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Report to the Chairman, Committee on the District of Columbia, House of Representatives

September 1994

DISTRICT OF COLUMBIA

Status of Sports Arena Project

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Accounting and Information
Management Division

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September 15, 1994

The Honorable Fortney H. (Pete) Stark
Chairman, Committee on the District of Columbia
House of Representatives

Dear Mr. Chairman:

This report responds to your August 5, 1994, request that we provide information on a proposal to build a sports arena in the District of Columbia. Specifically, this report describes the status of the project and discusses the cost, benefit, and financing data contained in the proposal.

BACKGROUND

The District of Columbia has proposed building a sports arena to generate economic development for the District's downtown. Although the Congress is not required to specifically approve the project, the District has proposed that financing for the project be arranged in part by a recently authorized corporate instrumentality (enterprise). This enterprise would issue revenue bonds backed by the pledge of specific taxes. Such financing would require changes to the District of Columbia Self-Government and Governmental Reorganization Act (Home Rule Act).[1] H.R. 4888 would amend the Home Rule Act to authorize this type of financing.

The District is proposing to build a 23,000 seat, state-of-the-art sports arena in the downtown area of the city at a site commonly referred to as Gallery Place. The total cost of the arena is estimated to be about $200 million, and it is expected to be completed in September 1997. Most of the funding for the arena is expected to be provided by revenue bonds issued by the newly created Sports Commission[2] and backed by a new gross receipts tax assessed on District businesses (also known as the Arena Tax), and by project bonds issued by the National Capital Development

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[1]Public Law 93-198, 87 Stat. 744 (1973).

[2]The Sports Commission was created by the Omnibus Sports Consolidation Act of 1994, DC Act 10-265, signed by the Mayor on June 30, 1994 (Act 10-265: 41 DCR 4636).

Corporation (NCDC) backed by non-tax revenue generated by the arena and a pledge of additional revenue by the owner of the Washington Bullets and Washington Capitals (franchises). The arena would be owned by NCDC on land leased from the District or the District's Redevelopment Land Agency. The feasibility of developing and constructing the arena hinges on the owner of the franchises agreeing to designate the new arena as the home facility of the franchises on a long-term basis.

The Home Rule Act confers limited autonomy to the District over its local affairs and also provides for congressional oversight. The District is authorized by the Home Rule Act to issue long-term debt in the form of either general obligation bonds or revenue bonds. The District can issue general obligation bonds to finance capital projects or refinance existing debt. General obligation bonds are backed by the full faith and credit of the District including any special tax levied to pay the principal and interest of any general obligation bonds. The District is authorized to create a security interest in any District revenues as additional security for payment of the general obligation bonds. The Home Rule Act limits the amount of general obligation debt. Specifically, general obligation bond issuances are not permitted if total debt service in the fiscal year exceeds 14 percent. As of August 1, 1994, this debt service percent was 11.4 percent.

The District can also issue revenue bonds, notes, or other obligations to finance or refinance undertakings in certain areas. Such revenue obligations are not general obligations of the District nor can they be backed by the full faith and credit or the taxing power of the District. Instead, they are payable from earnings of the respective projects and may be secured by mortgages on real property or creation of a security interest in other assets. The amount of revenue bonds that the District may issue is not limited by the Home Rule Act.

The District is proposing to finance the construction of the sports arena by authorizing a District enterprise (the Sports Commission) to issue revenue bonds that would include as security a pledge of dedicated taxes. This proposed method of financing requires amending the Home Rule Act. Thus the District is seeking an amendment to the Home Rule Act to authorize the Sports Commission to issue revenue bonds backed by dedicated taxes to finance part of the cost of constructing the sports arena. H.R. 4888 would authorize the District: (1) to issue such revenue bonds, and (2) to delegate authority to District enterprises to issue the bonds and to collect and expend the dedicated tax revenues.

SCOPE AND METHODOLOGY

To develop information for this report, we analyzed studies that were prepared by consultants for the project. However, we did not independently validate information in these studies because the proposal was very tentative and we were requested to complete our analysis in a short time frame. We contacted the consultant who prepared the economic projections. We also held discussions with various consultants who were involved in similar projects in other jurisdictions. We met with District of Columbia officials in the Mayor's Office, Office of Financial Management, and the Department of Finance and Revenue, and analyzed District information on the project. We also met with staff of the Council of the District of Columbia. We met with and obtained information from officials of the National Capital Development Corporation. We obtained information and discussed general financing arrangements with the National Association of State Treasurers, Standard and Poor's, and Moody's Investor's Service. We did our work in August and September 1994, in accordance with generally accepted government auditing standards.

RESULTS IN BRIEF

The proposal to build a sports arena is in the early stages of development. The District will need additional information on the project before more precise cost and benefit projections can be made. As a result, certain revenue, expense, and economic benefit projections in current proposals could be significantly affected by additional information as the development process progresses. Based on the experiences of other jurisdictions, the level of detail contained in the District's sports arena project proposal is fairly typical for a project at this stage of development.

The most recent sports arena proposal indicates that the project should be able to generate sufficient direct revenue to cover currently known expenses; however, a number of unanswered questions could significantly affect the projection. The construction costs of the sports arena are very tentative--the project does not yet have a formal feasibility study, an environmental impact study, or an architectural and engineering design, all of which will more specifically define project costs and time frames and better quantify project benefits. The current cost projections also do not include needed infrastructure changes or the cost of all the land that may be required. Unanswered questions involving operations include the cost to the District for police, who would be needed for traffic control and security in the area, and the specific relationships between the operating entities and the District. For example, it is unclear what impact, if any, sustained losses by NCDC would have on the District.

The proposed financing for the project involves revenue bonds backed by specific District taxes. Although this type of financing is new to the District of Columbia, such financing is routinely used for similar projects in other jurisdictions. The District's high level of general obligation debt makes using general obligation bonds to finance this project and needed capital improvements to other District programs unlikely. As with the costs and benefits, further development of the project will be needed before detailed financing arrangements can be identified.

The District has outlined the next steps that need to be taken to provide answers to the various questions. Following these steps should put the District in a position to make key decisions about how or whether to proceed with this project. One key step will be authorizing contracts for various studies. These studies will better define the project and allow the District to specifically assess the costs and benefits of the project.

PROPOSED COSTS AND BENEFITS OF THE PROJECT

Recent studies and other information developed by the District indicate that projected revenues will exceed currently known projected expenses for the sports arena. However, unanswered questions on both the cost and operations of the facility will affect the projection. For instance, a formal feasibility study, an environmental impact study, and an architectural and engineering study need to be completed, and certain operating expenses need to be defined to better identify the economics of the project.

The District's current initiative to build a sports arena began when the President of the Federal City Council[3] alerted the city that the owner of the Washington Bullets and Washington Capitals was considering relocating the franchises and was interested in a downtown location. The Federal City Council joined with the D.C. Chamber of Commerce to create NCDC, a nonprofit civic organization. NCDC was formed to negotiate a deal to relocate the franchises from their current location outside of the District to a new downtown arena.

District officials believe the new downtown sports arena will benefit the District because it will (1) have a positive economic impact on the area surrounding the arena, as well as the District as a whole, which would contribute to the continued

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[3]The Federal City Council, a nonprofit organization that carries out activities designed to improve Washington, D.C, is composed of and financed by business, professional, educational, and civic leaders.

revitalization of downtown, (2) generate jobs for the District, (3) expand the District's tax base, and (4) foster a sense of civic pride among District residents.

Under an agreement negotiated with the franchises' owner, NCDC would build and own the arena and oversee its operations. NCDC and the District's Sports Commission would issue bonds to help finance the arena. NCDC would issue project bonds backed by arena revenues and the Sports Commission would issue revenue bonds backed by dedicated taxes. The franchises' owner would operate the arena under contract for a term concurrent with the franchises' leases.

Under the current proposal, the District will (1) provide most of the land required for the project, (2) exempt the arena from real property taxes, (3) provide a portion of the financing for the development and construction of the arena, and (4) establish a Sports Commission to consolidate the District's efforts in promoting, managing, and coordinating sporting events.

The current proposal outlines the expected revenues and expenses of NCDC as owner of the arena. Any excess revenues over expenses are to be provided to the District to cover the lease payment on land owned by the District. The proposal does not indicate who would cover potential NCDC losses. Table 1 shows NCDC's projected revenues and expenses in the first year of operation.

NCDC hired the public accounting firm of Coopers & Lybrand to assist them in developing preliminary estimates of costs and benefits. In addition, the District hired Sportscorp, Ltd., (a sports facilities development consulting firm based in Chicago) to analyze Coopers & Lybrand's initial estimates and to develop additional information.

Table 1: NCDC First Year Projected Revenues and Expenses
(Dollars in thousands)

	Amount
Revenues	
Rent from franchises' owner	$3,500
Percentage of executive suites revenue	3,100
Percentage of club seats revenue	3,500
Naming rights annual fee	1,000
Total revenues	11,100
Expenses	
Project bonds debt service	8,800
NCDC operating expenses	700
Capital replacement fund	400
Total expenses	9,900
Net Revenues (Land Lease Payment to District)[a]	$1,200

Notes: These are tentative estimates based on information available in August 1994 and could change substantially.
[a]The amount of the land lease payment to the District is based on the net revenue of NCDC in a fiscal year and therefore may vary.
Source: National Capital Development Corporation

Economic justification proposals from these consultants, NCDC, and other information from the District indicate that the District can expect to realize sufficient revenues to cover the annual debt service on the revenue bonds backed by dedicated taxes.[4] While the justifications vary, even the most conservative estimate shows a net gain to the District. Table 2 shows the estimated District annual revenues and expenses that will be generated from the sports arena from 1995 to 2002.

[4]The District, as used here, refers to both the District and the Sports Commission. The Sports Commission would issue the revenue bonds backed by dedicated taxes and pay the debt service on the bonds. Other tax revenues would be generated for the District's general fund as a direct result of the sports arena.

Table 2: Projected District Revenues and Expenses of Sports Arena
(Dollars in thousands)

	1995	1996	1997	1998	1999	2000	2001	2002
Revenues								
Arena Tax[a]	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
District tax revenues				4,762	4,929	5,101	5,280	5,465
Debt service fund interest		583	583	583	583	583	583	583
Preconstruction cost reimbursement		6,000						
Land lease payment				1,119	1,350	1,589	1,836	2,093
Total revenues	10,000	16,583	10,583	16,464	16,862	17,273	17,700	18,141
Expenditures								
Debt service		9,641	9,641	9,641	9,641	9,641	9,641	9,641
Debt service reserve[b]		9,700						
Preconstruction costs	6,000							
Employee Relocation[c]		500						
Total expenses	6,000	19,841	9,641	9,641	9,641	9,641	9,641	9,641
Net Revenues	$4,000	($3,258)	$942	$6,823	$7,221	$7,632	$8,059	$8,500

Note: These are tentative estimates based on information available in August 1994 and could change substantially.

[a]The specific amount of the Arena Tax that will be collected is unknown. Originally, the District estimated that annual collections would be $31 million. However, actual collections of a similarly based tax have been less than expected. This estimate is based on information from the District's Department of Finance and Revenue.

[b]Debt reserves are frequently required by bond underwriters. The amount is based on the likelihood of the collection of the tax revenues that are backing the bond. Given the uncertainty of the Arena Tax collections, this amount could be increased substantially.

[c]These are costs to relocate District agencies currently located in buildings on G Street between 6th and 7th Streets. Additional continuing costs could be incurred if new office space for these employees costs more than the current office space.

Source: This table is based on information from a July 27, 1994, analysis by Sportscorp, Ltd. which used assumptions from NCDC and Coopers & Lybrand. In addition, we added the District's most current estimates of the revenues from the new Arena Tax to the analysis.

The arena proposal also outlines a number of indirect economic benefits that could accrue to the District. These benefits include indirect tax benefits of $3.1 million in 1998 to $8.4 million in 2027, the creation of 500 jobs during the construction phase, and the creation of an additional 540 jobs annually from arena operations. In total, the studies estimated the net present value of economic benefits to the District over 30 years to be from $70 million to $130 million.

Although the arena proposal forecasts benefits, a number of unknown costs and factors could affect this projection. For example, unknown construction-related costs include the cost of additional land needed, utility relocation expenses, and demolition costs. Various infrastructure cost improvements are also unknown, such as the costs associated with METRO access and the cost of rerouting G Street. The costs of security and traffic control are also unknown. The land lease payment that the District is to receive from NCDC is based on net NCDC revenues. If there are no net revenues, the District would receive nothing for the land lease. In addition, the specific relationship among the entities involved--NCDC, the Sports Commission, and the District--has not been spelled out. Finally, the role of the District in exercising oversight and control over NCDC is also unknown.

PROPOSED FINANCING ARRANGEMENTS

The District currently plans to use revenue bonds backed by dedicated taxes to partially finance the sports arena. These bonds will not be backed by the full faith and credit of the District.[5] Such financing is commonly used in other jurisdictions. Forty-nine states allow this type of financing. Moreover, many recently developed sports arenas were financed by bonds backed by dedicated taxes. For example, although financing arrangements varied substantially, sport arenas in Cleveland and Phoenix were financed in part with bonds backed by dedicated taxes.

Another method of financing these types of projects involves using general obligation bonds backed by the full faith and credit of the jurisdiction. Although the District theoretically could use general obligation bonds for this project, its current high level of general obligation debt, when added to additional debt to finance the arena, would approach its general obligation debt limit and, according to District officials, could affect its general obligation bond rating.

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[5]The District intends to limit its liability to the taxes pledged to the bonds by not pledging its full faith and credit to payment of the bonds.

The District Home Rule Act specifies that general obligation bond issuances are not permitted if total debt service in any fiscal year exceeds 14 percent of the District's revenues. As of August 1, 1994, the District had $3.65 billion in long-term general obligation debt. The District projects that with additional planned capital borrowing of $250 million annually from fiscal years 1995 through 1998 and $190 million annually in fiscal years 1999 and 2000, the District's debt service will climb to 13.0 percent of revenues by fiscal year 2000 even without the additional debt associated with the arena. Based on estimates of revenue and planned capital project borrowing, the District estimates that the debt service percent would be 13.2 percent in fiscal year 2000 if it uses general obligation debt instead of the planned revenue bond backed by dedicated taxes. District officials said that this high level of debt could affect its general obligation debt rating.

A critical component of financing costs involves the level of risk associated with the bond. Higher risk bonds generally have higher interest rates, may require insurance, or may require the issuer to set up large debt service reserves. Officials at bond rating agencies have indicated that a number of factors are important in their assessment of bonds backed by specific revenues. First, if the bond is backed by a tax, the collection history of the tax is important. Bonds backed by taxes with a solid collection history are less risky than new or unproven taxes. Second, the tax backing for a bond is less risky if it is assessed on a broader range of goods, services, or population. Third, revenue streams that have some legislative risk (that is, revenues based on an appropriation) make the bond higher risk. Finally, the general economic strength of the area is critical to the bond assessment.

The current plan calls for the use of two different types of bonds to finance the sports arena--an $80 million project bond and a $92 million revenue bond backed by dedicated taxes. The project bond would be issued by NCDC and would be backed by arena revenue and a $7.3 million pledge from the operator of the arena. NCDC would pay the estimated $8.8 million annual debt service with revenues from the arena. A change of 1 percent in the interest rate would change the annual debt service by about $700,000. The other bond would be issued by the new Sports Commission. The bonds will be a $92 million revenue bond backed by the Arena Tax and would have an estimated annual debt service of $9.6 million.

The planned Arena Tax is similar to the current one-time Public Safety Fee that is to be collected in fiscal year 1994.[6] The District originally estimated that the Public

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[6]The Public Safety Fee is a gross receipts tax on all profit and nonprofit organizations. Nonprofit organizations would not be assessed the Arena Tax.

Safety Fee would raise a total of $34 million and the Arena Tax would raise $31 million. The District estimated that $25 million of the $34 million Public Safety Fee would be collected by September 30, 1994. However, as of September 1, 1994 collections of the Public Safety Fee totalled just $10 million. On the basis of that experience, District officials now estimate that the original Arena Tax projections could be too high. Although Arena Tax collections should be sufficient to cover the bond's debt service, the uncertain collection future of the tax may require the District to pledge additional taxes or other security to back the bonds, or require the District to substitute another existing tax with a better collection history for the Arena Tax. As noted in table 2, the uncertain collection history of the Arena Tax could also require the District to establish a larger debt reserve. These factors add to the list of uncertainties regarding the sports arena.

NEXT STEPS TO BE TAKEN BY THE DISTRICT

The District needs additional information on the sports arena project before more accurate cost and benefit projections can be made. The project needs a formal feasibility study, an environmental impact assessment, and an architectural and engineering design to further define the proposal. Such studies are typically needed before bonds can be authorized.

Consultants involved in the sports arena and other officials familiar with similar projects in other jurisdictions that we met with said that firm costs and benefits of projects are often not determined until environmental impact and architectural and engineering studies are completed. These officials pointed out that the level of detail contained in the proposal for the sports arena project is fairly typical for projects at this stage of development.

These officials also noted that jurisdictions typically need to spend resources prior to obtaining project bond revenue to fund up-front costs. For example, such costs for one jurisdiction's arena came from an infrastructure budget, while another jurisdiction used a variety of funding sources, including a parking fund, a state grant, a low interest State loan, and mass transit funds, for their up-front costs. The officials also pointed out that these up-front funding sources are frequently repaid with the project bond proceeds.

The District plans to begin collecting the Arena Tax for the sports arena in January 1995 and anticipates using this revenue for up-front costs. However, even though the taxes will be collected, they cannot be spent without a congressional appropriation or amendments to the Home Rule Act (such as those in H.R. 4888). The District estimated they needed to spend from $5 million to $8 million for studies and other items for the sports arena prior to obtaining revenue from the proposed bonds. District officials said this estimate included: $2.5 to $4.5 million for design and engineering, $1.5 to $2.0 million for special studies (such as environmental, traffic and transportation), and $1.0 to $1.5 million for project structuring and feasibility work.

The District has laid out timetables to complete the numerous steps necessary to implement the project. Some of the key steps are outlined in figure 1. Following these steps should put the District in a position to make key decisions about how or whether to proceed with the project.

Figure 1: Timeline for Completion of the Sports Arena

1994		
	AUGUST	• NCDC board formed and interim funding secured
	SEPTEMBER	• Select design/build team
	NOVEMBER	• Feasibility study delivered • Mayor certification of "no financial impact"
	DECEMBER	• Receive commitments for 10 founder suites • Complete preliminary design and project budget • Execute final "program agreement" • Complete draft of environmental documentation
1995		
	MARCH	• Sign lease agreement between RLA and NCDC
	APRIL	• Receive naming rights commitment • Environmental impact results • Urban renewal plan amendment approved
	JUNE	• Complete review of final design
	AUGUST	• Sell financing bonds
	SEPTEMBER	• City council approval of street closing
	OCTOBER 1995 to SEPTEMBER 1997	• Other milestones to be determined
1996		
1997		
	SEPTEMBER	• Ribbon cutting for new sports arena

Source: District of Columbia Government

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As you requested, we did not obtain official comments from District of Columbia officials on this report. We did, however, discuss the report's contents with District officials, who agreed with the facts presented.

We are sending copies of this report to the Mayor of the District of Columbia, the Chairman of the City Council, and other interested parties. Copies will also be made available to others upon request.

Please contact me at (202) 512-8549 if you or your staff have any questions concerning this report. Major contributors to this report are listed in appendix I.

Sincerely yours,

John W. Hill, Jr.

John W. Hill, Jr.
Director, Audit Support and Analysis

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