



Legislation Details (With Text)

File #:	2018-0552	Version:	1	Name:	
Type:	Action Item	Status:		Agenda Ready	
File created:	12/3/2018	In control:		Board of Port Commissioners	
On agenda:	12/11/2018	Final action:			
Title:	PRESENTATION ON THE ECONOMIC CONSIDERATIONS RELATED TO TIDELANDS REAL ESTATE DEVELOPMENT AND CAUSES AND IMPACTS OF PROJECT DELAYS				
Sponsors:					
Indexes:					
Code sections:					
Attachments:	1. 17. 2018-0552 Attachment A, 2. 17. 2018-0552 Attachment B, 3. 17. 2018-0552 Attachment C, 4. 17. 2018-0552 Attachment D, 5. 17. 2018-0552 Attachment E, 6. 17. 2018-0552 Attachment F, 7. 17. 2018-0552 Attachment G				

Date	Ver.	Action By	Action	Result
------	------	-----------	--------	--------

DATE: December 11, 2018

SUBJECT:

PRESENTATION ON THE ECONOMIC CONSIDERATIONS RELATED TO TIDELANDS REAL ESTATE DEVELOPMENT AND CAUSES AND IMPACTS OF PROJECT DELAYS

EXECUTIVE SUMMARY:

At the November 6, 2018 Board meeting, staff was asked to prepare an economic analysis of risks to development projects. As more fully discussed below, staff has analyzed and attempted to quantify these into three primary risks for discussion by the Board: schedule delays, cost increases, and performance failures. The analysis covers policy considerations and concludes with staff's observations as to characteristics of projects that effectively mitigate risk.

This analysis assumes the San Diego Unified Port District (District) continues to fund its operations with capital invested by private entities into development projects through public-private partnerships, primarily via commercial and industrial ground leases and maritime trade. Thus, mitigating development risk is critical to ensuring that the District has enough revenue to fulfill its many missions under the Port Act. The District currently employs several risk mitigation strategies. This analysis identifies additional measures that may be useful to further mitigate risk associated with development. As staff's analysis shows, development projects with broad stakeholder support and flexibility reduce development risk because they include project features important to stakeholders, which may require more time initially to identify and incorporate into a proposed project - ideally before the entitlement process begins - but which ultimately reduce subsequent challenges and shorten the overall development timeline.

Shorter development timelines bring more revenue to the District sooner. As a result, projects which

successfully mitigate risk and come to market sooner are an integral part of the District's success in its public mission. For the purpose of the Board's discussion, staff's analysis is organized as follows:

- I. Overview of the District, as a Self-Sustaining Entity
- II. A Typical Development Project Lifecycle - Planning/Scoping, Plan, Specification and Estimate (PS&E), Construction and Operations
- III. Three Primary Development Risk Categories
 - A. Schedule Delays
 - B. Cost Increases
 - C. Performance Failures
- IV. Impacts of Risk Categories on Development Projects
- V. Policy Options to Mitigate Development Risk
- VI. Conclusion

RECOMMENDATION:

Receive presentation and provide feedback to staff.

FISCAL IMPACT:

This presentation has no fiscal impact.

Compass Strategic Goals:

This agenda item is part of the reporting system to promote communications with the community and supports the following Strategic Goal(s).

- A Port that the public understands and trusts.

DISCUSSION:

I. The District is a Self-Sustaining Agency that Relies on Generated Revenues to Reinvest in Public and Environmental Amenities

The District manages 34 miles of San Diego Bay waterfront along Chula Vista, Coronado, Imperial Beach, National City and San Diego in trust for the State of California. The District is a protector of the environment and our communities, an innovator for businesses and a host to visitors and residents. Self-funded, the District reinvests the revenue generated primarily from long-term ground leases and three marine terminals back into the tidelands in the form of public infrastructure, public parks and other public access, public safety, environmental protection and activation. Developing real estate and maritime is one way that the District enhances the waterfront, grows businesses, creates vibrant experiences, stimulates positive economic impacts for the State and local community - including thousands of good paying jobs, bolsters the robust regional tourism and hospitality industry, and generates the revenues used to self-fund the many public features along the waterfront. Consequently, the District has a great proprietary interest in the development of tidelands. Without a consistent flow of development projects in the pipeline, revenues would likely plateau and ultimately decrease, resulting in reduced revenue to the District and by extension reduced reinvestment in the tidelands, diminished experiences for the public, and fewer public amenities.

II. A Typical Development Project Lifecycle Occurs in Four Broad Phases - Planning/Scoping, Plan, Specification and Estimate (PS&E), Construction and Operations

Developments on District tidelands usually occur through a development process that can be categorized into phases. This process is not a one-size fits all approach and differs for each project, but for the sake of this analysis, it is split into four broad phases: Planning/Scoping; Plan, Specification and Estimate (PS&E); Construction; and Operations. Attachment A: Lifecycle of a Typical District Development Project shows how these phases fit together in a typical project lifecycle. It should be noted that these phases are oftentimes characterized differently by different experts. For example, Urban Land Institute breaks the development cycle into eight phases: Idea Inception; Idea Refinement; Feasibility; Contract Negotiation (Planning/Scoping); Formal Commitment (PS&E); Construction (Construction); Completion and Formal Opening; Property, Asset and Portfolio Management (Operations). Whereas, University of Florida professors David Ling and Wayne Archer break the development cycle into eight different phases: Establishing Site Control; Feasibility Analysis, Refinement and Testing; Obtaining Permits (Planning/Scoping); Design; Financing; Construction (Construction); Marketing and Leasing; Operation (Operations). While different sources use different vernacular to describe the development cycle, they correspond to the four phases used for this analysis.

While these phases are presented as linear and discrete in Attachment A, the District and its chosen developer partner(s) can and often do work on multiple phases simultaneously or return to previously -completed phases as a result of changes to the project, the local market, or even national finance markets. In addition, and other than in limited circumstances, the Board retains the discretion to modify the development process at any time.

The Planning/Scoping Phase Involves the Selection of a Development Partner(s) and Approval of Project Entitlements

The first phase of the lifecycle is the Planning/Scoping phase, which typically involves issuance of a solicitation for development as required by BPC 360, such as a Request for Proposals (RFP) or Request for Qualifications (RFQ), selection of a development partner and the environmental review, permitting and the entitlement processes. The District's "real options"¹ are greatest during the Planning/Scoping Phase, where close coordination between the District and the developer will uncover new information about project design, costs, feasibility, and ultimately lease revenues. These real options represent decision points that can be valued, such as the decision whether to (a) enter into the ENA, (b) allow changes to the project or its design, (c) consider the environmental analysis and approve such analysis (e.g., approve a Mitigated Negative Declaration or certify an Environmental Impact Report), (d) add project elements such as public parks or amenities, or (e) approve the project and move into the PS&E phase. The value of these real options depends on the amount of control and discretion the District possesses. For example, if a project requires approvals from other agencies, such as the Coastal Commission's certification of a Port Master Plan Amendment or the U.S. Army Corps of Engineers' approval of a dredging permit, the real option to award the right to develop a site is less valuable than if the proposed development did not require any such approvals.

First Step - Establish the District's Goals and Vision for a Site by Analyzing Multiple Factors such as Public Benefits, Highest and Best Uses and Legal Constraints

Normally, this phase begins with the District establishing the goals and vision for a site, which often includes, without limitation, an analysis of the highest and best use of the development site, legal constraints (such as the Port Act and Public Trust doctrine), desired public benefits (amenities and revenues), a review of the entitlement status and adjacent uses.

Second Step -- Issue Solicitation with Specific Criteria that Furthers the District's Goals and Vision and Select Development Partner(s)

Once the District has decided on the goals and vision for the redevelopment, a solicitation is issued. The solicitation process is designed to eliminate performance risk through thorough vetting of a potential development partner, as well as to maximize public benefits (public amenities and District revenues) through a competitive solicitation process. Development partners are typically selected based on specific criteria included in the solicitation. These criteria often include approach to the project, a firm's relevant experience, a firm's capability to perform and the strength of the project proforma. Selection of a strong partner with a proven track record of success is key to mitigating risks (defined below) that oftentimes leads to delays and can, in turn, result in increased costs due to interest rate fluctuation and rising construction costs. Selection of a partner that has little experience working with the government or is inflexible in changing project features, for example, can lead to unexpected delays obtaining necessary permits, or a partner that is overaggressive in developing the project proforma may lead to a reduction in the projected revenue from the completed development.

Third Step - Start Exclusive Negotiations and Preliminary Design to Allow for Further Due Diligence

Once a development partner is selected, the District normally continues the vetting process through negotiations and preliminary design. During this period, the District and its development partner typically engage in exclusive negotiations and often an Exclusive Negotiating Agreement is executed. This gives the District time to conduct additional due diligence on the selected development partner and proposed project to ensure that the developer can perform as advertised and the project is feasible. This provides an additional layer of risk mitigation as the proposed project has not been entitled and the developer has no legal interest in the real property. If the development partner(s) does not perform as advertised, the District may reissue the solicitation or chose a different partner from the previous solicitation.

Fourth Step - Environmental Review and Permitting, which can Result in Delays and Revenues Lost to the District due to, without limitation, Inflexibility on the Part of the Development Partner and a Lack of Consensus Building

During the exclusive negotiating period, the project description is further developed and environmental review pursuant to the California Environmental Quality Act (and the National Environmental Policy Act, when required) commences, as well as processing of other permits or discretionary entitlements. Coordination with other permitting agencies, such as the California Coastal Commission and other stakeholders also often occurs during this time. Environmental review and permitting for a development project requires significant staff and consultant resources and may take months to years depending on the complexity of a project and the amount of stakeholder interest. Substantial schedule risk can occur during environmental review and permitting, which can also result in cost risk due to market fluctuations and cost increases during delays. Challenges to the environmental review, permits and Port Master Plan Amendments when required, which may come from environmental groups or other stakeholders, may take years to resolve, as we have seen in some projects on tidelands. When opposition is present and/or a project

proponent refuses to make changes to a project, delays with permitting, whether in the form of a disapproval from the District, an appeal of a Coastal Development Permit to the California Coastal Commission or the denial of a Port Master Plan Amendment by the California Coastal Commission, may also delay a project indefinitely. Project delays substantially increase the probability of cost risk due to changing financial markets, access to capital and increasing construction costs. In addition, the Case Study included as Attachment B: Case Study of a Typical Hotel Development shows that project delays result in substantial negative revenue impacts to the District. For example, a five-year delay during a typical hotel development may result in a reduction in the Net Present Value (NPV) of the revenue stream to the District of over 25%.

Consensus Building, Partnerships and Project Flexibility to Mitigate Delays During this Phase

One way the District attempts to mitigate this risk by thoroughly vetting potential partners during the solicitation process. Some developers have had success in avoiding challenges to the environmental review and permits outside of the solicitation process by building consensus among various stakeholder groups, entering into Settlement Agreements with potential opposition, and/or establishing partnerships with other concerned parties in advance. Additionally, challenges can be minimized when a development partner is flexible and agile in making project changes requested by the District, other permitting agencies and stakeholders. A mitigation strategy that the District may want to consider would be to include in the solicitation selection criteria credit for successfully engaging with stakeholders to address their needs and achieving stakeholder alignment, as well as flexibility in making project changes. This may include entering into agreements likely to head off potential challenges during this phase. As shown in the Attachment B, project delays, irrespective of the cause, ultimately penalize the District in the form of reduced revenues.

The Plan, Specification and Estimate (PS&E) Phase Involves Negotiation and Execution of a Definitive Agreement with the Development Partner and Can Be Subject to Delays from Market Conditions and Project Changes

The Planning/Scoping phase transitions to the Plan, Specification and Estimate phase² which in recent times, involves negotiating and entering into a Disposition and Development Agreement, or other definitive agreement with the development partner. During this phase, the District negotiates a definitive agreement with the developer which includes a series of milestones necessary to execute the ground lease such as project financing, management agreements with operators or other third parties and final construction drawings (although the District may choose to go directly to a ground lease depending on the type of development). This phase is subject to cost risk as changing markets and limited access to capital may further delay the project or render it infeasible. If a developer is unable to finance the project due to a tightening of the financial markets or increases in interest rates, the project might be delayed indefinitely or fail completely. Additionally, changes to the project or proforma during this phase also extend the timeline.

Limiting Project Changes, Establishing Milestones and Creating Contingency Plans to Mitigate Risk

Risks during this phase are typically mitigated by limiting project changes from the project that was permitted, establishing milestones as part of the definitive agreement and requiring that the developer make timely submittals to keep the project on track. The ground lease between the District and developer also includes several forms of security intended to ensure delivery of the project such as payment and performance bonds, completion guarantees and lease guarantees. These forms of security must be in place before the project commences. The District may also wish to consider

requiring potential partners to submit contingency plans in case of an unfavorable shift in the market.

The Construction Phase Involves Developing the Project and May include Cost Increases Due to Construction Trends

The second to last phase of the project cycle is the construction phase which includes the physical development of the project. The project may face cost risks during this phase as construction costs may increase making the project infeasible or causing further delays.

Security and Guarantees to Mitigate Risk

The ground lease between the District and developer includes several forms of security intended to reduce this risk and ensure delivery of the project such as payment and performance bonds, completion guarantees and lease guarantees.

As described above, there are numerous potential sources of project delay or unanticipated cost increases, and all of them lead to changes in costs for the public, District, and/or project developer. Attachment G: Risk Factors and Potential Policy Mitigation Measures lists those categories again, summarizes their impacts, and proposes potential measures to reduce or mitigate those risks in future District projects.

The Operations Phase Involves Operating the Project and May Require Time for Revenue Stabilization

In the final phase of the development lifecycle, the project has completed construction and has begun operations. Typically, development projects require an initial period, anywhere from one to five years, to stabilize revenues. This initial stabilization period continues to present potential risks to the District and the developer as the project may remain unproven and, as a result, is at risk of underperforming. The project is also highly susceptible to market forces at this time and may present both financing and sale challenges until the product is fully stabilized, thus impacting the developer's return.

III. Three Primary Development Risk Categories

Schedule Delays caused by Opposition and Market Timing Leading to Project Changes, Denial or Impediment of Implementation

A schedule delay is defined as a risk that development activity will take longer than expected. These delays can increase uncertainty and project costs while reducing the receipt of project benefits, including projected revenue to both the District and the developer. For the purpose of this analysis, staff organized these risks into two main categories: challenges by opposition and market timing.

Challenges by Opposition

The District prioritizes stakeholder engagement, from the largest to the smallest of projects. In any development project, there exists the risk that insufficient engagement may lead stakeholders to oppose a project throughout the entitlement process and challenge the project along the way. This includes the risk that a project applicant proposes a project that is inconsistent with the Coastal Act, Port Act or certified Port Master Plan (when a proposed Port Master Plan amendment is not proposed or desired), and the applicant is inflexible to bring a project into compliance. Under these

circumstances, it can take months to years to be resolved and completed. Opposition, lack of consistency with requirements and inflexibility with regards to project changes, can generate extensive schedule delays (and indirectly or directly, cost increases), and can cause a project to be denied when discretionary approvals are required. Additionally, appeals of appealable Coastal Development Permits to the California Coastal Commission can occur, which may usurp the District's Coastal Act jurisdiction.

Market Timing

Lack of access to capital due to a market failure, recession or changing market conditions can delay a project as developers take longer to finance their project than expected. This contrasts with rising interest rates, which directly increase costs and lead to changes in the business case for a project per its pro forma.

Cost Increases caused by Changes in Financing Costs and Construction Costs Leading to Delays or Infeasibility

Cost risks are defined as risks causing an escalation of project costs because of poor estimating accuracy, changes in scope, and/or changes in market conditions (short of a market failure). These risks can grow with time, and they can result in project delays, renegotiations between the District and the developer, or cancellation altogether. These risks can be organized into financing costs and changes in construction costs.

Financing Costs

Changes in financing costs, particularly interest paid, as a result of changes to the Federal Funds Rate³ or the Bank Prime Loan Rate⁴ increase the overall cost of the development and may render it infeasible. Attachment C: Effective Federal Funds Rate and D: Bank Prime Loan Rate show that interest rates have been historically low since the 2008/2009 recession, but also that rates can change quickly at times. Interest rates are currently on an upward trajectory, and these rising Bank Prime Loan rates will likely increase the financing cost, and ultimately development cost, for a project. Since financial markets follow the national business cycle, the longer a project is delayed, the greater the chances that unforeseen changes in the national business cycle/financial markets will affect the cost or availability of capital. In the best case, interest rates will go down and make the financing costs for a project lower than anticipated. In the worst case, these changes will impact the viability of a project, requiring developers to either wait for more favorable interest rates or to redesign the project to be viable given the new financing conditions.

Construction Costs

Changes in the construction market⁵ (and ultimately construction costs) can both delay a project and make its business case unviable. Construction costs include both labor and materials costs of building a project, and they can change when an expansionary phase of the local business cycle increases demand for local contractors or a change in demand or laws will lead to an increase in the cost of construction materials such as steel. The inverse is also possible; a recessionary phase of the business cycle can decrease construction costs, and changes in laws or demand can reduce materials costs. In either case, the longer the time between when a project developer is selected and the start of construction, the greater the chance that a change in market conditions will lead to a change in costs. Similar to financial risks, an unanticipated increase in labor or material costs may

reduce a project's financial viability, requiring delays, redesign or renegotiation.

The costs above can also compound due to changes in the business cycle. At times, financing cost changes and construction cost increases might occur simultaneously, compounding the costs of building a project and potentially greatly reducing its viability. This simultaneous increase in construction and finance costs could happen near the peak of an expansionary phase of the business cycle, as construction firms are already highly employed and the Federal Reserve is increasing interest rates to reduce inflationary pressures. Conversely, construction costs and financing costs can both go down simultaneously, such as during a recession. Finally, since these two risks are independent, it is also possible for them to move opposite each other (interest up, construction costs down or the reverse), and in those cases, one might partially offset the other. An example of this would be during the 2008/09 recession, where construction firms were seeking work, but banks were hesitant to lend to all but the safest projects.

Performance Failures Cause by an Inadequate Design, Work Stoppage, Partial Construction and Underperformance Leading to Suboptimal Revenues

Performance risks are defined as the risks that a project will fail to materialize at all or fail to perform as projected.⁶ The impact of these risks is that project revenues or utilization are different than projected (higher or lower) and can potentially lead to sub-optimal District revenues. These risks are as follows:

- *Inadequate Design.* The project has not been sufficiently designed to secure all necessary permits and approvals, either from the District or other regulatory agencies. As a result, the project may suffer delays or may obtain some or most but not all the required approvals to complete construction.
- *Work Stoppages.* While construction is taking place, there are operational risks of delays because of disputes and challenges between the developer, the contractor, and the workforce building the project. These delays can include work stoppages because of arguments over who should bear the cost of a change order, changing materials costs, construction mistakes, a prime-or-sub contractor going out of business, or a strike.
- *Incomplete Construction.* Risks that the District's developer partner(s) fail to complete all aspects of a project to the project specifications and accompanying agreements. If this occurs, then the public benefits or District revenues from a project could be lower than anticipated.
- *Underperformance.* Risks of a project under-performing projections. If not accounted for in project plans and accompanying documents, project under-performance could lead to lower rents or revenues.

IV. Impacts of Risks on Development Projects May Result in Increased Direct and Indirect

Costs to the District, Developer and Ultimately, the Public

Risks can create impacts which can be either direct or indirect, and they ultimately can be quantified in terms of benefits and costs. Both direct and indirect impacts lead to changes in the business case for a project, potentially requiring changes to project timelines or terms to keep the project viable. The District is a self-sufficient entity that does not impose taxes. Consequently, when a project is delayed or not realized as anticipated, the public ultimately bears the costs. For example, public amenities that are proposed by a project may not be developed or the District may lose rent revenues that it can expend on other public. Three major groups are impacted by project risks:

- The Public: This category is meant to capture all the stakeholders that the District is meant to benefit.
- The District: This category refers to the San Diego Unified Port District.
- The Developer(s): This category refers to the entity(ies) that have entered into an ENA/DDA/lease agreement with the District to execute the development project.

Attachment F: Impacts of Realized Project Risks, provides a conceptual schematic diagram of how direct and indirect costs at various stages of the project timeline can affect these stakeholders. The impacts of project risks can be classified as either direct or indirect costs to the public, the District, or the developer.⁷ Some costs to the District, developer or contractors associated with contract delay are recoverable by the entity incurring the cost; others are not. As shown in Attachment F, ultimately, all costs are eventually borne by the public.

Direct Costs

The direct impacts of realized project risks are the actual out-of-pocket costs borne by any stakeholder affected by a delay in project delivery. Direct impacts are divided into three categories:

- *Delays reduce revenue to the District.* Delays cost the District revenues that would otherwise be generated by the project. Since these revenues would be used to either manage, maintain, or further improve the District tidelands, the public is deprived of the benefits these revenues would be used to generate.
- *Development projects require District staff time and resources.* Shepherding a project through the development process requires Board and District staff time and resources, which grow when a project is delayed, renegotiated or a project proponent is unwilling to make project changes to bring a project into legal conformity. Under these circumstances, additional District consultants may be required, and Board and staff resources may be diverted from working on other projects that benefit the public.
- *Cost increases are borne by the developer.* Third, the realization of risks leads to cost increases, reducing the benefits of a project over time. Once the District selects a developer, the developer normally becomes responsible for carrying the costs related to project design, entitlements, financing, construction, and even due diligence on the project site. Thus, the direct responsibility for cost increases in any of these categories most likely fall on the developer; and so, these costs are either borne by a developer directly (if those costs are incorporated into the bids received from construction firms) or indirectly (if those increases occur after a contractor is awarded the project by a developer).

Whether the cost increases are a direct result of financing and construction market changes, or from delays and performance failures, the results are often the same, with the District and the public bearing some or all these costs. Attachment F shows three potential outcomes stemming from these cost changes:

- The developer might be successful in recouping these costs from the District, ultimately reducing the revenues the District must pursue other projects that benefit the public.
- The developer might not be able to get the District to reimburse these costs directly but might recoup these costs indirectly by altering the project scope or delaying the project pending more favorable financial or construction terms.
- The developer might not be able to get any reimbursement, making the project unviable and leading to its cancellation.

Indirect Costs

Indirect impacts are the hidden costs or dis-benefits⁸ that are borne by stakeholders, and they often have a much greater impact than the direct costs of project delay. These are also divided into three categories:

- *Regional Economic Impacts.* Examples of these impacts include how a new hotel will increase regional employment and tax revenues, as well as more specific impacts such as the amount of people spending money in nearby shops and restaurants. Delays in completing projects reduce these regional economic impacts for the projects.
- *District Opportunity Costs.*⁹ Cost to the District resulting from delays in a development project, especially when the delayed project requires Port Master Plan Amendments that can tie up other projects. For example, if a site is subject to a change in entitlement as part of a redevelopment on an adjacent site, that site is unable to be redeveloped until the entitlement process has concluded. While some of these costs are financial costs that can be quantified, others involve actions such as seeking approval from permitting agencies (i.e., soft costs).
- *Developer Opportunity Costs.* In contrast to the District, the developer's opportunity costs are related to them being unable to use resources tied up in the project in question on other projects. The returns from completing the project should compensate the developer for these costs.

V. The District has Potential Options to Mitigate Development Risk

Formal project risk management processes are often used in identifying and reducing project risks. Additionally, the District has policies and Board staff expertise to assist in identifying many of these risk factors. The emphasis in this analysis is on potential policies that can help reduce risks or track project risks through a project risk management process,¹⁰ and in that way, those risks are addressed or at least quantified. When analyzing new types of projects or services with greater uncertainty, the District or developer could utilize analytical tools such as the concept of Failure Mode Effects Analysis (FMEA),¹¹ which provide forward-looking approaches to identify "failure modes" where a

project, process, or service might fail. There are also public and stakeholder outreach, legal, policy, and project management options to try to reduce the impacts of these risks by anticipating the general possibility for delays and cost increases, and the policy measures section of this analysis contains some potential mitigation strategies that fall within those categories.

As described above, there are numerous potential sources of project delay or unanticipated cost increases, and all of them lead to changes in costs for the public, District, and/or project developer. Attachment G: Risk Factors and Potential Policy Mitigation Measures lists several risk categories and identifies potential mitigation measures to reduce those risks in future projects.

VI. Conclusion

The District is responsible for the management, stewardship, operation, and development of the submerged lands within San Diego Bay and the surrounding tidelands. To carry out its mission, the District relies on revenues generated from several sources, but primarily, from the investment of capital in the development and operation of commercial and industrial projects. Reducing time to market, and ensuring that projects are planned, designed, financed, and operated as closely as possible to projections allows the District to fund its many missions without taxes. Staff's analysis suggests that there are several features of successful development projects on District tidelands, and the most beneficial projects are the ones that come to fruition, largely through successfully mitigating risk.

Several conclusions may be drawn from the above analysis and the District's experience with real estate development:

- Project delays cost the District and the region both directly and indirectly.
- Risk mitigation strategies may reduce delays and lead to successful projects.
- A well-qualified, experienced development partner is critical to success.
- Reducing risk up front saves time and resources over the project lifecycle.
- Broad stakeholder support results in fewer regulatory and legal challenges.

The Board may consider policy options to support and encourage these features of successful redevelopment projects. Staff recommends the Board receive staff's presentation and provide feedback to staff.

General Counsel's Comments:

The Office of the General Counsel has reviewed the agenda sheet and attachments, as presented to it, and approves them as to form and legality.

Environmental Review:

This presentation to the Board does not constitute a "project" or an "approval" of a "project" under the definitions set forth in California Environmental Quality Act (CEQA) Guidelines Sections 15352 and 15378 because no direct or indirect changes to the physical environment would occur. CEQA requires that the District adequately assess the environmental impacts of its projects. If a project is formulated and CEQA review is conducted, the Board reserves its discretion to adopt any and all feasible mitigation measures, alternatives to the project, including a no-project alternative, a statement of overriding considerations, if applicable, and may approve or disapprove the project and

any permits or entitlements necessary for the same. Those decisions may be exercised in the sole and absolute discretion of the Board. Based on the totality of the circumstances and the entire record, this presentation does not commit the District to a definite course of action prior to CEQA review being conducted. No further action under CEQA is required at this time.

In addition, this Board item complies with Section 87 of the Port Act, which allows for the establishment, improvement, and conduct of a harbor, parks and recreational facilities, and for all Public Trust compliant commercial and industrial uses and purposes, and the construction, reconstruction, repair, and maintenance of commercial and industrial buildings, plants, and facilities. The Port Act was enacted by the California Legislature and is consistent with the Public Trust Doctrine. Consequently, the proposed actions are consistent with the Public Trust Doctrine.

Finally, these items do not allow for “development,” as defined in Section 30106 of the California Coastal Act, or “new development,” pursuant to Section 1.a. of the District’s Coastal Development Permit (CDP) Regulations because it will not result in, without limitation, a physical change, change in use or increase the intensity of uses. Therefore, issuance of a CDP or exclusion is not required. However, the District’s projects require processing under the District’s CDP Regulations. If a project is formulated as a result of these items, the Board will consider approval of the project after the appropriate documentation under District’s CDP Regulations has been completed and authorized by the Board, if necessary. The Board’s direction in no way limits the exercise of the District’s discretion under the District’s CDP Regulations.

Equal Opportunity Program:

Not applicable.

PREPARED BY:

Stephen Shafer
Principal, Economics and Policy

Tony Gordon
Director, Real Estate

Attachment(s):

Attachment A: Lifecycle of a Typical District Development Project
Attachment B: Case Study of a Typical Hotel Development
Attachment C: Effective Federal Funds Rate, July 1954 to November 2018
Attachment D: Bank Prime Loan Rate: Bank Prime Loan Rate, January 1949 to November 2018
Attachment E: California Construction Cost Index
Attachment F: Impacts of Realized Project Risks
Attachment G: Risk Factors and Potential Policy Mitigation Measures

¹ Real options theory is a modern theory on how organizations or businesses make decisions about investments when the future is uncertain. In the business world, a ‘real option’ is a choice available to a company about an investment opportunity, and the term ‘real’ is used because the choice relates to a tangible asset and not a financial instrument (the parallel financial instruments are options and derivatives). Real options theory refers to the “right,

but not the obligation, to take different courses of action (for example defer, abandon and expand) with respect to real assets (for example an oil well, a new product or an acquisition) as opposed to an option on financial securities or commodities" (CIMA, 2005, p. 95)). It further posits that in situations where a project does not include one irreversible decision, then a discounted cash flow (DCF) method of valuing a project based on its net present value (NPV) is insufficient because it does not account for the need and ability to amend or change decisions as new information is acquired. Real options apply to situations where:

1. *When there is a contingent investment decision. No other approach can correctly value this type of opportunity.*
2. *When uncertainty is large enough that it is sensible to wait for more information, avoiding regret for irreversible investment.*
3. *When the value seems to be captured in possibilities for future growth options rather than current cash flow.*
4. *When uncertainty is large enough to make flexibility a consideration. Only the real options approach can correctly value investments in flexibility.*
5. *When there will be project updates and mid-course strategy corrections.* (Schulmerich, 2007, pp. 23-24)

² The approval and execution of the definitive agreement cannot occur until after environmental review is conducted and approved.

³ The Federal Reserve is currently making moves to increase interest rates by raising the Federal Funds Rate. As seen in Attachment D, Effective Federal Funds Rate, July 1954 to November 2018, , after nearly seven years of holding steady just above 0%, the Effective Federal Funds Rate has increased from 0.12% in October 2015 to 2.19% in October 2018.

⁴ The Bank Prime Loan Rate is the rate that banks offer to their least risky customers, and, although not officially linked, it is generally about 3% greater than the Federal Funds Rate. This rate increased from about 3.25% in October 2015 to over 5% in October 2018. This Bank Prime Loan Rate is the likely floor for any real estate project being developed on District land. Attachment E, Bank Prime Loan Rate: Bank Prime Loan Rate, January 1949 to November 2018, shows the current trajectory in Bank Loan rates, and how quickly these rates can change. It further demonstrates how the recent period of stable interest rates was an anomaly seen only twice over the last 70 years.

⁵ These changes in construction costs are common in California, and these costs are currently increasing. California's Division of General Services publishes a California Construction Cost Index (CCCI, seen in *Attachment E: California Construction Cost Index*) to track increases in construction costs. The CCCI use data from San Francisco and Los Angeles, so it is not a perfect fit for San Diego, but in the absence of a San Diego-specific index, this appears to be the most applicable indices. According to CCCI, the cost of building materials and labor has increased by about 9% from October 2015 to October 2018. (calculation is $(6679-6114)/6114 = .0924$). This increase is highly generalized, but it does demonstrate the degree to which building costs change over time in CA.

⁶ Although this risk category is relevant for District real estate developments, most of these risks are borne by the developer. They are more acute when the District is leading a project on its own, such as an IT system deployment, maritime terminal project, or maintenance capital acquisition.

⁷ Since contractors are normally hired by the developer in District real estate projects, they are grouped with the "developer" category.

⁸ Dis-benefits include, but are not limited to, stakeholders not being able to access the land where the project would be built because of the delay or cancellations.

⁹ Opportunity cost is defined as the added cost of using resources (as for production or speculative investment) that is the difference between the actual value resulting from such use and that of an alternative (such as another use of the same resources or an investment of equal risk but greater return).

Per Merriam-Webster Dictionary. <<https://www.merriam-webster.com/dictionary/opportunity%20cost>>.

¹⁰ The aim of project risk management is to identify and minimize the impact that risks have on a project. The challenge with risk management of any kind is that risks are uncertain events. In the management of projects, and the subsequent operations of the project's product, organizations attempt to reduce their exposure to these uncertain events through risk management. This is usually done through a formal management process which consists of the following steps: plan risk management, identify risks, perform qualitative risk analysis, perform quantitative risk analysis, plan risk responses, and control risks. An extensive description for quantifying risk is available on the Project Management Institute website article by Werner Meyer (2015).

¹¹ Failure Mode Effects Analysis is a step-by-step approach for identifying all possible failures in a design, a manufacturing or assembly process, or a product or service. It is described in depth on the American Society for Quality's website: <<http://asq.org/learn-about-quality/process-analysis-tools/overview/fmea.html>>. FMEA is just one example of analytical processes to qualitatively or quantitatively address project risks.