



Anatomy of a Successful Public Private Partnership: Gallery Place

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Executive Summary

This paper explores the use of tax increment financing on public-private partnerships by specifically focusing on one such project: the Gallery Place Project in Washington, D.C. This research is timely because D.C. has proposed using TIF for numerous future projects, but there is no current literature that discusses the successes and challenges of this approach.

In addition to detailing the creation of the public-private partnership, this paper provides an actual case study of the project, including the economic and non-economic goals of the participants, and analyzes the successes and challenges by looking at the project post-completion. Using these inputs, conclusions and recommendations are drawn for future public-private partnerships financed in part by TIF.

What this paper finds is that the financial benefits of the partnership – using TIF - are accretive to the District. The 1 million square foot, \$275 million project used a \$74 million TIF issuance to help finance the project's development. Even after payment of debt service on the bonds, the city government is collecting more tax revenues than it would have had an unsubsidized project been constructed. In addition to the financial benefits, the city also fulfilled its non-economic goals, namely the creation and enhancement of a lively 24/7 entertainment, retail, and housing district.

Even with its success, however, the costs of using TIF, both in terms of actual issuance costs and time (opportunity cost), make this type of project only feasible for development projects of a certain scale. Unless other methods of TIF issuance are used, these costs make TIF an inherently costly way of providing public support for a public-private partnership.

Introduction

1. Goal of Research Project

The Gallery Place Project in Washington, D.C. presents a case study in how a complex public/private partnership was used to develop a cornerstone for the revitalization of a large swath of a downtown core. This \$300 million, 1 million square foot development involved multiple government agencies, including a regional transportation authority, three separate public financial partners, two developers, four equity investors, four lenders, and numerous underwriters, attorneys, consultants, and other third-party professionals. Development obstacles included a complex land assemblage from both public and private owners, environmental contamination, a vertical mixed-use development, and historic preservation of adjacent properties.

Gallery Place is the largest and most expensive public-private partnership ever executed in the District of Columbia, and by every measure has been a tremendous success. The successes and challenges faced over the decade long pre-development, financing, and development of Gallery Place provide unique insight into how public/private partnerships both in D.C. and elsewhere can be structured to maximize public benefits efficiently, minimizing public investment and risk.

The implications locally for public-private partnerships are readily apparent: multiple partnerships, most including the use of tax increment financing (TIF,) have either been proposed or are being negotiated. These include a TIF for a new convention center hotel, the redevelopment of a public housing project in the North of Massachusetts Avenue area of town, the construction of a House of Blues music venue, revitalization of the city's Southwest Waterfront, and a planned stadium for the local professional soccer team.

Other jurisdictions throughout the nation are also evaluating and using TIF for urban development and redevelopment purposes. These uses run the gamut from financing sports venues to more traditional infrastructure improvements. Public-private partnerships are also

becoming more common and complex, as governments increasingly look to private firms to assist in areas that have previously been municipal responsibilities. Examples of this include the recent privatizations of toll roads in Illinois and Virginia, as well as proposals at the federal level to raise additional funding for infrastructure construction and maintenance via local and state partnerships.

The goal of this research project is to present a detailed case study of this complex project from a primarily financial standpoint, assess its successes and challenges, and apply principals and lessons learned to future public-private partnerships in both the District of Columbia and other jurisdictions. Other tangential results, such as spurring additional development and the creation of a revitalized neighborhood, will also be explored, as these successes and challenges may impact future partnerships both locally and nationally.

The intent of this project is also to build on past, theoretical and academic research into tax increment financing with a study of the practical results from an actual development project.

2 Historical Context

From the time D.C. was granted limited home rule in 1973, the city has undertaken a number of large public-private partnerships. The most notable was the regional construction of a mass transportation system under the authority of the Washington Area Metropolitan Transportation Authority (WMATA). This agency built, and continues to expand, a regional subway rail and bus system throughout Maryland, Virginia, and D.C. Other public-private projects in the city include the construction of a 20,000 seat arena in a desolate downtown section of the city, near its decaying and now closed convention center. Although the arena itself was privately financed, the land and infrastructure were publicly financed, and the project benefited from other public incentives such as tax-free and tax-advantaged financing.

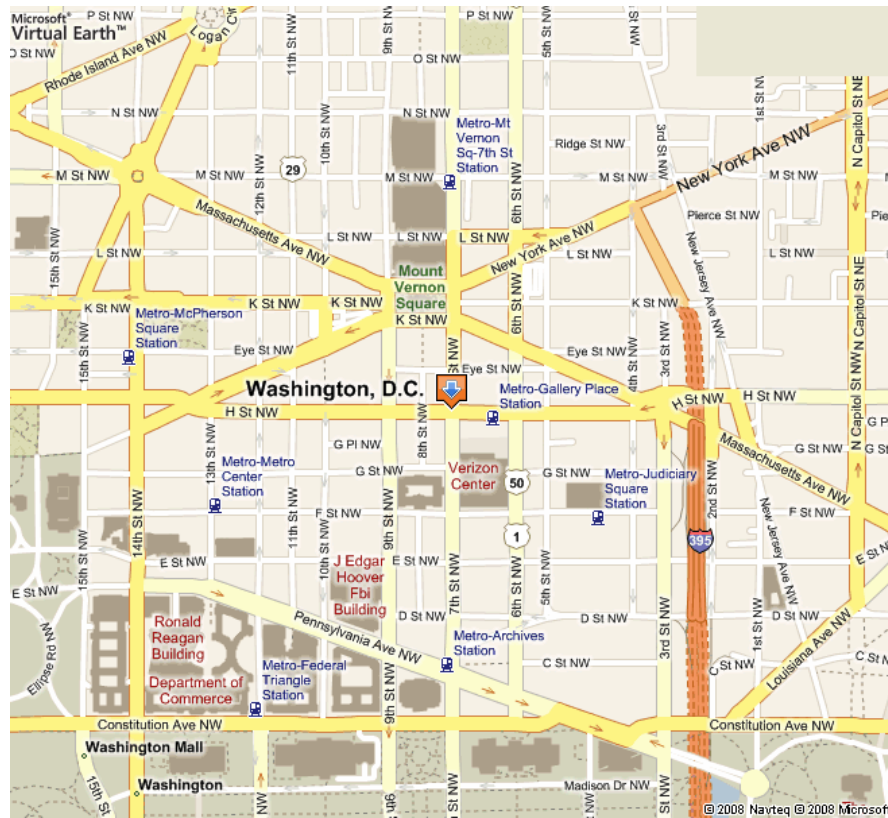
By the early 1990's, D.C.'s financial situation was bleak; a reduced population, the inability to levy taxes on commuters, a large non-taxable property base, and government inefficiencies all contributed to a long-term decline in the health and vitality of the city. Public works were

neglected, economic development and infrastructure investment were non-existent, and the city's real estate market, both commercial and residential, weakened as the city quickly became an increasingly undesirable place to live and work.

These ills eventually resulted in Congress imposing an independent financial control board in 1997. The board had sweeping powers to control virtually all city activities, and included the appointment of an independent city Chief Financial Officer. After four years of budget surpluses, the control board automatically went out of business, but its impact remains important to the way D.C. operates. A key goal of the CFO's office was to restore the city's investment grade rating by reducing general obligation debt and only issuing new debt prudently. This focus remains, even well after the control board's era.

During the financial crisis and control board reign, roughly 1994 to 2001, there were limited funds available to promote economic development. The few major projects completed during this time were for the most part privately financed. The one notable partnership executed during this time period was the MCI Center, a 20,000 seat multi-function arena that would become home to the NHL's Washington Capitals and the NBA's Washington Bullets/Wizards. Although the arena itself was privately financed, the city contributed land and infrastructure improvements to allow for its construction.

The construction of the MCI Center was one of, if not the most important, catalyst for the redevelopment of the East End section of Washington. A new, larger convention center, opened in 2003, also helped cement the area's status as a thriving commercial and residential neighborhood. The Gallery Place Project became an important centerpiece, helping to connect these two anchors with a thriving mixed use streetscape.



The East End of Washington – roughly defined as the area east of 15th Street, south of Massachusetts Avenue, west of 4th Street, and north of the National Mall – was historically D.C.’s first downtown. This can be seen in the historic buildings that have been renovated over time: the Customs House, which became a hotel, an 1839 post office, also converted to a hotel, the city’s first major downtown department store, now an office building, and rows of historic row houses and school buildings.

The area became the city’s Chinatown neighborhood in the 1930’s, after the original area where Chinese immigrants settled became the Federal Triangle office complex. The area has remained a cultural hub for the Chinese community, although the number of actual ethnic Chinese residents has gradually declined due to gentrification, housing stock depletion, and a general immersion of immigrant communities in suburban areas throughout the city. Even with the decline of the physical population, the area’s roots remain in the architecture and character of the area, where all buildings are required to include both English and Chinese signage.

In the mid-2000's, over five years after the MCI Center opened for business and within 12 months of Gallery Place opening, the area is one of the most vibrant 24/7 neighborhoods in the city. Law firms, generally regarded as one of the more conservative demand segments of the commercial real estate market, have flocked to the area for new, modern office buildings. Some 5,000 condominiums and apartments have been constructed and new hotels, restaurants, and shops cater to the daytime business and convention crowd and the burgeoning nighttime population. The East End by itself is a case study in fostering development within an established neighborhood and creating a true urban destination; the Gallery Place Project is a major component of this resurgence.

3. Tax Increment Financing – Overview and Application to Public-Private Partnerships

Tax Increment Financing (TIF) was conceived in the early 1950's in California as a means to allow local governments the flexibility to finance infrastructure improvements without tapping general obligation revenues. The structure was born in part out of a need to tap other revenues because of statutory caps in property tax increases. Over the past 50 years, 49 states and the District of Columbia have enacted versions of TIF legislation; Arizona is currently the only state without any type of TIF legislation.

On the scale of public financing techniques, TIF falls between private and pure public financing. It is a subsidy to developers, one which is not repaid by the developers, however it is not a direct payment from a public source, like a grant. The map below highlights TIF's place in the financial spectrum.

<i>Private</i>			<i>Public</i>		
Fully Private Debt/Equity	Capital Markets Debt/Equity	Tax Increment Financing	Subsidized Loans	Direct Public Investment	Public Grants

The financial aspect of TIF is relatively simple: by capitalizing up front the anticipated increase in a tax base as a result of a capital improvement, a municipality can fund the capital improvement without obligating its full faith and credit or otherwise tapping into already

earmarked tax revenues. A TIF bond is in essence a standard revenue bond, only the revenue is a specific tax (or multiple specific taxes) as opposed to user fees or some other municipal revenue.

Like any other bond issuance, the transaction is covered by an Indenture Agreement, with a Trustee appointed to receive and disburse cash. The bondholders receive a security interest in the cash flow, but no secured interest in the underlying project (such as a mortgage or pledge of equity interests.) If the increment is insufficient to cover the debt service, there is typically no guarantee from an entity or individual that the debt service will be paid. Therefore, bond underwriters, typically Wall Street investment houses, underwrite TIF issuances using conservative estimates and high debt coverage ratios, and ratings agencies will provide underlying ratings to assess risk. In many cases, and this is also the case in the municipal bond market, a bond insurer will collect a premium to provide a AAA rating to the issuance, reducing the risk of credit default.

Each state has developed its own variation of TIF, although there are some common elements to most. Some states allow only incremental ad valorem (i.e. property) taxes to be used to back bonds; others allow local sales taxes. Some states go even farther: in New Jersey, for example, incremental employment taxes generated by private development can be used to service TIF bonds. Most states give local entities – counties, cities, and local authorities – the ability to utilize TIF. Others allow TIF to be executed at the state level. The primary benefit of a state-level TIF is the ability to use a full measure of incremental sales tax revenue to service TIF debt, as opposed to only a local municipality's portion of that sales tax. TIF bonds may also be tax-free, allowing for interest expense savings to accrue to the developer. In the District of Columbia, the city is afforded all of the benefits of a state's ability to utilize TIF; this is part of the reason why TIF has been both successful and future projects are likely in D.C.

Different states also allow TIF bond proceeds to be used for different purposes. Some allow TIF to be used only for public infrastructure improvements, such as municipal water and sewer lines, roads, etc. Other states allow private commercial and industrial development;

some states allow for residential development, while others allow for entertainment and recreational development. The use of funds within each state may be limited to infrastructure, such as environmental remediation, utilities, access, and public areas. And some states allow for TIF proceeds to be used for land assemblage, professional fees, and general construction costs. In D.C., TIF is eligible to be used for any project budgeted costs as approved by the Council.

Most states impose a requirement that prior to issuing TIF bonds, a project must meet a “but for” test. In other words, would the project be feasible but for the use of TIF? Most states also require a feasibility analysis of the project, however even in those that do not, bond underwriters and purchasers would typically require such studies. Some states provide for eminent domain capability to support a project funded via TIF, and most require public hearings prior to bond issuance.

Although one of the major benefits of TIF is the ability for a local jurisdiction to finance infrastructure outside of its normal “full faith and credit” channels, some states allow municipalities, at their discretion, to issue bonds backed by that municipality’s credit. These bonds are also typically subject to the municipality’s debt ceiling, if any. TIF bonds issued for use in a public/private partnership are typically not direct credit obligations of the municipality, although some investors perceive a moral obligation on the part of a municipal entity to backstop its debt.

The District of Columbia passed its TIF act in 1998 with an eye toward stoking development. Out of numerous proposals, the Chief Financial Officer’s office and the Deputy Mayor for Economic Development chose three projects to initially received TIF assistance¹. These three projects were diverse in scope, size, and complexity. The smallest and least complex project was a TIF for the development of a Spy Museum with ancillary retail, restaurant, and residential uses. The second, more complex project, was a TIF for a new five-star Mandarin Oriental Hotel in the Southwest waterfront section of the city, near a federal office complex

¹ The Chief Financial Officer of the District of Columbia is by Congressional statute a separate entity from any other within the city government. The CFO’s appointment is subject to Congressional approval and operates as an independent branch of the executive branch.

but close to tourist destinations on the Mall. The third, and by far the largest, was the TIF for Gallery Place.

Since the original three submissions, the TIF act has been used to lure retailers to the downtown area by assisting with tenant improvement costs. This program has never achieved the success intended, partly because of the steep up front costs associated with a TIF. Other projects have received limited TIF assistance, although several other large proposals, most notably a convention center hotel, are in the pipeline. The city's TIF issuance authority is currently capped at approximately the amount outstanding, so any new issuance would require council legislative action and likely Congressional approval.

4. Previous Research into TIF and Public-Private Partnerships

The use of tax increment financing for economic development purposes is a relatively new concept, one explored only in the last fifteen to twenty years. Prior to that, TIF was used mainly as an alternative funding vehicle for public improvements, even if such improvements ultimately helped benefit private interests.

Previous research has concentrated on three areas: the ability to use TIF for public-private partnerships, and the policy implications of such uses; the best practices associated for using TIF; and general descriptions of the different ways TIF is used in varying jurisdictions. There are relatively few resources that highlight specific successes or failures of TIF, a gap that this paper in part attempts to fill.

By far the most in depth work in this area is a collection of papers edited by Craig Johnson and Joyce Man titled *Tax Increment Financing and Economic Development: Uses, Structures, and Impact*, published in 2001. This work focuses on the public policy aspects of TIF, and specifically frames the debate over the advantages and disadvantages of TIF on a macro level. This work explores the risks to municipalities, bondholders, other stakeholders, and generally discusses how programs have evolved over time. The works in this publication focus on the need to apply the theoretical backing of TIF to public-private partnerships, rather than having

TIF fill a gap that exists for financial reasons only. In the conclusion, Johnson notes that “TIF is a process for allocating public resources, not just a redevelopment finance technique.” (Joyce and Mann: 2001) As history shed more light on the successes and failures of TIF in public-private partnerships, this is an important concept to remember.

As the use of TIF has grown, a number of public and private market participants have attempted to define the “best practices” of using TIF. These include academic works as well as papers by firms such as Economic Research Advisers, who advise municipalities and investors on the business models behind major public-private partnerships. These works stress the need for “but for” tests and properly underwritten financial projections, but do little to offer after the fact analyses on applications.

The third area of research is a more practical guide to the varying uses of TIF in different jurisdictions. Each state, and within each state its various sub-municipalities, has its own unique methodology for implanting TIF. A savvy developer, financier, or economic development official needs to understand the intricacies of these systems in order to effectively plan and accomplish a public-private partnership using TIF. These guides are also handy for governments as they seek to define their economic development arsenals.

As the first generation of public-private partnerships evolves, and as private investment in infrastructure continues to increase, more research will delve beyond the academic and into the practical application using historical guides of specific successes and failures. And as states continue to seek creative sources to fund critical services and infrastructure repairs and upgrades, the applicability of this research will increase in importance.

5. Gallery Place Project Introduction

In 1999, the District of Columbia council approved the use of TIF to redevelop a 2.3 acre site in the East End neighborhood of D.C., an area that had never fully recovered from the late 1960’s riots and suburban flight. In 1997, the city welcomed a new 20,000 seat arena fully financed by Abe Pollin, the majority owner of the city’s professional basketball and hockey

teams. In a move deemed risky at the time, Pollin moved his teams from their suburban location with ample parking and easy access to an area with limited parking and primarily public transportation access, a location with few amenities and personal security concerns.

The city contributed some modest infrastructure upgrades, notably paying for a new entrance to the WMATA subway station at the base of the arena. The city also encouraged adaptive reuses of abandoned buildings in the area. In addition, as a major landowner in its own right, the city offered various properties for sale, including the functionally obsolete building at 614 H Street that was demolished in part for the development of Gallery Place.

In 1995, the city and WMATA jointly offered the land for Gallery Place in a public offering; however, with the real estate market in recession and few financial options available, no developers responded with legitimate offers. In 1998, after two years of negotiation, the city and WMATA jointly entered into a preliminary agreement with The John Akridge Company and Western Development to construct the project.

The focus of this paper is the development of the project, the creation and evolution of the public-private partnership required to develop the project, an analysis of the successes and challenges of the partnership, and the implications for future similar financial and development arrangements in Washington, D.C. with lessons for other municipalities as well.

Case Study

1. Gallery Place Project Detail

Description of Project

The Gallery Place Project is an 8-story, 1.1 million square foot development that includes approximately 202,098 square feet of net rentable Class A office space, 276,879 net rentable square feet of destination and entertainment retail space, 192 residential condominiums units, and a 750-space underground parking garage, all on a 2.43 acre parcel of land. The project is a combination of interior retail spaces and ground-level, street-facing retail space.



Gallery Place - Corner of 7th and H

The residential condominiums were originally intended to be rental apartments – at the time of conception, the residential market in the East End area was still unproven, and the project design incorporated a limited number of small apartments for professionals working in the area. However, as the project design moved along, and as other parts of the submarket began to develop, a decision was made mid-construction to map the condominium and sell the apartments individually. From a tax perspective, this would tend to lower the increment as owner-occupied dwellings were taxed at an ad valorem rate of \$0.85 per \$100 assessed value, with a primary residence deduction on the first \$40,000 of taxable value. Rental apartments

are treated as commercial property and taxed accordingly. However, as will be discussed later in this analysis, the residential increment was not a significant part of the overall project increment.

The goal of the public-private partnership for Gallery Place was to create more neighborhood and destination retail in the area around the MCI Center and the new convention center; therefore, the maximization of the retail program was a must. The project's 276,879 square feet of retail is anchored by a 63,000 square foot, 2,800 seat Regal Cinemas, and a 50,273 square foot Bed Bath & Beyond, which occupies primarily subterranean space. Other tenants include a health club, bowling alley/nightclub, spa, numerous restaurants, and soft good retailers. A full rent roll is below.

Retail Tenant Listing

Tenant	SF
Regal Cinema	63,000
Bed Bath Beyond	50,273
Urban Outfitters	12,395
Aveda	16,871
Lucky Strike	21,575
Washington Sport	19,817
Clydes	23,348
Haagen Daaz	808
Miso Hungry	1,693
City Sports	8,723
BB&T	2,610
AT&T	8,813
Thai Chili	3,376
Ann Taylor Loft	5,738
Zengo	8,619
Bar Louie	11,436
Kiosk / Storage / Other	17,784
Total Retail Space	276,879

The office space is fully occupied by a mixture of government, nonprofit, and some small back-office tenants. The primary tenants are the Federal Bureau of Investigation and the District of Columbia Court System, which together account for over three-quarters of the space.

WMATA, the regional authority that operates the area's primary mass transportation system, occupies 15,000 square feet for use as a medical emergency and operations center. The agency negotiated for this space as the former majority land owner. WMATA's Gallery Place station is the third busiest station in the subway system, and the agency's headquarters is located just blocks from the site.

Key Figures

There are a number of individuals responsible for the development of the project, but there are a few whose personal involvement were key to the overall execution of what exists today.

At the District of Columbia, Deputy Mayor for Economic Development Eric Price coordinated the vision for using TIF to revitalize the area. He also was a major force behind the city's new convention center, as well as the public interface for private developers in the area, helping to build his vision of a 24/7 retail, residential, and office destination. More than anyone else in Mayor Anthony Williams administration, Price oversaw the agencies responsible for streamlining the development process to create a resurgence in downtown D.C. At the office of the city's CFO, an independent agency, John Ross coordinated the mechanics behind the TIF and is perhaps the leading expert of TIF issuance in this area.

The two principal developers were John "Chip" Akridge and Herbert Miller. Akridge built his firm, the John Akridge Company, into one of the city's premier development firms over the course of 25 years. Primarily specializing in office properties, Akridge is a fully integrated developer, owner, and manager of some of the city's premier office space. Miller's firm, Western Development, developed some of the city's top mixed-use projects, including Washington Harbour, Georgetown Park Mall, and Market Square. Miller also previously

founded the Mills Corporation, pioneering the concept of destination outlet and entertainment retail facilities worldwide.

Miller brought substantial financial wherewithal and a vision for creating a destination to the project, and combined that with political savvy in navigating the city's bureaucracy. Akridge brought his experience in executing construction and overall project management experience, in addition to a large in-house team dedicated to development, construction, leasing, and oversight. Together, Miller and Akridge provided the city with a strong private partnership to assist the city in its goals.

2. Financing Plan

Introduction to Financial Partnership

Gallery Place is the largest public/private partnership ever completed in Washington, D.C. and one of the most complex financial structures involving tax increment financing to date nationwide. A multi-phase financing structure was required to accommodate the political needs of the city, the requirements of the TIF bond underwriters and purchasers, and the return requirements of the developer and equity investors.

Prior to the TIF, the developer had to assemble the site from a variety of public and private owners. The public portion of the land assemblage involved environmental concerns, District government peculiarities, and requirements imposed by various parties related to use, historic preservation, and project design. The private portion involved simultaneous negotiation with numerous individual landowners.

The public ownership included land owned by the Washington Metropolitan Area Transit Authority (WMATA), which acquired its land when building the city's subway system in the 1970's. WMATA imposed certain requirements on its land acquisition, including the need for space within a completed project to house a medical infirmary and other functions related to station operation. The D.C. government was the second largest landowner. Its holdings

included a nine-story office building on H Street as well as previously closed alley-ways and easements. The building, an environmentally contaminated site, had been abandoned in the mid-1990's during the city's financial crisis.

Both the District government and WMATA were clear in their vision for the site, adjacent to the MCI Center and atop one of the busiest subway stations in the city: a mixed-use development that would anchor an entire redevelopment district. Additional anchors already existed or were proposed – the MCI Center, a 20,000 seat arena, and a new, 2 million square foot convention center. A mixture of residential and destination retail was the preferred use, with other uses allowable depending on the developer and market forces. A large parking component was also mandated, to support the arena and other downtown uses.

The aggregate sources and uses of funds is presented in the table below. Each of the components of the sources is more fully described in this section.

ESTIMATED PROJECT SOURCES AND USES

SOURCES OF FUNDS

Private Construction Financing	\$	123,800,000	45.3%
Private Equity Investment		66,403,153	24.3%
TIF Bond Proceeds (Gross)		74,336,530	27.2%
District of Columbia Direct Payments		9,000,000	3.3%
Total Sources of Funds	\$	273,539,683	100.0%

USES OF FUNDS

Land Costs	\$	46,573,235	17.0%
Direct Construction Costs		136,276,817	49.8%
Indirect Costs		50,953,543	18.6%
Developer's Fee		7,475,000	2.7%
Construction Loan Interest		8,924,558	3.3%
TIF Issuance Costs		23,336,530	8.5%
Total Uses of Funds	\$	273,539,683	100.0%

Net TIF Proceeds	\$	51,000,000
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The "Net TIF Proceeds" equals the gross issuance of \$74,336,530 less the costs of issuance of \$23,336,530.

Tax Increment Financing

The single most important component of the financing plan was the TIF. Without the TIF, the highest and best use for the property would have been an office building with street-level retail space – the development patterns in the area did not support residential development or retail development, as there were insufficient residents or daytime users to support destination retail. The underlying purpose of the TIF was to allow and foster the creation of a destination by subsidizing the difference between the value of the project as an office building versus the public policy goal of the creation of a vibrant mixed-use destination.

The financing gap created by the project design was pegged at \$51 million. This amount was derived from the returns expected and required by the private equity investors and developer. The return requirement sized the equity component, while the debt component was sized by anticipated value and debt coverage. The gap, or delta, between the amount of private financing available and project costs was the amount required to be funded by the TIF.

Even though this delta was \$51 million, the gross amount of the actual TIF was dependant on interest rates and the construction schedule. Investors buying the TIF bonds would require, as all bondholders do, a yield on their investment from the day the investment is acquired. In this case, the cash flows supporting the debt service for the bonds, namely the taxes generated by the project, would not begin to accrue until the project was completed, occupied, and stabilized. Therefore, an interest reserve would need to be established and funded at the time the bonds were floated. The amount of this reserve would depend on the coupon required to sell the bonds, which in turn as dependant on the rating assigned to the bonds by the major ratings agencies.

In the end, in order to obtain \$51 million in net proceeds, the total bond issuance required was \$73.65 million. This large difference in the gross versus net proceeds highlights an inefficiency of the TIF process; in order to pay interest on a current basis, a project must

generate significant additional tax increment to repay amounts advanced for an up front interest reserve.

The bonds were sold in two groups; \$36,405,000 were sold to Fannie Mae, which was able to buy them because the project was creating housing in an urban renewal center. These bonds mature in 2027 and 2031. The remaining \$37,245,000 of bonds were sold in the private markets; these bonds carried maturities from 2005 through 2022, roughly matching a conventional amortization schedule. All of the bonds carry a AAA rating and are fully insured by Financial Security Assurance, Inc., a major municipal bond insurer.

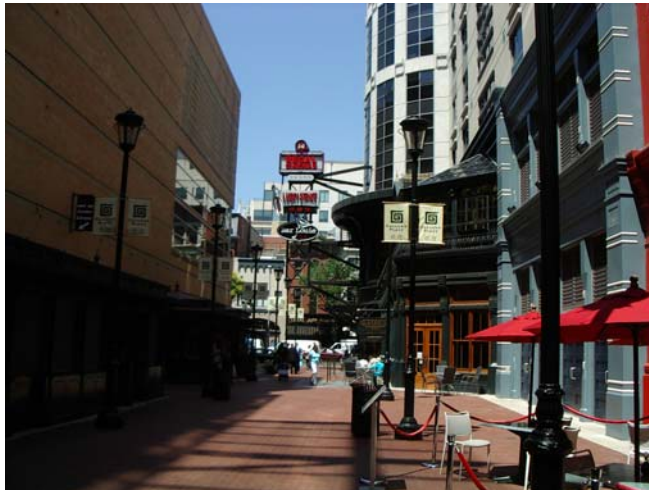
There are two primary methods of avoiding the economic inefficiency generated by having an interest reserve funded up front upon issuance of the TIF bonds. One is a pay as you go method, whereby bonds are floated on a regular (monthly, quarterly, semi-annual, or annual) basis as project costs are incurred. The problem with this approach is that there is no guaranty that a future issue of a bond could be floated, which would negatively impact existing bondholders and cause potential delays and disruption to the construction process. On the tax-exempt private purpose bond issuance market, such bonds are backed by a private letter of credit from a top-rated financial institution; for TIF bonds, which are generally taxable, the costs of obtaining a letter of credit would be prohibitive and create significant negative arbitrage. However, for certain projects and structures this might be an appropriate solution.

The other primary method of avoiding an up front capitalized interest reserve is through issuing TIF notes. This is a hybrid bond/loan scenario, whereby a developer and/or public authority are issued notes that accrue with interest and are repaid with that accrued interest by a long-term TIF bond issuance upon completion of the project. This is a “pay as you go” method but requires binding commitments by the developer and TIF issuing authority to float TIF bonds at completion. For this reason, this structure works well for smaller TIF issuances where the ultimate float occurs shortly after work has commenced on a project, reducing the risk to the developer.

A hybrid scenario is beginning to emerge where the developer monetizes the TIF notes by selling their rights in these notes to third parties, usually large financial institutions. Although this market has not yet fully developed, there is promise in structures like this as they allow investors to target certain risks and create pricing for variations in risk, such as size, timing, municipal credit ratings, etc. Whatever the ultimate structure, a pay as you go system for TIF interest is clearly the most cost beneficial method for using TIF, and seems likely to be the future for most TIF issuance.

Public Investment

In addition to issuing the TIF Bonds, the government of the District of Columbia supported the project in other direct and indirect ways. Directly, the government provided waivers for sales taxes, recordation taxes, building permit fees, and other normal and customary fees and charges worth up to \$7 million. The government further appropriated and provided \$2 million to the developer to improve infrastructure and pay for streetscape improvements, sewer upgrades, and other project related costs. Indirectly, the government allowed the developer to close and incorporate a public alley into the project, providing improved access to the MCI Center and additional valuable street-front retail space.



G Street Alley Retail

D.C. provided expedited permit review, assisted in the creation of a project labor agreement to assist the construction team in identifying capable subcontractors and workers for the massive construction component, and mediated discussions between the developers and private landowners and stakeholders to smooth the assemblage and pre-development processes.

Not easily quantifiable is the political support the city gave to the development and the developers throughout the process. In addition to its financial investment, this project provided an avenue for the city to showcase its financial acumen and business-friendly spirit, both of which would further the city's goals over the coming years. The "win" created by a successful TIF, a successful project, and a centerpiece to the city would ultimately help improve its credit rating, reducing future borrowing costs, guide the award of a Major League Baseball franchise, and direct billions of dollars in new development of residential and commercial real estate.

Private Equity

A total of \$66.4 million of private equity was invested in the project. Of this, \$8.4 million was cash equity from the developer, and the remaining \$58 million was provided equally by the AFL-CIO Building Investment Trust, a fund of union pension fund investors, and Mass Mutual, a large multi-line insurance company.

The developer's equity investment was augmented by an additional \$4 million letter of credit pledged to the construction lender to cover potential cost overruns and otherwise collateralize a completion guaranty provided by the developer's principals. Project upgrades and scope changes required this letter of credit to be invested in the project, however all equity was returned to the investors upon completion, attesting to the value created.

Private Debt

With the up front private equity and significant municipal investment (and grant), arranging the private debt component should have been relatively easy. Private credit markets, however, had not worked within a TIF structure before, and financing for large, complex mixed use properties was left to a few large lenders. The loan requirement for construction was \$123.8 million, which would in part take out a \$42.7 million land loan; with most banks limited to a maximum of \$25 million for construction loans, the developers sought other sources for construction financing.

General Motors Acceptance Corporation (GMAC) had distinguished itself in the market for providing financing for mixed use properties. With a large national staff and multiple product lines, GMAC also owned Newman & Associates, a major underwriter and broker for TIF issuance. Financing the construction of the Gallery Place Project was a natural fit for GMAC.

The land lenders were The Union Labor Life Insurance Company (ULLICO) and the Ultra Construction Loan Fund (Ultra), both funds comprised of multiple union pension fund investors. Because most large construction loans are made by groups of lenders, referred to as syndicates, both ULLICO and Ultra agreed to join with GMAC in making the construction loan.

When the scope of the project changed to provide for a smaller theater and more office space, the projected retail tax revenue decreased, and Newman was dropped out of the lead underwriter position for the TIF issuance and was replaced by UBS / Painewebber. The developer elected to sever ties with GMAC as a result, and ULLICO committed to the entire construction loan and brought together a syndicate of lenders to finance the project. After the project was completed, ULLICO made a permanent loan for the project, repaying the other lenders in the syndicate and paying off the original equity investors. Although the lending group changed during the course of the financing timeline, the construction debt aspect of the project was among the easier pieces of the project financing.

3. Public-Private Partnership

Purpose

The force instigating the public aspect of the project was the Washington Metropolitan Transportation Authority (WMATA), the intergovernmental agency created to build and operate the Washington area subway system. After completing the core of the system in the early 1990's (the entire 103 mile system was completed in 2001 with the addition of 5 stations in suburban Maryland on the Green Line), Metro sought to dispose of excess land near its stations and right of way acquired for the original construction.

WMATA's goals for public private partnerships involving its land are to "promote transit oriented development (TOD)", "attract new riders to the system", and contributing to economic development by helping local jurisdictions expand their tax base [WMATA Joint Development Policies and Guidelines]. Of note, these goals do not necessarily relate to the typical highest and best use of a property, but rather form a framework defined by communal goals shared by the entire region served by WMATA. The agency utilizes a combination of leasing and outright land sales for its surplus land, although in most cases leases provide the greater measure of control over the development process. Given the multiple landowners involved in Gallery Place, the transaction had to be structured as a fee sale of the land.

With WMATA providing the original purpose for creating the Gallery Place Project, the additional layers of the overall public private partnership provided the framework for the development of the site.

The D.C. government was also instrumental in creating the public private partnership, both through its statutory authority to issue TIF bonds as well as its role as a large landowner at the site. Additionally, to create the type of vibrancy sought by city leaders, a municipal role was required to allow for the renovation and adaptation of city infrastructure, such as allowing private use of a public alley to create synergies between the MCI Center and the Gallery Place project.

Creation

Essential to the development of the Gallery Place Project was the cooperation between WMATA and the D.C. government. WMATA owned the largest parcel of land, and its guidelines dictated a mixed-use project that was not consistent with the highest and best use of the site assuming it was unencumbered with WMATA's restrictions. This inherent conflict require creativity on the part of the D.C. government, the development team, and the financing team in order to create a structure that allowed for all parties to maximize returns (economic and non-economic) while bearing standard market risks for each party's investment.

The D.C. government helped bridge the gap in three important ways: by contributing additional land at below market value, by bundling a package of incentives, and most importantly by directly investing in the project through a tax increment financing (TIF), the first and largest of its kind in the city.

The private developers brought two important keys to creating a successful project – the vision to understand the market and design a series of integrated projects that would create retail vibrancy, a residential atmosphere, and otherwise provide a gateway to the revitalizing Gallery Place/Penn Quarter neighborhood, and the ability to deliver a complex construction project following that design.

Financial Performance

The Gallery Place public-private partnership is a living creation, one that evolved prior to commencement of construction of the project, during construction, and post construction as the project and area surrounding it matured. Prior to construction, the multiple pieces of the partnership operated like a clock – different gears moving at different paces towards a common goal.

Today, the partnership continues primarily as a financial partnership – the project generates tax revenues and services the debt on the property. Since completion, the project has been refinanced twice, and was under contract to be sold to a foreign investment group before a restructuring of the existing ownership group was completed. The two original private equity investors have been repaid in full, and the developers have achieved the return of their entire equity investment. During development, the general contractor was acquired by another company, some of the original tenants backed out of their commitments, and the individual components of the project were re-sized and re-designed.

To understand the financial benefits to the city of the TIF investment, an analysis must be done comparing the actual, as-built tax generation to the pro forma tax generation of the project had it been developed differently, without the benefit of a public-private partnership. The first step of this process is to ascertain the actual tax revenue generation for the project.

The incremental taxes generated by the project are readily available through public information records. Based on 2006 individual assessments, the residential condominiums had an aggregate assessed value of \$59,601,330, generating \$506,611 in annual property taxes. The retail and commercial components had an assessed value of \$149,172,350, generating annual property taxes of \$2,759,688, for a total incremental property tax of \$3,266,299.53. The commercial assessment is expected to rise significantly when it is reassessed, in line with increases to most DC commercial properties.

The sales tax generation for the property is more difficult to calculate, because individual tenant sales are not public figures. However, general retail sales figures can be used to estimate the range of sales taxes generated by the various tenants. The general sales tax rate for DC is 5.75%; for restaurant sales, the rate is 10%, although 1% is dedicated to the Washington Convention Center Fund, leaving 9% to be used as the increment. The 12% tax on commercial vehicle parking operations is a separate revenue stream dedicated to the District Department of Transportation, and therefore is not included in this analysis, however it is important to note that the large parking component is accretive to the city.

The chart below shows the 2006 reported annual estimated sales for each tenant at the property, along with the appropriate tax rate and sales tax generation. These sales figures were estimated by an appraiser for the property using public sales records, interviews with D.C. officials, and knowledge available to the developers in negotiating leases. Although this data is therefore difficult to verify, it probably represents a good estimate given the traffic, occupancy, and continued growth in the retail district in this area. Additional verification from D.C. is available through its financial reports: for 2006, the city reported incremental sales taxes of \$11.6 million. The TIF projects outside of Gallery Place have limited sales tax receipts, so it is not only plausible but likely that the estimate of \$6.9 million of incremental sales taxes attributable to Gallery Place is a low estimate of the true amount.

Tenant	SF	Total Sales	Tax Rate	Incremental Taxes
Regal Cinema	63,000	\$ 25,200,000	5.750%	\$ 1,449,000.00
Bed Bath Beyond	50,273	\$ 24,382,405	5.750%	\$ 1,401,988.29
Urban Outfitters	12,395	\$ 6,197,500	5.750%	\$ 356,356.25
Aveda	16,871	\$ 2,530,650	5.750%	\$ 145,512.38
Lucky Strike	21,575	\$ 11,326,875	8.188%	\$ 927,387.89
Washington Sport	19,817	\$ 495,425	5.750%	\$ 28,486.94
Clydes	23,348	\$ 14,008,800	9.000%	\$ 1,260,792.00
Haagen Daaz	808	\$ 606,000	9.000%	\$ 54,540.00
Miso Hungry	1,693	\$ 592,550	9.000%	\$ 53,329.50
City Sports	8,723	\$ 4,361,500	5.750%	\$ 250,786.25
BB&T	2,610	\$ -		\$ -
AT&T	8,813	\$ 3,304,875	5.750%	\$ 190,030.31
Thai Chili	3,376	\$ 1,181,600	9.000%	\$ 106,344.00
Ann Taylor Loft	5,738	\$ 2,869,000		\$ -
Zengo	8,619	\$ 3,447,600	9.000%	\$ 310,284.00
Bar Louie	11,436	\$ 4,574,400	9.000%	\$ 411,696.00
Kiosk / Storage / Other	17,784	\$ -	0.000%	\$ -
Total Sales Tax Generation	276,879	\$ 105,079,180	6.611%	\$ 6,946,533.80

The chart below summarizes the total sales and property tax increment generated by the project, as well as shows the relation of that increment to the debt service on the TIF bonds

issued and secured by that increment. As can be seen, the debt coverage of 1.96 times at 2006 was more than adequate. With the area becoming more of a retail hub, increased leasing, higher rents, and higher sales will only serve to augment this cash flow.

Tax Increment Generation

Property Tax Increment

Residential Property Tax	\$	506,611.05
Commercial Property Tax	\$	2,759,688.48
Total Property Tax	\$	3,266,299.53

Sales Tax Increment

Theater Sales Tax	\$	1,449,000.00
Retail Sales Tax	\$	5,497,533.80
Total Sales Tax	\$	6,946,533.80

Total Property and Sales Tax	\$	10,212,833.33
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Annual Debt Service - TIF Bonds	\$	5,203,000.00
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Projected Stabilized Debt Coverage		1.96x
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The next step in the public benefit analysis is to estimate the tax generation were the project not to have been developed using a public-private partnership with tax increment financing. This scenario involves significant assumptions, given that market forces and development obstacles let the site sit fallow for many years, despite its proximity to transportation and amenities within a growing market.

According to zoning maps prepared by the District of Columbia, the site lies within C-4 Central Business District zoning, with special overlays for housing and the Chinatown historic district. A maximum floor area ratio of 10.0x of which 1.0 must be retail and 2.0 must be residential are mapped in this district, although lower FAR's are allowed with no residential requirement. Additionally, properties must comply with design requirements imposed by the Chinatown overlay.

For purposes of this analysis the property was assumed to be developed with an office/retail building to a maximum FAR of 8.0, of which 1.0 was retail. The chart below highlights the critical assumptions used in the alternate analysis:

Assumptions

Site Size		105,851
Max. FAR		8
Max Rentable SF		846,806
Buildable SF		840,000
Office		735,000
Retail		105,000
Class A Office Rent	\$	41.00
Retail Rent (NNN)	\$	35.00

Tax assessments are generally completed in D.C. using a direct capitalization approach to valuation. Often these assessments are made using older data for similar buildings. For the purposes of this analysis, actual 2006/2007 data was utilized to prepare the direct capitalization for valuation and assessment.

Below is the stabilized 2007 pro forma as might be prepared by the tax assessor for the project as developed as an office/retail property:

Revenues

Office Rent	\$	30,135,000	
Retail Rent	\$	3,675,000	
Gross Rent	\$	33,810,000	
Vacancy (5%)	\$	(1,690,500)	
Effective Rent	\$	32,119,500	\$ 38.24

Expenses

Cleaning	\$	1,323,000	\$ 1.80
Repairs & Maintenance	\$	1,506,750	\$ 2.05
Utilities	\$	1,911,000	\$ 2.60
Security	\$	918,750	\$ 1.25
Insurance	\$	330,750	\$ 0.45
General Admin	\$	845,250	\$ 1.15
Management	\$	1,212,750	\$ 1.65
Other	\$	1,580,250	\$ 2.15
Real Estate Taxes	\$	3,932,250	\$ 5.35
Total Expenses	\$	13,560,750	\$ 18.45

Net Operating Income \$ **18,558,750** **\$ 22.09**

Selecting a capitalization rate for assessment purposes can differ from a more market based capitalization rate. Although assessed rates are based in part on market transactions, in order to better withstand scrutiny, the most common approach is to develop an overall rate based on the band of investment theory. This theory states that the overall rate should be the weighted average of the cost of debt and equity. As the table shows below, the indicated overall rate is 8.00%, which is well above a more market oriented rate at current levels, but which approximates a longer-term average capitalization rate.

		Weight	
Cost of Debt	6.00%	75.0%	4.500%
Cost of Equity	14.00%	25.0%	3.500%
Indicated Rate			8.000%

Using the overall rate above, the net operating income developed in the pro forma, and the District's real property tax rate, the property's pro forma tax burden (or inversely, the property tax generation), is demonstrated below.

Direct Cap Rate		8.000%
Capitalized Value	\$	231,984,375
Tax Rate		1.85
Tax Burden		4,291,711

The table below combines the as-is tax generation (both before and after servicing the TIF bonds) and the pro forma tax generation had the property been developed as an office building with significant retail component.

Public Tax Benefit Analysis

TIF vs. Non-TIF Development

As-is Tax Generation

Property Taxes	\$	3,266,300
Sales Taxes	\$	6,946,534
Total Tax Revenue	\$	10,212,833

Less: TIF Debt Service	\$	5,203,000
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Net Tax Revenue to City	\$	5,009,833
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Pro Forma Tax Revenue

(as Office/Retail project)	\$	4,291,711
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Annual Benefit	\$	718,122
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As this analysis shows, the TIF issuance is accretive to the District of Columbia as a participant in the public-private partnership to develop Gallery Place. From a strictly financial standpoint, the combination of *ad valorem* property taxes and sales taxes generated by Gallery Place surpass those which would have been generated by the alternative project,

even including those taxes required to service the TIF. Upon retirement of the TIF bonds, the full tax generation accrues to the city's coffers.

In addition to the financial success of the specific project, a key, yet almost unanswerable question, is how much of the surrounding development base was aided by the development of Gallery Place. In other words, would the same type of development occurred in the same time frame had the public-private partnership for Gallery Place been established, or would the pace and structure of development have moved a different way. Answering this question is key because the benefits of guided urban development are the key indicator of a successful partnership; if Gallery Place encouraged more rapid development, and therefore a stronger tax base, then its success extends beyond the project's boundaries.

The answers to this question are complex and ultimately unsatisfying. Some smaller scale development had already started by the time Gallery Place commenced construction. Much of this development was predicated on the MCI Center opening, the convention center development, and the planned development of the Gallery Place site. It seems likely that development of additional office space, such as the redevelopment of the Hecht's building, was likely to have occurred without Gallery Place – the infrastructure for office development, in terms of access, transportation, proximity to the urban core – already existed. Pioneering residential development may also have occurred. The residential component of Gallery Place is relatively small, and likely the least profitable use of developable space on this site at the time. However, the city government had a core mission of increasing downtown residential development, and negotiating a residential component to Gallery Place was a key to that.

The creation of a retail hub, however, seems to have been significantly aided by Gallery Place. Although street-level retail has been a zoning requirement in D.C. for longer than the Gallery Place project was proposed, traditionally it consisted of low foot traffic generators – bank branches, restaurants, delis, and similar. By creating a streetscape of hard and soft goods retailers along Seventh Street, Gallery Place stoked additional, non-traditional D.C. retailers, including urban necessity shops such as Radio Shack, furniture stores, soft goods, and homewares stores on adjacent blocks. Typically, these retailers all seek a certain

concentration of similar type of stores, and this concentration would likely never have been achieved without Gallery Place.

Retailers also need “rooftops”, or residents proximate to the retailer. A store like Bed Bath and Beyond in particular caters to residential consumers. Restaurants, in order to capture both a lunchtime and dinnertime business, seek residential development nearby.

Continuing Evolution

The Gallery Place project is a living thing, vibrant and changing like every other living organism. Although its structure remains the same, the façade has been modified, additions made, tenants replaced, and refinements are always in process.

Some of the original tenants have gone out of business, but the retail space is fully leased and occupied. The adjacent MCI Center has been renamed the Verizon Center, and the city recently awarded Abe Pollin, owner of the arena, with \$50 million of city money to modernize certain components such as creating additional retail space at the street level. Blank walls have been retrofitted with plasma televisions leased to AT&T, providing additional revenue and value to the project. A row of new kiosks lines a former alleyway. Former storage space on a mezzanine level has been converted to leaseable and usable retail space, again providing revenue and taxes not originally modeled.

In a move unrelated to the city’s involvement in the project, the city court system leased two floors of office space in the project, taking advantage of rents slightly below other market rents due to the space’s unique configuration in an area of the project formerly designed for the theater. Another partner, WMATA, has realized the value of its headquarters building one block from Gallery Place and is planning to sell its building and build a new headquarters in an emerging part of the city.

The success of this public-private partnership has opened doors for the developers’ principals as well. Herb Miller created a plan for the city to realize a long-term return on its investment

in a new baseball stadium by creating a public-private partnership for development adjacent to the site; the city elected to move that process to a public request for proposals, and there is no assurance that Miller will prevail, but it is an example of potential future partnerships in the mold of this existing successful one.

Neighbors in the Gallery Place/Penn Quarter neighborhood have succeeded as well – local developer Doug Jemal fully leased a row of historic rowhouses across Seventh Street, with the lower floors containing retail uses and the upper floors serving as the U.S. headquarters for Greenpeace. The area is home to numerous restaurants, including some of the city's trendiest nightspots, and new office construction has in general leased very quickly, with high-profile law firms, associations, corporate headquarters, and traditional office users now seeking the desirability of this 24/7 market.

As the Gallery Place project continues to evolve, so too will the ability and desire of both the public entities and private developers to create new public private partnerships for other pending needs in the city. With evidence of the accretive nature of this type of partnership, this trend will likely accelerate.

Analysis

1. Successes

The clearest identifiable success of the Gallery Place Project was the achievement of the city's ultimate goal – creating the hub of a neighborhood whose redevelopment had already begun, but which needed expanded 24/7 foot traffic in order to stoke additional retail development, residential development, and tax generation. The true success was more than simply creating this place – it was creating it quickly, within a very short horizon of three to five years (after commencement of construction.) Additionally, the city was able to utilize former surplus government property to add vibrancy to this area of the city core.

Additional development in the area includes residential construction, both condominiums and rental apartments, office space, and additional retail space. Long-abandoned retail eyesores in the area, including two former department stores, were rehabilitated in the months before Gallery Place opened. The former Woodward & Lothrop department store became retail space housing apparel seller H&M's flagship DC location, in addition to West Elm, a popular furniture store. The former Hecht Company location was renovated into trophy quality office space for the Venable law firm, representing one of the first "traditional" downtown tenants to move into the East End submarket.

The project is also a success from a financial perspective. The bonds issued to advance the city's portion of the partnership have performed as agreed, with taxes generated by the project more than adequate to cover debt service and sufficient to add more value to the city than the "but for" project would have achieved. This financial performance should continue to aid the District as it seeks to complete additional TIF issuances and enter into other public-private partnerships. Future TIF bonds would likely carry higher inherent ratings, reducing bond insurance premiums and interest rates, and saving the projects and city money.

Other, sometimes subtle, successes can also be found. Where fast food restaurants were the norm in 1997, by 2006 upwards of 23 mid and upscale restaurants had opened in the Gallery

Place/Penn Quarter area, including some of the city's most noted dining destinations. Zaytinya, Zengo, Zola – three of the area's premier destinations, are all located in or within two blocks of Gallery Place. Local chain Clyde's opened its \$15 million flagship restaurant in the prime corner location in Gallery Place overlooking the MCI Center.

The project has also been a great success for the developers and their investors. After completion of construction, the value and cash flow generated by the sales of the condominiums and leasing of the retail and office space allowed for a full refinancing of both the debt and equity components. With all of its capital returned, the free cash flow generated by the project now provides the developers with a substantial return in addition to an unrealized equity value in the project. Debt service on the bonds is more than adequately supported as well from receipts generated by the property, the original intent of the financing. With the additional credit support from a larger tax increment area, the bonds have retained their triple-A credit ratings. The District's bond rating has also risen from Single-A to almost AAA, a testament to the city's conservative approach to debt while also building its tax base.

In part due to their successful development of the project, both development entities have been able to capitalize on their public-private experience. Herbert Miller has been active in attempting to create a public-private partnership with the city near its new baseball stadium, set to open in time for opening day 2008. Akridge has successfully raised an investment fund comprised of institutional investors like the ones who saw fantastic profits in the Gallery Place transaction. These funds earn their sponsors fees and revenues from development and property management with little capital risk.

Key executives involved in the project have also seen success. One of the key development executives formed his own firm and is the principal development expertise behind the massive Wax Museum site mixed use residential and retail project, another of the city's public-private partnerships. A former development executive at Akridge also ventured to start his own development firm, acquiring land near the new baseball stadium for future mixed-use development. This executive has parlayed his experience into becoming a leading expert on the use of TIF for urban mixed use development projects.

The re-creation of the city's historic core has also helped bring a larger 24/7 feel to Washington. Hotels opening in the area, combined with the 280+ events annually at the MCI Center and business at the convention center have brought more business, tourism, and local visitors to the area. This has in turn sparked additional development, additional retail, and higher taxes. The circular decline of the 1960's has been replaced with a circle of job creation, new residents, economic development, and civic pride.

2. Challenges

The issuance costs for the TIF transaction for Gallery Place were stratospheric: of the total issuance of \$74,336,530, only \$51,000,000, or 68.6%, was invested in the project. The remainder of the issuance was consumed by an interest reserve, bond insurance, issuance fees and premiums, and other TIF-related costs. These issuance costs are not unique, of course, to TIF issuance; all municipal and revenue bonds require similar reserves, fees, insurance premiums, and issuance costs. For that matter, purely private securities issuance costs are present in all such transactions. However, the inefficiencies of a transaction of this scale are striking in their size and impact the ultimate public cost/benefit analysis.

One way of quantifying the inefficiency of capitalizing the debt reserve up front versus a "pay as you go" type of system is to examine the difference between interest payments on the TIF versus a conventional construction loan. A conventional construction loan has monthly draws, with interest based on the previous month's outstanding balance. Because the project required \$51 million in net proceeds, and the TIF was advanced proportionately to the construction loan, a comparison is relatively straightforward.

Mathematically, the inefficiency can be expressed as the difference between the debt service actually incurred versus that which would have occurred had the funds been drawn like a construction loan. Principal amortization is excluded in this equation, leaving only the variable component, interest. The TIF is assumed to pay semi-annually, versus a monthly payment of construction loan interest.

The table below shows the aggregate interest paid under both scenarios, as well as the net present value of these payments discounted at the coupon rate of each. The difference is also computed on a present value basis. Over 36 months, this analysis pegs the debt service inefficiency at \$4.4 million. This figure captures only one aspect of the inefficiency, however, and ignores other significant but difficult to value public policy costs.

TIF	\$	74,500,000
Total Int.	\$	11,957,250
NPV	\$	10,913,049
Conv. Loan	\$	51,000,000
Total Int.	\$	7,320,625
NPV	\$	6,485,584
Variance - TIF to Loan		
Total Interest	\$	4,636,625
Present Value	\$	4,427,464

The interest inefficiency analysis provides an estimate of the resource inefficiency for the TIF component. In other words, if the District acted as a lender, or conduit, for the TIF proceeds, it could advance the \$51 million TIF component at a cost reduction of \$4.4 million was required to float the bonds up front; in other words, the District could lend its money to itself, with future repayment from a TIF issuance in the future for significantly less.

The implications of this possibility are broad, but come with their own potential problems. It may be impractical politically or legally for the municipality to act as a lender for private enterprise, hence the need or desire to use TIF. One potential avenue for a hybrid of the government as lender scenario uses a private intermediary to act as the lender – in this structure, the intermediary lends money to a developer backed by a guaranty from the municipality to issue TIF bonds upon completion or some other predetermined event. The intermediary earns a fee and interest to compensate for the risks involved, but otherwise

serves only to facilitate the time period when the inefficiency of an interest reserve is most costly, the construction phase of a project.

The debt service costs were not the only ones involved in using TIF in the Gallery Place Project. The city and developer's legal fees alone for structuring the TIF exceeded \$400,000. Legal fees for the lender, equity investors, and developers combined exceeded \$1.7 million, although not all of those fees are directly attributable to the TIF. The time involved on the part of the city is an opportunity cost but one that should not be overlooked, as the other side of that cost is yet another inefficiency that argues against TIF for all but the largest public-private partnerships.

In addition to the quantifiable inefficiencies demonstrated above, there was a substantial opportunity cost due to the length of time needed to effect the TIF process. Although not easily quantifiable, these costs were evident in a number of different ways. Construction prices increased monthly, as did the carrying costs related to the site and the project. Had the project been completed earlier, the developers and their partners may have achieved even higher financial returns, although some or all of the public benefits may have been omitted.

The lost opportunity costs were somewhat offset by a gradual improvement in real estate market fundamentals during the TIF process; an overall revitalization of the East End submarket allowed a nascent residential market to stabilize, allowing the project to deliver into a stronger market than originally intended. The office market also continued to improve, as firms were more willing to move to what had been a transitional neighborhood. All of these factors helped create a stronger retail environment, allowing for a more fully executed retail strategy to develop.

A third cost – in addition to the actual costs and the opportunity costs – is one that is evident on many public/private partnerships – a loss of flexibility in the development process. Most real estate developers attempt to preserve as much flexibility as possible throughout the design, development, financing, and construction phases of development. With a public

entity as a partner, however, there is a tendency for the public entity to lock down all aspects of the development up front, with little room for change as the project evolves.

With a TIF, bonds are underwritten and sold based on detailed assumptions for use, square footage, operations, tenant mix, and other factors. Changing one assumption, however slightly, results in the need to re-underwrite the TIF structure in its entirety. At Gallery Place, the need for constant analysis and re-analysis took 6 months and created a need for a dual-project approach. The entire project was underwritten twice, once assuming a smaller office and larger retail components, and once using larger retail and smaller office square footage numbers. Part of the solution to the constantly changing project structure was to create a larger tax increment area, thereby reducing the influence of the specific project as a security for the bond payments.

Although pre-closing flexibility was limited, post-closing flexibility appears to work as intended. For example, when the project was under construction, the residential component became more valuable as for-sale condominiums than as rental apartments. The bondholders approved conversion of the residential component, and indeed the condominiums have resulted in far greater tax increment than the property tax valuation would have as rental apartments. Even the bankruptcy of the general contractor resulted in only minimal delays and changes, with the developer able to continue work with direct subcontractor agreements.

Despite the cost, timing, and flexibility challenges faced by the project, the TIF bonds for Gallery Place closed and were funded in conjunction with the other components of the overall financing in 2002. Construction moved forward, and the project was completed with only modest budget overruns that were fully offset by the increased value associated with the project.

From a financial standpoint, the Gallery Place TIF bonds must be judged as a total success. In 2005, the District of Columbia had to allocate an additional interest payment of approximately \$5.5 million due to construction delays, mostly a result of the general contractor filing for bankruptcy during construction. However, the bonds were underwritten with sufficient debt

coverage from incremental sales and property taxes in the increment area that this payment was easily covered. As of 2006, Gallery Place has been a self-sustained TIF, with incremental tax revenues more than sufficient to pay for its own debt service. The debt coverage for all of the District's TIF issuances was approximately 105.15%, according to the District's year-end 2006 annual financial statements. Of the total tax increment of \$13.1 million, \$11.6 million represented sales taxes, the primary reason for creating the Gallery Place TIF.

Moreover, the incremental taxes generated by Gallery Place are accretive to the District of Columbia, generating revenues above both the bond debt service and above the level that a strictly private development would have garnered.

Conclusions

1. Conclusion

We have seen throughout this case study how, despite the inefficiencies of utilizing tax increment financing for the Gallery Place Project, ultimately the project succeeded in its primary goal of helping to create the resurgence of an area of downtown Washington, D.C. This resurgence resulted in a higher property tax base, increased sales taxes, and generally stronger economic development that happened more quickly than expected but for the TIF. It helped spark a 24/7 feel to a previously desolate office core, creating a safer, more vibrant area that ultimately helps create more for the city than just two square blocks of development. The project is accretive to the District's tax coffers, adding in excess of \$700,000 annually above what would have been created from an unsubsidized private development.

But the vast magnitude of the financial inefficiencies as demonstrated by Gallery Place brings into question whether TIF is the best economic development tool in a municipality's arsenal to help stimulate this type of development. The interest inefficiency alone is over \$4 million, or 7.8% of the net proceeds of the TIF issuance. There are other methods by which a city can assist in creating the type of growth and development it chooses, and there is always the option not to assist development in any meaningful way, rather letting only market forces dictate property use.

Had the District not used economic development tools at Gallery Place, the highest and best use of the property would have been the development of the site as a Class A office building with street-level retail. Given the continued strength of the office market, this would have likely been a very profitable development strategy and created an increased marginal property tax revenue benefit. But as we have seen, the property tax generated by an office/retail project is dwarfed by the total property and sales taxes generated by Gallery Place.

However, in addition to property taxes, the 200,000 square feet of retail space, with sales averaging \$600 per square foot, generates gross annual sales of \$120 million. Using the

current D.C. sales tax rate of 5.75%, this generates an incremental \$6.9 million in sales taxes. Additionally, the condominium residences at Gallery Place provide an estimated additional \$1 million annually in property taxes, and the parking garage generates sales and use taxes of 12% (parking taxes are dedicated to other bond repayments and are not included in the increment available for TIF, however the magnitude of this garage creates a significant additional tax base for the city). The value and taxes generated in the blocks surrounding the project is impossible to quantify, but empirical evidence suggests that it is significantly higher than it would have otherwise been without Gallery Place. Of equal importance, the taxes generated by the surrounding development likely occurred more quickly than they would have without Gallery Place, increasing their present value to the city. This case study analysis clearly shows that the District had and continues to have a vested financial interest in guiding the development of this particular project, and the lessons learned here can be extrapolated to other projects where the city has an interest in creating a use that is not the highest and best use of a property.

A municipality does have other options available to guide development. One option is providing direct assistance, in the form of a grant, free land or development rights, or another type of direct incentive or payment to a developer. While this might be the most cost beneficial option economically, politically it is often not palatable, practical, or ideal. A system of using direct assistance can create other problems, such as fraud, abuse of funds, or perceived favoritism toward particular developers. The TIF method, although it approximates direct financial assistance to a project, allows an independent investor (the bondholders) to retain some negotiating rights as well as provides an important check and balance for a project's viability. The due diligence associated with selling bonds provides a municipality with political cover in case the investment does not pan out.

Governments can also alter zoning or create special districts to foster development patterns. This works particularly well in areas where a city can create zoning "overlays", such as requiring street-level retail in all buildings in an area. In fact, D.C. uses such zoning overlays in multiple locations, including the East End area where Gallery Place is located. Special zoning rules become difficult to apply to single projects, however, for a number of reasons,

including property rights' concerns and setting precedents for changing zoning. In addition, simply creating more development space does not necessarily lead developers to design projects that fulfill larger planning goals; that level of specificity almost always requires some financial support for a project.

Other funding mechanisms available to a city include municipal revenue bonds, which are backed by specific revenue streams but which are obligations of the municipality, thereby usually reducing borrowing costs. These bonds impact a city's debt limits, which TIF bonds generally do not, and are therefore not a preferable alternative from a city's perspective. However, for a state entity, or for a city with limited existing debt, this may be a viable option.

Another method of direct public financing is currently being used by the District of Columbia to finance its new baseball stadium. The government is levying a special business receipts tax on large businesses in order to float revenue bonds; based on current economic conditions, there is anticipated to be sufficient excess revenues to float bonds for other public purposes, such as a new soccer stadium or additional convention center related development. The excess revenue could also be used to retire the baseball bonds early.

The public financing of the baseball stadium has come with a heavy political price; although the bonds are supported by new tax revenue streams, the financing fails the "but for" test – in other words, the baseball stadium itself does not generate sufficient revenues to support the bonds, rather it is an economic development tool that will hopefully accelerate development around its location. The tax revenues raised from expanding a business receipts tax could also potentially have been raised for general government funds, unlike TIF.

However, the baseball stadium financing represents a cost efficient financing plan – bonds can be issued in phases as proceeds are required for construction, reducing the interest carry burden created by floating the entire issuance up front, as is currently required in TIF bonds. And because the bonds are obligations of the District, there is an underlying credit rating to reduce borrowing costs.

Using TIF for public-private partnership but using it more effectively may be a possible solution, at least for smaller transactions. TIF notes, issued directly to the developer, who then places them with investors, are a pay as you go system, allowing interest to be accrued only as the principal is used. This type of issuance also removes marketing risk from an underwriters syndicate, saving on some of the up front fees associated with a bond issuance.

However, few developers of major projects have the financial capacity to take advantage of this type of system – it requires developers or their investors to advance project costs ahead of an eventual repayment through incremental tax generation. In addition, interest rates on TIF notes will likely be higher than bonds, in order to compensate developers for their generally higher return thresholds. TIF notes may also be “sold” (or issued) at a discount, enabling higher yields at similar effective interest rates. For developers that do possess the financial strength or investor resources, strong non-development (i.e. financial) returns are possible using TIF notes as opposed to bonds, further leveraging the proceeds and public investment in a specific project.

It seems likely that the future of TIF structures lies in a hybrid bond and note system, where a combination of bonds and notes are issued in a pay-as-you-go type system. As credit markets mature and begin to achieve an understanding of these mechanisms, the perceived risk factors during construction will be better underwritten and an appropriate return assigned. Interest rates will reduce as construction risk is mitigated, opening up the buy-side to investors by segregating different types of risk and returns, much in the way securitized debt currently trades.

One example of a hybrid pay as you go bond issuance system can be seen in New York, where the Housing Finance Agency (HFA) issues bonds to fund so-called “80-20” projects, where 80% of an apartment building’s units are market rate units and 20% are affordable (there are various permutations of this structure, but for ease of explanation the standard 80-20 designation and definition is used here.) Both taxable and tax-exempt bonds are issued on an annual basis to cover anticipated project costs. Although a sizeable interest reserve is still

required, it is not as significant as it would be if all bonds were issued at the beginning of construction. One aspect of this type of bond issuance is that the bonds are credit enhanced by third-party lenders, typically banks, which provide letters of credit to underwrite construction risk.

Although not completely analogous to TIF because HFA bonds are only used for multifamily projects, the concept of a credit-enhanced, pay as you go model is one that municipalities may be able to take advantage of in the future to squeeze increased efficiency out of projects financed in whole or part through TIFs.

While any or all of the above options may work for specific projects, tax increment financing has proven its worth as a viable public financing technique for public-private partnerships, including the one assembled for the Gallery Place Project. By adding in the private piece of the partnership, which requires a financial return in addition to the public sector's policy goals, additional complexity is inherent. TIF is clearly a valuable tool in a policy-makers arsenal to accomplish public goals while allowing the private sector to achieve its market-oriented returns.

2. Application to Future Public-Private Partnerships

The District of Columbia continues to see interest in its TIF program to finance projects to be developed as public-private partnerships with the city. These include convention center hotels, retail development, a new soccer stadium, a revitalization of the Southwest waterfront, and others. With the city again growing and adding population, interest in retail and mixed-use development remains strong, while the desire of the government to maintain its financial house is also evident.

The years since Gallery Place was first proposed and built have also seen a growing awareness in the city that TIF is not the only solution, and in fact that public-private partnerships are a tool rather than a mandate. For example, after first requesting proposals from developers to build and finance a new Major League Baseball stadium, the city decided

to build the project itself and fully finance it through taxes levied and increased for that purpose. The result is a stadium that is currently ahead of schedule and under budget, with excess financing proceeds and a revenue stream that greatly exceeds the bonds' debt service requirements.

Another example of how the city has evolved is its treatment of existing tax increment financing obligations; although these are not full faith and credit or even so-called moral obligation bonds, they are reported similarly to general obligation bonds. The city's conservative treatment of TIF will probably result in its limited future use, due to debt limit constraints that in this case are self-imposed by the city. This type of conservative debt management on the part of the city should be rewarded by the capital markets, which will keep borrowing costs low and availability in line with other credit-worthy entities.

There are other areas where public-private partnerships show promise in assisting public policy goals. One notable example is the District's school system, which is overburdened by excess real estate, a declining student population, and a chronic dysfunction that has hindered the city's overall growth for decades. Organizations such as EdBuild are testing the waters to pair developers with the city in order to maximize the school system's resources by combining charter schools and maximizing use of the city's space. Past experiments in partnerships, such as the exception Oyster School in the Northwest quadrant of the city show that success is possible.

Although private development of school sites is a hot button issue, the potential to add to the city's tax rolls has the potential to assist in the city's goal of a modern school system. TIF could allow some of this development to take place in a manner, and particularly scale, that is in line with existing neighborhoods with minimal to no cost to the city.

To be sure, TIF is not necessarily appropriate for every potential development site. A downtown location suitable for immediate development may require not financial assistance. However, a neighborhood school may have excess land suitable for affordable or workforce

housing, and the public policy goal of providing this resource may be worth the marginal financial and political cost of providing financial assistance.

TIF is an important financing tool for public-private partnerships, and one that has worked on both small and large scales. The benefits of TIF are significant – maximizing public goals while providing for private market returns. The drawbacks, most notably the inefficiency of actually consummating the financial transaction, need to be seriously weighed against those returns. For the right type of project, as we can see from the example of Gallery Place, TIF has the potential to provide the right solution to a public-private partnership for real estate development.

Anatomy of a Successful Public Private Partnership: Gallery Place

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