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Report to the Chairman, Subcommittee on the District of Columbia, Committee on Government Reform and Oversight, House of Representatives

December 1996

DISTRICT OF COLUMBIA

Status of the Sports Arena

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Accounting and Information Management Division

B-275392

December 31, 1996

The Honorable Thomas M. Davis III
Chairman, Subcommittee on the District of Columbia
Committee on Government Reform and Oversight
House of Representatives

Dear Mr. Chairman:

You requested that we monitor and periodically report on the progress of the sports arena project in the District of Columbia. This report discusses the project's predevelopment costs, revenue collections, financing, interest rates received on the arena bonds, and construction status.

Results in Brief

As of October 18, 1996, while the estimated predevelopment costs for most cost categories for the arena had somewhat changed, overall estimated predevelopment costs increased by a net amount of $617,000 or approximately 1 percent—from about $55.2 million to about $55.8 million—since our last report.[1]

The District had $66.6 million available to fund its predevelopment activities and establish a debt service reserve for the arena project. This amount consisted of $57.4 million in net bond proceeds (after financing costs) and $9.2 million in 1995 revenue tax collections from the dedicated Arena Tax. Of the $66.6 million, $11 million is held in reserve—$5 million for cost overruns and $6 million for debt service. Based on estimates as of October 18, 1996, the District had sufficient funds to pay predevelopment costs. The bond trustee has made the 1996 debt service payment of about $5.9 million on arena bonds, and the District's projections of Arena Tax revenues of $9 million annually appear sufficient to redeem the bonds by the year 2002 as scheduled.

Arena predevelopment activities are nearing completion. All land has been acquired; however, the final cost of the parcel of land acquired through condemnation proceedings will be determined by the outcome of legal proceedings. The buildings formerly on the arena site have been demolished and the relocation of utilities and the securing of regulatory approvals are nearly complete. District employees have been relocated

[1]Sports Arena (GAO/AIMD-96-43R, February 21, 1996).

and office improvements are underway. Construction of the Metrorail connection is about 25 percent complete. In addition, arena construction began on February 18, 1996, and the arena should open in late 1997.

Background

The District of Columbia government (acting through the Mayor and the District's Redevelopment Land Agency[2]) and District of Columbia Arena, L.P. (DCALP)—a limited partnership formed by the owner of the Washington Bullets and the Washington Capitals—have agreed that DCALP will build a sports arena (estimated to cost about $175 million) and the District will be responsible for financing certain predevelopment costs.

The District agreed to be responsible for the following predevelopment costs:

- acquiring land, including the purchase of property not then owned by the District,[3]
- connecting the Gallery Place Metrorail station to the sports arena,
- relocating District employees from two buildings on the site to other locations, and
- demolishing buildings, remediating soil,[4] relocating utilities, and securing all regulatory approvals necessary for construction of the sports arena.

To finance the predevelopment costs of the arena, in August 1995, the District received a $53 million loan commitment (line of credit) from a consortium of banks led by NationsBank and Crestar Bank. In January 1996, the RLA issued about $60 million in revenue bonds backed by the Arena Tax and paid off the $36.6 million portion of the line of credit used. The Omnibus Budget Support Act of 1994 (Arena Tax Act)[5] as amended, provides for a Public Safety Fee (Arena Tax) to be levied on businesses located in the District based upon the annual District gross

[2]The District of Columbia Redevelopment Land Agency was created and established as an instrumentality of the District of Columbia government pursuant to the District of Columbia Redevelopment Land Act, 60 Stat. 793, August 2, 1946 (D.C. Code Annoted, & 5-801 et seq.), as amended (the "RLA Act"). The purpose of the RLA is to protect and promote the welfare of residents of the District through the acquisition and assembly of real property and the lease of such property for redevelopment.

[3]As of September 30, 1996, the District had acquired two properties needed for the arena, one through condemnation proceedings. However, according to the District's Project Manager for the sports arena, the purchase price of the property acquired through condemnation will be determined by pending legal proceedings.

[4]Remediating the soil encompasses any and all corrective actions taken to clean up a site in order to meet District or federal standards for soil quality.

[5]D.C. Code (1996 Supp.) Secs. 47-2751 through 47-2753.

receipts of such businesses. The Arena Tax is due on or before June 15 of each year. The Arena Tax Act also authorized the RLA to pledge the Arena Taxes as security to repay loans to finance predevelopment activities.

Further, the Arena Tax Act provides that if, on or before December 1 of each year, the Mayor estimates the Arena Tax revenue is less than $9 million, the Mayor is required to raise the Arena Tax rates to provide for an estimated revenue of not greater than $9 million. The Arena Tax was first levied in fiscal year 1995. During the first year of the Arena Tax, most of the Arena Tax collections were used to fund predevelopment activities. In subsequent years, the Arena Tax will be used to pay principal and interest (debt service) on the bonds as required by the bond resolution.[6]

As previously stated, the District is responsible for the predevelopment costs of the arena. DCALP, the developer, is responsible for arranging and repaying the financing needed to pay all costs associated with the design, development, construction, and operation of the sports arena.

Objective, Scope, and Methodology

To obtain information on the status of the arena project, we reviewed relevant contract agreements, vendor invoices, and the bond trustee's disbursement records supporting the predevelopment costs. We also reviewed various financial reports and bank statements for Arena Taxes collected and deposited as of August 1996.

We interviewed District officials from the Arena Task Force, the Office of the Corporation Counsel, the Office of the Treasurer, the Department of Finance and Revenue, and the RLA. We also met with trustees for the lockbox (into which dedicated tax collections are deposited) and the bonds. In addition, we discussed the construction progress of the arena and the Metrorail connection with officials from DCALP and the Washington Metropolitan Area Transit Authority (WMATA). Further, we interviewed officials from Merrill Lynch regarding the structure and pricing of the bonds. Finally, we interviewed officials from Standard & Poor's Rating Service (S&P) and Moody's Investor Service (Moody's) concerning the rating of the bonds.

We did not audit the arena's predevelopment cost estimates or evaluate the financing to determine if the reported amounts were correct. The amounts for the predevelopment costs and financing were provided by

[6]The bond resolution authorizes the issuance of bonds to pay for the predevelopment costs of the arena project. It sets forth the terms, rights, and obligations of the RLA, bondholders, and trustees.

District officials and, where applicable, were verified to disbursement records maintained by third parties acting as trustees for either tax collections or bond proceeds. Accordingly, we do not express an opinion or any other form of assurance on the arena's predevelopment cost estimates or its financing.

We also did not audit the reported taxes collected and deposited for the sports arena project. We, therefore, did not determine if the District government accurately identified the universe of taxpayers or reported all dedicated taxes for this project. However, we reviewed monthly statements provided by the lockbox trustee[7] to determine the amount of taxes collected and placed in escrow for this project. Our review built on previous work,[8] and we conducted our review from March 1996 through December 1996 in accordance with generally accepted government auditing standards.

Predevelopment Project Costs

As of October 18, 1996, estimated predevelopment costs had increased from about \$55.2 million to about \$55.8 million or by a net amount of about \$617,000 (1 percent), since our last report.[9] The District's predevelopment activities consist of four major categories: (1) acquiring land, (2) constructing the Metrorail connection, (3) relocating District employees, and (4) demolishing two buildings, remediating soil, relocating utilities, and using consultants to secure regulatory approvals.

All land has been acquired for the arena site. However, the final cost for one of the parcels of land acquired will be determined by the outcome of legal proceedings. Construction of the Metrorail connection is about 25 percent complete as of October 18, 1996. All District employees have been relocated; however, office improvements on the new space have not been completed. Finally, the two old buildings have been demolished and relocating utilities and securing regulatory approvals are nearly complete as of October 18, 1996. The District is awaiting final bills for these activities.

[7]As was done in 1995, taxpayers were directed to send their payments to a lockbox. The trustee of the lockbox in turn forwards the tax payments to the bond trustee—who then makes payments to the bondholders.

[8]District of Columbia: Status of Sports Arena Project (GAO/AIMD-94-192, September 15, 1994); District of Columbia: Status of Sports Arena and Convention Center Projects (GAO/T-AIMD-95-189, July 12, 1995); Sports Arena (GAO/AIMD-95-209R, July 26, 1995); and GAO/AIMD-96-43R, February 21, 1996.

[9]GAO/AIMD-96-43R, February 21, 1996.

The District's Project Manager for the sports arena stated that based on the project's current status and known estimates for predevelopment costs, as of September 30, 1996, the District does not expect to exhaust the $5 million capital reserve fund established to cover cost overruns. We verified that no funds had been expended from the capital reserve fund. The changes to the predevelopment costs are highlighted in the following table.

Table 1: The District of Columbia's Estimated Predevelopment Costs To Be Financed for the Sports Arena Project

Dollars in thousands

Predevelopment costs	Original budget	Revised budget as of January 24, 1996	Revised budget as of October 18, 1996	Increase (decrease) since January 24, 1996	Completion Status of Work[a]
Land acquisition					
Appraisal/purchase price		$34,250	$34,268	$18	[b]
Appraisal fees		33	50	17	100%
Total	**$28,000**	**$34,283**	**$34,318**	**$35**	
Metrorail connection					
Construction costs	$7,000	$17,000	$19,360[c]	$2,360	25%
Less: Capital Assistance Grant (after $3 million District cost)		(12,000)	(12,000)		
Less WMATA contribution		(2,000)	(2,360)	(360)	
Less DCALP contribution			(2,000)	(2,000)	
Total	**$7,000**	**$3,000**	**$3,000**		
Relocation of District employees					
Lease commitments and rent advances		$1,986	$1,922	($64)	100%
Lease appraisals and space consultants		70	70		100%
Leasehold improvements		972	1,344	372	75%
Furniture and equipment move		638	638		100%
Telecommunication equipment move		875	875		85%
Total	**$7,000**	**$4,541**	**$4,849**	**$308**	
Building demolition, soil remediation, relocations; legal, environmental, and consultant fees					
Building demolition		$1,000	$1,000		100%
Soil remediation		$940	$3,521	$2,581	98%
Less FETCA[d] contribution for soil remediation			(569)	(569)	
Utility relocation		4,616	2,770	(1,846)	90%
Business relocation		25	25		100%

(continued)

Dollars in thousands

Predevelopment costs	Original budget	Revised budget as of January 24, 1996	Revised budget as of October 18, 1996	Increase (decrease) since January 24, 1996	Completion Status of Work[a]
Legal, environmental, and consultant fees		2,483	2,533	50	98%
D.C. Sports Commission reimbursement	3	02 3	02	9	0%
Total	**$11,000**	**$9,366**	**$9,582**	**$216**	
Bank fees and costs		$1,257	$1,315	$58	100%
Total		**$1,257**	**$1,315**	**$58**	
Reserve for unanticipated increases		$2,750	$2,750		
Total Costs To Be Financed by the District	**$53,000**	**$55,197**	**$55,814**	**$617**	

[a]Per the District's Project Manager for the sports arena, the completion status of work represents his estimate of the percentage of work completed for which the District may or may not have received final bills.

[b]The District did not reach a purchase agreement with the Unification Church on the second parcel of land. On November 30, 1995, the District obtained the property through a "Declaration of Taking," which required the District to deposit about $5.3 million in escrow with the Superior Court of the District of Columbia according to the District's Project Manager for the sports arena. The purchase price of the property will be determined by the outcome of pending legal proceedings. The plaintiff asked $8.6 million for the property. The District offered about $8 million.

[c]Included in the Metrorail connection cost estimate is a $1.1 million reserve for cost overruns for transportation expenses only.

[d]Far East Trade Center Associates, L.P., were part owners of the parcel of land that the District purchased to build the sports arena.

Metrorail Connection

As of October 18, 1996, the total cost for the Gallery Place Metrorail connection was estimated at about $19.4 million, a $2.4 million increase from our last report; but the District's cost remains the same—$3 million. The majority ($2 million) of the increase reflects the cost of needed construction changes to the station because of the sports arena. For example, new vent shafts will be added in order to accommodate the construction of the sports arena. This increase was offset by the developer's contribution[10] of $2 million to the cost of the Metrorail connection. The other $360,000 increase reflects a decision by WMATA to upgrade the station elevators from hydraulic elevators to traction elevators. The funding for this upgrade is being provided by WMATA.

[10]This contribution was made pursuant to a December 29, 1995, Memorandum of Understanding between the District and DCALP.

As of October 18, 1996, the Metrorail connection budget contained a $1.1 million reserve for contingencies (as shown by note c to table 1)—a decrease of $400,000 since our last report. WMATA officials stated that their maximum responsibility to the project is limited to their $2.4 million contribution. They also stated that they will not absorb any unanticipated costs. WMATA officials stated that an example of unanticipated costs is the discovery of asbestos in sections of the duct work running through the station's mezzanine. According to the District's Project Manager for the sports arena, the $50,000 approximate cost for the removal of the asbestos is being funded out of the Metrorail connection contingency reserve.

Building Demolition and Environmental Soil Remediation

The demolition of the two buildings formerly located on the arena property has been completed, and final bills are forthcoming. The budget of $1 million has not changed.

Costs to remove hazardous and contaminated soil have increased as excavation progresses. The revised budget for soil remediation was $3.52 million as of October 18, 1996, an increase of about $2.58 million from the $940,000 reported in our last report. In a testimony before the RLA board, the District's Deputy Corporation Counsel stated that the District will take legal action against the source of the contaminants if compensation is not made to the District by the source.

The property on which the arena is being built contains contaminated and hazardous soil based on archeological digs, tests performed for the environmental impact statement, and tests performed by the developer. The extent of the amount of contaminated soil was underestimated by the original tests, which estimated that the site contained about 7,400[11] tons of petroleum contaminated soil and hazardous waste. As discussed below, the actual amount of contaminated soil was almost 15 times the original estimate.

The site originally had residential and commercial buildings. According to the District's Project Manager for the sports arena and an official from DCALP, when the land was cleared some 20 years ago, oil storage tanks in buildings and in the ground were not removed. As a result of the demolition of the buildings, contaminants were leaked into the soil. Both contaminated (petroleum) and hazardous (cleaning fluid) substances have been found in the soil. As part of its agreement to purchase the parcel of

[11] The original estimate was prepared by Peer Consultants, Inc., under contract to EDAW, Inc., the District's preparer of the environmental impact statement.

land owned by WMATA and the Far East Trade Center Associates, L.P. (FETCA), the District received a credit of about $569,000 from FETCA for the removal of contaminated material.[12]

As of October 1996, according to the District's Project Manager for the sports arena, 13 underground oil tanks and 4 water separators were removed from the site, along with 109,000 tons of contaminated soil and approximately 5,100 tons of hazardous soil. Most of the excavation of the hazardous and contaminated soil has been completed. According to a DCALP official, in the spring of 1997, it will be necessary to remove a temporary dirt ramp from the site to complete the excavation process. Tests done on the soil on both sides of the ramp show the soil to be contaminated. Therefore, the District's final cost for soil remediation will not be known until the spring of 1997. The District has hired a firm, Environmental Consultants and Contractors, Inc., to monitor the removal of all contaminated and hazardous material.

Utility Relocation

Our last report showed a budget of $4.6 million for utility relocation—$4.3 million for Bell Atlantic to relocate utility lines under G Street and $300,000 for the relocation of other utilities. Included in the $4.3 million budget was an estimate of $1.4 million for overtime costs to meet the revised November 30, 1995, deadline to relocate Bell Atlantic utility lines. As of October 18, 1996, the budget for Bell Atlantic utility lines has been reduced from $4.3 million to $2.5 million or by $1.8 million;[13] while the amount of $300,000 for the relocation of the other utilities has remained the same. The revised budget for total utility relocation is now about $2.8 million. According to the District's Project Manager for the sports arena, Bell Atlantic was able to accomplish the relocation of the utility lines within the scheduled time frame without having to use premium time (overtime) as originally estimated. If Bell Atlantic had had to use premium time to relocate the utility lines, the hourly charges would have been one and a half to twice the cost of normal time.

Leasehold (Office) Improvements

To begin construction of the arena project, the District demolished two office buildings that previously provided office space for its employees. The employees were relocated into District-owned and leased office

[12]The amount of the credit was agreed to by the District, WMATA, and FETCA. This amount relieves WMATA and FETCA of any additional responsibility for the removal of contaminants from the soil.

[13]In addition to the $1.4 million reduction in the budget for overtime costs, an additional $400,000 in material and labor costs reductions for Bell Atlantic utility lines was achieved.

buildings. To pay for office improvements, a budget was established at $5 per square foot or about $972,000. Since we last reported, this budget for leasehold improvements has increased by $372,000 and, as of October 18, 1996, totaled about $1.34 million. According to the District's Project Manager for the sports arena, the increase in the budget for office improvements is attributable to increases in improvements at the leased space at 800 9th Street, SW, which were not provided for in the original budget but were requested by the agency occupying the space—the Department of Human Services. The District leased four floors of office space at 800 9th Street SW and is required by the lease to pay for the renovation to the new space.

According to the District's Project Manager for the sports arena, this cost is considered a qualifying predevelopment cost of the arena project. However, we found that this cost was funded from the District government's appropriated funds rather than from funds available to pay allowable arena predevelopment costs. We informed the District's Chief Financial Officer of this matter, and he agreed to recoup the funds from the arena project's predevelopment funds.

Arena Tax Revenue Collections

According to the District's Debt Manager, Arena Tax collections for 1995 totaled approximately $9.3 million, exceeding the original projection of $9 million. The District forecasts Arena Tax collections of $9 million for each year the bonds are outstanding. We verified that the $9.3 million was collected for 1995 and transferred by the lockbox trustee to the escrow account.

Between May 15 and May 23, 1996, notices were sent to District taxpayers informing them that the 1996 Arena Tax was due on June 15, 1996. According to the District's Debt Manager, approximately $9.4 million had been collected for the 1996 Arena Tax through November 30, 1996. We also verified that this amount was transferred from the lockbox to the bond trustee. In contrast to the 1995 tax collections, most of which were used to pay the arena's predevelopment costs before the RLA bonds were issued, the 1996 tax collections, as required by the bond resolution, were used to make the payment—principal and interest of $5.9[14] million—due November 1, 1996, on the RLA bonds.

[14]Principal and interest payments over the term of the bonds—until the year 2010—vary from $5.91 million to $5.99 million.

The bond resolution requires that any additional tax collected over the required payment be placed in a fund[15] and be used to redeem the term bonds earlier than their due date. As mentioned, $9.4 million in Arena taxes were collected through November 30, 1996. In addition, interest of $165,337 was earned on deposits in the Debt Service Accounts. Of these amounts, about $5.9 million paid the debt service due on November 1, 1996, $2.2 million was deposited into the Super Sinker fund,[16] and the remaining $1.5 million will be applied toward the May 1997 debt service payment. The District's projections of Arena Tax revenues at the current level of $9 million annually appear sufficient to redeem the bonds by the year 2002.

Financing Predevelopment Costs

In August 1995, the District secured a $53 million loan commitment from a syndicate of banks led by NationsBank and Crestar Bank to finance predevelopment costs for the arena project. This loan was subsequently paid off in January 1996 from the proceeds of an approximate $60 million bond sale arranged by the RLA.

The funds originally available to pay the arena's predevelopment costs and establish a debt service reserve totaled $66.6 million. The make up of these funds consisted of (1) $57.4[17] million in net bond proceeds (after financing costs) from the sale of RLA Revenue Bonds in January 1996 and (2) $9.3[18] million in 1995 tax collections from the dedicated Sports Arena Tax. Of the $66.6 million available, $11 million is held in reserve in two parts. A mandatory $5 million capital reserve[19] required by the bond resolution was established to pay for cost overruns. In addition, a $6 million reserve was established for debt service. As shown in table 1, the current estimate of total predevelopment costs is $55.8 million. The unreserved[20] amount of $55.6 million and the $5 million capital reserve for cost overruns are available to pay this current estimate. As of September 30, 1996, we

[15]Such a fund which permits early redemption of term bonds is commonly referred to as a Super Sinker fund.

[16]See footnote 15.

[17]Of the approximately $60 million in bond proceeds, $2.6 million was used to cover various fees associated with the bond offering.

[18]In 1995, Arena Tax collections totaled approximately $9.3 million. Of that amount, about $9.2 million was used for predevelopment costs, and the remaining $119,000 was used for debt service.

[19]Any funds over $1 million in the capital reserve fund after September 1, 1997, are to be used for bond redemption. In addition, as of September 1, 1998, any remaining portions in the capital reserve must be used for bond redemption.

[20]Of the $55.6 million, the District has reserved $2.75 million for unanticipated cost increases.

verified that no funds have been used from the mandatory capital reserve. In addition, barring unforeseen cost increases over established reserves, the District has sufficient funds to pay its estimated predevelopment costs.

RLA's Bonds Received Interest Rates Similar to Investment Grade Securities

During the July 1996 testimony before your subcommittee,[21] concerns were raised regarding the interest rates to be paid on the bonds issued to finance the sports arena's predevelopment costs. We analyzed relevant information regarding this matter.

The RLA was advised by a number of investment bankers, as part of its financing strategy, that in order to improve the desirability of the bonds to investors, the bonds must be structured in a way to reduce default risk. Specifically, the bonds had to have:

- a dedicated revenue stream, with the legal requirement to increase the Arena tax, if revenues at any time did not cover debt service,
- a lock-box mechanism under the direct control of a trustee who directly collects dedicated revenue receipts pledged for debt repayment, and
- a Super Sinking fund to allow the District to redeem bonds early at par.

When the bonds were issued in January 1996, the bond resolution reflected the advice of the investment bankers as described above. At that time, the RLA sold $44.5 million of term bonds redeemable on November 1, 2010, at an interest rate of 6.05 percent and about $15.4 million of serial bonds redeemable between the years 1996 and 2000 at interest rates ranging from 4.5 percent to 5.4 percent.

Prior to the bond sale, the bonds received a split rating from two rating agencies—Moody's and S&P. Moody's rated the bonds as investment grade (Baa) and S&P rated the bonds as noninvestment grade (B). An official of S&P told us that it did not give an investment grade rating to these bonds because they were unable to separate the District's financial condition and its credit from this transaction. Moody's rating of "Baa" is its lowest rating of four ratings for investment grade bonds. According to officials from Moody's, the rating was based upon legal provisions insulating the Arena Tax revenues from the District's financial difficulties and pledged arena revenues offering adequate debt service coverage.

[21]Testimony before the Subcommittee on the District of Columbia, Committee on Government Reform and Oversight, House of Representatives, District Government: Information on Its Fiscal Condition (GAO/T-AIMD-96-133, July 19, 1996).

Even though one of the two ratings the bonds received was noninvestment grade, Merrill Lynch officials stated that relative to prevailing market conditions at the time of the bonds issuance and the split rating, the bonds were well received by investors. This was indicated by strong demand from investors which resulted in various bond series being oversubscribed between 2 to 10 times the amount of bonds being sold. Given this demand, the Merrill Lynch officials stated that the RLA bonds were repriced.[22] In addition, Merrill Lynch officials stated that the bonds were priced (carried interest rates) based primarily upon (1) their structure rather than the District's financial condition and (2) the prevailing conditions in the bond market at the time the bonds were sold. Consequently, they said that they believed the bonds' interest rates were similar to interest rates on investment grade rated securities.

Construction Status

As of December 10, 1996, according to a DCALP official, the erection of structural steel beams for the roof of the arena had started. DCALP officials expect the roof to take about an additional 4 months to complete, depending on weather conditions. The roof is expected to be in place by summer of 1997. DCALP stated that the arena should open in late 1997.

Agency Comments

We obtained oral comments from the Mayor of the District of Columbia and the Chief Financial Officer on a draft of this report. They concurred with the information presented.

We are sending copies of this report to the Chairmen and Ranking Minority Members of the Senate and House Appropriations Committees' Subcommittees on the District of Columbia; Senate Committee on Governmental Affairs, Subcommittee on Oversight of Government

[22]Prior to the sale of bonds, the underwriter samples the market to test investor interest. Based upon investor interest and the underwriter's judgment, the underwriter sets a preliminary price for the bonds. On the day of sale, orders for the bonds are received. When demand exceeds supply, the underwriter increases the price of the bonds which decreases the bonds' effective interest rates.

Management and the District of Columbia; and the Ranking Minority Member of your Subcommittee. If you need further information, please contact me at (202) 512-9510. Major contributors to this report are listed in appendix I.

Sincerely yours,

Gregory M. Holloway
Director, Governmentwide Audits

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