The NEAL SPELCE AUSTIN LETTER

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Dear Client:

When legislators arrive in Austin in January, they'll face a tight budget situation. Not news. We, and a host of others, have pointed this out. But here is something else to point out: about $10 billion will be just sitting there, unallocated. It's in the Rainy Day Fund – a "savings account" to be used during unforeseen financial emergences. But the temptation to tap this money will be mounting, especially as individual pet projects surface.

The official name is the Economic Stabilization Fund (ESF). But it quickly was referred to as the Rainy Day Fund when it was established by the Texas Legislature in 1989. It was a good idea. The state had hit some financial hard times (remember the recession of the 1980s?). And over the last quarter century, **the ESF has now grown to more than $10 billion, even though it has been partially drawn down by certain legislatures in the past**.

The arguments – pro and con – will be powerful. The purists say "don't' invade the Rainy Day Fund, we **need it in case of a natural disaster or a recession**. After all we're deciding on spending for the next two years." Those who may want to siphon off some money say "**look, as a state, we're growing so fast we can't keep up** and our oil and gas tax revenue has been down for the past two years. We need more money to keep Texas on the upswing."

It's pretty hard to draw down money from the Rainy Day Fund. It takes a **two-thirds vote of both the House and the Senate** to use the Fund for any purpose.

Changes may be discussed in how the Fund is managed. For instance, those who want to keep the ESF almost sacrosanct want the **threshold set at a four-fifths vote of both Chambers – to make it really hard to tap the Fund**. Another change suggested is that when the **Rainy Day Fund exceeds a cap, the excess could be used to reduce taxes or pay off existing state obligations**.

The huge size of Texas' Rainy Day Fund has long been the envy of most other states. It has helped the state's bond rating, resulting in lower interest rates on borrowed money. And, psychologically, it helps keep an even balance among varied economic measurements. But **underlying the ESF's growth, and also questioning its future size, is the health of the state's oil and gas business that produces critical tax revenue for the state**. Check out the next item for an out-of-state economist's view of a potential oil and gas recovery in Texas.

Firmer oil prices should help *Texas* generally. But it may take a while for *Houston* to bounce back. While oil is important to Texas, it is fortunate the state economy is fueled by more than just oil. Here's a quick status report from Comerica's top economist, Robert A. Dye.

Dye said the price for West Texas Intermediate crude oil appears to be stabilizing in the range of $45 to $50 per barrel. And this, he says, is "**providing a floor for drilling activity in Texas**." **He said oil producers "continue to gain efficiencies" so the cost of drilling is dipping** and this means more rigs will start pumping black gold in Texas in 2017.

Dye didn't suggest a robust return. In fact, he pointed out "**there remains a worldwide glut of oil that may take a year or more to absorb, keeping downward pressure on prices**."

He's bullish on the overall Texas economy. But he cited the state's two biggest metros as examples of the contrast in the Lone Star State. **The Dallas/Fort Worth metro's job growth was up 3.8% year-over-year in September, while the Houston metro slipped to just 0.5% year-over-year**. Dye said "we look for a slow turnaround in Houston in 2017."

For now, Austin's housing market is humming right along. Upper end luxury homes are taking longer to sell than was the case earlier in the year. But homes priced around $300,000 and below continue to be in high demand. And this helps the latest numbers for the overall Austin housing market to continue to be quite vibrant.

The number of homes sold in the Austin metro area **for the first nine months of 2016 was 25,428 – or 3.8% greater than the same period in 2015**, according to **Chris Ramser**, Director, Research, for the Greater Austin Chamber of Commerce.

Diving a bit deeper you find one of the key markers is driving this part of the economy. **Austin has had less than three months inventory for sale on the market since November 2012**. This means the sellers have a big-time advantage. For instance, six months of inventory is considered a "balanced" market – where neither seller nor buyer has an advantage. **In September, inventories of available homes was at 2.8 months**.

Of course, this heavy demand keeps pushing home prices higher and higher. Ramser confirmed this when reporting the year-to-date volume sales in September was **9.3% higher than last year and the average home price is up 5.3% compared to the first nine months of 2015**.

Also the specter of **rising mortgage interest rates** is looming over the housing market. The effect of this will be something to watch in the New Year.

The City of Austin should be closely watching the action by the Lower Colorado River Authority (LCRA) as it relates to the cost of wind power to generate electricity. **The LCRA is paying millions of dollars to cut its losses from a wind power contract**. **It claims wind power is not as economical as LCRA's fossil fuel-generated electricity**.

About seven years ago, the LCRA management team, in place at the time, signed an 18-year deal to **buy wind power from the Papalote Creek Wind Farm to be constructed northeast of Corpus Christi** by the North American operations of E.ON, a German company. The project apparently relied upon the contract to build the Wind Farm and is now screaming "foul."

When the contract was signed, **it locked in a price of $64.75 per megawatt hour. Now wind power is selling for much less than that price**. After spending about $45 million for the pricey wind power, the LCRA stopped taking power from Papalote. It argues an opt-out clause in the contract allows the LCRA to bail out by paying $60 million to E.ON. By doing so, the LCRA says it will save tens of millions of dollars in the long run.

Not so fast, argues E.ON, the opt-out provision was for the construction phase. Oh no, answers LCRA. And a federal court-appointed mediator agreed with the local folks. **The Papalote Wind Farm continues to operate without LCRA revenue**, **selling wind power for about $25 a megawatt hour on the open market**.

So what is the river authority doing about replacing wind as a source of power for electricity? Along with the City of Austin, it **shares electricity generated by coal at the Fayette Power Plant in nearby La Grange**, **and is increasing its allotment**. **Coal-fired power is much less expensive**. **The LCRA is also getting more electricity from its natural gas plants – also at a much lower cost**.

The kicker for the LCRA's customers such as the **Pedernales Electric Cooperative** in Johnson City and **Bluebonnet Electric Cooperative** in Bastrop, as well as individual cities in Central Texas? The cost of wholesale power generation is a *pass-through for LCRA's customers*. So, if their consumption of power is the same, **the customers will see lower monthly bills**.

The lesson here for the City of Austin that is heavily invested in wind-and-solar-power-generated electricity? **Austin has been trying for years to find a way to get out of the Fayette coal-fired plant in La Grange**. **And it is dragging its feet on the possibility of building a new natural gas-fired plant**. Both of these sources are less expensive than wind/solar to generate electricity for Austin Energy customers.

When a new City Manager is hired next year for Austin, **he/she should order a new assessment of the cost of electricity to help lower Austin Energy customer's hefty monthly electricity bills**. Frankly, though, this is not likely. The City Manager will probably be hired on the basis of agreeing with this City Council's commitment to alternative energy sources.

The national headline read: "No Longer A Fluke; Austin is for Real." Fluke? What? C'mon. Really? First of all the Austin Story was never a fluke and its' economic dynamism has been recognized for years. Austin's enviable growth has been the product of decades of well-planned and orchestrated progress (okay, with a few bumps along the way). Let's look at that report.

Well at least the view that Austin is "For Real" was acknowledged. Interestingly, the story was based on a report we detailed for you three weeks ago (see our 11.4.16 edition in our "archives" section on the website.) This was the report where "**the Austin metro emerged #1 in the nation in the Urban Land Institute (ULI) 2016 edition of *Emerging Trends in Real Estate*.**"

> "Viewed as a fluke when it hit the study's top 10 list five years ago, **Austin's rise to the top of the list signals the durability of the city's long-term appeal to investors**," says **Mitch Roschelle**, PwC partner and real estate research leader, as reported this week by GlobeSt.com. (It's hard to believe where these guys were five years ago as Austin was topping just about every US ranking of desirability.)
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> Be that as it may, they now point out "**Austin wins top city status thanks to its niche neighborhoods and depth of diversity, from manufacturing to education, health care and technology**." Okay, we'll buy that observation and are glad they've finally climbed aboard Austin's economic growth train.

They further observed: "market characteristics such as authentic, niche neighborhoods with strong economic diversity are driving growth outside of gateway markets. **The attractiveness to both workers and employers alike is supporting real estate growth**."

It's always nice to get such recognition, even from those who arrive late to the party.

Dr. Louis Overholster, looking ahead to the upcoming tight budget session of the Texas Legislature, opined some legislators are of such a mood that if someone introduced the Ten Commandments, they'd want to cut them down to eight!

Sincerely,

Neal Spelce

Editor/Publisher