2. Planning and Development of Port Properties

- **The Port finances large development projects through private developer participation rather than issuing debt because the Port has insufficient revenue coverage to issue revenue bonds. This approach has allowed the Port to undertake large projects on the Port's property. Since the adoption of the Waterfront Land Use Plan in 1997, governing land use and development on Port property, the Port has completed or nearly completed three development projects with private developers: the China Basin Ball Park, the Pier One building, and the Ferry Building.**

- **Under the Port's agreements with private developers, the developers bear the risk of constructing large-scale projects, including retrofitting deteriorating piers or rehabilitating historic bulkhead buildings, but by guaranteeing that the developer receives a preferred return on equity, the Port shares the risk with the developer. According to the Port, the Port enters into leases that provide the developer a preferred return on equity to encourage developers to make substantial capital investments in Port property. However, because the developer receives the preferred return on equity before the Port participates in the project's income, the Port's increases its uncertainty about its financial return from these projects. In two of the Port's projects, the Port has transferred much of the risk to itself, by guaranteeing that the developer receives the preferred return on equity before the Port receives minimum annual rent, as in the Pier One lease, or by not capping the amount of the construction costs that can be used to determine the developer's equity contribution and preferred return on equity, as in the Ferry Building lease.**

- **In the lease for the Pier One building, in which the developer rehabilitated the historic building located on Pier One for use as office space, the Port guaranteed that the developer would receive an 11 percent return on equity prior to the calculation of the minimum annual rent to the Port. Because the Pier One construction costs were higher than anticipated and therefore the developer's equity contribution and preferred return on equity were higher, the actual minimum annual rent to the Port of $1.34 million is $440,000, or 24.7 percent, less than the minimum annual rent of $1.78 million originally anticipated in the lease. The Budget Analyst estimates that the net present value of the Port's revenues over the first 30 years of the lease will be reduced by $6.5 million, or approximately 14.8 percent, from the original estimate of approximately $43.9 million to $37.4 million.**

- **In the lease for the Ferry Building, in which the developer rehabilitated the historic ferry building structure for multi-purpose use, the Port did not cap the amount of the construction costs that could be used to determine the developer's equity contribution and preferred return on equity. The Port receives minimum annual rent of $1.4 million, but the developer is guaranteed an 11 percent preferred return on equity before the Port participates in the Ferry Building's surplus revenues. Because the estimated final construction costs for the Ferry Building of approximately $100 million are approximately $30.1 million, or 43 percent, more than the original estimate of $69.9 million, the developer's equity contribution will increase by an estimated $8.0 million and the developer's preferred return on equity will increase by an estimated $880,000, resulting in decreased revenues to the Port. The Budget Analyst estimates that the net present value of the Port's revenues over the first 30 years of the lease will be reduced by $3.8 million, or 9.6 percent, from the original estimate of $39.6 million to approximately $35.8 million.**

- **Under the Charter, the Port Commission has the complete and exclusive authority to manage the Port of San Francisco and to do all things it deems necessary in operating and managing Port property. The Waterfront Land Use Plan provides for a community planning process to develop the concept, goals and objectives of Port development projects, but the Port Commission has authority to make decisions regarding Port development projects, including approving the project concept and selecting the developer. However, the Port has approved two development projects, the Broadway Hotel and the Piers 27 to 31 mixed-use recreation project that did not respond to the goals and objectives developed through the community planning process, contributing to project delays. The Port Commission approved developing the Broadway Hotel as a large hotel, despite community opposition to the size of the hotel and lack of response to the Request for Proposal (RFP). The Port has had to revise the scale of the project and extend the negotiating period for 4 ½ years. The Port Commission awarded the Piers 27 to 31 mixed-use recreation project to the Mills Corporation, although the RFP evaluation conducted by Port staff and an outside consultant found the Chelsea Piers proposal more responsive to the project's goals and objectives, which were developed through the community planning process. The negotiations for this project have extended for 45 months, and the current Exclusive Right to Negotiate extends through January of 2005.**

- **The Port staff have recommended approval of two development projects, the Rincon Park Restaurants and Broadway Hotel projects, to the Port Commission despite Port staff concerns about the financial feasibility of the projects. The developer of the Rincon Park Restaurants project, which was approved by the Port Commission in 1998, later defaulted, and the Port assigned the development agreement to a new developer in 2003. The Port staff expressed concerns about the Broadway Hotel construction costs and the feasibility of the large scale hotel project when recommending approval of the developer who was selected through the RFP process in 1999. The Port Commission has approved four extensions to the timelines for negotiating the development agreement and lease with the selected developer of the Broadway Hotel project, until July of 2004.**

Planning and Implementing Development Projects

The Port adopted the Waterfront Land Use Plan in 1997, which governs the process of developing Port properties. The Waterfront Land Use Plan defined the permitted uses of the Port's property and standards for property development, as discussed in the Introduction.

The Port enters into public-private partnership for development of Port property, such as the development of the Ferry Building and Pier One building. Additionally, the Port undertakes development of its own projects, such as the construction of the Hyde Street Harbor and the Brannan Street Wharf.

The Port's Planning and Development Division is largely responsible for planning and managing the implementation of public-private partnership development projects. Planning and implementing each development project can extend over several years. Under the Waterfront Land Use Plan, the Port determines the goals and objectives of the development project through a community planning process. The Waterfront Land Use Plan requires the Port to establish community advisory groups, whose members are selected by the Port, to provide input and guidance at an early stage in the development process. The Waterfront Land Use Plan conceived that the advisory groups would participate in developing the project concept, goals and objectives.

The Port includes the goals and objectives developed through the community planning process in the Request for Proposal (RFP) to select the developer. The Port Commission approves the RFP prior to issuance, the selection of the developer through the RFP process, and the "Exclusive Right to Negotiate". Upon Port Commission approval, the Port enters into the Exclusive Right to Negotiate with the developer on the terms and conditions of the development agreement and associated lease. Once the Port and the developer have completed negotiations and reached agreement on the terms and conditions of the development agreement and associated lease, the required environmental review has been completed, and the Port Commission has approved the development agreement and associated lease, the Port submits the lease to the Board of Supervisors for approval.

The Port's development projects must comply with State and local land use, environmental, and other regulations and laws. The Port's Planning and Development Division works with the City Planning Department, the State Lands Commission, the Bay Conservation and Development Commission, and other agencies to ensure that the project meets Federal, State and local requirements.

The Port's Development Projects

Since the implementation of the Waterfront Land Use Plan in 1997, the Port has entered into exclusive negotiations, approved development agreements, or completed or nearly completed nine development projects and has completed the concept and design for a tenth project, as shown in Table 2.1.

Table 2.1

Status of the Port's Development Projects Adopted under the Waterfront Land Use Plan, 1997 to 2004

Project	Description	Status
Ball Park	Privately developed ballpark for the San Francisco Giants.	Completed in 2000
Pier One	Privately developed office building, including office space for the Port and private businesses.	Completed in 2001
Ferry Building	Privately developed mixed use project, including ground floor retail, transportation and public uses, and upper floor office and commercial use.	Substantially completed in 2002 and all tenant improvements are scheduled for completion in 2004
Rincon Park Restaurants	Two-restaurant development in Rincon Park. The Board of Supervisors approved the original ground lease in October of 2000. The developer defaulted under the original development agreement and the Port assigned the development agreement to a new developer in June of 2003.	The Board of Supervisors approved assignment of the development agreement in February of 2004.
Pier 24 Removal and Embarcadero Improvements	Removal of condemned Pier 24, funded by the Port, to create open bay water and public views to complement Rincon Park. Adjacent to Rincon Park and the former Pier 24 site, additional funding from Caltrans and the Port is being expended to replace a wall along The Embarcadero with railing to match the decorative railing to the north, along the edge of The Embarcadero.	Pier 24 substantially completed in March of 2004. The Embarcadero railing replacement construction is expected to be awarded and completed by the end of 2004.

Project	Description	Status
Piers 30 to 32 (The Cruise Terminal) and Seawall Lot 330	Privately developed cruise terminal and mixed use project, including two-berth cruise terminal, ground floor retail and restaurant, and upper floor office and entertainment use. This project also includes development of condominium housing on an adjacent seawall lot. In July of 2003, the Board of Supervisors approved the ground lease and sale of the seawall lot to the private developer for construction of condominium housing. Subsequently, the Board of Supervisors approved the exchange of the seawall lot, which was removed from the Trust, for non-Trust land of comparable value, which was placed into the Trust, to enable the sale of the seawall lot to the private developer.	The Board of Supervisors approved the lease for the Seawall Lot 330 condominium development and the Piers 30 and 32 cruise terminal development in July of 2003. Escrow on the seawall lot closed and construction on the condominiums commenced in March of 2004. Escrow on the Piers 30 to 32 (the cruise terminal) is scheduled to close in April of 2006 with the possibility to extend until April of 2008.
Pier 34 Removal	Removal of condemned Pier 34, funded by the Port, to create open Bay water as the new setting for the Bryant Street Pier (Piers 30 to 32 and James R. Herman Cruise Terminal) project, and creation of the Brannan Street Wharf public park.	Completed in 2001.
Brannan Street Wharf	Bay front urban park on the Embarcadero between Piers 30-32 and Pier 38, requiring removal of Pier 36, funded and developed by the Port of San Francisco in conjunction with the Piers 30 to 32 project.	Concept design completed. The Port is targeting an early completion of the park by 2006.
Piers 1 ½ , 3, and 5	Restoration of historic bulkhead buildings with ground floor restaurants, upper floor office, public access and a guest boat dock. The Board of Supervisors approved the ground lease in August of 2003.	The Board of Supervisors approved the lease of a multi-use development project in July of 2003. Escrow closed and construction commenced in April of 2004.
Hotel at Broadway and Embarcadero	Privately developed hotel on inland Port property.	The Port Commission approved the selection of the developer and the "exclusive right to negotiate" on August 10, 1999. The Port has extended the "exclusive right to negotiate" several times, as discussed below.

Project	Description	Status
Piers 27 to 31 Recreation Project	Mixed-use recreation development of 19-acre complex of historic piers on the Northeast Waterfront, including a Northeast Wharf Plaza, a new YMCA, Marine Sports Basin, indoor and outdoor recreation, and some office, parking, restaurants, and café.	The Port Commission approved the selection of the Mills Corporation as the developer for the project and the "exclusive right to negotiate" on April 18, 2001. The Port Commission approved a second extension of the "exclusive right to negotiate" on January 13, 2004, extending the "exclusive right to negotiate through January, 2005.
Pier 26	Rehabilitation of historic pier and bulkhead building with a museum, public access and related commercial and office uses. The Board of Supervisors adopted a resolution in March of 2003, exempting the potential lease of Pier 26 by the Port to the International Museum of Women from the competitive bidding process.	The Port has entered into an "exclusive right to negotiate" agreement with the International Museum of Women, which expires in June of 2005.
Pier 14 Public Access Pier	Creation of a public access pier atop the Downtown Ferry Terminal breakwater, extending 600 feet into the Bay, located south of the Agriculture building, funded by numerous grants and the Port.	Phase II of the construction due to be completed by June of 2004. The Port is seeking additional grant funds to complete the final phase of the project.

Source: Port of San Francisco

The Port's Planning Process and Community Advisory Groups

The Port has implemented community advisory groups to develop the goals and objectives of projects, prior to the development of the Request for Proposal (RFP). Initially, the Port set up specific advisory groups to give input to Port staff for Port-wide projects, including the Ferry Building, the Broadway Hotel, and the Cruise Terminal projects. Because different Port projects overlapped within the same areas, the Port set up standing advisory groups for each of its planning areas. According to the Port's Planning Director, the Port staff recommends and the Port Director approves the individual advisory group members based upon the special issues for the geographic planning area. In addition to providing input for development project RFPs, the Port's advisory groups also provide public input for the public planning efforts affecting various geographic waterfront planning areas. Currently, the Port has seven standing advisory groups as follows:

- The Cruise Terminal Environmental Quality Committee, which meets on an as-needed basis to discuss cruise ship-related water and air quality impacts;

- The Fisherman's Wharf Waterfront Advisory Group, which meets monthly to discuss Port property located in Fisherman's Wharf;

- The Fisherman's Wharf Environmental Quality Advisory Committee, which meets monthly to discuss water quality issues in Fisherman's Wharf and Aquatic Park;

- The Maritime Commerce Advisory Committee, which meets every other month to discuss the Port's maritime industries;

- The Northeast Waterfront Advisory Group, which meets monthly to discuss the Northeast Waterfront, between Pier 35 and the Ferry Building;

- The Pier 70 Advisory Group, which meets on an as-needed basis to discuss development of the Port property on and near Pier 70 in the Southern Waterfront;

- The Southern Waterfront Advisory Committee, which meets monthly to discuss the Port property between Pier 80 and Pier 98 on the Southern Waterfront.

For the waterfront area between Rincon Park and China Basin, the Port staff meets with the Rincon Point-South Beach Citizens Advisory Group, which was established by the Redevelopment Agency and meets monthly.

In many cases, the Port precedes the development RFP phase with a community planning process. These public planning efforts build on policies from the Waterfront Land Use Plan, and develop more specific objectives for public benefit improvement and development project opportunities. The Port has public planning processes underway or planned for Fisherman's Wharf and the Southern Waterfront. For Fisherman's Wharf, the Port and Bay Conservation and Development Commission (BCDC) have jointly managed a planning process under the direction of a joint committee of the Port and BCDC to define public open space, public access, development and uses within that portion of the Wharf under the Port and BCDC's jurisdiction. Within the Southern Waterfront, the Port has proposed two public planning processes for two areas: Pier 70, located south of Mission Bay; and Piers 90 to 94 Backlands, located on the south side of Islais Creek, east of Third Street. In March of 2004, the Port submitted a report to the Board of Supervisors laying out a planning and funding strategy for these two areas, and has requested release of Port capital funds currently on reserve by the Board of Supervisors Finance Committee to pay for the planning activities for these two projects.

The RFP for each development project should incorporate the project's goals and objectives, established by the community advisory group. The advisory groups are not directly included in the developer selection process but can participate through public hearings and testimony.

Notwithstanding the current public planning processes, the Port has worked inconsistently with the community advisory groups on development project RFPs. Although some Port projects have successfully incorporated community priorities, the Port has failed to include community priorities in the development of the RFP or the selection of the developer for two large projects: the Broadway Hotel project and the Piers 27 to 31 mixed-use recreation project. The Port's failure to incorporate the community priorities for these projects has resulted in ongoing discord about the projects and significant project delays, as discussed below.

Private Participation in the Port's Development Projects

The Port finances large development projects through private participation of the developers rather than issuing debt to finance these projects because the Port has insufficient revenue to support the issuance of revenue bonds. According to the Assistant Deputy Director for Development, the public private development projects that have been completed since 1997 have invested approximately $500 million of private funds into Port properties. Although the program of private participation has allowed the Port to develop Port properties that it could not have developed through debt financing, private participation also directs revenues away from the Port to the private developers. As discussed in Section 1, the Port does not currently have the option of financing Port development projects with revenue bonds or other forms of public financing.

Development Projects' Lease Structures

The Budget Analyst reviewed the lease structures in the leases for five of the six Port development projects in which the Board of Supervisors has approved the lease, including Pier One, the Ferry Building, Rincon Park Restaurants, Piers 1 ½ to 5, and the Piers 30 to 32 Cruise Terminal. The development of the Ball Park was not included in the review.

Under the Burton Act, which transferred jurisdiction over the Port from the State to the City and County of San Francisco, the Port can enter into long term leases of up to 66 years. The Port's leases for the Ferry Building, Cruise Terminal, and Piers 1 ½ to 5 development projects are for 66 years, including options to extend the lease, and the leases for the Pier One and Rincon Park Restaurants development projects are for 50 years, including options to extend the lease.

Under the Port's development and lease agreements, the developers finance construction and development of the property and the Port receives rental income. The Port's goal is to balance the degree of risk that the Port assumes in developing the project with the ongoing financial returns to the Port once the project is completed. According to the Port, development project characteristics include:

- The developer makes a substantial capital contribution to the project. This can include retrofitting existing piers, such as the Piers 1 ½ to 5 project, or rehabilitating existing Port buildings, such as Pier One or the Ferry Building, or constructing a new structure on Port land, such as the Rincon Park Restaurants project. The Port should bear minimal risk for the costs of developing the project.

- Once the project is completed, the developer becomes the master tenant for the property or subleases the property to another master tenant. The master tenant is then responsible for all the operational, maintenance, and repair expenses of the property, and the Port bears minimal operating responsibility or expenses.

- The Port receives income from the property, consisting of guaranteed minimum rent, plus participation in the financial success of the project. The minimum rent is generally fixed, except for the Pier One lease as discussed below, with Consumer Price Index (CPI) increases. In addition to this guaranteed minimum rent, the Port participates in the financial success of the project. This participation includes percentage or participation rent based upon the income generated by the project, and for most projects, participation as well in the net proceeds from the sale of the leasehold.

The lease structure is determined by the complexity and scale of the project and the degree of risk assumed by the developer to construct the project.

- In the Rincon Park Restaurants and the Piers 1 ½ to 5 projects, the project will have a master tenant and subtenants. The Port receives minimum rent and participates in a percentage of the rents received by the master tenant from the subtenants. The developer's construction and operating expenses are not included in the rent structure.

- For the Ferry Building, Pier One, and the Cruise Terminal development projects, which the Port considers to be large and complex developments, the lease structures provide for Port participation in the developer's profits, after certain construction expenses have been deducted. In these three leases, the developer receives a "preferred return on equity", equal to approximately 11 to 12 percent of the equity that the developer contributes to the project. The developer's equity contribution is determined by construction costs, although the lease structure may not allocate all of the construction costs in calculation of the return on equity.

The Port receives more certain income from leases in which the developer is not guaranteed a preferred return on equity, such as the leases for the Rincon Park Restaurants and Piers 1 ½ to 5 development projects. According to the Port, the Port's income from lease structures that guarantee a preferred return on equity, such as the leases for the Ferry Building, Pier One, and Piers 30 to 32 Cruise Terminal projects, is more volatile and difficult to predict. According to the Assistant Deputy Director for Development, the Port enters into these lease structures if the Port determines that it needs to grant a preferred return to a developer so that the developer is willing to undertake the greater risk inherent in large complex projects.

Lease Structures based on the Developer's Preferred Return on Equity

Decreased Port Revenues Due to Higher than Anticipated Construction Costs, Resulting in Increases in the Developer's Preferred Return on Equity

Under the lease agreements between the Port and the developers of the Ferry Building, Pier One, and the Cruise Terminal, the developer receives a preferred return on equity, equal to approximately 11 to 12 percent annually of the developer's equity contribution, which is determined by the construction costs. The developer receives the preferred return on equity prior to the Port receiving participation rent. Therefore, if construction costs are higher than anticipated, the amount of the developer's preferred return on equity will increase, resulting in lower rent revenues to the Port.

The leases for the Pier One and Ferry Building projects transfer much of the risk of higher than anticipated construction costs to the Port. Under the lease agreement for the Pier One project, the developer's preferred return on equity, based on construction costs, is deducted when calculating the amount of minimum annual rent to the Port, as discussed below. Under the lease agreement for the Ferry Building project, the developer's preferred return on equity, based on construction costs, is deducted from the calculation of participation rent payable to the Port. The lease for the Ferry Building does not cap the amount of construction costs above the guaranteed minimum rent than can be used in calculating the developer's preferred return on equity.

The lease for the Piers 30 to 32 Cruise Terminal project caps the amount of construction costs used to calculate the developer's preferred return on equity that is deducted from the Port's participation rent. Therefore, although the Port continues to bear some risk for the project's construction costs, the Port's participation rental revenues are more certain.

Impact of the Developer's Increased Preferred Return on Equity due to Higher than Anticipated Construction Costs on Minimum Annual Rent in the Pier One Lease

Under the lease agreement for the Pier One development, the minimum rent is determined by total projected rental income, less the developer's preferred return of 11 percent on equity. Although the lease estimates minimum annual rent to be $1,782,859, the lease adjusts the minimum rent if the construction costs increase or decrease. In fact, the total construction costs were approximately $54,000,000, which exceeded the original construction cost estimated of $34.5 million by $17.5 million, or 56.7 percent. The lease capped the amount of construction costs that could be claimed to calculate the return on equity at $41,804,485. Because the developer received an historic landmark tax credit of $3,238,698 for the project, the construction costs equaled $38,565,787 for purposes of calculating the minimum annual rent, as shown in Table 2.2.

Table 2.2

Calculation of the Pier One Project's Estimated and Actual Minimum annual rent to the Port over the 50-year Term of the Lease

	Estimated Minimum annual rent	Actual Minimum annual rent	Increase/ (Decrease) in Actual Rent
Total Project Construction Costs[1]	$34,511,526	$41,804,485	
Less, Historic Landmark Tax Credits		(3,239,698)	
Construction Costs for Minimum Rent Calculation	34,511,526	38,564,787	
Times, Developer's 11% Return on Equity	x 0.11	x 0.11	
	3,796,268	4,242,127	
Projected Total Rental Income[2]	5,579,127	5,583,670	
Less, Developer's Preferred Return on Equity	(3,796,268)	(4,242,127)	
Minimum annual rent	$1,782,859	$1,341,543	($441,316)

Source: San Francisco Port

[1] Although total project construction costs equaled $52,288,561, allowable total construction costs under the ground lease were $41,804,485.
[2] Due to a revision in total project square footage, the total rental income in the ground lease of $5,579,127 was revised to equal $5,583,670.

As shown in Table 2.2, the Port receives less minimum annual rent due to the increased developer's costs and preferred return on equity. The actual minimum annual rent of $1,341,543 is $441,316, or approximately 24.7 percent, less than the minimum annual rent of $1,782,859 estimated in the lease. Because the lease does not provide for Consumer Price Index (CPI) rent adjustments, the minimum annual rent remains unchanged over the 50-year term of the lease. Under the lease agreement, the Port does not receive participation rent until the sixth year of the lease. Beginning in year six, the Port receives participation rent, equal to 50 percent of the difference between actual total rental income and projected total rental income of $5,579,127, if the difference between actual and projected total income is positive.

Based on the Port's initial cash flow projections, the Budget Analyst estimates that the net present value of the Port's revenues over the first 30 years of the Pier One project will be reduced by approximately $6.5 million, or 15 percent, compared to the original revenue estimates. Because actual construction costs were more and the actual minimum annual rent is less than the estimated minimum annual rent and construction costs included in the lease, the net present value of the Port's rental revenues over the first 30 years of the Pier One project lease will be reduced from approximately $43.9 million, as originally estimated, to $37.4 million.

Reduction in the Port's Participation in the Ferry Building Project's Profits due to Increases in the Developer's Preferred Return on Equity, Resulting from Higher than Anticipated Construction Costs

Under the Ferry Building project lease, the Port receives $1,400,000 in minimum annual rent, which is adjusted by the Consumer Price Index (CPI) every five years. The Port participates in 50 percent of the project's surplus income after deducting operating expenses and other adjustments and the developer's return on equity. Under the lease agreement, the developer's return on equity equals total construction costs, less certain adjustments, including any principal balances on the developer's loans to construct the project. The lease states that the developer shall make a "best effort" to obtain a leasehold loan (or the developer's loan to construct the project) equal to at least 50 percent of the total construction costs.

Increases in construction costs or decreases in the amount of leasehold loans increase the developer's equity investment and return on equity and reduce the Port's participation rent. Therefore, the Port's revenues from the Ferry Building project are less if the developer's construction costs are high, or if the leasehold loan is low. Under the calculation of the developer's return on equity, the construction costs less the leasehold loan equal the equity investment on which the 11 percent return on equity is calculated. The Ferry Building lease agreement does not set caps on the construction costs or the amount of equity investment. As shown in Table 2.3, the Port's initial cash flow projections for the project assumed that the developer's equity investment would be approximately $18.7 million, based on construction costs of approximately $69.9 million.

Table 2.3

Calculation of the Ferry Building Developer's Estimated Preferred Return on Equity

	Estimated
Total estimated development costs	$69,899,980
Less, estimated leasehold loan (60 percent of costs)	(41,939,988)
Less, estimated historic tax credit	(9,300,000)
	$18,659,992
Times, developer's preferred return on equity	x 0.11
Annual estimated developer's preferred return on equity	$2,052,599

Source: San Francisco Port

Under the lease, the Ferry Building developer began paying minimum annual rent of $1,400,000 during the construction period in FY 2000-2001. The Port does not begin to receive participation rent, however, until six months after the "stabilization date", or the date when the Ferry Building project begins to receive a positive cash flow. Positive cash flow is determined by gross income, less operating expenses, vacancy allowances and other reserves, and the developer's preferred return on equity. Although the lease does not specify the stabilization date, the Port's initial cash flow projections assumed that the Port would begin to receive participation rent in year 3 of the lease, or 2005.

According to Port staff, the developer completed construction of the Ferry Building shell in 2002 but has not fully completed construction of the tenant improvements. Although the Port does not yet have data on the final construction costs, historic landmark tax credits, and leasehold loans, the Port believes that the construction costs may be an estimated $100 million, which is approximately $30.1 million, or 43 percent more than the initial projected construction costs of $69.9 million. Based on the Port's original cash flow assumptions, the Budget Analyst estimates that the net present value of the Port's revenues over the first 30 years of the lease will be reduced by approximately $3.8 million, or 9.6 percent, from $39.6 million, as originally estimated, to $35.8 million, due to the increased construction costs.

Caps on the Cruise Terminal Project's Construction Costs for Calculation of Participation Rent

Under the Piers 30 to 32 Cruise Terminal lease, the Port receives minimum annual rent plus participation rent in the project's surplus income. The Port receives annual construction period rent of $150,000, adjusted for inflation, and begins to receive minimum annual rent of $850,000 adjusted for inflation, upon completion of construction, or 2009. Under the lease, the Port participates in 25 percent of the project's surplus income, which equals the project's total operating income, less expenses and certain adjustments and the developer's 12 percent preferred return on equity, based on construction costs. Unlike the lease agreement for the Ferry Building project, the lease agreement for the Cruise Terminal project includes the developer's final maximum allowable construction budget at the close of escrow and prior to the commencement of construction. Consequently, the construction costs that can be used to calculate the developer's preferred return on equity are capped. Additionally, participation rent is to begin on the third anniversary of operations or approximately 2012.

Lease Structures Based on Minimum Rent and the Port's Participation in Gross Receipts

The lease agreements for the Rincon Park Restaurants and Piers 1 ½, 3, and 5 projects provide for minimum annual rent payments to the Port and the Port's participation in gross receipts. The Rincon Park Restaurants lease sets an minimum annual rent of $200,000, which is adjusted by the CPI and bases percentage rent upon the developer's gross rental receipts in excess of a breakpoint amount. Under the ground lease for the Piers 1 ½, 3, and 5 development project, the developer pays minimum annual rent to the Port of $500,000 with a CPI adjustment every five years, and percentage rent equal to 15 percent of gross receipts, if gross receipts exceed minimum annual rent. Because neither lease accounts for the developer's operating or construction costs, or preferred return on equity in calculating rent, the Port's rent revenues are more predictable, based only on the projects receipts and not on costs.

Policies on Development and the Financial Return to the Port

The Port Commission considers development projects on a case by case basis, including the financial arrangements and Port rents. The financial terms for the project are included in the Requests for Proposals (RFP) issued by the Port for each project. The Port Commission authorizes the issuance of the RFP, including the financial objectives and the key lease provisions, which vary in the degree of specificity. For example, the RFP for the Pier 1 ½, 3, and 5 project stated that the minimum annual rent would be at least $316,000 and the percentage rent would be calculated on gross receipts. The RFP for the Ferry Building project stated only that the project must provide the Port financial benefits, equal to $1.4 million annually, with cost of living adjustments and participation in future increased revenues.

The Port's development projects differ in complexity, ranging from large mixed-use projects to less complex office, retail and restaurant projects. The financial structure of these projects varies with the type of project. According to Port staff, the development agreements and leases, which are negotiated agreements, are intended to ensure the financial feasibility of the development project for the private developer as well as maximize revenues to the Port. Rent structures based on a guaranteed minimum annual rent and a percentage of gross receipts with a preferred return to the developer provide the Port with a relatively predictable outcome and represent the least risk to the Port.

According to the Port, the Port enters into lease agreements that provide the developer a preferred return on equity to encourage developers to make substantial capital investments in face of the large risks inherent in large, complex projects. Under these agreements, the Port shares some of the risks of the project's costs and income. Because the developer receives the preferred return on equity before the Port participates in the project's surplus income, the Port's financial return from the project is less certain.

The development projects are long-term agreements and the Port's revenues from these agreements contribute to the Port's operating expenses as well as maintenance and capital improvements to the Port's properties. Because the Port's financial return from development projects are a major source of funds for the Port's capital program, the financial return from these projects affect the Port's development overall.

To reduce the uncertainty in rental revenues to the Port from large development projects, the Port Commission should establish criteria for the financial return to the Port in negotiating and structuring development project leases. These lease criteria should include pre-set guaranteed minimum rent with periodic CPI adjustments, and, in leases for larger, complex projects where the developer is granted a preferred return before the Port receives participation rent, there should be caps on the developer's equity contribution for calculating the developer's preferred return on equity.

The Board of Supervisors and the Port Commission should adopt a policy to submit development negotiation term sheets for projects with development costs greater than $10 million to the Board of Supervisors for endorsement. Such a policy would allow the Board of Supervisors to consider the financial goals of the project prior to approval of the lease and would reduce uncertainty for the Port and the developers regarding the lease approval process.

Problems in Developing and Evaluating Requests for Proposals for Development Projects

The Board of Supervisors has approved leases for six Port development projects. The Budget Analyst reviewed the Port's process for developing and issuing Request for Proposals (RFP) and selecting developers for five of these projects, including the Ferry Building, Pier One, Rincon Park Restaurants, Piers 1 ½ to 5, and Piers 30 to 32 Cruise Terminal projects. The Budget Analyst also reviewed the RFP process for two development projects in which the Port Commission has approved the selection of the developer and the Exclusive Right to Negotiate, including the Broadway Hotel, and the Piers 27 to 31 mixed-use projects. The Budget Analyst found deficiencies in the RFP evaluation and developer selection process for three of the seven development projects reviewed, including the Rincon Park Restaurants, Broadway Hotel, and Piers 27 to 31 mixed-use projects.

The Port has used various procedures for different projects for evaluating Request for Proposal (RFP) responses. Generally, Port financial staff review the financial statements and other records provided by the respondents to determine if the respondents have the financial capacity to undertake the project. Port staff and outside financial consultants review the financial terms of the respondents' proposals, projecting the development project's potential cash flow and financial return to the Port.

The Port configures RFP evaluation committees in different ways. The Port has selected review committees, consisting of Port staff solely, of Port staff in conjunction with City staff from other agencies and the Mayor's Office, or with outside financial consultants. In the most recent RFP evaluations, the Port has combined Port staff review of the proposals with a review by a financial consultant.

Aggressive Expectations for Development Projects

The Port has had prolonged negotiating or development processes from the failure of projects to meet the Port's financial expectations, resulting in significant delays in Port projects. In 1998, during the economic boom in San Francisco, the Port Commission approved two development projects with aggressive financial expectations, which did not materialize. The Port's aggressive expectations for the scale or financial return of the Rincon Park Restaurants and Broadway Hotel projects contributed to significant delays in developing the project. The original developer of the Rincon Park Restaurants project defaulted under the terms of the development agreement after failing to finance the construction of the restaurant project, and the Port had to assign the development agreement and the associated ground lease to a new developer. The Port has extended the timelines for the Exclusive Right to Negotiate with the selected developer for the Broadway Hotel project and has not yet entered into a development agreement and lease because the scope of the project has had to be revised.

Problems in Evaluating the Rincon Park Restaurants Proposals

The Port received two responses to the RFP for the Rincon Park Restaurants project, which were reviewed by Port staff. According to the November 10, 1998 Port Commission minutes, Port staff reviewed the two proposals to determine their responsiveness to the RFP goals and objectives and an outside consultant reviewed the financial components of the proposals for responsiveness to the RFP criteria and financial return to the Port. Port staff reported to the Port Commission on the responsiveness of each proposal to the RFP goals and objectives. The staff reported concerns regarding specific RFP objectives for each of the respondents, although Port staff recommended and the Port Commission approved selection of Nice Ventures, Inc. for the restaurant project.

Rincon Park Restaurants project's financial feasibility

The Board of Supervisors approved the ground lease with Nice Ventures, Inc. in November of 2000. Previously during the RFP selection process, the Port staff had voiced concerns about the financial feasibility of the project.

- According to the staff report to the Port Commission, both RFP respondents were proposing high construction costs of $6 to $8 million, and supported these costs with overly optimistic sales projections, justifying this level of investment. Nice Ventures, Inc. had projected estimated annual restaurant sales of $970 per square foot, or approximately $19.4 million annually, which exceeded the appraisal estimate of $825 per square foot, or approximately $16 million annually.[1] No other Port restaurants had achieved such high sales volume in the prior twelve months.

- The staff report noted that the Nice Ventures, Inc. proposal relied primarily on debt financing of a magnitude that Nice Ventures had not previously sought. Nice Ventures proposed financing the project, with estimated construction costs of up to $8 million, with approximately 50 percent in equity commitment and subordinate debt for its equity partners, and 50 percent in conventional debt.

Nice Ventures, Inc. failed to obtain the necessary financing for the project within the time frame specified in the development agreement. The Port Commission continued to work with Nice Ventures, Inc. over the next two years, before requesting the Board of Supervisors approval to assign the development agreement and ground lease to a new developer in December of 2003.

[1] Clifford Associates prepared a report for the Port in July of 1998, appraising the proposed development site.

Problems in Developing and Evaluating the RFP for the Broadway Hotel

The Broadway Hotel development project has been delayed due to problems in developing and evaluating the RFP. Representatives of various community organizations opposed the development of a large hotel on the Broadway and Embarcadero site. Community representatives, including members of the community advisory group, expressed concern about the size of the hotel, including height and bulk and the number of rooms, during the community planning process. The Waterfront Land Use Plan had identified this location as having "high near-term revenue-generating potential for the Port", and considered that development of a hotel was preferred use for this site.

According to the October 27, 1998 Port Commission minutes, the advisory group for the Broadway Hotel development project made a number of recommendations regarding the planning and design of the hotel project that were incorporated into the RFP, including recommendations to limit the height and bulk of the project. The RFP set a minimum of 300 guestrooms. The hotel concept approved by the Port Commission for inclusion in the RFP envisioned a large-scale hotel of three to five stories and 350 to 400 rooms.

According to the October 27, 1998 Port Commission minutes, members of the Broadway Hotel advisory group and representatives of community organizations expressed concern about the use of the site for a hotel and the potential size of the hotel. According to one advisory group member, representing the Chinatown Community Development Center, although her organization accepted that the site would be used for a hotel, the organization had expected to discuss whether this would be a full-service hotel, or a small boutique hotel. However, according to the advisory group member, the type of hotel was never discussed within the advisory group, but rather "a 300-room hotel was a dictate by the Port and they were asked to accept that".

Three developers submitted responses to the RFP and based upon qualifications, the Port Commission requested that two of the three respondents submit full proposals. Only one of the two developers finally submitted a proposal. A review of Port documents regarding the Broadway Hotel development suggests that the development community considered the large hotel project on the Broadway development site to be unfeasible, presenting too many regulatory and design problems. The one respondent to the RFP, Stanford Hospitality, Inc., proposed construction of a 450-room hotel. An outside consultant, specializing in hotel projects, reviewed the Stanford proposal, rating it "C+", indicating the proposal only partially met the Port's objectives. The Port's evaluation of the financial capacity of the respondent and the feasibility of the project indicated doubts about the developer's ability to finance the project and the ability to achieve sufficient cash flow to justify the development costs. According to the August 10, 1999 Port Commission minutes, Port staff requested the right to enter into exclusive negotiations with Stanford Hospitality, Inc., indicating some concerns regarding Stanford's construction costs and the feasibility of the project.

From August of 1999 through September of 2002, the Port Commission has approved four extensions of the exclusive right to negotiate. The current extension will expire in

July of 2004. The negotiating period for development of the Broadway Hotel, therefore, has extended for nearly five years. According to the October 23, 2001, Port Commission minutes, Port staff acknowledged that the RFP issued certain sets of guidelines which conflicted with community concerns and recommendations from the Waterfront Advisory Design Advisory Group. In September of 2002, the Port Commission approved an extension of the exclusive right to negotiate to allow Stanford to redesign the hotel as a 260-room hotel, with smaller height and bulk than the Port had envisioned in the original RFP.

Strengthening the Financial Analysis of Port Development Projects

The Port needs to strengthen its analysis of the financial feasibility of the Port's development projects. The appraisal for the Rincon Park Restaurants indicated that the restaurant project would generate less revenue than projected by the developer. Although the consultant for the Broadway Hotel project stated that the large hotel project was financially viable, the poor RFP response caused Port staff to question the feasibility of the large hotel. The Port Commission needs to hold an open discussion about the financial feasibility of Port projects prior to issuing RFPs and awarding projects to developers.

The Port Commission's Lack of Responsiveness to the Community's Goals and Objectives of the Development Project

The Port Commission's determination to build a large-scale hotel on the Broadway Hotel site, despite community opposition, has contributed to delays in developing the project. These delays impact the Port's potential revenues from the currently proposed or possible alternative projects. The Port Commission has also ignored the goals and objectives developed by the community advisory group and incorporated into the RFP for the Piers 27 to 31 mixed-use recreation project by rejecting the developer that was considered to be most responsive to the RFP.

The Port Commission's Reversal of the RFP Evaluator's Recommendation for the Piers 27 to 31 Project

The Port Commission approved issuing an RFP for a mixed-use recreation project on Piers 27 to 31 in September of 1999. After two amendments to the initial RFP and discussions with the Bay Conservation and Development Commission regarding the development project, the RFP process was completed in April of 2001. The Port hired an outside consultant to review the proposals submitted by the Mills Corporation and the Chelsea Piers. The evaluator concluded overall that the Chelsea Piers proposal was "very responsive" to the RFP and that the Mills Corporation proposal was "partially responsive". According to the April 18, 2001, Port Commission minutes, Port staff was directed not to recommend a particular respondent for exclusive negotiations. Members of the Northeast Waterfront Advisory Group, which had collaborated on the RFP goals and objectives, stated that although the Port created the advisory group process, the Port Commission was not approving the development proposal that most closely responded to the RFP goals and objectives created by that process. The Port Commission authorized the Port to enter into exclusive negotiations with the Mills Corporation for the Piers 27 to 31 development project by a 3 to 2 vote.

The Port Commission has authorized two extensions to the exclusive right to negotiate with the Mills Corporation. On January 13, 2004, the Port commission authorized a twelve-month extension to the exclusive right to negotiate, through January 18, 2005, for a total of 45 months of negotiations.

Meeting the Goals and Objectives of the RFP

The Port Commission's failure to respond to community concerns about the Broadway Hotel and Piers 27 to 31 mixed-use recreation project have been costly to the Port in terms of project delays and uncertain revenues to the Port. The Port Commission also risks proceeding with development projects on the waterfront that do not meet the objectives of the community. The Port Commission should adopt policies through the public hearing process to better respond to the community's goals and objectives for Port development projects.

Conclusion

Since the adoption of the Waterfront Land Use Plan, the Port Commission has approved nine development projects on the Port's piers and seawall lots. Two of these projects, the China Basin Ball Park and the Pier One project, have been completed and the Ferry Building is nearly completed. The Board of Supervisors has approved the leases for three other projects, and construction of two of these three developments has not yet begun. The Port Commission has approved the Exclusive Right to Negotiate for three developments, two of which, the Broadway Hotel and Piers 27 to 31 mixed-use recreation development projects, have been significantly delayed. The processes for planning and developing the RFP, evaluating the RFP responses, and negotiating the terms of the development agreements has evolved over time, but the Port has continued weaknesses in developing RFPs and selecting developers based on the goals and objectives formulated by the community planning process.

The Port needs to develop policies and practices that ensure community objectives are met in planning and approving projects. The Port Commission's early determination that the Broadway Hotel site would include development of a large hotel not only impaired community input in the development of the RFP goals and objectives, but contributed to the controversy and delays that have plagued the project. The Port Commission's rejection of the developer most responsive to the RFP goals and objectives, developed through the community planning process, for the Piers 27 to 31 project has extended the controversy surrounding the project and negotiations for the development and lease agreements for 45 months.

The Port has also approved projects based on overly optimistic financial projections, such as the Broadway Hotel and Rincon Park Restaurants projects. Because the Rincon Park Restaurants developer was unable to obtain financing for the project and defaulted on the development agreement, the Port had to assign the development agreement and associated lease to a new developer. Only one developer responded to the Broadway Hotel development RFP, suggesting that the development community did not consider the large-scale development project to be financially feasible. The Port has had to work with the developer to design a hotel project that is much smaller than originally conceived, resulting in a delay of nearly five years in implementing the project. the Although the financial projections for development projects can be wrong for a variety of legitimate reasons, the Port Commission needs to develop guidelines to strengthen the analysis of the financial feasibility of Port development projects and conduct open discussions about the financial feasibility of Port projects prior to issuing RFPs and awarding projects to developers.

The Board of Supervisors should provide policy input to the Port Commission regarding the City's goals in Port development projects. The Port enters into development agreements and leases for these projects for terms up to 66 years. The financial feasibility and return to the Port, and the associated risk to the Port have a long-term impact on the Port's revenues and financial health.

Recommendations

The Board of Supervisors should:

2.1 Request the Port Commission to submit development negotiation term sheets for projects with development costs greater than $10 million to the Board of Supervisors for endorsement, and submit the development agreements to the Board of Supervisors for approval.

The Port Commission should:

2.2 Adopt policies through the public hearing process to better respond to the community's goals and objectives for Port development projects.

2.3 Establish criteria for development project lease structures, ensuring that Port is protected from unnecessary risk, including:

(a) Setting the minimum rent at a pre-determined amount with periodic CPI adjustments; and

(b) Establishing caps on construction costs or the developer's equity contribution and other methods for minimizing the Port's risk.

2.4 Develop guidelines to strengthen the analysis of the financial feasibility of Port development projects and conduct public hearings about the financial feasibility of Port projects prior to issuing RFPs and awarding projects to developers.

2.5 Adopt a policy to submit development negotiation term sheets for projects with development costs greater than $10 million to the Board of Supervisors for endorsement, which include:

(a) An analysis of the project's financial viability,

(b) The project's overall financial projections,

(c) The estimated financial return to the Port, and

(d) A summary of the project's structure to share financial risks between the Port and the private developer.

2.6 Submit development agreements for the Port's development projects to the Board of Supervisors for approval.

Costs and Benefits

The Port's public private partnership development projects are a major source of Port capital funds and revenue and contribute to the Port's ability to meet its operating and capital expenditure requirements. Implementation of these recommendations would increase accountability and reduce uncertainty in awarding, negotiating the terms and conditions, and approving development projects, thus reducing financial risks to the Port from uncertain revenues and project delays or defaults.