



## **An Eye on Sacramento Report**

**On**

## **The Arena Project and Financing Plan**

**May 18, 2014**

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## TABLE OF CONTENTS

<b>EXECUTIVE SUMMARY</b>	4
<b>LETTER FROM EOS PRESIDENT</b>	5
<b>INTRODUCTION</b>	6
<b>Democratic Processes Were Denied in Sacramento</b>	7
Constitution Enshrines Voters' Control Over Tax and Borrowing Powers	7
Voters' Rights Have Been Undermined by Judicial Decisions, Exploited by City	7
History of Voter Rejection of Arena Subsidies; Polling Data	8
Broken Campaign Promises Undermine Trust in Representative Democracy	8
Initiative Hypocrisy	8
Steinberg Bill Undermines CEQA & Eminent Domain Law, Diminishes Legislature's Legitimacy	9
The Public Interest Sacrificed to Secure Union Support of Arena Project: the PLA	10
The Role of the Media: Erosion of Public Trust in an Unbiased Local Media	10
The Failure of City Government to Focus on the Long-Term; Opportunity Costs	11
Steps Can We Take to Restore Our Control Over Our City Government	12
<b>City's Financing Plan</b>	13
Recap of Bond Terms	13
Total Amount to Be Borrowed on Arena Bonds	14
Bond Interest Costs	14
Projected 6.7% Annual Interest Rate on Arena Bonds	15
Capitalized Interest	16
Debt Service Reserve	16
Complexities and Costs Created by City's Plan to Secure Interim Financing	16
Interim Financing Could Leave a Large Hole Where Downtown Plaza Now Stands	17
Uncertain Costs of Up To \$325 Million of Interim Financing	18
The Role of the Vampire Squid: Goldman Sachs, the City's "Nonadvisor" Advisor	18
City's Last-Minute \$12 Million Loan to Kings Owners	19
Missing Issue in Negotiations: City's Rights to Naming Rights Revenues	20
<i>EOS Recommendation</i> : Independent Review of Projections, Assumptions and Financing	20

<b>Arena Bond Payments Will Be a Burden on City's Deteriorating General Fund</b>	20
Shift from Revenue Bonds to Lease Revenue Bonds Changes Funding Payments	20
Relying on Parking Profits to Fund Bond Payments is Now Misleading	21
Shift From Profits Interest & Ticket Surcharge to Lease Payments: a Good Deal?	22
The City's Optimistic Projections of Growth of Parking Profits	23
Legal Constraint on Use of Parking Profits: the Calif. Streets & Highways Code	23
Legal Constraint on Parking Meter Rate Hikes	24
Potential Consequences of Legal Challenges to Use of Parking Profits and Meter Rates	24
Major Storm Clouds on the Horizon: The Proposed 2014/2015 Budget and 5-Year Forecast	24
Risky Reliance on Hotel Tax: Analysis of City Consultant's Dubious TOT Forecast	25
(a) Background and Scope of Work of PKF Consulting's TOT Study	26
(b) Sacramento Lodging Market	27
(c) Employment Growth	28
(d) Income Growth	28
(e) The Airport	28
(f) The Convention Statistics	28
(g) Hotel Tax Summary	29
<b>A More Sensible Arena Solution</b>	
By Jean Fleury, EOS Volunteer and Report Contributor	30
<b>Review &amp; Critique of the Agreements &amp; Bond Documents</b>	32
City's Construction Change Orders	32
Solid Provisions Obligor ArenaCo to Keep Arena Up-To-Date	32
Need for Major Individual Team Owners to Personally Guarantee All Obligations	33
ArenaCo's Obligation to Pay for Municipal Services at Arena: Marginal vs. Average Costs	33
Weaknesses of the Non-Relocation Agreement	33
Disclosure Issues in the Official Statement	34

## EXECUTIVE SUMMARY

Basic notions of democracy and democratic processes fundamentally failed in Sacramento during consideration of the arena project. Through a combination of unsound judicial decisions and a city government bent on exploiting every possible loophole to avoid a public vote and public accountability, the voters of Sacramento are being denied their rights under the California constitution to vote on Sacramento's issuance of \$300 million of bonds to fund the arena project. City government leaders have turned their backs on its citizens and thumbed their noses at four decades of consistent voter opposition to a taxpayer-subsidized arena. Two councilmembers broke their campaign promises to oppose any public subsidy for an arena without voter approval.

Meanwhile, Senate Pro Tem Darryl Steinberg and the State Legislature, acting in concert with powerful unions and politically juiced crony capitalists, made a mockery of the legislative process and representative democracy, while undermining CEQA, eminent domain statutes and the rule of law by passing a special bill (SB 743) that will have as its most lasting legacy decades of traffic gridlock on I-5 and the imposition of a cost-spiking project labor agreement that is poised to rip off Sacramento and its taxpayers.

Our city government has abandoned all notions of long-range strategic planning, sober assessment of alternative public investment opportunities and all sense of fiscal prudence and caution by approving a general fund-draining, ultra expensive massive bond offering that is pre-programmed to impose its greatest burden on city finances just as the city goes off a fiscal cliff in 2019.

The media bears its share of the blame for this travesty for their failure to perform their vital role as a questioner and skeptic of the actions of government and powerful interests. Instead, too many in the media became cheerleaders of the arena project and left their critical faculties at home. An unbiased, independent media is an essential predicate to a functional democracy and far too many were AWOL this past year.

Sacramento is facing difficult times ahead as this report describes. Sacramento's triumph over nonresponsive, reckless and arrogant government will come not from government itself or media, but from Sacramento voters who must reclaim control of their own government. Our report outlines a number of actions that the average citizen can take to begin the important work of reclaiming Sacramento for its people, not its overseers.

# EYE ON SACRAMENTO

KEEPING WATCH ON LOCAL GOVERNMENT FOR SACRAMENTO'S FUTURE

May 18, 2014

Mayor Kevin Johnson and Councilmembers  
915 I Street, Fifth Floor  
Sacramento, CA 95814

Re: Eye on Sacramento Report on the Arena Project and Financing Plan

Dear Mayor Johnson and Councilmembers:

On behalf of Eye on Sacramento's board of directors, staff, volunteers and report contributors, I am pleased to present to you EOS's Report on the Arena Project and Financing Plan in advance of your May 20th city council meeting on these matters. Last year EOS provided you with our report on the term sheet between the city and the Kings owners (see "[An EOS Report on the Arena Proposal](#)," March 26, 2013).

Eye on Sacramento is a nonprofit corporation which has three functions: to be a diligent watchdog of the actions and policies of local Sacramento government, to offer smart policy solutions to challenging municipal problems, and to keep Sacramentans informed about, and engaged with, their local government.

We focus on civic matters that are of public importance, but which we perceive as not receiving adequate scrutiny by media, government or concerned citizens. In essence, we try to shed light on the darker shadows of local government, based on the wise axiom of U.S. Supreme Court Louis Brandeis that "sunlight is said to be the best disinfectant."

This report reviews policy issues involved in the arena project (i.e. denial of democratic processes, burdens on city finances, traffic impacts and site selection), as well as an analysis of the specific agreements and financial documents that collectively comprise the proposed deal. While you may choose to dismiss our policy concerns, we urge you and your advisory team to carefully consider our specific suggestions on how the documents could - and should be - modified to protect the interests of the city and its taxpayers.

Thank you for your consideration of our comments. If you have any questions, please feel free to call me at (916) 718-3030 or e-mail me at [craig@eyeonsacramento.org](mailto:craig@eyeonsacramento.org).

Sincerely,

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/S/  
Craig K. Powell, President

## INTRODUCTION

Most, but certainly not all, of the policy issues raised by the arena project have been the subject of extensive public debate over the past year. As to such issues, this report makes only passing reference. EOS's 2013 [Report](#) on the term sheet deals with several of them. Some policy issues, however, like the denial of democratic processes in Sacramento, the arena's impacts on traffic and the arena bond's burden on city finances, have not received adequate public attention and are reviewed in some detail.

With regard to the city's recently modified arena financing plan, certain significant new legal issues have arisen that have not been publicly aired, such as state law constraints on the city's plan to use parking profits to partially fund arena bond payments and the impact Proposition 26 may have on the city's plans to significantly increase hourly parking rates to increase city parking profits. Meanwhile, city manager John Shirey's recently released 2014/2015 general fund budget projects major general fund deficits in the same years when available sources of funds for arena bond payments will be at their lowest ebb.

Importantly, EOS volunteers have reviewed every page of the more than 2600 pages of agreements and legal documents that the city released to the public on Friday, May 9th, in accord with the city's 10-Day Sunshine Rule for transactions exceeding \$1 million in value.

We are mindful that few members of the public or media will undertake the task of reviewing every provision of these vital documents. Our analysis and critique of them is perhaps the only independent, third-party review that the arena project will receive.

It is our hope that the city council and senior city staff will give our comments and suggestions for changes every consideration before final approval of the arena project. Our review has been conducted with a single purpose in mind: to identify those provisions that can - and should - be modified to protect the interests of the city and its taxpayers. As the old adage warns: "the devil is in the details."

EOS is grateful to city staff for their uniform willingness to provide us documents upon request and to discuss countless aspects of the arena project over the past year. We also wish to recognize the hard work and obvious skill of the city staff members and attorneys (both in-house and outside counsel) of each of the parties who collectively bore the heavy lifting of crafting the voluminous, extremely complicated and interdependent agreements and other documents that comprise the "arena project."

We also wish to thank our EOS directors, volunteers and report contributors whose hard work and dedication made this report possible: Craig Powell, Dennis Neufeld, Jean Fleury, Bill Reany and Sarah Foster.

## **Democracy Process Were Denied in Sacramento**

### Constitution Enshrines Voters' Control Over Tax and Borrowing Powers of Government

California has been a trailblazer, beginning with reforms adopted in the Progressive Era, in recognizing that the people of California wield ultimate power and authority over their government, both state and local. In California, government has been designed to serve the people, not the other way around - or at least that's the theory. California voters have consistently protected and expanded their power to hold their government accountable through direct democracy by adopting such state constitutional powers as the initiative, the referendum and the recall. Voter control over government has been expanded further in the modern era, with the adoption of constitutional provisions that limit the power of government to incur debt without voter approval, to impose news taxes without voter consent (Prop. 13) and to rein in the excesses of representative government through the enactment of legislative term limits and redistricting reforms.

Whenever government has failed to respect limits on its powers, voters have imposed new limits on governmental power, such as the adoption of Proposition 218 which limits the power of government to impose property tax assessments without property owner approval or Proposition 26 which halts the abusive efforts of government to dodge public votes on new taxes by mischaracterizing new taxes as "fees."

In California, our representative democracy, which is perfectly sound in principle but often deficient and compromised in practice, is kept in check through a number of voter-approved direct democracy constraints on government's power to incur debt and tax citizens, which are two of the most powerful levers of governmental power.

### Voters' Rights Have Been Undermined by Judicial Decisions, Exploited by City

Regrettably, California courts have undermined the basic constitutional requirement (Cal. Constitution Article XVI, Section 18) that municipalities obtain two-thirds voter approval before issuing new bonded debt by creating a number of judicial exceptions to the general rule that bond issuances must be approved by voters. Such unsound decisions have allowed local governments to dodge voter approval requirements by issuing new debt through complex - and contorted - new instruments, such as sales/leaseback and lease revenue bonds, certificates of participation, revenue bonds - that too often allow creative lawyering and financial engineering to trump fundamental approval rights of voters.

The bond structure contemplated under last year's version of the arena financing was a revenue bond model, which has been ruled exempt from voter approval under the so-called "special fund" doctrine. The restructured arena financing plan calls for the issuance of lease revenue bonds, where the legal fictions involved are so convoluted that: (1) the Kings owners are transferring ownership of much of Downtown Plaza to the city who will, in turn, (2) lease the land to the Sacramento Public Financing Authority, a joint powers authority controlled by the city, who will, in turn, (3) sublease the land back to the city who is, in turn, (4) subsublease the land to an affiliate of the Kings owners.

The city is engaging in such legal gymnastics for a single reason: to cheat city voters out of their constitutional right to approve, by a two-thirds majority vote, the issuance of up to \$325 million of arena bonds. Instead of respecting the clear, unambiguous and consistent expression of voter intent to exercise control over local government borrowing, city leaders are engaging in the equivalent of legal jujitsu to defeat voter control over arena project borrowing.

#### History of Voter Rejection of Arena Subsidies; Polling Data

Three times over the past four decades, city and county voters have considered the imposition of taxes to finance the construction of a new arena. On each occasion voters rejected the proposal by wide margins, the latest such vote occurring in 2006 with a rejection of a half-cent sales tax hike to fund a new arena. (Arena subsidy proponents claim that such historical votes are not relevant since the current arena project does not specifically impose any "new taxes." Such arguments are specious since all new government spending is ultimately paid for by taxpayers through higher taxes, unless offsetting cuts are made to existing government spending, typically to core public services.) Similarly, a professional poll of 500 city voters conducted early last year reported that 78% of voters agreed that voters should have final approval over the use of public funds to subsidize the construction of a new arena.

Despite long established voter opposition to public subsidies for an arena, city leaders are blithely ignoring the will of the voters and arrogating to themselves and themselves alone the authority to run up as much as \$325 million of public debt to subsidize the arena project. On May 20th, the city council is poised to repeal its own existing city policy that has long called for a public vote of any public subsidy for an arena.

#### Broken Campaign Promises Undermine Trust in Representative Democracy

Two current members of the city council won election to council in campaigns in which they promised voters that they would oppose city subsidies for a new arena without a public vote. Both of those now incumbent councilmembers have since broken their campaign promises by consistently voting in favor of major arena subsidies without public approval. When politicians win election to office and fail to honor their campaign promises, trust in representative democracy breaks down. It is imperative that voters reassert ultimate control over their own government by adopting reforms that limit the opportunities elected officials have to abuse the power entrusted to them by the voters.

#### Initiative Hypocrisy

Then is also more than just a whiff of hypocrisy among councilmembers who have insisted that a strong mayor initiative (SMI), which would expand mayoral powers, should be placed before city voters out of respect for democratic rights (the SMI initiative was previously blocked from the ballot by court action), but who opposed a public vote for the arena initiative (and which was also blocked from the ballot by court action) with assertions that it's not the province of voters to second guess the city council on such matters. *Both* initiatives secured the required number of signatures to qualify for the ballot, but some councilmembers hypocritically



invoke voters' rights to advance the SMI to the ballot, but oppose such rights when it comes to voter review of city subsidies for an arena.

Anyone honestly committed to voters rights and democratic control of government would have no trouble in supporting the referral of *both* measures to the ballot, by council action if necessary. But those who support a public vote in one instance but oppose it in another are revealing themselves to be "situational democrats," committed to voters' rights only in situations in which they agree with the proposed action.

EOS has consistently spoken out in favor of placing *both* the SMI and the arena initiative before city voters, not because EOS has endorsed either measure (it has not), but because we believe that basic respect for the ultimate authority of the voters demands it.

### Steinberg Bill Undermines CEQA & Eminent Domain Law, Leads to Traffic Gridlock

The passage of special bills like the Steinberg's SB743, which benefitted a single developer in a single project, undercuts the legitimacy of, and respect for, the legislative process. When only powerful special interests receive relief from regulatory burdens that apply to everyone else, we do harm to the bedrock principle that we are nation governed by the rule of law, not men. By divesting the courts of their authority enjoin violations of the California Environmental Quality Control Act ("CEQA"), the Steinberg bill stripped Sacramentans of the essential protection of California's single most important environmental mandate. By stripping from CEQA consideration of traffic congestion impacts, the Steinberg bill is relegating Sacramentans to a future of unmitigated major and chronic freeway congestion and near gridlock on I-5 during late afternoon commute times for decades to come.

CalTrans submitted comments on the draft EIR on the arena project that made it abundantly clear that the arena project will lead to 15-minute blockages on I-5 at the J Street exit on game nights, which will gridlock already heavily congested traffic on I-5 during the afternoon commute. CalTrans also made it clear that these impacts could not be mitigated without building extremely expensive freeways improvements, such as constructing additional freeway lanes, a horrendously expensive proposition for elevated freeways located in urban centers like I-5 in downtown Sacramento, improvements that no one can afford to fund.

Instead, CalTrans recommended that the Kings owners make only minor mitigation payments, including a small contribution to the costs of studying a possible trolley car system in downtown Sacramento. The Steinberg bill will serve as midwife to the predicted traffic gridlock on I-5 which will degrade the quality of life for every commuter seeing to transit through downtown in the afternoons on game nights, as well as increase air pollution in the region as thousands of cars sit idling in stalled I-5 traffic. So much for the state legislative process protecting the welfare of the people of Sacramento. At least gridlocked Sacramento commuters will know whom to curse as they sit stuck in gridlocked I-5 traffic.

## The Public Interest Sacrificed to Secure Union Support of Arena Project: the PLA

City officials' agreement to subject the arena project to the cost-spiking provisions of a project labor agreement (PLA) in order to secure the support of labor unions was a Faustian bargain that is sacrificing the financial interests of the city and its taxpayers for the sake of obtaining the support of a narrow special interest. Only 8% of construction workers in Sacramento belong to a union, yet the prime work on the arena is being reserved for only unionized construction workers. Studies have shown that public projects that are subject to project labor agreements are typically 15% more expensive for taxpayers than those public projects built without a PLA. PLA's effectively preclude non-union contractors from bidding on projects and reduced contractor competition leads to increased costs to taxpayers. In the case of the arena project, a 15% increase in hard constructions costs equates to almost \$50 million of unnecessary additional costs to taxpayers.

## The Role of Media; Erosion of Public Trust in an Unbiased Local Media

For a democracy to function properly, media must act as independent, disinterested pursuers of the facts. In the case of print and broadcast media involvement with the arena story, coverage of the issue has too often been slanted and incomplete, too accepting of official explanations and insufficiently engaged in the elements of the story that have the greatest impact on the city and its taxpayers. This is not just EOS's view. Two former editors of the Sacramento Bee have been highly critical of the Bee's coverage of this issue. Broadcast media have been heavily engaged in the arena story, but typically lack the investigative resources to drill deeply into the issues.

The most egregious example of biased reporting in the arena story has been the issue of how large the public subsidy actually is. City staff claims that the total city subsidy would amount to \$255 million (\$223 million of cash and land parcels worth a claimed \$32 million<sup>1</sup>). But the \$255 million fails to include the value of 3,700 parking garage spaces or the value of the six digital billboard sites that the city is gifting to the Kings owners.

EOS previously estimated that the parking garage spaces have a value of approximately \$57.8 million, based on garage space valuations determined by a Walker Parking Consultants study commissioned by the city ("Market, Financial and Condition Assessment of Parking Assets," November 23, 2011). We determined that the digital billboards have a present rental value of about \$18 million, based on a comparable digital billboard deal the city entered into with Clear Channel Outdoor two years ago. We concluded that the total public subsidy amounted to more than \$330 million. The Sacramento Bee itself examined the value of these six free billboards and found that they offered Kings owners a current value of \$19 million. The city treasurer, Russ Fehr, has been quoted in the local media as saying that the city should include the value of the 3,700 parking garage spaces in the city's disclosure of the total public subsidy.

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<sup>1</sup> One of the properties being gifted to Kings owners is an undeveloped parcel currently used as a parking lot by the Crocker Art Museum. The Crocker reports clearing \$250,000 per year in profits from operating the lot. Last year, the city regained control over the parcel from the Crocker by forgiving \$7.5 million of debt the Crocker owed to the city. The city claimed that the parcel had a value of just \$390,000.

So how has local media reported the total public subsidy? By consistently reporting that the total subsidy is just \$258 million!

In other words, even in the face of a public admission by the city's most senior financial officer that the city's "official" subsidy number mistakenly omits the value of 3,700 parking garage spaces, amounting to almost one-half of the city's total garage spaces, and the Bee's finding that the billboards are worth \$19 million, local media - including even the Bee - has stuck by the "official line" on the value of the total subsidy. Such obeisance to a clear and acknowledged government misrepresentation is unconscionable.

Another failure of local media has been its lack of coverage of the fact that city leaders have failed to assert any claim to the estimated \$120 million value of naming rights to the new arena, despite coverage of the issue in the national [sporting press](#).

There's been speculation as to whether some local media have been truly independent and disinterested in their coverage of the arena story. There is no question that some local media financially benefit from Kings news coverage and, in several cases, Kings advertising dollars. The prospect of losing such advertising and coverage opportunities may or may not be affecting coverage of the story. The fact that many members of the public are actively speculating about the impact of such financial interests on the news coverage is itself corrosive of public trust in media. No good comes from a public perception that major local media is "in the tank" for the arena deal.

Erosion of public trust in established local media makes it difficult to sustain basic community cohesion and often leads to division into camps that become increasingly distrustful of one another. We see this phenomenon at work at the national level where steady erosion of the public's trust in established media has helped fuel political divisions that make consensus governance a distant memory.

One media outlet that has been diligent in drilling deeply into the arena story to report the unvarnished truth for its readers has been the Sacramento News & Review, whose coverage has been led by SNR reporters Cosmo Garvin and Nick Miller. Their reporting has been consistently thorough and reliable.

### The Failure of City Government to Focus on the Long-Term; Opportunity Costs

The Sacramento city council has too often been a temporary way station for ambitious politicians whose ultimate ambitions have been to run for higher office, typically state legislative office (three current councilmembers are currently running in the June primary for the state assembly). As a result, the council too often focuses on short-term issues instead of being meaningfully invested in the long-term consequences of its actions. For short-term oriented politicians, keeping the Kings in Sacramento, building a "state-of-the-art" arena (at least for a handful of years, when it, too, will become obsolete), creating short-term construction jobs (more specifically, union jobs to keep union backers happy) and enjoying access to the city's "public suite" at the arena is pretty much the sum total of their concerns. They blithely claim that the arena will be "transformative" and a "game changer" for downtown redevelopment and the local

and regional economies - all the while ignoring the overwhelming weight of academic and economic studies which demonstrate that such claims are baseless.

The fact that such temporary construction jobs for Sacramento residents comes at an eye-popping projected taxpayer cost of \$1,016,482 per job is not a major concern.<sup>2</sup> Nor is the fact that such debt will push the city's total debt to \$2.5 billion a major worry.<sup>3</sup> The creation of a new net \$15.4 million annual bond payment burden<sup>4</sup> on the city's general fund in the face of a looming \$41 million general fund deficit five years down the road<sup>5</sup> is merely a unpleasant blip on a distant horizon.

When city manager John Shirey admits that the city has done no assessment of alternative uses the city could make of its extremely limited general fund borrowing capacity, we have a problem. The city's failure even to consider the opportunity costs of committing up to \$325 million to an arena is deeply troubling.

What are some of the potential projects that Sacramento is giving up? Development of the city's waterfront on the Sacramento River is one, specifically the endlessly delayed "Docks Project." Funding the renovation or replacement of the Community Theater appears to be another foreclosed option as hotel tax revenues will be vacuumed up by an increasing distressed general fund approaching a fiscal cliff in 2019. While the city is poised to approve up to \$325 million of new spending on an arena, the city manager's budget for next year proposes an accrual of \$1.5 to \$2.0 million of deferred maintenance costs on city facilities, adding to an existing deferred maintenance backlog of \$37.4 million.

What does it say about our city government when it can find the money to fund a very expensive new civic amenity, but cannot find the money to pay for needed maintenance on its deteriorating existing facilities?

### Steps Can We Take to Restore Our Control Over Our City Government

What lessons can be learned from the breakdown of local democracy on the arena issue and what steps can be taken to restore it?

1. Certain local media outlets should do some serious soul-searching and recommit to basic journalistic principles of unbiased, disinterested and independent reporting. Whenever a

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<sup>2</sup> The taxpayer cost per local construction job created by the arena project was determined by taking the sum of (a) projected principal and interest payments on the arena bonds and (b) the city's valuation of the land parcels it is gifting to Kings owners and then dividing such sum by the number of construction jobs that the arena project will create for local residents, as reported in the arena project's draft environmental impact report.

<sup>3</sup> Total post-arena bond issuance city debt was determined by taking the sum of: (a) the city's total long-term liabilities of \$2.165 billion as of June 30, 2013, as reported by the city treasurer in his "[Report on City's Long-Term Liabilities](#)" dated January 28, 2014; (b) the projected accrual of \$29 million in unfunded pension liabilities in the current fiscal year; and (c) the issuance of \$300 million of arena bonds.

<sup>4</sup> The projected \$21.9 million annual bond payment, less the \$6.5 million annual arena lease payment.

<sup>5</sup> The city manager's proposed 2014/2015 general fund budget includes a [five-year budget forecast](#) that projects a general fund deficit of \$41 million by FY 2019/2020.

media outlet has a financial stake in the outcome of an issue, it should be especially diligent about installing safeguards to insulate its editorial function from its pecuniary interests.

2. Voters should support local ballot measures that ban the use of cost-spiking project labor agreements in taxpayer-funded projects and should oppose union-backed state legislative candidates who support laws that seek to coerce local government into adopting PLA's by threatening to withhold state funding from those local governments who refuse to use PLA's.

3. Voters should insist that state legislative candidates commit to a pledge to oppose all "special bills" that exempt politically juiced developers and projects from the general application of state laws such as CEQA and eminent domain statutes. Such bills are invitations to corruption and serve to reward favored crony capitalists and unions at the expense of public confidence in the rule of law.

4. Local media need to keep elected officials accountable when they break major campaign promises and voters need to send a clear message that politicians who break their campaign promises will be pay a steep price for their perfidy at the next election.

5. Perhaps most importantly, voters need to support state and local ballot measures that restore meaning to existing state constitutional limitations on local governments' power to incur debt without voter approval. The judicially created exceptions to the voter approval requirement for new debt should be repealed through such ballot measures so that never again can a local government, already facing \$2.1 billion of existing debt and crippling future budget deficits, run up a third of a billion dollars of new debt without the prior approval of the people who will have to pay that debt.

6. To restore at least some measure of long-term focus to the city decision-making, the public should support the creation of a fiscal oversight commission, comprised of unaffiliated public and private sector experts in fiscal management and long-term planning, who would be responsible for monitoring, reviewing and publicly commenting on annual budgets and all city borrowing plans.

## **The City's Arena Bond Financing Plan**

### Recap of Bond Terms

The city's plan for financing its cash contribution to the arena project has changed considerably in the past month from the financing plan announced on March 26, 2013.

First, the city has abandoned its original plan to sell revenue bonds secured, first, by the city's parking revenues and assets, second, by a pledge of its hotel tax and backed by a general fund guaranty. In its place, the city is proposes to sell, through its controlled financing joint powers agency, lease revenue bonds that involve no specific pledge of assets or revenue streams to secure the bonds, apart from annual lease revenues it is slated to receive from Sacramento Downtown Arena LLC ("Arena Co"), an affiliate of the Kings owners. In practical effect, the lease revenue bonds will be unsecured obligations of the city's general fund.

The city must raise a total of \$223.1 million to fund its cash contribution to the project. It plans to raise \$212.5 million from the sale of lease revenue bonds, \$5.6 million by tapping reserves in the city's parking enterprise fund and \$5 million from redevelopment funds set aside for future projects by David Taylor Interests (Taylor has consented to the diversion).

The basic terms of the bond financing involve a 36-year term (up from 35 years under the original plan), a 6.7% estimated annual interest rate (up from an estimated 5.5-5.75% interest rate in the original plan), the issuance of 100% taxable bonds (instead of a mix of taxable and non-taxable under the original plan), fixed annual payments of \$21.9 million (as opposed to interest-only annual payments of \$17 million for the first eight years under the prior plan, rising to \$24 million annual payments after 20 years).

One major improvement in the latest financing plan over the prior plan is that it drops the plan's to issue interest-only or only partially amortizing payments in the first 20 years of the bonds. Under the revised plan, the bonds will require fully amortizing annual payments starting in the 3rd year of the bond. That single modification should save city taxpayers more \$50 million over the life of the bonds, according to EOS estimates.

Total Amount to Be Borrowed on Arena Bonds

While the city needs only \$212.5 million cash from the arena bonds financing, it proposes to sell \$298.4 million in arena bonds, borrowing 40% more than the cash it needs to raise to fund the city's cash contribution to the arena project, an astonishing display of financing inefficiency. The proposed use of the bond proceeds is as follows:

Arena Project Funding	\$212.5 million
Debt Service Reserve	22.6
Capitalized Interest (3 years)	59.1
Fees and Other Issuance Costs	<u>4.2</u>
Total Issue	\$298.4 million

Bond Interest Costs

The bonds will require the city to make \$21.9 million annual payments for 31 years. (The bond calls for interest-only payments for the first 3 years which will be covered by a capitalized interest reserve and the final year's payment will be covered by tapping a debt service reserve, discussed below). Total payments will amount to \$713.6 million, of which \$295.4 million will be repayment of principal and \$415.2 million will be interest cost. So the city will have to pay \$2.03 in interest for every dollar it raises from the bond financing, for total payments of \$3.03 for every dollar raised from the bond sales. Such is the high cost of 36-year term taxable bond financing at 6.7% annual interest.

## Projected 6.7% Annual Interest Rate on Arena Bonds

City treasurer Russ Fehr projected last May that the arena bonds would be issued at an interest rate of between 5.5 and 5.75%. Fehr is now saying that he expects the city to pay a 6.7% interest rate on the bonds, which happens to be the *exact same interest rate* at which muni junk bonds were sold last fall by bankrupt Jefferson County (Birmingham), Alabama. [Bankrupt Jefferson County Completes \\$1.8 Billion Sale of Bonds - Bloomberg](#)

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 fact that the bonds will now be sold as fully taxable bonds explains only about .5% of the higher interest rate estimate. With an anticipated arena bond interest rate of 6.7%, it is obvious that the credit markets consider the proposed arena bonds to be high-risk investments, and close to muni junk bonds.

The Bloomberg Municipal Index reports that the current market yield on 30-year general obligation bonds issued by AAA-rated municipalities is 4.20%. The interest rate on the proposed bonds, with an expected rating of A/A-, is a very substantial 2.5% higher than the municipal bond interest rate standard.

EOS estimates that the higher interest rate on the arena bonds above the rates projected by Fehr last March will impose more \$60 million in higher costs on the city and its taxpayers, or approximately \$500 in higher costs for the typical Sacramento family over the life of the bonds, more than offsetting the projected \$50 million of savings from the shift away from interest-only payments to fully amortizing bond payments (see "Recap of Terms" above).

Last year, city treasurer Russ Fehr stated that water and sewer revenue bonds Sacramento had just 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 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 arena bonds that will now rely *solely* on the city's general fund can only further degrade the city's credit rating and raise its future borrowing costs - to the extent the city is able to further access the capital markets for additional credit after issuing \$298.4 million of arena bonds.

Another reason for the expected higher interest rate on the bonds is that, under the city's original plan, the city was to issue revenues bonds secured by a pledge of specific city revenue streams (i.e. both parking revenues and hotel tax revenues). Under the new plan, no revenue streams are pledged to secure the bonds, resulting in greater risk to investors and a higher interest rate.

As far as the reliability of Fehr's new upward estimate of the likely interest on the arena bonds, no one can ignore the fact that long-term market interest rates remain at or near historic lows. There is near unanimity of opinion among capital market observers that long-term rates will increase with further economic recovery and a corresponding withdrawal of the Federal Reserve's extraordinarily expansive monetary policy. With Fehr's prediction that the city will

not issue long-term arena bonds until sometime in calendar year 2015, it is quite likely that long-term market interest rates will be higher than they are now, requiring a higher than 6.7% interest rate to market the bonds.

Fehr claims that he has accounted for the anticipated rise in market rates by including a "1/2% contingency" in his prediction of a 6.7% interest rate on the arena bonds. The problem is that he claimed the same thing last year: that his original interest rate prediction of between 5.5% and 5.75% included an adequate "contingency" for a future rise in market rates. He was wrong then and we have no reason to believe that his latest rate prediction is any more accurate.

Apart from this latest major miss, however, Fehr has a strong track record of making accurate and conservative interest rate predictions on proposed city bond financings. We hope his prediction of the arena bond interest rate is more in line with his high career batting average on interest rate predictions, although we have our doubts.

### Capitalized Interest

The use of "capitalized interest" - the practice of borrowing more bond money to pay 100% of the interest on the bond in its first few years - adds considerably to the total amount borrowed and more dramatically increases total interest costs to taxpayers. The \$59.1 million the city plans to borrow to fund a capitalized interest reserve will cost taxpayers \$82.2 million in additional interest costs.

### Debt Service Reserve

The \$22.6 million debt service reserve is a standard feature of muni bonds. Issuers are typically required to set aside an amount equal to one-year's payment in a reserve account to provide additional security to investors. The reserve balance is then used to make the final year's payment on the bond. Since the city apparently doesn't have the cash resources to fund the debt service reserve from other sources, it must borrow more on the bond to fund it. The cost to the city of such additional borrowing? The city will pay \$31.4 million in additional interest to fund the \$22.6 million debt service reserve.

### Complexities and Costs Created by City's Plan to Secure Interim Financing

An added complexity in the redrawn financing plan is that the city now intends to fund its cash contribution in two stages, starting with an "interim financing" that would close this summer and followed up about one year later with a sale of long-term bonds, instead of immediately issuing long-term bonds, as the original plan provided.

The reason for the two-step financing is that city is facing a major conundrum. The Kings owners have expressed their intent to borrow the great bulk of the funds they need to fund their contribution to arena construction. It is unclear, at this point, whether the Kings owners are putting *any* substantial amount of their own equity funding into the arena project as they borrowed from Goldman Sachs to purchase Downtown Plaza and are now planning to borrow to fund their share of arena construction costs. Debt financing of all or substantially all of the



Kings owners' investment in the project increases the financial risk of the arena and reduces the owners' "skin in the game" (although the Kings owners have a very substantial equity stake in the team franchise).

The owners' lender is apparently unwilling to lend to the Kings owners to finance their share of the project costs unless and until the city has irreversibly funded its cash contribution to the project. The city's conundrum is that it has not yet secured clear legal title to the land underlying the Men's Macy Store, which is the subject of a pending eminent domain lawsuit initiated by the city at the behest of the Kings owners (perhaps the first instance of the city outsourcing its eminent domain power to a private party). In addition, the city expects that, following city council approval of the project, a CEQA lawsuit will be brought that will seek an injunction to halt the project from proceeding based on alleged failures to comply with CEQA (the "California Environmental Quality Act"). The city is not able to secure long-term bond financing so long as such title and environmental issues remain outstanding

So the city is proposing to secure stopgap interim financing by pursuing one of two options: (1) either selling short-term bonds and placing the bond proceeds into an escrow account until all title and CEQA issues are finally resolved, or (2) by buying a "forward commitment" from an investment bank to purchase the city's long-term bonds at some point in the future once the title and CEQA issues are resolved (expected time frame: one year). City treasurer Russ Fehr is leaning towards the "forward commitment" option, but is asking the city council to give him authority to choose either of the two options depending on which would offer "the lowest cost and least risk to the city" ([Fehr staff report](#), May 13, 2014, pg. 7).

#### Interim Financing Could Leave a Large Hole Where Downtown Plaza Now Stands

The use of two-step financing raises a number of issues, such as what happens if the city loses the CEQA litigation? The theory is that in such event the city would cancel its agreements with the Kings owners, eat the cost of the busted short-term financing and the Kings owners would have to decide whether to proceed with construction of the arena project with their own funding or walk away from the arena project entirely. The situation will be complicated by the fact that the Kings owners intend to commence arena construction this fall using construction funding provided by their own lender. There is therefore the possibility that a collapse of the city's financing could lead to a Kings owners' decision to walk away from the project, relocate the team to another city and leave the city with a large hole in what was Downtown Plaza.

The risk of a Kings walk-away is, to at least some degree, increased by the fact that the Kings owners' equity investments in the Kings and the arena project are concentrated mostly in their ownership stake in the Kings franchise (since the NBA prefers owners to invest equity rather than borrowing to purchase NBA franchises) and to a much lesser extent in the arena project, as indicated by the owners use of Goldman Sachs debt financing to purchase Downtown Plaza and their announced plan to use construction financing to fund their share of arena construction costs. If the owners serious "skin in the game" is in the franchise and not in the arena, a collapse of the city's financing could impel the owners to take the asset that is more valuable to them (the Kings franchise) and move it elsewhere.

To avoid such risks and complexities, the city should seriously consider delaying the start of construction until it is in a position to secure long-term financing for its cash contribution to the project, meaning waiting until after title and CEQA litigation is resolved to begin construction. According to announced timetables, such a change would involve a six-month delay in the commencement of construction. Since the Kings owners' current plan is to open the arena one year before the NBA-imposed 2017 deadline (and the NBA deadline is not necessarily carved in stone), such a delay should not imperil the project.

### Uncertain Costs of Up To \$325 Million of Interim Financing

Apart from the risks, we have a concern with the uncertain costs of the two-step financing plan and the profits to be reaped by the proposed funder of the city's interim financing, Goldman Sachs. The bond documents released by the city do not disclose the fees, rates or other compensation that Goldman Sachs would receive from extending short-term financing to the city, making it impossible to determine the fairness of the terms to the city and taxpayers. The proposed council resolution leaves it solely to Fehr to determine not just which option to pursue, but to set the rates, fees and compensation that Goldman Sachs will receive in connection with the short-term financing. That would be an excessive and inappropriate delegation of council power and authority. Given the longstanding entanglements of Goldman Sachs with the city, the council should require that all rates, fees and other items of Goldman Sachs compensation be specifically approved by the council prior to authorizing such financing.

We are very troubled by the proposed council resolution that would authorize Fehr to commit the city to borrowing as much as \$325 million in interim financing - \$31.6 million more than the proposed \$298.4 million face amount of the long-term bonds. Fehr's explanation for his request for the authority to secure a larger amount of interim financing is less than clear and less than satisfactory. He claims that it is needed "to ensure the recovery of forward commitment costs and interest rate movements up to the time of issuance may be accommodated." The council and the public deserve a better explanation for why the city should go \$31.6 million further into debt to Goldman Sachs.

### The Role of the Vampire Squid: Goldman Sachs, the City's "Nonadvisor" Advisor

An article by reporter Nick Miller in the most recent issue of Sacramento News & Review ("[The Vampire Squid Goes Cow Town](#)," May 15, 2014) provides a recap of Goldman Sachs unsavory history of cheating clients, as well as its multi-year role in advising the city on ways to finance a new arena. Indeed, the financial projections that describe how the city's arena financing would work were actually produced by Goldman Sachs last year in collaboration with city treasurer Russ Fehr.

Yet, now that Goldman Sachs proposes to lend the city the interim arena financing it requires, Goldman Sachs is now disingenuously claiming in the bond documents ([Bond Purchase Agreement](#), paragraph 2, page 153) that it is not an "advisor" to the city on the arena financing, to avoid triggering the application of a rule of the Municipal Securities Rulemaking Board that imposes a legal duty on municipal advisors to act in the best interest of bond issuers (Rule G-17).

For a comprehensive account of Goldman Sachs' remarkable 100-year plus track record of mistreating and financially abusing the trust of its clients, read The Partnership (Charles Ellis, Penguin Press, NY, 2008).

EOS has previously 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. This is not an investment banking firm that the city should be using on this or any other transaction.

Relying on *any* investment bank for financial structuring advice when that same bank stands to profit from the city's issuance of bonds is unwise because the bank has an inherent and irreconcilable conflict of interest. In such circumstances, a bank has a built-in economic incentive and bias to encourage municipalities to sell high risk bond offerings as bank earnings are based on underwriting commissions, and commissions are always higher in riskier bond deals. With an anticipated interest rate of 6.7%, the proposed arena bonds clearly fall within the category of risky bonds.

### City's Last-Minute \$12 Million Loan to Kings Owners

A last minute addition to the arena deal is a plan for the city, which is currently more than \$2.1 billion in debt and is facing a fiscal cliff in the next five years, to make a \$12 million loan to the Kings owners to finance the cost of permits, impact fees and entitlement fees. The city proposes to fund the loan with \$12 million it intends to draw from its self-insurance risk pool.

Frankly, we find the very concept of such a loan offensive. Why in the world is a city which is laden with debt and facing very substantial future budget deficits seriously considering a loan of \$12 million to a handful of extremely wealthy individuals who hardly need the loan? If the city's self-insurance risk pool is so flush, why aren't city officials exercising the good sense to tap the city's risk pool to fund all or part of the \$22.6 million mandatory debt service reserve on the arena bonds. Such a move would save the city and taxpayers an estimated \$31.4 million in avoided future interest costs on the bonds. (See discussion of the "Reserve Account," supra).

Ironically, at the same time as the city is tapping the risk fund to make a \$12 million loan to billionaires, the proposed city budget acknowledges that the risk fund is currently underfunded and requires a \$2 million cash allocation in next year's general fund budget, as well as \$2 million more in each of the next two years, according to the city budget director.

We also have a concern with the repayment arrangements on this loan. Under Section 2.3(c) of the Arena, Financing and Disbursement Agreement, the Kings owners apparently would have no duty to repay the \$12 million if the city fails to secure its initial financing within 150 days of council approval.

### Missing Issue in the Negotiations: City's Right to Naming Rights Revenues

In the negotiations between the city and the Kings owners to date, we have seen no mention of any discussion of how revenues from the naming rights to the arena would be divided. The term sheet is silent on the issue of division of naming rights revenues. In the

proposed Arena Management, Operations and Lease Agreement (AMOLA), we discovered Section 5.2(A) which gives to the owners of the Kings a grossly unfair 100% of the naming rights to the arena, even though the city is providing the bulk of the capital to construct the arena.

An article appearing in the [sporting press](#) in December reported that the Kings owners were shopping the rights and had set a minimum asking price of \$120 million for a 20-year naming rights deal, with annual payments of between \$6 to \$8 million per year. Harvard Professor Judith Long in her book Public/Private Partnerships in Major League Sports Facilities (2013) writes that the single most important point for a city to stand firm on in negotiating a sports facility deal with a sports franchise owner is to insist that the city retain 100% of the revenues derived for the grant of naming rights. Instead, Sacramento city officials propose to hand over all naming rights revenues to the Kings owners. Had city officials followed Professor Long's most emphatic piece of advice, the annual \$15.4 million arena bond payment shortfall would have been cut in half.

#### EOS Recommendation: Independent Review of Projections, Assumptions and Financing

As EOS recommended in its original arena report, we again urge the city to engage an independent financial firm to review all of the projections and assumptions involved in the arena project and its proposed financing. The size of the transaction and the major impact it will have on city finances for the next 36 years justifies the city taking the time and opportunity to obtain an independent third party assessment of all financial aspects of the arena project.

Our concerns with the lack of independent financial review are exacerbated by the fact that the city has been using Goldman Sachs as its principal financial advisor on the structuring and pricing of the arena bonds.

#### **Arena Bond Payments Will Be a Burden on City's Deteriorating General Fund**

##### Shift from Revenue Bonds to Lease Revenue Bonds Changes Funding of Payments

The city's restructuring of its arena financing plan included a major change in the nature of the bonds. Under the prior plan, the city planned to issue revenues bonds secured, primarily, by a direct pledge of the city's (remaining) parking assets and parking revenues and, secondarily, a pledge of the city's hotel tax. The original plan called for a back-up general fund guaranty of the revenue bonds.

Under the modified plan, the lease revenue bonds will involve no security other than a pledge of arena lease payments. The bonds will effectively become direct obligations of the city's general fund. This change *reduces* the central role that parking profits will play and makes the city's general fund the *sole* of funds for making lease revenue bond payments, net of arena lease payments received from the Kings owners.

The annual arena bond payments are slated to be \$21.9 million and the Kings owners are slated to make annual lease payments to the city, starting when the arena is completed, of \$6.5 million. The lease payments will increase by the greater of 3% per year or the annual rate of

inflation, subject to an annual 5% inflation cap. So, by the end of the 36-year arena lease term, lease payments will have risen from \$6.5 million to at least \$18 million and perhaps more if inflation exceeds 3% per year. So the city's general fund will need to cough up \$15.4 million per year to cover the funding shortfall, although that annual shortfall amount will slightly decline each year.

As noted above, interest on the arena bonds for the first three years will be covered by a capitalized interest reserve that the city will fund with additional bond borrowing. The city also plans to create and fund a modest short-term "liquidity reserve" by redirecting \$2 million from the city's hotel tax each year for three years into the new reserve, as well corralling increases in city parking profits and some minor income items from the arena itself (i.e. parking revenues from arena events at city parking facilities) for the first three years or so. The city intends to then draw down the liquidity reserve to cover the early years of the arena bond payments when the cash crunch is expected to be most severe. The reserve would, according to Fehr's forecast, increase to a peak of \$20.8 million in 2018 before dropping to just \$4.4. million in 2021.

### Relying on Parking Profits to Fund Bond Payments is Now Misleading

Unfortunately, the city treasurer's latest financial analysis still relies on an analysis of how city parking profits will serve as the primary source for funding the bond payments. But the city's parking profits, viewed in isolation, are now much less significant to the city's ability to fund the annual shortfall amount. Parking profits will no longer be pledged to pay the bonds. Because the burden of covering the annual bond payment shortfall will now falls solely on the general fund, the city's future parking profits constitute but one component of the general fund's total revenues and expenses. With this change, the future financial condition of the city's general fund *as a whole* becomes of primary concern in determining the city's ability to fund the annual \$15.4 million arena bond payment shortfall. That is not to say the performance of any single stream of revenue that flows into the general fund, such as parking profits, is not an important component of general fund performance, but parking profits have, with the shift from revenue bonds to lease revenue bonds, become just *one* factor among many, many factors that determine general fund performance.

To continue to analyze city parking profit growth potential in isolation is comparable to a grocer who is thinking about taking out a mortgage with big monthly payments to buy a new store location and seeks to rationalize his decision by pointing to anticipated growing sales in an existing product line in his store, but who fails to consider that the rest of his store's business is bleeding heavy red ink. Senior city officials and the city council must focus now on the overall performance of the general fund to assess the city's ability to fund the shortfall. And the anticipated future condition of the general fund is looking very bleak indeed (see the discussion below of "Major Storm Clouds: The Proposed 2014/2015 Budget and 5-Year Forecast" below).

While the city could, under Fehr's plan, divert hotel taxes, parking profits and other items of general fund revenue into "liquidity accounts" and can " earmark" future increases in parking profits for arena bond payments, such a practice is, in reality, a form of budgetary sleight-of-hand *since every single general fund revenue dollar "reserved" or " earmarked" for arena bond*

*payments creates imbalances in the general fund budget that must be filled either by tax hikes, spending cuts or a combination of both.*

### Shift From Profits Interest & Ticket Surcharge to Lease Payments: A Good Deal?

Under the original term sheet, the city was to receive an interest in the profits of the arena (with a \$1 million minimum profit distribution), plus the proceeds of a ticket surcharge that was expected to bring in \$3.7 million annually (based on the city's attendance projections), for total "base" cash receipts from the arena of \$4.7 million annually. Under the revised deal, the city has effectively swapped its highly variable profits interest and semi-variable ticket surcharge for a fixed annual lease payment of \$6.5 million. The \$6.5 million lease payment will be \$2.8 million higher than the "base" arena revenues the city was set to receive under the original deal. So, is the swap of interests a good or a bad deal for the city?

The swap allows the city to reduce risk to a small degree. Since the city's \$1 million minimum profit distribution was to be contractually guaranteed just like a lease payment obligation, the city's risk reduction comes from shedding its semi-variable ticket surcharge tax, which could have deviated by as much as \$1 million or even \$2 million from the projected surcharge tax receipts of \$3.7 annually, plus or minus. But if the city's attendance projections were reasonable, the deviation would have likely been no more than \$1 million annually, plus or minus.

The city gave up its interest in the arena's profits, which were described in the [term sheet](#) (pg. 6):

- 15% of first \$10 million of profits
- 30% of next \$5 million of profits
- 50% of any profits above \$15 million

So if the arena cleared a profit of, say, \$10 million per year, the city would have received a \$1.5 million profit distribution plus, presumably, \$3.7 million from the ticket surcharge tax, for a total of \$5.2 million, still \$1.3 million below the \$6.5 million the city is set to receive in lease payments under the new plan. But if arena profits amounted to \$20 million per year, the city's share would have been \$5.5 million, which, when added to \$3.7 million from the surcharge, would have generated \$8.7 million for the city or \$2.2 million more than the \$6.5 million lease payment the city will now be collecting. The equivalence point - the point at which the city's receipts would be the same under the old or new structures - would be about \$16 million in annual arena profits.

Since the Kings owners will control the books of both the team and the arena, there would have been the ever present risk of the owners shifting expenses from the team to the arena or shifting revenues from the arena to the team to "massage" (minimize) reported arena earnings to the disadvantage of the city.

Given that the city would receive higher contractually assured revenues under the lease model, particularly under worst case scenarios, and the fairly high level of profits the arena

would have to achieve to produce higher returns for the city under the original plan, it is clear that the city made a smart choice in agreeing to the swap. The new model also avoids bickering over the accuracy of the owners' accounting.

### The City's Optimistic Projections of Growth of Parking Profits

Since parking profits currently flow into the city's general fund, the future growth of the city's parking profits are, certainly, a factor in the city's ability to cover annual arena bond payment shortfalls. So let's examine the kind of parking profit growth that Fehr is forecasting. The city's parking operation - before being stripped of 3,700 parking garage spaces at Downtown Plaza - delivered about \$9 million of parking profits annually to the city's general fund. Fehr is predicting that those profits will increase \$7.5 million or 78% over the next five years to a total of \$16.5 million - even after the 3,700 parking garage spaces at Downtown Plaza are given up.

But there is a disconnect between treasurer Fehr's projection that city's parking profits will increase by \$7.5 million and the city budget director Leyne Milstein's far more modest projection that city parking "revenues and expenditures are projected to grow by approximately 1% to 2% annually for the next five years" ([City Manager's Proposed 2014/2015 General Fund Budget and Five-Year Budget Forecast](#), pg. 38, released May 8, 2014). Fehr claims that the city plans to rapidly grow parking meter profits by expanding the number, hours, rates and locations of parking meters in the city. If so, either no one told Leyne Milstein or she's not buying the projected rapid rise in parking profits.

Fehr latest [staff report](#) (May 20, 2014, pg. 10) claims that "the various measures [to hike parking profits] are not being developed merely to raise revenue for the ESC [arena]" and "have been and are being formulated by the Public Works Department over time in the initiative to "modernize" [Fehr's quotes, not mine] the Parking System and make most efficient use of this city asset." This is, to put it charitably, balderdash. The plan to aggressively increase parking profits was developed *solely* to fund the city's arena obligations. If the plan to greatly increase parking profits had originated in the Public Works Department, as Fehr claims, the city budget director would have been privy to the plan and would have included the higher projected profits in the city's five-year budget forecast.

### Legal Constraint on Use of Parking Profits: the Calif. Streets & Highways Code

The Legislature enacted a statute in 1943 which limits how profits from municipal parking may be used by local governments (Streets & Highways Code section 31827). It provides that such profits can only be used to fund a municipality's parking operations and may not be used for any other purpose (like making arena bond payments). Fehr is trying his best to portray his plan to spike parking profits as part of a Department of Public Works plan to "modernize" city parking and make it more "efficient" to try to shoehorn his arena financing plan into a state law that strictly limits the use of municipal parking profits to supporting parking operations. But the facts are clear and everyone involved in the process know them: the plan to spike city parking profits has had little to do with "modernizing" city parking or making it more "efficient" and has had everything to do with identifying a cash source for making arena bond



payments - a use of parking profits which is forbidden under Streets & Highways Code Section 21827.

It also begs the question: how has the city been legally justifying the distribution of city parking profits to its general fund for decades, since general funding spending doesn't fit within the permitted uses of parking profits under Streets & Highways Code Section 31827? Such questions are likely to get much closer scrutiny in the near future.

### Legal Constraint on Parking Meter Rate Hikes

Proposition 26 imposes limits on the amounts government can charge for certain fees, typically limiting such fees to no more than the reasonable cost of providing the service for which the fee is charged. According to Fehr, the city is planning several rounds of increases in the hourly rate charged by Sacramento parking meters, phased in over the next few years. If the hourly meter rates, however, exceeds the reasonable cost of the "service" (the service of making a street parking space available to someone for a one-hour period), then the rate may be determined unlawful under Proposition 26, which would put a major crimp in the city's plan to spike parking revenues. The city also plans to start using "dynamic pricing," deploying new smart meters to jack up the hourly rates of city meters during Kings games, for example. Since Proposition 26 generally limits fees to government's reasonable cost of providing the service, will "dynamic pricing" exceed such limits?

One of the key elements of any city plan to aggressively expand the city's parking meter program is: what effect will substantially higher hourly rates, expanded hours of operations, expanded numbers of meters and dynamic pricing of meters during high draw events have on Midtown businesses who rely upon patronage from parkers for their survival. The failure of the city to conduct a dynamic analysis of the cumulative impact of these impositions on customers and residents, many of whom may choose to shop instead at other locations where parking is free, is a critical oversight. Midtown merchants should be very concerned about such an oversight.

### Potential Consequences of Legal Challenges to Use of Parking Profits and Meter Rates

A taxpayer's suit may be brought against the city to enforce the Streets & Highways Code's restriction on the use of parking profits (as well as to challenge the legality of the city's hourly parking meter rates under Proposition 26). If such a suit succeeds in embargoing parking profits from being used to make arena bond payments, the city may have to scramble to fund the \$7.5 million annual arena bond funding shortfall through other means.

### Major Storm Clouds on the Horizon: Proposed 2014/2015 Budget and 5-Year Forecast

The city manager is projecting that the general fund will return to deficit in two years, starting with a \$2.2 million deficit in 2016, a \$12 million deficit in 2018 and by 2019, due to sharp increases in pension contributions mandated by CalPERS and the 2019 expiration of Measure U, leaping to \$41 million of red ink or what the city manager refers to as the city's coming "fiscal cliff." If higher parking profits are either not realized or are legally prevented



from being used to fund arena bond payments, the general fund deficit would likely grow to around \$53 million.

While the city manager's proposed budget reflects a small surplus in the coming fiscal year, it relies on weak government accounting rules that ignore the current costs being run up for city retiree health care costs.

Because the city hasn't been setting aside funding for retiree health care costs until very recently, the city is facing a \$470 million unfunded liability for such costs. The city is accruing \$29 million per year in such costs which are owed to city employees for services rendered in the current year, but which are not reflected in the city's general fund budget. If the current costs of providing retiree health care benefits were included, the projected \$2 million general fund surplus next year would become a \$27 million deficit, while the \$41 million projected deficit in 2019 would become a \$70 million deficit. This year, for the first time, the city manager is proposing a contribution to a trust fund for such costs as part of the annual budgeting process, but the amount of the contribution - just \$1 million - is largely symbolic. Regrettably, it's also designated as a one-time allocation, not a recurring one.

According to Fehr, the funding sources available to help cover the arena bond payment shortfall will be at their very thinnest in 2020 - the same point at which the city's budget director is projecting that the general fund will go over a fiscal cliff with a \$41 million annual deficit, making the city council's decision to approve the arena project on the terms proposed a dangerous proposition for the city and its taxpayers.

#### Risky Reliance on Hotel Tax: Analysis of the City Consultant's Dubious TOT Forecast

One of the key city revenue sources for financial ballast to arena debt obligations is its hotel tax (or transit occupancy tax or TOT). The city plans to sell \$298.4 million in lease revenue bonds to help build the arena, with an annual city debt obligation of \$21.9 million. In order to attract interest from arena bond investors, the city contracted with PKF Consulting ("PKF") to provide projections of the city's future hotel tax revenues thru fiscal year 2050/51. That 58-page report, entitled "Transient Occupancy Tax Forecast Sacramento, California," was delivered to the city treasurer on February 13, 2014.

Although the city will, on paper, commit only \$2 million of TOT revenues to a arena bond liquidity reserve fund in each of the first three years of the project's non-revenue (construction) period (ending June 30, 2017), the city's ultimate revenue stream for the project's financial protection is the general fund, to which hotel tax revenues provide an important contribution. Consequently, an analysis of the accuracy and credibility of PKF's hotel tax projections is an important component of this report.

The Hotel Tax Revenue report by PKF to the city appears, on the surface, to be a cogent, thoroughly researched, believable documentation of solid future income. But once you scrape away the well-layered consultant phraseology and obfuscatory verbiage, a façade of overly optimistic projections emerges and reveals itself as nothing more than a camouflaged collection of speculation.

EOS's analysis will scrutinize each successive section of PKF's report, including: (1) Background & Scope of Work; (2) Executive Summary; (3) Sacramento Lodging Market, and (4) Forecast of Future TOT Revenue. The report ends with projections of TOT revenues assuming, (a) no new supply of lodging rooms, and (b) a recession during fiscal years 2018/19 and 2019/2020.

(a) Background & Scope of Work of PKF Consulting's TOT Study

PKF's report begins, ". . . *the City of Sacramento is planning a major redevelopment of the Sacramento Downtown Plaza. . . A key component of this redevelopment is the relocation of the Sacramento Kings to a new arena to be built at this location. As a part of the overall financing plan for this facility, the City requires a forecast of TOT revenues generated by hotels located within the City over the term of any bond financing. Accordingly, the City has retained PKF Consulting to develop a forecast of the City's likely TOT revenues through fiscal year 2050/51, which will be used as a credit enhancement for bonds issued pursuant to the finance plan.*"

Clearly, from the very beginning of this report, as reflected in the above quote, PKF has as its assignment an implied responsibility to come up with a favorable projection of future City TOT revenues that establishes TOT revenues as a credit "credit enhancement" for arena construction bonds.

The Scope of Work appears solid, with the exception of insufficient historical TOT statistics from the city prior to fiscal year 2003. TOT data back to the proposed construction of the first convention center (early 1970s) would have provided greater depth of revenue statistics and may have discovered revenue turbulence similar to that experienced during the recent 'Great Recession' of 2008-2011.

As it is, the city's TOT revenue still fell twice during PKF's eleven-year data analysis period. It fell from \$21 million in 2007/08 to \$18.9 million in 2008/09 and further the next year to just \$17 million. And, significantly, the city's TOT revenues *have yet* to return to its \$21 million level of 2007/08. Although the Great Recession was the most severe economic contraction since the Great Depression, the earlier recessions of 1972/73, 1982, 1991 would have likely precipitated TOT revenue swings reflecting stronger historical data and, consequently, greater accuracy upon which to project future hotel tax receipts.

Also, in PKF's list of eight completed tasks for its report, it specifically referred to "City of Sacramento" or "City" six times. However, when stating its most important task, "*Reviewed the trends in historical supply growth in Sacramento as a basis for projections of long term average annual supply growth,*" the reference to "City of" is missing. Why? The answer is because PKF's estimates of future TOT revenue, *the* most important element of its report, use Sacramento MSA (Metro Statistical Area) data to boost projections rather than sticking specifically with data derived within Sacramento city boundaries. More on this later.

## (b) Sacramento Lodging Market

At the very beginning of PKF's report, their deliverance letter has a cautious tone. It states: "*Since the future performance of the Sacramento lodging market is based on estimates and assumptions that are subject to uncertainty and variation, we do not present them as results that will actually be achieved.*" PKF then couches this statement by stating their analysis, however, has been conscientiously prepared on information obtained during the course of their assignment. But one does wonder if such cautious, self-protecting language contains a not so hidden hint that Sacramento's lodging future is anything but healthy.

The report's initial focus is on the three Sacramento lodging sub-markets. They are: (1) Primary, (2) Downtown, and (3) Secondary. The Secondary Hotel Market represents 47.4% of the total market supply and generates 33.7% of total TOT revenues. The Primary Hotel Market represents 52.6% of the overall Sacramento lodging market and generates 66.3% of total TOT revenues. The Downtown Hotel Market is a subset of the Primary category and represents 48.3 % of the Primary Market and 42.4% of total TOT revenue (2012/13). Thus the Downtown Hotel Market is a key contributor to the city's TOT income.

From this concise breakdown of the three sub-markets of hotels/motels within the City's boundaries, one would expect the report to focus its analysis and projects strictly on city limit-based TOT statistics. However, after providing this intra-city TOT data, the report suddenly switches to summarizing "*the historical performance of the overall Sacramento lodging market.*" That market is the Sacramento MSA lodging area, which, quoting from the report: ". . . includes hotels both in the City and surrounding market areas." The key graph upon which PKF bases its projections is entitled: "Sacramento MSA Lodging Market, Historical and Projected Performance"

Sacramento's MSA size is considerably greater than just area encompassing Sacramento's city boundaries (see map). It is officially titled the "Sacramento-Arden-Arcade-Roseville MSA", which includes not only the City of Sacramento, but also the county, plus Placer and Yolo counties. The CBD (Central Business District) has a higher occupancy rate and revenue growth rate than those of the "Total Hotel Market" for Sacramento; PKF's report, however, focuses its projections on the data from these 2 categories, rather than on the one that more accurately reflects the TOT revenue sources noted in the 11-year historical data. What's the problem with using the Sacramento MSA, you ask? Well, it's like comparing oranges and mandarins. They are similar citrus, but not exactly the same. Projections based, in part, on hotel occupancy in Roseville cannot be as valid (and believable) as that data found from sources within the city limits.

PKF's reliance on Sacramento MSA data results in inflated TOT projections. Since those projections reach out 38-years, one can distorted the out-year projections truly are and how unreliable the TOT would be as a credit enhancement for arena bond investors.

(c) Employment Growth

In building their TOT future forecast, PKF also reviewed employment growth, income growth, airport utilization, convention statistics, and planned development projects. They then projected hotel demand and room rate growth for the primary, downtown, and secondary lodging markets for the City. Again, keep in mind the oranges versus mandarins comparison metaphor.

For employment growth data, the report uses research from the six-county Sacramento Region. The job growth rate was a meager 0.5% between August 2012 and August 2013. The report also noted two of the five largest sectors are experiencing job rate declines. Again, this is Sacramento MSA employment data, and not employment specifically related to new jobs generated within city limits.

(d) Income Growth

Income growth, as noted by PKF, helps hotels to increase room rates during times of healthy economic conditions. Again, PKF's report utilizes Sacramento MSA data, indicating income growth averaged 3% from 1995 through projected 2017. Although such Sacramento MSA data is useful, statistical averages from a six-county population cannot be counted upon to be as precise when compared to income growth for city residents. The income growth for city residents was not included in the report.

(e) The Airport

Sacramento International Airport, with its new Terminal B, has had its passenger-count challenges. PKF states, as airport utilization increases “. . . *it can be generally assumed that there would be an increase in demand for hotel rooms from business travelers, groups, and vacationers.*” However, their report shows significant shrinkage in enplanements and deplanements (departures and arrivals). In 2007 a total of 10.8 million passengers departed or landed at SIA. For 2012, the number was just 8.9 million. Through YTD September 2013, passenger volume decreased 2.9% from same period for 2012. Thus, passenger volume at SIA fails to meet the above assumption that hotel room occupancy (and thus TOT revenues) will be increasing soon.

(f) The Convention Statistics

The convention statistics section of the report focuses on actual and projected room night bookings throughout the city based on convention activity booked by the Sacramento Convention and Visitors Bureau. Room nights booked for years 2008 through 2010 ranged from 152,000 to 157,000. For 2011 and 2012 room bookings exceeded 190,000 mainly attributable to Jehovah Witness conferences at the City's convention center. Those 2014 and 2015 conferences may be booked “at another Sacramento venue located approximately seven miles from downtown,” per the report. Although some city room night bookings are expected, their exit from the Convention Center will likely drop such bookings from past numbers and have a negative impact on TOT revenues. The Bureau's future bookings, per the report, are tepid, at best.

The report also assumes that several new hotels will be built over the 38-year span of the study, with one opening by January 1, 2017 near the new arena, and others in years 2027, 2037, 2047, all with 250-room capacities. Such added room capacity enhances projected city TOT revenues. But is this assumption realistic? Is there even any planning activity now for a new hotel by the arena? None is anywhere near the developmental stage where it could be built and fully operation in just over 2.5 years. Remember Embassy Suites Hotel? It took some five years to cobble together financing and construction efforts to complete that project. Regarding the other three proposed hotels, their dates are so far into the future their construction is nothing more than distant speculation.

(g) Hotel Tax Summary

A key assumption of PKF's report is that average room rate (ADR) growth will accelerate to average over 4% for fiscal years 2014, 2015, 2016, 2017, and 2018, although the report, itself, *has no citywide data specifically reflecting average room rate growth of this magnitude*. Mathematically, when you front load your 38-year TOT revenue projections with inflated growth rates, especially with undocumented data, the remaining 30+ years of revenues magnify the TOT numbers to unrealistically bloated totals.

Also, for the remaining 33-years (2018/19 through 2050/51), without interruption, the TOT revenues are projected to increase. There is not one year of these 33-years where TOT revenue will drop, although in just the past seven years the City has experienced two years of TOT revenue contraction. It boggles statistical common sense to believe such magic-wand numbers.

Another example of similar statistical padding: the report's authors point out that the city's Primary Hotel Market, which includes the Downtown Hotel Market, averaged annually over the past 11-years a 1.5% growth rate in TOT revenues. The Primary Hotel Market generates 66.3% of the City's TOT revenues. The Secondary Market generates 33.7% of TOT income. Over the same 11-years its TOT growth rate was 3.0%. When you weight-average these two markets, you get a cumulative 2.0% TOT growth rate. These numbers are the best reflection of the City's historical TOT statistics. But did PKF use 2.0% as its benchmark for future TOT revenue projections? No. It, in effect, comingled Sacramento MSA data into its calculations so they would reflect higher future TOT estimates. Lesson: be sure the data-oranges are not compared with data-mandarins.

Consequently, the report's TOT revenue projections are riddled with statistical inconsistencies and subterfuge.

In summary, the PKF report is a well masqueraded effort at revenue projection fiction that is clearly revealed with modest analytical probing. This is not a confidence-building report. It appears to have been written to provide political and legal cover for a difficult to finance arena project, so that bond issuances, backed by the city's general fund, can go forward.

## **A More Sensible Arena Solution: Develop Mixed Use Retail & Market Rate Residential Housing at Downtown Plaza Site and Build New Arena in Natomas**

By Jean Fleury, EOS Volunteer and Report Contributor

I applaud the Kings owners for stepping up to keep the Kings here in Sacramento. The city has a fan base that has been extraordinarily loyal and has stuck with the team through good times and bad. Unfortunately, the last few years have been less than stellar with the team's poor basketball performance, the maneuvering of the previous owners to try to move the team to other cities, and a city hit hard by the Great Recession. But that is past now and what is needed going forward is an arena plan that protects the city so that both it and the team's owners can flourish.

I am not against keeping the Kings in Sacramento or building a new arena. But I seriously question any plan that will put taxpayers on the hook for arena subsidies that could lead to future cuts in needed city programs and services and jeopardize the city's ability to meet its long-term financial commitments. I also question any plan that raises the risk of a future tax increase to cover arena bond payments should the income from the arena, and taxes from the associated development, not be sufficient to fund such payments. Arena bond obligations also reduce the city's ability to secure financing on future **necessary** undertakings or infrastructure improvements. I do not think that the current arena plan is the best solution. I believe that the city, already in a precarious financial condition, is taking on too much debt which could put it in serious financial jeopardy, particularly in the event of another economic downturn.

I believe that the city should choose a different course of action on the arena. It should encourage the Kings owners to construct a new mixed use retail and market-rate residential project to replace Downtown Plaza, owned and operated by the Kings owners, and it encourage them to construct a new arena on the city land in Natomas. The Kings owners have a mall expert on their ownership team, Mark Friedman. The city's unjustified and unquestioned faith in the belief that downtown arenas are saviors for struggling city cores has fogged its judgment. There are numerous excellent studies that show that sports facilities are not the catalysts of urban renewal and can often exacerbate them. While many arena advocates may think that the downtown arena is the answer, the plan it has chosen is not the best strategy for economic success.

What many arena supporters do not know, or do not wish to acknowledge, is that sports facilities are largely redistributors of discretionary spending income, drawing consumer dollars from some businesses to others. The net new economic activity of an NBA arena has been estimated by one economist as about one-half of the growth impact of a big-box retail store. And the many stars who perform at the ESC will take their paychecks with them when they leave. They will, by and large, not be spending it in our area. The same is true of team owners who live and operate businesses elsewhere, and players who may only live here part-time. Much of the revenue generated by the arena will leave town and be spent elsewhere.

An arena is a depreciating asset that will have a short beneficial lifespan before it will need replacement or major renovations. An NBA arena's average lifespan is 18-20 years before the NBA, and team owners, start crying that the "arena is inadequate and obsolete," and demand

a massive makeover---or a brand-spanking new one with all the latest bells and whistles. If they don't get it, the team will threaten to leave town, regardless of contractual obligations.

Downtown sports facilities are only part-time operations on valuable central city land that could be used for mixed retail and residential development that will be utilized many more hours a day, every day of the year.

SACOG has estimated that the Sacramento region will have 900,000 more new residents by 2035, a mere 21 years away. Many of them will live and work downtown. A mixed use retail and market rate housing project at the Downtown Plaza location will increase the number of people living in the city core and reduce regional commuting. And the more hours per day that a business or other venue is open, the more the traffic to it will be spread throughout the day, lessening peak-hour traffic congestion. The arena does not meet that criterion; a mixed use retail and market-rate residential project would. An arena would be open only a handful of hours per week; a mixed use retail/residential project would be open many hours a day for nearly 365 days a year. During the hours the arena is active, traffic will be concentrated on streets, intersections and freeway on/off ramps during peak traffic hours. Many of these streets, freeway ramps and intersections are already deemed to be significantly impacted according to the ESC environmental impact report (EIR). A downtown arena will only exacerbate both traffic congestion and air pollution.

The Kings own the mall site. They have a world-famous architectural firm that could design a world-class mixed use development that, if done right, could be highly profitable. An imaginative, well-designed retail/residential facility could be a significant economic stimulus. The contemplated retail surrounding the proposed arena would not bring as many shoppers or other business patrons as would a large scale, mixed use retail/residential development would. As a matter-of-fact, a downtown arena will discourage many shoppers from patronizing nearby retail and other businesses because of the traffic congestion, crowds and parking issues it will create during its active hours. And the types of businesses it will attract are likely to be "arena-centric," meaning that when the arena is open, they may flourish, but when the arena is not in use, they may suffer.

A new arena should be located in Natomas, on the city-owned 100-acre parcel. The existing arena site is only 5 miles and a 10-minute drive from Downtown. This would also prevent years of lost economic activity in Natomas. There is ample parking. The arena parking in Natomas can be used to help finance a new arena at that location. Most of the needed infrastructure is already in place, including the sewers able to handle thousands of half-time flushes. An EIR should be fairly simple because the land use would remain the same. There is enough land for a professional soccer facility next door that could pay the city a lease payment for use of the land and share parking with the arena. Putting the soccer stadium in Natomas next to the arena should be the goal.

The existing arena design could still be used. It is not too late to make changes to the design so that it will fit the Natomas site. And it should be designed to be above the flood plain so that it would not be damaged in case of a flood. It would not have to wait for the rescinding of FEMA's de facto building moratorium. And it could serve as an area of refuge for Natomas

residents who may need to vacate their homes in case of a levee break or overtopping, or other emergency, as the Superdome in New Orleans served during Hurricane Katrina.

Another plus for an arena in Natomas is that it would be much more visible and more impressive than at the Downtown Plaza site. It could be viewed from all sides to great advantage and have more landscaping around it for more green, shaded areas. An arena at the Downtown Plaza site will have limited visibility as it will be surrounded by buildings on three sides. It will really only be fully visible as one is driving or walking down L Street.

But one of the best reasons for an arena on the city land in Natomas is that there is enough land to build a new arena when this one currently on the drawing boards is obsolete. A large area of land can be preserved for the future use. It could serve as a RV park in the meantime so that out-of-town visitors and performers, many whom travel in RV's, could park near the arena. Visitors could spend a day or two in Sacramento checking out the sights. Being able to park an RV near the arena would encourage more people from out-of-town to attend events if they do not have to pay big hotel room prices and can even cook in their RV's. And the city could generate revenue from renting spaces. As it stands now, when a downtown arena needs to be replaced, the city may need to buy more land for it elsewhere. Land will likely be much more expensive then. And who will pay for new land and for a new arena? If the Kings or the NBA demands a new arena sometime in the next 36 years, before the debt on this arena is paid off, there will be no city money for it.

The location of a new arena in Natomas and the development of a mixed used retail and market-rate residential project at the Downtown Plaza site is a far better economic and environmental solution to the arena issue. Its needs to be more closely explored before this project proceeds further.

## **Review and Critique of Agreements & Bond Documents**

### City's Construction Change Orders

The Arena Design and Construction Agreement provides the city with excellent protection from project cost overruns and the costs of change orders, other than change orders requested by the city itself. Given the importance of a cap on the city's costs for the arena project, we encourage the city to adopt a policy of requiring council approval of all city change orders, including full costing and a financing plan that calls for 100% payment of change order costs in the current fiscal year to avoid running up additional year-over-year city debt on the arena project.

### Solid Provisions Obligating ArenaCo to Keep Arena Up-To-Date

Section 4.3 (G) of the Arena Management, Operating and Lease Agreement ("AMOLA") requires ArenaCo to act with diligence, at its sole expense, to make all additions and capital repairs "to insure that the level of amenities and technology at the Arena is above the median level (i.e. in the top half) of the other arenas in the U.S. that serve as home arenas for NBA



teams." This provision provides the city with excellent contractual assurance that ArenaCo. will keep the arena up-to-date.

#### Need for Major Individual Team Owners to Personally Guarantee All Obligations

The Kings owners have elected to create almost a half dozen new affiliated legal entities to compartmentalize their ownership and operation of the team, the arena and the land parcels the city is giving to them. The financial condition of ArenaCo and TeamCo, in particular, are of major concern to the city as these are the key entities with major contractual obligations to the city. The Kings owners will manager inter-company accounting between each affiliate entity and, therefore, in a position to rearrange and even manipulate the financial condition of these entities. The city needs the assurance that an insolvency or bankruptcy of either of these two entities will have the least possible impact on the city's rights and financial interests.

The single best way to assure that the city receives the performance it is due under the deal documents is to insist that the major/principal individual Kings owners sign personal guaranties that guarantee that each Kings affiliate performs it obligations to the city under all agreements. Without such guaranties, a bankruptcy filing by one of more of the Kings affiliates could leave the city without meaningful recourse or remedy for contract breaches.

#### ArenaCo's Obligation to Pay for Municipal Services at Arena: Marginal vs. Average Costs

Under Section 4.7 of the AMOLA, Arena is obligated to pay only the city's marginal cost of municipal services it receives from the city, instead of being required to pay a fair share of the cities fixed costs of delivering services, as every other customer of city municipal services must pay. Section 4.7 should be modified to required payment of the city's prevailing rates for municipal services so that Sacramento residents do not pick up the burden of ArenaCo's fair share of the city's fixed costs.

#### Weaknesses of the Non-Relocation Agreement

Currently, only the city and TeamCo are parties to the Non-Relocation Agreement ("NRA"). All affiliate entities of the Kings owners and the major/principal individual Kings owners should be made parties to the NRA to assure that each entity and individual commits to be bound by promises not to relocate the Kings during the 35-year term of the lease.

Additionally, the city and the public should be aware that these agreement are sometimes heavily litigated and that a future bankruptcy of TeamCo. could result in its obligations under the NRA being rejected as an "executory contract" in a bankruptcy proceeding, which might free TeamCo from its promise not to relocate the team. NRA's are sometimes also challenged as a violation of federal antitrust laws. The NBA does not enjoy the sort of exemption from federal antitrust law that Major League Baseball has long enjoyed.

The NRA also includes a stiff stand-by liquidated damages clause that seeks to impose huge financial liability on TeamCo if it breaches the NRA (\$580 million from the outset) and moves the team. The liquidated damages clause seeks to impose a major disincentive to TeamCo

to breach the NRA. But without personal guaranties by the Kings owners of TeamCo's obligations under the NRA, the owners may be able to dodge the burden of the liquidated damages by putting TeamCo through a strategic bankruptcy proceeding. Additionally, the huge size of the liquidated damages award may subject the clause to attack as an unreasonable amount.

We urge the city to also insist that TeamCo grant to the city a security interest in its ownership of the Kings franchise to secure TeamCo's obligations under the NRA, perfected by the filing of a UCC-1 Financing Statement with both the California Secretary of State and the NBA. That way, if TeamCo. seeks to dodge its obligation under the NRA via bankruptcy or otherwise, the city could foreclose on its security interest in the Kings franchise to secure recovery of the large liquidates damages award.

#### Disclosure Issues in the Official Statement

We have a few issues with the contents of the draft Official Statement, which is the city's principal disclosure document to assure compliance with the requirements of the federal securities laws. We will seek to discuss such issues privately with the city treasurer and/or the city attorney.