City of Milwaukee

Office of the Comptroller

W. Martin Morics, C.P.A.
Comptroller

Michael J. Daun
Deputy Comptroller

John M. Egan, C.P.A.
Special Deputy Comptroller

Craig D. Kammholz
Special Deputy Comptroller

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Members of the Zoning, Neighborhoods
& Development Committee
City of Milwaukee
City Hall, Room 205
Milwaukee, WI 53202

Re: Developer loans to the City of Milwaukee

Committee Members:

During your meeting of January 9th, you requested that our Office examine the issue of developer loans to recommend the types of projects or project characteristics which would constitute an appropriate use of this tool along with any policy guidance we might suggest.

There are two parts to a developer loan transaction. In the first, the City of Milwaukee makes a grant to the developer. While no funds change hands, the grant creates an obligation by the City to the developer (developer loan). Second, the developer obtains its own private total financing for the project, including the amount of the City grant. As annual property tax increments are generated by the developer's completed project, all or a portion of these increments are paid to the developer according to an agreed upon schedule to satisfy the City obligation. Such payments are then used by the developer to amortize the private debt which was created to fund the City grant.

As a two-part transaction (City grant to developer followed by developer loan to City), the developer loan operates like an extended, 100% property tax abatement to the benefit of the owner of the developed property. That is, each annual loan repayment by the City is matched dollar-for-dollar to the property owner's annual property tax due, canceling that liability.

The incentive to utilize developer financing of a TID derives from mainly from its ease of use, inasmuch as it is an "off budget" transaction. Whereas the alternative funding method, General Obligation (GO) City debt, is limited to an amount specified in the City budget. There are no budgetary limits on the amount of developer financing loans which can be made. The off budget treatment of City developer loans avoids the difficult City project tradeoffs required in capital budgeting. Since no funds are transferred by the City to the developer, it is easy to view this as a "no-cost" alternative. However, it is important to remember that both GO debt and a City grant-developer loan constitute long term obligations of the City, and are disclosed as such in the City's Official Statement for Bond sales.

The biggest disadvantage of the developer loan alternative is its increased cost. The rate of interest charged in City grant-developer loan agreements is normally far above that of the City's cost of funds, leading to substantial added taxpayer costs. This defers the time when the TID can be closed and the general taxpayer begins to benefit from the project. For example, $5 million in City financing of a project would cost about $1.5 million (+20%) more if performed through a City grant-developer loan than through conventional City GO borrowing.[1] In this example, a 20 year TID under City GO financing would require 24 years to retire with City grant-developer financing, deferring the general taxpayer benefit by four years.

Before considering the City grant-developer loan alternative, DCD and your Committee should first determine if a simple City loan to the developer is the best method of providing City financial assistance. In the past, the City of Milwaukee has helped finance a number of successful projects with funds loaned directly by the City.

[1] This assumes City borrowing at 4% versus a City grant-developer loan at 6.5%, both level payment over 20 years.

Room 404, City Hall, 200 East Wells Street, Milwaukee, Wisconsin 53202-3567, Phone: (414) 286-3321, Fax: (414) 286-3281

Such loans are eventually repaid versus City grants which by definition are never repaid. Successful TIDs which employed City loans include City Hall Square, United Healthcare, Hotel Metro and Tannery Apartments. In these City loan projects, the TID receives not only the tax increments, but also developer loan repayments to help retire the TID. Each of these City loan based TIDs have already successfully closed. Where project cashflows are sufficient, the City taxpayer should expect repayment of its financial contributions rather than just assuming that a City grant to a project is the only viable way to assist. City loan term, repayment structure and interest rates can be adjusted to help make loan repayment by the developer feasible. However, the City has in the last few years drifted away from the use of this successful model, relying instead on direct grants to developers, which again is a higher cost alternative.

In spite of its inherent higher cost, there are situations where City grant-developer loan financing of City participation would be appropriate. Three project models we view as potentially appropriate for developer financing are outlined below. Clearly, combinations and variations of these three models might also be appropriate, but the following models illustrate the role City grant-developer financing could properly play in TID financing.

Model #1: The developer loan financing a City grant is offered at a rate which approximates or is below the interest rate available to the City through its GO bond financing.

A major benefit of developer financing of City grants is the use of developer cash as opposed to City cash in filling the necessary project financing "gap". If the developer's required interest rate falls within ¼% or so above of the City's cost of funds, this would generally make a developer financing proposal very attractive to the City. While these situations may be rare, the City should not be reluctant to use this mechanism once it has decided to grant funds to the developer and the developer's interest rate is favorable.

Model #2: Very Risky Project Plan where property tax base growth is the dominating City benefit and City funding needed "up front"

Here the typical Project Plan might envision an extensive real estate development with substantial projected property tax base growth but no other expected City benefit driving project approval. The developer cannot assure completion of the entire Project Plan yet the City's entire grant assistance is to be provided in the initial months of the project. In addition, assume there are substantial engineering, subsoil remediation, market and other risks which raise substantial uncertainty as to whether the development will proceed to completion. Also, assume the Project Plan must be constructed to completion and operate successfully for a number of years for the TID to be successful. This model would also hold true for a multi-phased project where most or all phases must proceed to completion for TID success.

In the above example, a City grant-developer loan functions as a way to "offload" City of Milwaukee risk to the developer, albeit at a higher cost. With a developer financing the entire project, should project construction not be completed as planned, it is the developer – not the City - which would sustain the cost of the failure. Similarly, if the development construction is completed but the operation of the development fails for lack of business, the developer sustains the bulk of the loss. This loss occurs by virtue of the lower amount of City loan repayments (and ultimate developer loss of tax abatement) due to the lower tax increments generated by the development.

Under this Model #2, where tax increments are the only major City benefit, a projected development and tax increment scenario could be determined for such a project which would leave the City in a "break even" position for either the City grant-developer loan or GO borrowing. Analysis as to the preferable alternative could proceed based on the likelihood of this scenario occurring. That is, if the project is likely to perform better than the break even scenario (less project risk), then GO borrowing is preferred. However, if the project is likely to perform worse than the break even scenario (more project risk), then the City grant-developer loan alternative would be preferable. In this latter case, the City is concluding that if it is to proceed, the City benefit of offloading the development risk is worth more than the added City interest cost.

Model #3: City Project driven by large, permanent job creation or other non-tax increment benefits.

In this model the project is being justified not mainly by the expected tax increment, but by extensive, permanent job creation benefits or other major City benefits (corporate relocation to Milwaukee, essential on-going commercial services, job training center, etc.). Here the tax exemption made possible through the City grant-developer loan forms a benefit subject to City "clawback" which can be easily suspended should the intended public benefit not be achieved in any year. For example, this developer financing method was the major tool utilized by the City of Chicago (along with substantial State government assistance) in attracting Boeing corporate headquarters from Seattle to Chicago in the mid 1990s. Under its agreement with the Boeing Corporation, in any year that Boeing did not maintain predetermined employment levels, the City of Chicago could suspend the tax exemption enabled through the Boeing "City grant-developer loan" agreement.

Therefore, in this model, the higher interest cost associated with the City grant-developer loan is offset by the requirement that the developer or company "earn" the benefit of tax exemption each year by evidencing that its contractually committed benefits (jobs, etc.) have in fact been provided each year. In short, the City grant-developer loan mechanism works extremely well as an on-going "clawback" tool for projected long term City benefits where non tax increment benefits are the main reason for establishing the TID.

Aside from the model chosen, where any City grant-developer loan is considered, it is our belief that certain City budget changes and core provisions should be in place for all future City grant-developer loan agreements. First, each City budget should define the maximum dollar amount of permitted City grant-developer loan financing for the budget year. This would bring developer financed TID proposals under the same scrutiny that GO financed TIDs now undergo. A provision specific to developer loans should be the existence of a no-cost option for the City to pre-pay the City grant-developer loan at any time without penalty. A third requirement should be to limit any City grant-developer loan agreement to a maximum repayment period of no more than, say, 17 years (normal term of City GO bond for TIDs), at which time the agreement would terminate without further City obligation. This limit might be further shortened by other development specific factors such as the development's expected useful life, projected TID closure date or superior TID project performance.

One final note on TID guidelines. Athough not necessarily part of City grant-developer financing, a potentially wasteful method of providing City TID assistance has recently been employed as an necessary exception to normal City practices. Our objection is to the concept of approving an amount of City TID provided financial assistance based solely on projected tax increments assuming the project meets certain tax increment "milestones" during development. While this method was justified in the case of the Brewery Project due to the condition and history of the property, this approach ignores the actual need for City financial assistance and should be severely curtailed or prohibited in any TID guidelines.

Calculating the maximum TID financing that can be supported by a proposed real estate development is a calculation that all developers seeking TID assistance would perform, for it becomes a ceiling as to the largest financial assistance amount the City could legally provide through a TID. However, to structure a TID in this manner ignores the fundamental "but for" question required by State TID Statutes. This Statutory requirement is that any local government TID financial assistance be limited to that amount necessary to allow the project to proceed after all other financing sources have been exhausted (TID as "gap" financing). The capacity of the TID to produce tax increments over its legal life is intended to be examined only AFTER this necessary minimum amount of City TID financial need has been established. This is done to see if the TID can support the project need. However, establishing a City TID assistance amount solely based on the maximum tax revenue that can be diverted to the project ignores developer need and distorts the intention of public TID financing. Instead, this approach produces a taxpayer "gift" to the developer regardless of its need for funds and without any public benefit.

I commend your Committee in this effort to provide sound policy parameters to guide the use of the City's TID funding mechanism. Should you wish to reduce the above comments to a set of City TID guidelines, we will help in that effort at your request and continue to support your Committee's work in this important matter.

Sincerely,

W. Martin Morics
Comptroller
Cc Richard Marcoux, Joel Brennan, James Scherer, Emma Stamps

✓ Linda Elmer