cost away from the Enterprise back to the General Fund simply exacerbates General Fund solvency issues.

**Creatively increase water marketing.**
The volume of water (Acre Feet) available and contracted from the marketing pool is summarized in the following table:

Figure 9.

| Source | Available | Contracted | Pending | Remaining | Right of Refusals | Remaining w/ ROR & Pending |
|---|---|---|---|---|---|---|
| Wolford | 8,100 | 3,038 | 0 | 5,062 | | 5,062 |
| Ruedi* | 11,413 | 5,263 | 0 | 6,150 | 900 | 5,250 |
| Eagle Park | 432 | 254 | 0 | 178 | | 178 |
| Elkhead** | 4,457 | 100 | 0 | 4,357 | | 4,357 |
| TOTAL AF | 24,402 | 8,655 | 0 | 15,747 | 900 | 14,847 |

The historical marketing trends are shown in the Figure 10 below. Wolford contracts have decreased since 2009. Ruedi contracts have been flat or decreased since 2013. The exception is the one year lease of 3,500 AF to the CWCB at the end of 2018 for in-channel uses on the FryingPan.

Staff believes that growth in the M&I sector will be slow in the foreseeable future for several reasons: 1) Municipal entities that could benefit from either Ruedi or Wolford water are already well situated for the foreseeable future through existing Ruedi and Wolford contracts and, 2) energy demands are expected to remain modest or potentially decline as the principal use for our marketing pool by industry has been for frac water and ancillary uses. Again, absent some large scale industrial demand (historically oil shale development) demands are expected to be flat.

There is a growing trend and acceptance for paying market rates for in-channel water. Evidence is the 3,500 AF lease to the CWCB as well as prices paid for various non-diversion agreements in recent years. Staff recommends that the Enterprise pursue creative ways to monetize our marketable yield for in-channel beneficial uses while preserving our ability to meet M&I demands when they arise. As depicted in the table shown above as Figure 9, there is sufficient volume in the marketing pool to do both. Figure 11 depicts a break even situation (variation on figure 8) in the Enterprise with additional water marketing. The amount of additional water marketing revenue required ranges from $623,000 in 2022 to $1,200,000 in 2040.

Figure 10.

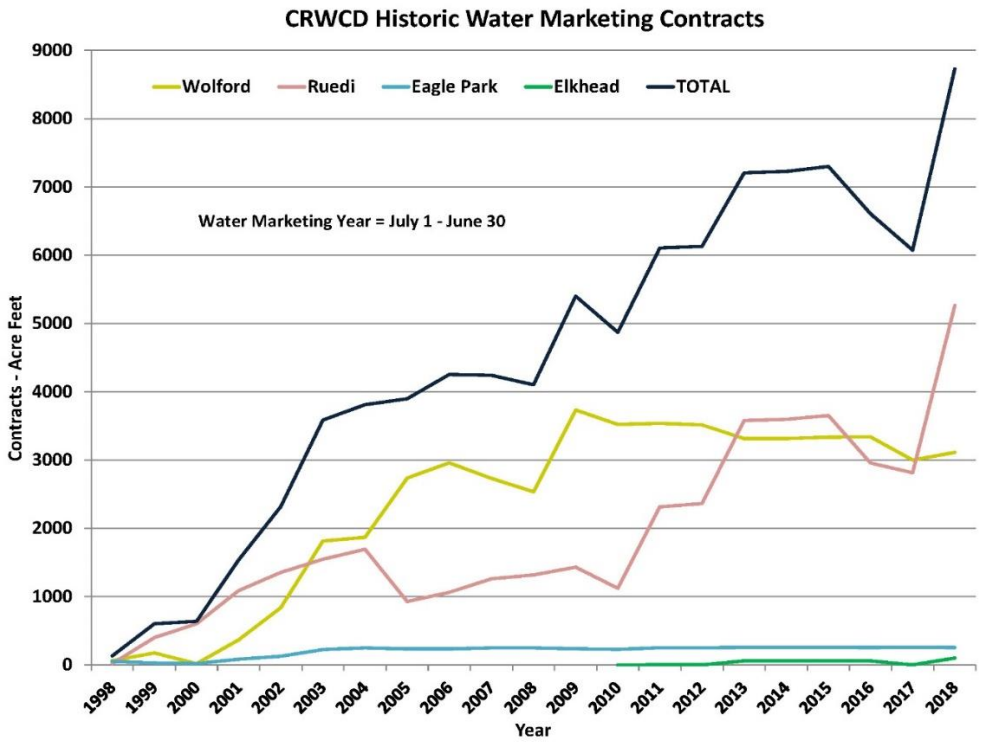
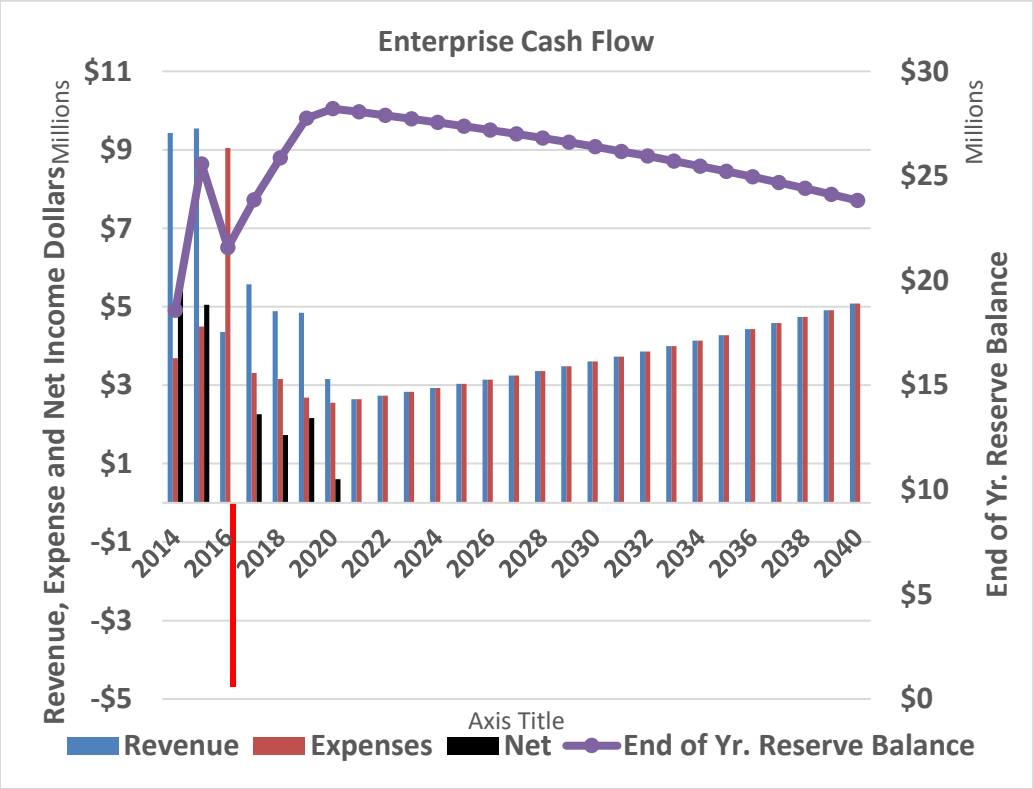



Figure 11.



Currently staff is discussing some creative in-channel contracts and will, when the time is ripe, be bringing one or more of these to the Board for further discussion.

## VII. STRATEGIES FOR THE FUTURE

The purpose of this memorandum was not to depress our dedicated Board members. We are hoping to use this memorandum and our presentation during the Board meeting to stimulate a discussion regarding potential remedies to these long term financial issues and, if deemed appropriate by the Board, to receive preliminary direction regarding potential ballot questions in 2019 or beyond. There are several areas that we believe the Board should explore at our workshop. These include but are not limited to the following:

1. Ballot question to mitigate the impacts of Gallagher
    a. Ask the voters to set the RAR permanently for the District;
    b. Ask the voters to authorize the Board to adjust the mill levy annually to offset the impacts of a reduced RAR; or
    c. Ask the voters to raise the mill levy.
2. Ballot question to mitigate the revenue/spending limitation and/or tax rate cap in TABOR
    a. Ask the voters to remove the revenue/spending limitation of TABOR;
    b. Ask the voters to raise the District mill levy and remove the revenue limitation; or
    c. Ask the voters to remove the revenue/spending limitation only as it applies to state grant funding.

3. A ballot question containing a mix of A and B above.

4. Form a Sub-district in the headwaters counties to fund certain activities related to River Health, increased irrigation efficiency and conservation.

5. Consider seeking legislative authority in the future to diversify the District's tax revenue in light of decreasing revenue from energy production and the Gallagher amendment.
    a. Is sales tax authority an option?
    b. Lodging tax?
    c. Bottle tax?
    d. Sin tax?

6. Take no affirmative action and direct District management to continue to reduce expenditures and workforce (and related service to our constituents) to accommodate reduction in revenue.

Staff will have financial and demographic information related to these options to present to the Board in order to inform the discussion.

We look forward to a lively discussion on Friday. Thank you.

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[i] The Colorado Constitution was amended to include TABOR in 1992. TABOR's stated purpose is to restrain the growth of government by limiting revenue, spending, and debt incurred by local and state governments. Colo. Const., Art. X, Section 20(1). TABOR is applicable to "Districts". Districts are defined as: "…the state or any local government, excluding enterprises. *Id.* at Section 20 (2)(b). TABOR requires each local government to establish a revenue and spending base, based on past revenue and spending, and then monitor any year-to-year growth in that base. A district's "fiscal year spending" is only allowed to increase at the same rate as inflation plus annual local growth. Any additional increase in revenue, spending or debt beyond the established base by a local government requires approval of the voters. Any "frivolous Revenue collected, kept, or spent illegally" over the previous four years must be refunded with 10% annual interest. *Id.*

"Fiscal year spending" is defined as "all district expenditures and reserve increases except, as to both, those for refunds made in the current or next fiscal year or those from gifts, federal funds, collections for another government, pension contributions by employees and pension fund earnings, reserve transfers or expenditures, damage awards or property sales." *Id*. at (2)(e). Although the language of TABOR speaks to distinct limits on "Fiscal year spending" (e.g., Section 20(7) is titled "Spending limits"), the Colorado Municipal League believes that those provisions are better read in the context of annual fiscal year revenue limitations instead of spending limits. *See*, CML's A Guide to the Taxpayers Bill of Rights (1999) ("CML") at 16. The justification for this interpretation is that, under TABOR, fiscal year spending equates each dollar of spending with a dollar of revenue. *See*, Section 20 (2)(e). In other words, each dollar of revenue received by a district during the fiscal year is considered fiscal year spending under TABOR. Therefore, the River District carefully tracks all revenue collected to ensure that, where applicable, its fiscal year spending limitations under TABOR are not exceeded.

As noted above, the definition of "districts" under TABOR does not include enterprises. TABOR defines an enterprise as : "…a government owned business authorized to issue its own revenue bonds and receiving under 10% of annual revenue in grants from all Colorado state and local governments combined." *Id.* at (2)(d). TABOR does not define "grants."