



**An Eye on Sacramento Report  
On  
The Arena Proposal  
March 26, 2013**

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## **I. Executive Summary**

The city council is poised to take action on an arena term sheet that will have lasting and significant long-term impacts on the city and its taxpayers. Prior to taking action, the council should consider:

1. The public has not had sufficient time to digest the proposed deal and the city's financing plan or provide feedback to council members on these proposals. There are significant dangers to the city and taxpayers of stifling public input in these decisions.
2. EOS finds that, despite rosy predictions of future economic growth from the development of a new arena, the near universal judgment of academics is that the arena will have negligible impact on economic growth and job formation (apart from the jobs of those working for the Kings and temporary construction jobs).
3. Constructing a new arena at Downtown Plaza is not likely to lead to broad-based urban redevelopment in downtown Sacramento, but has a fairly decent chance of redeveloping the area within one (and perhaps two) blocks of the arena, although current city policies supporting low-income housing and single-room occupancy hotels near and on K Street are sabotaging revitalization of the area.
4. City staff has grossly understated the total public contribution to the arena. Instead of contributing \$258 million, EOS estimates that city taxpayers will be contributing \$334 million to the project, representing not 58% of the project cost, as claimed by staff, but 75% of the project's cost (not counting subsidies provided by county government or future undetermined traffic infrastructure costs.)
5. The two key omissions in staff's count of the public contribution are the 3700 parking spaces at Downtown Plaza that the city is gifting to the investors, which have an estimated value of \$57.8 million, and the gifting to the investors of up to six sites for up to six digital billboards, which have a net present rental value of over \$18 million.
6. The city's financing plan is seriously flawed, exposes the city's general fund to potential liability, ties up the city's TOT revenues, involves very high interest rates, is of a type (garage bonds) that are causing problems in other cities and involves the payment of over \$80 million of additional interest in order to secure \$24 million in lower payments in the first eight years of the bonds - a horrible deal for taxpayers.
7. Almost every significant general fund "backfiller" identified by staff is shaky and/or overstated.
8. The city should jettison "public sector suite" in the arena, a totally unnecessary added expense, and negotiate a corresponding \$8 million reduction in the city's contribution to the arena.
9. The city should commission an independent review of the projections, assumptions and proposed financing to resolve inaccuracies in the total public

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contribution and the general fund backfill, professional disagreements over projections and assumptions and irreconcilable conflicts of interest of the city's investment bankers.

10. The city has failed to assess the opportunity costs of doing this deal - the future projects that it will be unable to do because of the use of its parking assets to securitize the arena bonds. Such projects range from developing Sacramento's neglected waterfront to financing levee improvements in North Natomas to secure a lifting of the federal building moratorium and restarting economic growth in Natomas.
11. The arena deal is subject to litigation risks under CEQA, a possible state law claim for violating the constitutional prohibition on gifts of public funds and possible claims for intentional interference with contractual relations, all of which should be reviewed by appropriate legal counsel before moving forward
12. Opponents of a publicly subsidized arena are organizing to qualify an initiative and perhaps a referendum to force a public vote on the arena subsidy. They may secure funding from Seattle sources if the NBA board of governors turns down the request to relocate the Kings to Seattle.

## **II. Eye On Sacramento's Role; Scope of Review**

Eye on Sacramento is a California nonprofit public benefit corporation which has three principal functions: (1) to serve as a diligent watchdog of the actions and policies of local Sacramento government and to help keep Sacramentans informed on such matters; (2) to offer smart policy solutions to challenging municipal problems; and (3) to engage in community outreach.

In its work as a civic watchdog, EOS is, by necessity, highly selective in the matters it chooses to review or investigate. Our policy is to focus on those civic matters that are of public importance, but which are not receiving adequate scrutiny by local media, government agencies or concerned private citizens. In essence, we strive to shed light on the darker shadows of local government, based on the wise advice of Supreme Court Benjamin Cardozo that "sunlight is the best disinfectant."

Until recently, the arena issue in Sacramento met the first criterion for EOS engagement - public importance - but not the second - inadequate scrutiny by media, etc. Local media, bloggers and citizen journalists were providing high quality coverage of the machinations of the Maloofs, the NBA and the City to come to terms on a deal to construct a new Kings arena. In the past several weeks, however, we have grown increasingly concerned that, as the "deal clock" on keeping the Kings in Sacramento runs out, Sacramento media appear to be having a difficult time covering and, more vitally, providing essential analysis and evaluation of the long-term implications, concerns and risks of an imminent deal between a nascent arena investor group and the City of Sacramento to build a \$440 million taxpayer-subsidized arena at Downtown Plaza.

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Such concerns led the EOS board to decide on March 15th - just 11 days ago - to "engage" on the arena issue for the first time. Given our very brief review period and the extraordinarily short amount of time city government is providing for public review of the proposed terms of this momentous deal and the city's financing plans, this report has been compiled with great haste. There is little question that such haste has diminished, to an undeterminable degree, the quality of this report. For example, we have had no opportunity to review this report in advance with city staff to solicit clarifying information. Similarly, we have had little opportunity to explore the issues, concerns and risks we've identified in any significant depth.

This report has been compiled from personal interviews, telephone conversations, document reviews, consultations with sports economists, legal research, review of academic studies and publications, as well as participation in "open houses" conducted by city staff on March 21st thru 23rd, 2013 and review of the terms sheet negotiated by the investor group and city staff and the March 26, 2013 staff report to council.

Finally, EOS has refrained from taking an explicit "support" or "oppose" position on the proposed arena deal. Instead, we have endeavored to fairly and independently inform and advise the public, the media and members of the Sacramento city council of the benefits, implications, concerns and risks of the proposed deal to the city and its taxpayers rather than to proscribe. In several instances, we have provided the city council with our recommendations on changes we believe should be made to the term sheet and financing plan that would provide greater protections for city taxpayers.

Craig Powell, President  
Eye on Sacramento  
March 25, 2013

### **III. Insufficient Public Engagement in Debate Over the Proposed Deal and the City's Financing Plan; Dangers of Stifling Public Input**

We understand that city officials are in a desperate race to negotiate a term sheet and adopt a city financing plan for the city's contribution to the arena before an April 3, 2013 meeting with the NBA's finance and relocation committees, and before an NBA board of governors meeting on April 18th and 19th, at which the NBA board will consider the Maloofs' application to sell the team to the Seattle investor group. But desperation is a terrible state for city negotiators (and city council members) to be in when negotiating and evaluating a transaction and financing plan that will have fundamental impacts on the city and its finances.

Instead of setting an early "drop dead" date for agreement on a term sheet and sticking with it, city officials have allowed the negotiations to largely consume almost all of the available time the public and the media would normally have to assess and evaluate the proposed deal and financings, and provide vital feedback to city council members. As a consequence, the public will be largely cheated out of a chance to evaluate the proposals, fully understand them and express their informed views to their

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elected representatives. Council members will be deprived of meaningful input from their constituents and will have insufficient time to evaluate the findings of this report.

As noted by Harvard urban design professor Judith Long in her new book *Public/Private Partnerships in Major League Sports Facilities* (2013), "The increasing complexity of sports facilities deals contributes to misunderstandings on the part of decision-makers and taxpayers as to the real nature of their ongoing commitments" (pg. 16).

Long's study sounds an alarm bell for decision-makers:

"Based on an analysis of public funding for over 250 sports facilities used for the major leagues...public funding has been significantly underestimated due to the systematic omission of public expenditures on land and infrastructure, public partners and teams rarely are equal partners in sports facility deals and that, despite significant efforts from the academic and public policy communities, public spending on sports facilities continues unabated.

...

[P]ublic partners pay far more than is commonly understood - almost \$10 billion more in total - due to routine omission of public costs of land and infrastructure, the ongoing costs of operations, capital improvements, municipal services and foregone property taxes." (supra, pg. 15)

Long issues a clear warning for local elected officials considering public subsidies of sports facilities:

"[T]he burgeoning number of public finance crisis with roots in sports facility deals points to a clear need for better understanding of the long-term risks and implications for taxpayers. Yet this kind of long-term financial analysis has been absent from much of the public discourse associated with the latest rounds of subsidies for major league sports facilities." (supra, pg. 4)

She even cautions local watchdog groups: "Even for deal watchdogs, the complexity of public-private partnerships means that monitoring deals can be overwhelming." (supra, pg. 4)

For city taxpayers the burdens of such deals are particularly severe:

"Residents in central cities pay a higher proportion of facility subsidy costs while also having disproportionately lower incomes than suburban counterparts [and] ... bear a disproportionate financial burden [of the subsidies' costs]." (supra, pg. 7)

Meanwhile, city decision-makers are not well prepared for negotiations with arena developers:

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"At the negotiating table, public and private partners would ideally engage in careful and informed forecasting of revenues and expenses to gauge the full extent of their obligations to the other partner. Yet there is little evidence that these deals are well understood by decision-makers, let alone taxpayers...[Decision-makers] face real difficulties of forecasting franchise performance - and, by extension, facility performance." (Long, pg. 13, supra)

Professor Long's book contains a long list of municipalities that are currently struggling under the weight of subsidized sports facility deals that have gone very wrong. "These revelations come on the heels of reports that theirs are some of the most generous deals made with major league teams in recent history." (Long, supra) With a public contribution percentage of 78%, the proposed term sheet may very well be considered one such deal. (See "V. City Staff Has Grossly Understated the Public Contribution to the Arena - Accurately Measuring the Subsidy," infra)

We are also concerned about the prevailing Sacramento city government perception that problems with the arena term sheet can just be fixed in subsequent negotiations with the investors, or that problems with the financial plan can be fixed sometime in the coming year. Holders of such views fail to understand the power of "deal momentum," the forward momentum a signed and approved term sheet (really a letter of intent) builds among the parties.

We are concerned that the city council will be extremely reluctant to ever push away from the negotiating in response to difficult future negotiations, including likely additional demands by the investors. Councilmembers will be extremely reluctant to push back from the table as they run the political risk of being accused of "losing the Kings." Private investors have no comparable political risk in deciding to walk away from negotiations that no longer advance their interests. Consequently, the city's negotiating posture is likely to be at its zenith now, before approval of the term sheet, and it will see its negotiating power eroding after the term sheet is approved. This asymmetrical deal dynamic is all the more reason why the city council needs to get the term sheet "right" this week and not defer significant issues to future negotiations.

### **IV. City's Three Goals: Economic Development, Urban Renewal & Keeping Kings**

The city's primary motivations for entering into the arena deal are: (1) to further economic growth and create new jobs; (2) to serve as a catalyst for renewal of the city's urban core; and (3) to secure the intangible, but very real, symbolic value of preserving and enhancing the city's reputation and status that comes with having an NBA franchise. We will examine each goal in turn.

#### **Will the Arena Deal Promote Economic Growth in Sacramento?**

There is near unanimous agreement among academics who have studied claims that taxpayer-subsidized sports facilities lead to greater local economic growth that such

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claims are largely baseless. A 2008 study (Coates and Humphreys, "Do Economists Reach a Conclusion on Subsidies for Sports Franchises, Stadiums, and Mega-Events," North American Association of Sports Economists Working Paper Series, Paper No. 08-18, August 2008) concludes:

"There now exists almost twenty years of research on the economic impact of professional sports franchises and facilities on the local economy. The results of this literature are strikingly consistent. No matter what cities or geographic areas are examined, no matter what estimators are used, no matter what model specifications are used, and no matter what variables are used, articles published in peer reviewed economics journals contain almost no evidence that professional sports franchises and facilities have a measurable economic impact on the economy."

Here is the blunt assessment of University of Chicago economist Allen Sanderson: "If you want to inject money into the local economy, it would be better to drop it from a helicopter than invest it in a new ballpark."

Victor Matheson is an economist at Holy Cross who has studied the economic impact of stadium construction for decades. When cities cite studies produced by parties with an interest touting the impact of such projects, Matheson says there is a simple rule for determining the actual return on investment: "Take whatever number the sports promoter says, take it and move the decimal one place to the left. Divide it by ten, and that's a pretty good estimate of the actual economic impact." The mayor's Think Big Sacramento organization commissioned an economic study last year that found that a downtown arena would generate \$7 billion in economic activity for the region over 30 years. You can do the math.

Keeping the Kings in Sacramento will preserve approximately the 800 jobs of those who work for the Kings organization, as well as create as many as 6,000 additional jobs, primarily temporary construction jobs, according to city manager John Shirey. We asked Stanford University sports economist Roger Noll, professor emeritus and an acknowledged leader in the study of sports facilities, to quickly review the issue of job creation under the proposed deal:

"The "jobs" calculation is not sufficiently explained to make an evaluation possible. I infer from the [staff report] that these are for the most part the temporary jobs arising from construction, and so they are not dependent on the purpose of the construction project. Generally, economists do not count as benefits the costs of the project - if we did, all of gross national product would be taken up by publicly financed construction. For the unknown proportion that comprise permanent jobs (the 800 current jobs that won't leave, plus some unknown fraction of the rest), the project cost is roughly in line with other sports facilities. A public cost of \$258 million will create at most 4,000 to 5,000 jobs (some temporary), at a cost of \$50,000 to \$60,000 per job. By comparison, the average cost per permanent job created for urban renewal projects is about \$10,000 to \$15,000. Thus, the facility will cost about four or five times as much

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per job created (and maybe a lot more if the jobs are temporary) as the typical urban redevelopment project." (March 25, 2013 e-mail from Professor Roger Noll to EOS President Craig Powell, copy on file)

### Will the Arena Deal Lead to Renewal of Sacramento's Urban Core?

From our review of the literature, the picture is very much mixed, depending on one's definition of urban core. Studies show that subsidized sports facilities have no meaningful impact on a city's downtown core as a whole. However, they can and sometimes do help stimulate development in the immediate vicinity of the facility (i.e. within one to two blocks of it). In this instance, there is a fairly good chance that the placement of an arena in Downtown Plaza will lead to urban redevelopment in the eastern portion of K Street and within a block or so of the Plaza in all directions, particularly if investors follow through on their professed intent to invest \$500 million to develop adjacent properties with retail, office and hotel development.

The fact that such properties will likely be in the hands, or under the control, of the investors or other private parties interested in such development, rather than in city government hands, increases the likelihood of development. City-subsided redevelopment along K Street has a horrid history of failure, with over \$500 million spent in city subsidies to produce negligible results over the past 50 years, according to Sacramento Bee columnist Dan Walters.

The prospect of successful urban renewal in and around Downtown Plaza, however, is and will continue to be hampered by the city's long-time unwise policy of subsidizing low-income housing and a large number of single-room occupancy hotels in the immediate vicinity of the K Street. As any K Street merchant will tell you, the biggest impediment to successful redevelopment of K Street is the presence of substantial numbers of inebriates, aggressive panhandlers and those suffering from mental illness who make it uncomfortable for shoppers and other consumers to patronize K Street businesses. People do not patronize areas where they feel uncomfortable.

The city council's approval earlier this month of \$30 million in city subsidies for the development of a mixed use, but predominantly low-income housing project (60% of the 112 housing units are designated low-income) on the 700 block of K Street, immediately adjacent to Downtown Plaza, does nothing to alleviate this problem and could add to the challenges investors will face in developing adjoining properties, including the 800 K Street property that the city proposed to transfer to the investors as part of the arena deal. K Street badly needs market rate housing and residents with the disposable income to make new business ventures successful. Instead city policy is moving in the opposite direction.

### Symbolic Value of Keeping the Kings in Sacramento

The symbolic value to Sacramento of being the home of a major league basketball team is intangible, but it is nevertheless very real. It helps to build Sacramento's stature in the world, it helps draw residents to our city and it is an important source of

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community pride. It is also a shared experience for Sacramento residents, helping to bring us together. While almost impossible to measure, there is no question that Sacramento derives significant, symbolic benefits from the presence of the Kings.

### **V. City Staff Has Grossly Understated the Public Contribution to the Arena - Accurately Measuring the Subsidy**

City staff claims that the term sheet calls for the city to make a public contribution to the arena project of \$258 million, representing 58% of the costs of building a new arena. This is incorrect. In fact, the term sheet calls for the city to contribute a total of at least \$334 million to the arena project, \$75.8 million more than stated by staff, representing a 75% share of the cost of the \$447 million cost of the arena.

City staff's numbers inexplicably fail to include: (1) the fair market value of the 3,700 city parking spaces at Downtown Plaza that the city is giving to the investors, having an estimated value of \$57.8 million; and (2) the \$18 million fair rental value, on a present value basis, of the city's agreement to provide city land for the location of up to six digital billboards for the investors, according to EOS estimations. Additionally, Sacramento County is providing the investors with an exemption from possessory interest taxes, a tax subsidy that we compute has a present value of \$12 million.

When these three uncounted public contributions are included in the numbers, the taxpayers total contribution to the arena is \$87.8 million more than staff has disclosed, for a total public contribution of \$346 million, representing a 77% public share of the cost of the arena.

#### **Failure to Include Value of 3,700 City Parking Spaces at Downtown Plaza**

Under the proposed arena term sheet the city is giving to the investors all of the 3,700 parking spaces at the three garages (one above ground, to the west of the Plaza, and two underground), representing approximately one-half of all of the city's garage parking spaces. According to the parking monetization study the city commissioned 18 months ago by Walker Parking Consultants ("Market, Financial and Condition Assessment of Parking Assets," November 23, 2011), the fair market value of these parking spaces is more than \$15,000 each. Accordingly, the total fair market value of the 3,700 parking spaces to be given to the investors amounts to approximately \$57.8 million.

#### **Failure to Include Rental Value of Sites for Six Digital Billboards**

Under the term sheet, the city is obligated to provide the investors with up to six sites on city land for the placement of six digital billboards. City staff has failed to include the fair rental value of these sites in its calculation of the total public contribution.

In December, 2010, the city entered into a five-year contract with Clear Channel Outdoor under the terms of which Clear Channel secured four sites on city land to place

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four digital billboards and agreed to pay an upfront fee of \$330,000 and annual payments of \$720,000. In a June 7, 2011 Business Journal Article ("City Cashes in As Digital Billboards Begin to Catch On"), Tom Zeidner, the city's project manager, was quoted as saying: "Electronic billboards have been good business for the city of Sacramento, which owns the land underneath the four built so far. Sacramento will receive more than \$1 million in payments from Clear Channel Outdoor Holdings Inc. in the first year."

By applying the rental rates secured by the city in the 2010 Clear Channel Outdoor deal, EOS has computed that the city is foregoing annual rent of approximately \$1,050,000 per year (plus a \$500,000 upfront fee) on the six digital billboard sites for the 35-year term of the arena lease. Applying a discount rate of 5%, EOS computes that the present value of this stream of foregone rental revenue amounts to over \$18 million.

### Value of Sacramento County Tax Subsidy

The term sheet confirms that Sacramento County has agreed to waive its possessory interest tax on arena assets, an annual subsidy of \$600,000. Applying a 5% discount rate over the 35-year subsidy period, EOS computes that the present value of this subsidy amounts to \$12 million.

### Uncertain Value of City Parcels to be Given to Investors

The term sheet states that the city is giving to the investors various parcels of city land possessing a current fair market value of \$38 million (although the value of the 100 acres of Natomas land adjoining the current arena is based on the assumption that the current federal building moratorium in the area is lifted, a clear benefit to the city). It states that the values were based on the broker opinion of CBRE, the city's real estate consultant. When asked if the values were based on appraisals, the city manager said that appraisals would take too long, up to 90 days.

The city is giving the investors city land at the bottom of a deep commercial property recession, when commercial land prices are significantly depressed. If the city holds on to these parcels until the market for commercial properties recovers, it would likely be able to command much higher prices than it is indirectly receiving in the proposed arena deal. The difference could amount to \$10 million or more in higher values.

We also are very concerned that such major transfers of land are occurring without the city taking the time to secure qualified appraisals of the land. We suggest that the city seek a modification of the term sheet to provide for a post-term sheet adjustment in the city's land contribution to the deal under which the quantum of land the city conveys to the investors would be reduced if subsequent appraisals determine that the value of the properties are higher than the represented \$38 million. Relying on a broker's opinion for the value of most of the city's most valuable parcels of property is very risky.

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One very substantial positive of the transfer of these city parcels to the investors is that the parcels will return to the property tax roll and start producing tax revenues for the city and other local government units.

### Failure to Count Traffic and Utilities Infrastructure Costs

The city has conducted no study to determine the traffic impact of a downtown arena. Several critics of a downtown arena have expressed deep concern with the impact of an arena on afternoon rush hour traffic, as downtown workers drive home while arena event attendees arrive. The greatest concern is with the capacity of the J Street off ramp and I Street on ramps on I-5 to handle the confluence of such traffic. Once a traffic study is finally commissioned, will it show that major modifications of these freeway access points will be required to handle the load? If so, who will pay for it? Without any cost-sharing arrangement in the term sheet for such improvements, it is highly likely that the cost will fall on taxpayers. Will the cost fall on state taxpayers or city taxpayers? Freeway modifications of this type are notoriously expensive (ranging in cost from \$50 to \$100 million) and the failure to account for such costs now leaves city taxpayers extremely vulnerable to additional, unknown cost burdens in the future.

While the term sheet provides that the investors will pay for municipal utilities services provided to the arena, will the city require them to pay for one-time sewer, water and drainage development fees, commonly known as hook-up fees? The term sheet is silent on this point.

### Loss of Sales Tax Revenue From Current Downtown Plaza Retail Tenants

Has city staff evaluated the impact on the city's general fund of the anticipated loss of most of the current retail stores at Downtown Plaza? How much do such tenants currently pay in sales taxes? How much does the city stand to lose in lost sales taxes from such tenants? There has been no disclosure or public discussion of such losses.

## **VI. City's Financing Plan**

### Overview of Bonding Plan

The staff report describes a plan to finance about \$212.5 million of its arena contribution by selling revenue bonds (both tax-exempt and taxable) through a newly created nonprofit corporation controlled by the city. The city's parking garage assets, and its collections from both its parking garages and parking meters (including all enforcement revenue) would be transferred to the nonprofit. In addition, the city's transit occupancy tax (TOT) revenues (commonly known as the "hotel tax") would be pledged to the bondholders as additional collateral for repayment of the bonds. The nonprofit would operate the parking assets, pay salaries and other parking operating expenses and make payments to bondholders. At the city's March 21st "Open House" on the deal at City Hall, assistant city manager John Dangberg stated that city's investment bankers (Goldman Sachs and Morgan Guaranty) anticipate that the bonds

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would be issued at an annual interest rate of between 5.5% and 5.75% - several percentage points higher than prevailing municipal bond market rates for revenue bonds.

### Is the City's General Fund on the Hook for the Bonds Or Isn't It?

At the third "Open House" on the arena deal on Saturday morning, March 23rd, at the Pannell Community Center, citizen journalist and blogger Isaac Gonzalez asked city manager John Shirey whether the city's general fund was liable for repayment of the bonds. Shirey gave a distinctly vague answer: "The city is responsible for the bonds, but not technically." EOS President Craig Powell then asked Shirey a follow-up question: "Do you expect that the city will be asked to execute an express guaranty of payment of the bonds." At that point, Shirey called upon city attorney James Sanchez to provide an answer. Sanchez answered in a similarly vague fashion, "The city has some ultimate responsibility for payment of the bonds [*italics added*]."

Nine hours later, the city staff report was issued. On page 8, it states as follows: "The revenue bonds would not be a debt obligation of the City [*italics added*]."

We are very troubled by city staff's less than candid response to a critical, straightforward question: Is the city's general fund at risk if there is a default on the bonds or is it not? The city council should insist upon a straight answer to this vital question before proceeding further.

### Staff Report Provides Misleading Information on Bond Interest Rate

The staff report never mentions the anticipated interest rate on the bonds (5.5-5.75%), nor is there any mention that the anticipated bond rate is several points higher than prevailing muni market rates. Instead, the staff report misleads: "Other revenue streams, such as TOT [are there other, unidentified revenue streams to be pledged?], would provide debt coverage and enhance the ratings of the bonds resulting in lower interest rates" (Staff Report, pg.8). This statement, while technically correct, misleads the council and the public into believing that the bonds would likely enjoy a low to moderate interest rate. In fact, the anticipated rates are sky high for a muni credit.

### What is the Import and Impact of a Bond Interest Rate Far Above Market Rates?

An interest rate that is multiple points above market rates is a clear, tangible and irrefutable signal that the credit markets consider the proposed credit to be high risk, meaning at enhanced risk of default. The unsettling truth is that even with the additional pledge of the city's hotel tax revenues, the market assesses the proposed credit as high risk. While it is uncertain whether the city plans to guaranty payment of the bonds, it appears that even if it does (or has), it would make little difference in the high interest rate demanded by the credit markets.

City treasurer Russ Fehr recently stated that the utilities revenues bonds that the city recently sold were issued at an annual 3.8% interest without a general fund guaranty. According to Fehr, "Indeed, a link to the General Fund, would have weakened

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this particular credit," a telling signal of the credit market's sour perception of the city's current ability to pay its debts. The issuance of the parking bonds can only degrade the city's credit rating and raise its future borrowing costs - to the extent it is able to further access the capital markets for additional credit after issuing the proposed parking bonds.

A recent article in Inside the City magazine ("Future Shock: Time To End the Denial Over the City's Debt Problems," by Craig Powell, February 1, 2013 issue) drew attention to Sacramento's declining credit position: "In October, Moody's announced that the risk of municipal bankruptcy is especially high in California and that it was reviewing the bond ratings of eight California cities for possible downgrade, Sacramento among them."

Sacramento would be issuing the parking bonds in the face of growing concerns over California municipal credits and bankruptcies, in general, and the City of Stockton's recent bankruptcy, in particular. Stockton is the largest municipality in the country to file for a Chapter 9 bankruptcy proceeding - so far. Like city staff is proposing, Stockton spent and borrowed lavishly on a downtown sports arena. The arena failed to meet performance projections and the burden of arena debt has played a significant role in tipping Stockton into bankruptcy. As a further cautionary tale from our southern neighbor, Wells Fargo Bank recently foreclosed on three Stockton parking garages after the city was unable to make bond payments on the garage (Central Valley Business Times, April 11, 2012).

### Troubles With Garage Bonds

Garage bond defaults are a fast growing problem across the country. Last October, the owner of the Yankee Stadium's parking garages defaulted on \$237 million of garage bonds, after New York City taxpayers paid \$234 million in subsidies to the nonprofit parking operator (TransportationNation.org; October 11, 2012). Scranton, PA, Spokane, WA and other cities are struggling with failed garage bonds.

The New York Times covered the growing number of bond defaults on nonessential civic assets last year:

"Surprised local taxpayers from Stockton, Calif., to Scranton, Pa., are finding themselves obligated for parking garages, hockey arenas and other enterprises that can no longer pay their debts.

Officials have signed them up unknowingly to backstop the bonds of independent authorities, the special bodies of government that run projects like toll roads and power plants. The practice, meant to save governments money, has been gaining popularity without attracting much notice, and is creating problems for a small but growing number of cities. ("With No Vote, Taxpayers Stuck With Tab on Bonds." June 25, 2012)

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### Plan to Massage Cash Flow With 8 Years of "Interest Only" Payments is Unwise

City treasurer Russ Fehr was quoted in the Sacramento Bee ("Arena Subsidy Borrows Against Parking Cash; March 25, 2013) as saying that the arena bonds need to be "interest-only" for the first eight years - that is, until existing city garage bonds, which require payments of \$4.7 million per year, are paid off in 2022. Thereafter, the new arena bonds will be paid off over 27 years in fully amortizing payments - a total loan term of 35 years.

EOS has run the numbers. Assuming the city needs \$221 million from the garage bonds to fund the lion's share of its arena subsidy, we estimate that it will need to issue a bond with a face amount of around \$235 million to account the anticipated high transaction costs associated with the bond, as the staff report warns will be involved. Based on an bond interest rate of 5.75% (within the range estimated by John Dangberg), the city will pay \$108.1 million in interest during the eight-year "interest-only" period of the bonds (Years 1-8) and in Years 9 thru 35 the city will make total payments (principal and interest) of \$466.5 million, of which \$231.3 will be interest. Total interest payments on the garage bonds: \$339.6 million.

If, instead, the city elected to issue a standard 30-year fully amortizing bond, the city would make total payments of about \$493.7 million, but pay total interest of only \$258.7 million - \$80.9 million less total interest than under the treasurer's proposed "interest-only for 8 years" bond proposal.

The difference in annual payments during the first eight years of each type of bond is as follows:

Fully Amortizing Traditional 30-Year Bond:	\$16.5 Million Annual Payment
Interest Only For 8 Years, 35-Year Bond:	13.5 Million Annual Payment
Difference:	2.9 Million Annually (8 Yrs.)

Over the first 8 years of the "Interest Only for 8 Years" bond, the city would pay 23.6 million in lower payments than under a fully amortizing bond, allowing the city to "massage" its way past the remaining bond payments on the existing garage bonds. **But to secure \$23.6 million in lower payments in the early years, the city would end up paying \$80.9 million more in total interest over the term of the bond - almost 3 1/2 times more than the amount saved in lowered payments.**

In describing the proposal to issue an "interest-only for 8 years" bond, Fehr is quoted in the Bee story as saying, "It's kind of tricky, but we're really proud of it." He shouldn't be. The bond proposed by city staff is a slightly less costly version of the much criticized "capital appreciation bonds" that ill-informed school boards have been passing in California in recent years. The key attributes of both: ultra long maturities and deferred payments of principal, resulting in interest charges on steroids.

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Note: The foregoing calculations are based on EOS's preliminary evaluation of the proposed financial plan which has been pieced together from the city staff report and media accounts.

### The \$3 Million Difference in Annual Bond Payments - Part of the "Backfill?"

We note in passing that the annual payments in the first eight years of the bond proposed by city staff would be about \$3 million less than they would be under a traditional, fully amortizing 30-year bond. Is this \$3 million differential the same \$3 million in "City Parking Revenues" that staff says will help backfill the \$9 million hole in the general fund? We don't know because the staff report does not explain the number. But we certainly hope not. Because such "Revenues" are not revenues at all but are nothing more than a reduction in bond payments bought at a massive and unjustifiable higher cost to taxpayers. (See "Backfilling the General Fund," infra)

### Transient Occupancy Tax (TOT or Hotel Tax)

The city is proposing to pledge its TOT receipts as additional security for the arena bonds. The city's TOT is highly variable, bringing about \$20 million annually pre-recession and bringing in about \$14-15 million annually today. The TOT provides revenue for the city's general fund, but a significant portion of the proceeds are being used to pay off existing bonds on the renovated Sacramento Convention Center. Once these bonds are retired all of the TOT will flow to the general fund. The pledge of the TOT as additional security puts the city's general fund at risk because if parking revenues are insufficient to fund debt payments on the bond, the TOT will be captured by bond creditors.

The city and community leaders have long discussed using enhanced TOT receipts (after retirement of the remaining convention center debt) to finance a renovation of the Sacramento Community Theater. A pledge of TOT to parking bondholders removes it as a source of collateral for a Community Theater renovation, depriving the city of the bonding capacity provided by the annual TOT collections. Essentially the financing plan contemplates sacrificing the renovation of an existing civic amenity (the Community Theater) to provide additional collateral for the building of a new amenity, a new Downtown Plaza arena.

### Reducing Taxpayer Risk by Outsourcing Day-to-Day Operation of City Parking Assets

One certain way to reduce the risk of parking revenues being insufficient to fund bond payments would be for the city to outsource day-to-day operation of its parking assets, particularly its garages and parking lots, to private parking operators. This is distinguishable from the plan explored by the city last year to essentially sell (i.e. 50-year lease) the city's parking assets to private investors to raise cash to fund a city subsidy of an arena. Outsourcing daily operations will allow the city to lower its operating costs substantially and would almost immediately increase the profitability of its parking operations. The wages and employee benefits costs of private garage workers would be significantly below (by perhaps as much as 40%) the salaries and

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benefit costs of current city parking employees. City policy on this issue is unclear. On the one hand, the staff report states: "Existing City parking staff, a private operator, or a combination of the two would operate the garages." (pg.8) On the other hand, the city manager has been quoted recently as saying that operation of the city's parking garages would not be outsourced to private operators.

The city council should seize upon outsourcing as an opportunity to increase city parking profits, reduce the risk of recourse to the TOT (see below) to fund shortfalls in funding bond payments and significantly reduce the risk of either a future bond default and future taps to the general fund to fund arena bond payments.

### VII. Backfilling the General Fund

City staff anticipates that using the city's current parking profits to make payments on the arena bonds will create a \$9 million annual hole in the city's general fund. The staff report states that the hole will be filled as follows:

<u>#</u>	<u>Item</u>	<u>\$</u>
1	City Parking Revenues	\$3,000,000
2	5% Ticket Surcharge	3,700,000
3	City Parking Revenues from ESC Events	625,000
4	ESC Generated Possessory Interest Tax-City	898,000
5	ESC Taxes (Sales/Utility User)-City	300,000
6	City Profit From ESC Operations	1,000,000
7	DT Plaza Garage Possessory Interest Tax	39,000
8	Investors Land Acquisition Tax	98,000
	Total	\$9,660,000

EOS has concerns with the computation of these "backfillers:"

#### Backfiller #1: City Parking Revenues - \$3 Million

It is very difficult to determine how staff arrived at this number. If staff is counting on future higher profits in parking operations, it should not be counted as a backfiller as those profits would flow into the general fund in any event, with or without an arena deal.

Is staff projecting that it will increase parking profits by \$3 million annually through capital improvements, operational efficiencies and perhaps outsourcing? Such improvements in the performance of the city's parking assets should be considered part of ongoing sound management of city assets and part of the organic growth in the general fund, not backfillers for arena financing.

Or is the \$3 million derived, not from increased parking revenues or increases in parking profits, but from issuing out arena bonds that require only interest payments in the first eight years of the 35-year term, making such payments \$3 million lower than they would be if the city were to issue standard fully amortizing 30-year revenue bonds?

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EOS has calculated that the \$23.5 million reduction in bond payments in the early years of the bond would come at an unacceptable taxpayer cost of \$80.9 million. (See "The \$3 Million Difference in Annual Bond Payments - Part of the "Backfill?," supra)

This backfill item also raises a serious concern: with the city giving away one-half of its garage parking spaces to the investors (the 3,700 parking spaces at Downtown Plaza), how in the world is the city going to service current debt payments on garage bonds, pay debt service on \$221 million plus of new arena bonds and also backfill \$3 million to the city's general fund? One analyst and author of a book on sports facilities (Field of Schemes, Neil DeMeuse) recently lampooned the city's plan as a "perpetual parking revenue machine." (www.fieldofschemes.com; March 25, 2013)

### Backfillers #2 and #3: Ticket Surcharge (5%) and Parking Revenues From ESC Events

The term sheet calls for the investors to collect and remit to the city a 5% surcharge on each ticket sold in the arena. The city also projects revenue from parking during arena events. These tax and revenue projections are highly dependent upon staff's projections of arena attendance and ticket sales. City staff have not released the ticket revenue and paid attendance projections and assumptions it is using in arriving at its estimate that the ticket surcharge would generate \$3.7 million annually in backfill to the general fund. We do not know if city staff has taken the time to update its projections and assumptions from those they used in last year's proposed arena deal. Those projections came under heavy criticism in a Beacon Economics report released last year. Who is right and who is wrong? The city and its taxpayers have a tremendous amount riding on that question. Absent an independent review of the projections, the city council and city taxpayers are taking a big risk relying on staff's revenue projections. (See "Need for Independent Review of Projections, Assumptions and Proposed Financing," infra)

Stanford professor Roger Noll has reported to us that the \$3.7 million estimate of annual tax surcharge revenue to the city is likely to be optimistic: "The 5% ticket tax will increase city revenues, but not by the full \$3.7 million. Most all of this revenue will come from city residents, who will spend less on other entertainment and recreation activities and so pay less taxes in other ways."

### Backfiller #5: ESC Taxes (Sales/Utility User) - City Share

We assume that this \$625,000 figure is a projection of the sales taxes and utilities taxes that the arena will generate. Has the staff netted out of the projected sales and utilities taxes that it will lose when Sleep Train Amphitheater is no longer in use? Has staff backed out the sales and utilities taxes that the city will lose from the loss of existing retail tenants at Downtown Plaza? We do not know and neither does the city council.

EOS caution: There is related issue that should concern the city. Several basketball arenas built in recent years include an array of interior retail. So much so, in fact, that they compete with nearby retailers doing business just outside of the arenas. Harvard

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Professor Judith Long advises that cities consider imposing limitations on the interior retail of arenas so as to provide an opportunity for nearby retailers to thrive.

### **Backfiller #6: City Profit From ESC Operations**

Under the term sheet section entitled "Operating Profit-Allocation (Waterfall)," the city is provided a sliding scale of the operating profits of the arena. It includes the following statement: "The minimum annual payment to the City shall be no less \$1,000,000." (escalated annually by CPI) The city counts this \$1 million as a general fund backfiller. But if there are no arena profits in a given year, the city would apparently not receive the \$1 million payment.

We asked Stanford professor and sports economist Roger Noll to comment on this provision. Here is his response:

"An especially nice touch is the profit sharing for the facility. There will be no profits -- if the team and the facility have common owners, the revenue flow to the facility will just be the amount to keep it operating. Thus, the city's revenue is likely to be the \$1 million minimum and no more. The total new revenue to the city is this plus some fraction of the tax on tickets. If the latter is \$3 million (probably optimistic), the total is \$4 million, which is not enough to produce a reasonable return on \$258 million." (Roger Noll's March 25, 2013 e-mail to EOS President Craig Powell, supra)

## **VIII. Need for Independent Review of Projections, Assumptions and Proposed Financing**

The failure of city staff to accurately and forthrightly portray the total amount of the public contribution to the arena, the raging dispute between city staff and Beacon Economics over the ticket revenue projections at a new arena and the very shaky and expensive financing plan for the arena bonds lead us to the inescapable conclusion that the city should commission a comprehensive, independent review of all aspects of the proposed arena deal and the city's financial plan, including a thorough review of the hastily prepared and inadequately disclosed general fund backfill assumptions of city staff.

Our concerns over the lack of independent financial review are exacerbated by the fact that the city is using Goldman Sachs and Morgan Guaranty as its financial advisors on the structuring and pricing of the arena bonds. EOS has previous provided the city council with a report on our deep concerns with the use of Goldman Sachs as the city's principal bond underwriter on major bond transactions. We are also concerned with the fact that Morgan Guaranty was the lead investor in the notoriously mishandled Chicago parking privatization debacle that has brought grief and heavy expense to Chicago taxpayers and residents. These are not the investment bankers that the city should be using on these transaction.

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Additionally, relying on investment banks for financial structuring advice when those same banks stand to profit from the city's issuance of arena bonds is unwise as the bankers have an inherent and irreconcilable conflict of interest. They have a built-in economic incentive and bias to structure high risk bond offerings as their earnings are based on bond commissions, which are always higher in riskier bond deals. With an anticipated bond interest rate of 5.5% to 5.75%, according to city staff, the proposed arena bonds clearly fall within the category of risky bonds.

### **IX. Additional Term Sheet Review**

#### Approval of Arena Designs and Plans (Page 1)

"The parties intend that the planning, design, development and construction of the ESC will be led by [the investors], which will have final decision-making authority for that process, subject to City review..." Page 3 of the term sheet says that the city shall have "meaningful input with respect to the development of the arena." Page 5 provides the city with "direct input." Such provisions cede to the investors extraordinary authority over almost every aspect of the development, design and construction of the arena, particularly since the city will actually own it.

#### Ownership (Page 2)

The term sheet provides that the investors will acquire the land under the arena and will lease it to the city for annual rent of \$1 for the 35-year term of the arena lease. At the end of 35 years, the parties agree to negotiate in good faith on the terms for a renewed land lease. Keep in mind, the city will be the owner of the arena when the lease expires. So this provision makes the city vulnerable to investor demands for sky high land lease payments after the expiration of the 35-year initial term.

According to media reports, Downtown Plaza has a complex ownership structure with four owners owning 37 discrete legal parcels of land, some of which involve mere air space in the multi-floor plaza. According to the term sheet, the investors will assemble these parcels under their ownership. There is a real risk that any one of the four owners could hold up the investors and demand a King's ransom (no pun intended) for their key parcel. Is the city prepared to seize a holdout owner's parcel(s) through its power of eminent domain? Could eminent domain judicial proceedings (condemnation) cause delays that could hold up meeting the target date of completing the new arena by 2016? It is possible.

#### Pre-Development Expenses (Page 4)

The investors and not the city will be responsible for paying pre-development expenses of the arena, a clear improvement over last year's arena deal.

#### Completion Guarantee and Cost Overruns (Page 5)

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The investors are required only to exercise "best efforts" to secure a completion guarantee from the general partner who builds the arena. That is not good enough - a completion guarantee is essential. This provision also states that the investors will provide the city with "cost-overrun protection," which is important. But the provision may do little to protect the city from the costs of needed change orders and increases in the costs of labor and materials that occur before a construction contract is signed. The city has, to our knowledge, made no provision for such higher costs in either its financing plan or its plan to backfill the city's general fund.

On the subject of project costs, the term sheet is silent on whether the project will be subject to prevailing wage laws or whether the investors will be subject to a project labor agreement (PLA). If such laws apply or the project is subjected to a PLA, construction costs will be significantly higher.

### Fast-Tracking Judicial Review Under CEQA (Page 5)

The term sheet makes it clear that the parties will seek Governor Brown's approval to fast track judicial review of any legal challenges to the project under CEQA, utilizing the mechanism established by AB900. The Governor would have to certify the project as an "environmental leadership development project." Fast-tracking would mean that any CEQA lawsuit would start in the 3rd District Court of Appeals, not in Sacramento Superior Court.

### Non-Relocation Agreement (Page 6)

The term sheet requires the investors to sign an agreement not to seek a relocation of the Kings for 35 years, which provides Sacramento will solid protection against an attempt to move the team elsewhere.

### Debt Financing of Investors' Capital Contribution (Page 8)

This provision contemplates that the investors may seek debt financing to fund their commitment to provide its \$187.9 million capital contribution. Debt financing of all or substantially all of the investors' capital contribution increases the financial risk of the arena and reduces the investors' "skin in the game."

### 5% Ticket Surcharge (Page 8)

The city's 5% ticket surcharge will not apply to the suite rentals during Kings games, reducing the revenue the city can expect from this source.

### Routine Repairs and Capital Repairs (Pages 10 and 11)

Under these provisions, the investors will be responsible for all routine repairs and all capital repairs to the arena, which provide excellent protection to the city.

### Capital Repairs Reserve Fund (Page 11)

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The investors have agreed to collect a \$1 per attendee charge and deposit the proceeds in a "capital repairs reserve fund." The term sheet leaves to future negotiations how the remaining balance in this fund is to be divided after the 35-year lease expires, leaving open the likelihood that some portion of the remaining fund will be claimed by the investors. This might create a disincentive for the investors to plough reserve funds into needed capital improvements in the latter years of the lease term since they would stand to profit from any remaining balance in the fund.

### Public Sector Suite (Page 13)

This provision is very troubling. It provides the city with one of the luxury suites in the arena, all associated suite tickets and preferential parking during all arena events. Stanford professor Roger Noll offered the following evaluating of this "perk:"

"My favorite part [of the term sheet] is a free luxury box and ten tickets to every event for the city council. The annual value of this is probably about \$50,000 for the box, \$250,000 for basketball games, and maybe another \$100,000 for the other events, for a total of \$400,000 per year. The present value of \$400,000 for 35 years using a 5% interest rate is \$8 million. So, right off the top, we might get the city's contribution down from \$258 million to \$250 million by making the city council pay when they attend events."

EOS received the following e-mail from a DMV worker which sums up likely public reaction to news of the city's luxury suite and VIP parking privileges:

"City officials should not only have to pay for their own seats, but should have to pay the ticket tax that they don't mind imposing on the general public. They should also pay for their own parking. If the public has to pay, so should city staffers and council! We are not building this arena for them and they definitely shouldn't get any perks from it!" (March 24, 2013 e-mail to Craig Powell; EOS is protecting the sender's anonymity)

EOS recommendation: Drop the city's utterly unnecessary luxury suite in exchange for a dollar-for-dollar reduction in the city's public subsidy of the arena, as professor Noll suggests.

### Natomas Land Entitlements (Page 15)

The city is agreeing to rezone the 100 acres of Natomas land it is giving to the investors to its "highest and best use." This means, essentially, that the city is committing to lifting land use controls over a very large parcel of land in Natomas. This has potentially serious long-term implications for the area and should be evaluated very carefully before committing to it.

The provision also contemplates that the investors may demolish the foundation for a major league baseball stadium that is currently in place on the parcel. This is a significant policy decision. It would throw away a key asset that would lower the future cost of attracting a major league baseball team to Sacramento. It is a decision that

should not be decided summarily without public debate in the context of an arena term sheet.

### **X. City's Opportunity Costs: What Future Projects Will the City Be Unable to Fund?**

At a city "open house" on Saturday, March 23rd, city manager John Shirey was asked by EOS whether city staff had done an analysis of the "opportunity costs" of using city parking assets to fund a new arena - those future, beneficial civic projects that will now not be affordable if the city proceeds with funding an arena deal. He failed to answer the question. He did, however, frankly acknowledge that the arena deal will preclude the city from financing a wide range of future civic projects.

What are some of these possible projects that Sacramento is giving up? Development of the city's waterfront on the Sacramento River is one, the long-delayed "Docks Project." Funding the renovation of the Sacramento Community Theater appears to be another foreclosed option (due to a pledge of TOT revenues as additional collateral to secure the arena bonds). The city is also giving up the chance to use its parking assets to finance the bulk of the remaining levee improvements in North Natomas, the key to lifting the federal government's current building moratorium that is squelching growth opportunities in that part of the city. With Congress continually balking at funding such improvements in an era of sequesters and trillion dollar budget deficits, the moratorium is likely to continue indefinitely without local civic intervention.

### **XI. Litigation and Referendum/Initiative Risks**

On March 14, 2013, two Sacramento attorneys, Patrick Soluri of the firm of Soluri Meserve and Jeffrey Anderson of the firm of Cohen Durrett, submitted an 11-page letter to assistant city manager John Dangberg that said their client, a nascent coalition of community groups and citizens opposed to a taxpayer-subsidized arena, was considering filing a legal challenge against the city. The attorneys identify a potential CEQA claim and an illegal gift-of-public funds claim, as summarized below. We have also read media reports in the Seattle press that the Seattle investors are likely to bring an action for intentional interference with contractual relations against the city and city officials if the NBA board of governors rejects the request to relocate the team to Seattle. In addition, the group STOP has promised to restart their initiative campaign to require a public vote on a publicly subsidized arena if the city council approves the proposed term sheet:

#### **The Term Sheet Is Arguably A "Project Approval" That May Require Prior CEQA Review**

The term sheet makes clear that CEQA review, in an unspecified form, will occur after the term sheet is approved. This may violate the California Environmental Quality Act ("CEQA") because approval of the term sheet may constitute "approval" of the

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arena project that necessitates prior review under CEQA. To put another way, is the city required to conduct its CEQA review prior to approving the term sheet?<sup>1</sup>

According to the regulations implementing CEQA (the “CEQA Guidelines”), “approval” means the decision by a public agency which commits the agency to a definite course of action in regard to a project intended to be carried out by any person.” (CEQA Guidelines, 15352, subd. (a).) Additionally, before conducting CEQA review, an agency must not “take any action” that significantly furthers a project “in a manner that forecloses alternatives or mitigation measures that would ordinarily be part of CEQA review of that public project.” (CEQA Guidelines, § 15004, subd. (b)(2)(B).)

The California Supreme Court has applied these principles in a case that considered whether a city “approved” a development agreement prior to performing CEQA review. (*Save Tara v. City of West Hollywood* (2008) 45 Cal.4th 116, 135). In *Save Tara*, the development agreement included language similar to the term sheet, expressly stating that the city’s approval was conditioned upon future CEQA review. The California Supreme Court was not persuaded by the express conditional language, and found that the city had committed to the project as a practical matter. The court explained:

[L]imiting approval to unconditional agreements that irrevocably vest development rights would ignore what we have previously recognized, that postponing environmental analysis can permit “bureaucratic and financial momentum” to build irresistibly behind a proposed project, “thus providing a strong incentive to ignore environmental concerns.” (*Id.* at 136.)

The court found that surrounding circumstances demonstrated that the city had committed to the project as a practical matter. The city loaned the developer “nearly half a million dollars” that was “not conditioned on CEQA compliance,” which would not need to be repaid if the project was not approved. The development agreement “significantly circumscribed” the City’s future CEQA authority. Statements by the city to other agencies, including the federal Housing and Urban Development, indicated that the city had committed to the project. Finally, the city proceeded with tenant relocation on the assumption that the project would be approved. In the opinion of the court, these surrounding circumstances negated the conditional approval language, and constituted “approval” of the project.

A more recent decision by the Sixth District Court of Appeal reached the opposite result in a case that is arguably more factually on point. (*Cedar Fair, L.P. v. City of Santa Clara* (2011) 194 Cal. App. 4th 1150, 1168.) *Cedar Fair* concerned a term sheet for public financing of the new 49ers stadium in Santa Clara. Noting that “[d]etermining on which side of the *Save Tara* line the term sheet falls is not an easy judgment call,” the court

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<sup>1</sup> The staff report claims that the term sheet is “exempt” from CEQA because it concerns “proposed business terms for future agreements.” However, the staff report does not cite any specific statutory provision, regulatory exemption or case law supporting this position.

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found that the term sheet did not constitute “approval” of the stadium project. The court distinguished Save Tara, in part, on the basis that “it is not alleged that respondents made any contractual promises to loan money to a private developer as in Save Tara, let alone a loan that can be recovered if the project is approved.” The court further found, “[T]he term sheet, even considered together with the alleged circumstances, did not preclude any alternative or mitigation measure that would ordinarily be part of CEQA review.” Ultimately, the court characterized the term sheet merely as “a commitment to continue negotiations” rather than a commitment on the underlying project.

It appears that the Sacramento arena term sheet falls somewhere between the agreements in Save Tara and Cedar Fair. While there appears to be no unconditional agreement to loan money like Save Tara, the term sheet is not merely a “commitment to continue negotiations” as in the Cedar Fair. The term sheet explains, “This Term Sheet, if approved by the City, will be submitted to the NBA” to make a decision about whether to approve an existing agreement to purchase the Kings by Seattle investors. Thus the term sheet is more than a mere agreement to negotiate; it is expressly intended to have independent legal significance in the form of reliance by a third party, namely the NBA, concerning whether to disapprove an existing agreement made by other third parties.

Cedar Fair is further distinguishable because the term sheet in that case expressly required subsequent approval by the voters. Approval by the city council could not reasonably be construed as a final approval in that instance. Here, however, there is no indication that the term sheet, or even the final agreements for the arena, would be subject to voter approval.

The term sheet also seems more similar to Save Tara because it appears to limit consideration of project alternatives. The term sheet specifies that the proposed arena location is Downtown Plaza. The “CEQA” section of the term sheet states that environmental review would include the possible adoption of a statement of overriding considerations (i.e. “balance the benefits of the ESC project against any significant environmental impacts”) as well as consideration of the no-project alternative (i.e. “determine not to proceed with the ESC project”), but the term sheet is silent as to consideration of other project alternatives – including alternate locations such as the Railyards or Natomas sites. In fact, in the “Location” section of the term sheet, it specifies that “other locations” will only be considered “by agreement.” These various provisions of the term sheet could reasonably be read together as violating CEQA Guidelines section 15004, subd. (b)(2)(B) by limiting future CEQA review of project alternatives such as the Railyards and Natomas locations.<sup>2</sup>

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<sup>2</sup> The term sheet’s silence as to consideration of project alternatives may indicate an intent to rely on a recent decision upholding an EIR that only considered the no-project alternative. (*Mount Shasta Bioregional Ecology Center v. County of Siskiyou* (2012) 210 Cal.App.4<sup>th</sup> 184. The court upheld the EIR that only considered the no-project alternative

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In summary, it appears unclear whether the term sheet would constitute an “approval” that requires prior CEQA review. While approval of the term sheet would certainly create “bureaucratic and financial momentum” for the arena and provide “a strong incentive to ignore environmental concerns,” it appears that the relevant facts put the matter somewhere between Save Tara and Cedar Fair. While a legal challenge asserting this claim would certainly have merit, it is unclear whether it would ultimately be successful.

### The Subsidy Might Constitute an Unlawful Gift of Public Funds

The proposed term sheet released by the City provides that the City will contribute \$258 million toward the arena constructing according to city staff, with the investors providing the balance of funding. The significant public subsidy may constitute an illegal gift of public funds. Article XVI, section 6, of the California Constitution prohibits the making of “gifts” of public funds. This provision renders illegal “any gift or authorize the making of any gift, of any public money or thing of value to any individual, municipal or other corporation ... .” (Ibid.) This provision has been applied to public agencies, including cities, in addition to the California Legislature. (Santa Barbara etc. Agency v. All Persons (1957) 47 Cal.2d 699, 707.)

There is no question that the City’s financial largess described in the proposed term sheet will benefit the arena developers and has obviously motivated their participation thus far in the arena project effort. And, it is true that what constitutes an adequate public purpose for expenditures that benefit private interests is a matter of legislative discretion which will not be disturbed by the courts so long as it is founded on a reasonable basis. (Redevelopment Agency of the City of San Pablo v. Shepard (1977) 75 Cal.App.3d 453, 457.) However, in order to avoid running afoul of the gift of public funds law, an appropriation of public money to private interests requires that there be “valid consideration” supporting the appropriation. (Jordan v. Department of Motor Vehicles (2002) 100 Cal.App.4th 431, 451.) Also, the governmental agency must engage in a legitimate evaluation of the project's benefits and quantify those benefits. To do otherwise subjects the governmental agency to the charge that its actions run afoul of the constitutional prohibition of gifting of public funds to private interests. (California Housing Finance Agency v. Elliot (17 Cal.3d 575, 581.)

The proposed term sheet (or the staff report for that matter) does not include any evaluation or analysis quantifying the “value” to the city of the arena project. The city will enjoy some level of economic benefit from the construction of the proposed arena.

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because the lead agency found no other alternatives were feasible given the project objectives. To the extent that the City attempts to rely on Mount *Shasta* and assert that off-site alternatives are infeasible because they do not advance the project objective to “redevelop[] the Downtown Plaza,” a reviewing court will likely find the project alternatives impermissibly narrow. The City cannot credibly argue that “redevelopment” of Downtown Plaza is a necessary project objective when the City Council voted just a year ago to approve a term sheet for an arena project in the Railyards.

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However, the staff report's conclusionary assertion that the project will "create between 2,300 and 6,500 new jobs and result in anywhere from \$380 to \$847 million in income and revenues" (page 13) may not rise to the level of legislative findings sufficient to avoid the charge of illegal gift of public funds.

Some cases have found that public subsidies for professional sports arenas do not constitute a gift of public funds, but such cases predate decades of economic studies that conclude that local agencies do not benefit from the predicted economic returns that are used to justify such subsidies. Consequently, there is some question whether the same result would occur in litigation alleging gift of public funds by the city, even under the deferential standard of review. (County of Alameda, *supra*, 16 Cal.2d at 281 (determination of public purpose "not disturbed by the courts so long as it has a reasonable basis").)

### Intentional Interference With Contractual Relations

According to news reports, the Maloofs have entered into a binding contract to sell the Kings to a Seattle investor group, subject only to a single condition precedent: approval of the relocation by the NBA board of governors. Sacramento officials, elected and appointed, are moving heaven and earth to cause this condition to fail (i.e. to persuade the NBA board of governors to turn down the request to relocate the team).

Two news media account in Seattle have mentioned that, if the NBA governing board turns down the team relocation request, the Seattle investor group is prepared to initiate litigation against Sacramento and its officials for intentional interference with contractual relations (or related torts, intentional interference with contract and intentional interference with prospective economic advantage).

EOS has not evaluated the city's potential liability under such a potential claim(s), but we do strongly advise the city council to direct the city manager to obtain a legal opinion from a respected corporate litigation law firm with experience in such matters before proceeding further in this transaction.

### STOP's Referendum and Initiative Efforts

The grassroots group Stop Taxpayers Opposed to Pork or STOP launched an initiative petition campaign last year in response to the announcement of a term sheet between the city and the Maloofs on a publicly subsidized arena in the downtown railyards. The initiative, if passed by the voters, would have required a public vote on any public subsidy of an arena. They halted their efforts once the deal with the Maloofs cratered. (Voters rejected a proposed hike in the sales tax to fund a downtown arena six years ago by a vote of 80% to 20%.)

STOP leaders have recently announced their renewed intention to launch an initiative campaign to require a public vote on any public subsidy of an arena. They have also been interviewing campaign consultants, petition gathering firms and professional fundraising consultants in recent weeks. They are also evaluating the option of pursuing a referendum of a council's decision to approve the proposed term

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sheet. Both an ordinance initiative and a referendum would require them to secure the signatures of approximately 23,000 registered city voters (10% of registered city voters, in the case of a referendum, and 20% of the number of voters who voted in the last gubernatorial election, in the case of an ordinance initiative). A referendum, which would overturn a "legislative act" of the council, would require that the requisite signatures be secured within 30 days of the effective date of the legislative act, while an initiative requires that the necessary signatures be obtained within 180 days of commencement of signature gathering.

One large unknown is the extent to which outside interests, potentially including members of the Seattle investment group, may fund STOP's efforts should the NBA board of governors decide not to approve the application to move the Kings to Seattle. We note that local Sacramento business interests funded a successful referendum campaign in the City of Anaheim two years ago after it was announced that the Maloofs were planning to relocate the Kings to that city. If STOP is successful in securing adequate funding, it is likely they will be able to qualify an initiative and may be able to qualify a referendum. There are legal uncertainties over exactly when (and even if) council approval of an arena deal arises to the level of a "legislative act" subject to reversal by voter referendum.

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