IBO

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West Side Financing's Complex, $1.3 Billion Story

SUMMARY

THE BLOOMBERG ADMINISTRATION'S Hudson Yards project proposes a major redevelopment of Manhattan's far West Side. The plan includes a city investment of roughly $3 billion (in 2003 dollars) to upgrade the district and facilitate the construction of thousands of new apartments and millions of square feet of new office and other commercial space. Among the proposed improvements are the extension of the #7 subway line, the construction of a platform over the Eastern Rail Yards, and the creation of a new boulevard and new parkland.

To fund its investment, the Bloomberg Administration has proposed a long-term financing plan outside the usual mechanism of the city's capital budget. Under the plan, a newly created Hudson Yards Infrastructure Corporation would sell long-term bonds backed by a variety of revenues that would be expected to be generated as a result of the improvements.

This report was undertaken at the request of Public Advocate Betsy Gotbaum. While the infrastructure investments and related zoning changes may be necessary for the future vitality of this former industrial area and the city as a whole, our focus is solely on the proposed plan to finance the public investment. Among IBO's findings:

- IBO estimates that the proposed financing mechanism will cost $1.3 billion (in 2003 inflation adjusted dollars) more than if the city simply borrowed the funds through its regular capital plan. Under this proposal, far more of the cost is shifted to the future than is typical of regular capital borrowing, yet the difference in present value terms still exceeds $500 million.
- Because the project will not generate enough revenue in its early years to cover debt service, the city will use commercial paper—a type of short term debt—to pay interest under the proposed plan. If investors are unwilling to purchase the commercial paper, the Transitional Finance Authority will buy it using a portion of the city's personal income tax revenue—revenue that would otherwise support basic city services.
- Most Hudson Yards revenue expected in the first 20 years is tied to office development. If the demand for office space in Hudson Yards falls short of expectations and fails to produce the anticipated revenue, more short-term borrowing to pay debt service may be necessary, borrowing costs will be greater, and the potential city budget risks grow.
- By keeping the borrowing out of the capital plan, the city would not have to pay debt service through its operating budget and the Hudson Yards investment would not compete with other capital projects such as schools, hospitals, and roads. It also means that legislators will not have their usual role in helping to decide if Hudson Yards should be a capital priority.

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INTRODUCTION

The Bloomberg Administration's Hudson Yards project envisions a major redevelopment of the area stretching roughly from 27th Street to 43rd Street between 8th Avenue and 11th Avenue on Manhattan's far West Side.[1] Under the current development plan, city investments would include an extension of the #7 subway line, building a platform over the Eastern Rail Yard (30th Street to 33rd Street between 10th Avenue and 11th Avenue), construction of a mid-block boulevard between 10th Avenue and 11th Avenue, additional open space, and other infrastructure.[2] The Bloomberg Administration estimates that the total cost of these projects, excluding borrowing costs, would be about $3 billion (all dollar references throughout this report are in 2003 dollars except where noted).[3] The city would create the Hudson Yards Investment Corporation (HYIC) to oversee the plan and borrow the necessary funds.

The Hudson Yards' planners believe that the infrastructure improvements, along with changes in zoning to allow the construction of larger buildings, will spark private development projects in the area. The plan estimates that by 2035, 28 million square feet of office space, 1.4 million square feet of hotel space, 680,000 square feet of retail space, and more than 12,000 apartments will rise in the Hudson Yards district.

This fiscal brief examines the proposed financing plan for Hudson Yards. After laying out the structure of the plan, the paper evaluates the different elements of the financing proposal—with special attention to its borrowing costs, revenue projections, and risks for the city.

STRUCTURE OF THE FINANCING PLAN

The current financing plan divides the Hudson Yards development project into two parts: Phase 1 includes the subway extension with one stop at 34th Street and 11th Avenue, construction of the Eastern Rail Yards platform, construction of the mid-block boulevard from 33rd Street to 36th Street, and construction of a park on top of a Department of Sanitation facility between 11th Avenue and 12th Avenue and 29th Street and 30th Street.[4] The Bloomberg Administration expects these components to cost $2.5 billion. Phase 2 includes a second subway stop at 41st Street and extension of the mid-block boulevard from 36th Street to 42nd Street. Phase 2 is expected to cost $521 million dollars.

The Bloomberg Administration has acknowledged that the main reason for dividing the project into two phases is money. Although it would cost less to construct all parts of the project in one phase, delaying part of the construction would reduce debt service payments in the early years of the plan period. The project planners justify the two phases by noting that development in Hudson Yards is expected to start at the south end and then expand north. The target date for completion of the second subway stop is 2015, and completion of the mid-block boulevard is expected sometime before 2025. The borrowing plan only covers expenses from Phase 1. Although there are no explicit plans for financing Phase 2, the anticipated revenues are intended to ultimately cover all project costs, including the Phase 2 financing.

The Borrowing Plan. The borrowing plan for Phase 1 consists of three steps:

Sale of Project Bonds. Between 2005 and 2011, HYIC would sell 30-year project bonds to raise approximately $2.4 billion to cover Phase 1 construction costs; an additional amount would be added to cover issuance costs and contributions to a reserve fund.[5] Because HYIC would sell these bonds, this total would not count against the city's debt limit. To keep debt service payments low in the early years, principal payments would not begin until 2018 for all project bonds.

Commercial Paper. Because the project is not expected to generate enough revenue in the early years to cover project debt service, the current plan is to use commercial paper—short-term promissory notes with maturities of up to 270 days—to cover the payments. Starting in 2005, HYIC would issue new commercial paper to cover debt service on project bonds not covered by current project revenues and reserve fund earnings, purchase outstanding commercial paper as it matures, and cover the issuance and interest costs of using the commercial paper. If revenue exceeds debt service and the costs of the commercial paper program, as expected in 2014 and 2016-2019, some commercial paper would be retired. By 2020, the outstanding balance of commercial paper is expected to be about $588 million.

TFA Credit Support. Credit support for this commercial paper, which the banks would require, would be provided by the Transitional Finance Authority (TFA). The TFA is an independent public benefit corporation created by New York State legislation in 1997.[6] It was created at a time when a sharp decline in measured local property values resulted in a dramatic drop in the amount the state constitution permitted the city to borrow to pay for its capital needs through the normal means of general obligation (GO) debt.[7] To deal with this problem, the state Legislature found that "an emergency financing mechanism" should be available to the city for financing its appropriated capital budget. Under the TFA enabling statute, all city personal income tax revenue goes to the TFA to be used in the following order of priority: (1) contracts with TFA bondholders (i.e., debt service), (2) TFA operating expenses, and (3) transfer to the city of the balance not required to meet contractual or other obligations of the TFA.

According to the Mayor's Office of Management and Budget, the credit enhancement for the commercial paper would take the form of a contingent bond purchase agreement that would be a contractual obligation of TFA. Under this agreement, if the commercial paper could not be sold publicly, TFA would purchase the commercial paper as a last resort. That is, TFA would use personal income tax revenue to retire outstanding commercial paper, which would reduce the balance of personal income tax revenues that would be available to fund the city's general expenditures.[8]

Sale of Bonds to Retire Commercial Paper. In 2020, HYIC would sell 25-year bonds to raise $653 million to retire outstanding commercial paper, including reserve and issuance costs. The timing of this proposed sale reflects the expected revenue schedule. Revenues (project revenues plus reserve fund interest) are expected to exceed debt service payments for project bonds in 2014 and then continuously starting in 2016, but would be insufficient to also cover debt service on these additional bonds until 2019. The choice of 2020 provides a one-year buffer.

There are two reasons for this sequential structure: First, significant project revenue is not expected for nearly a decade after the starting dates for project construction and borrowing. During this period, revenue from another source must cover debt service. Second, because the Hudson Yards project would stand alone, rather than within a larger capital plan (such as that of the city or the Metropolitan Transportation Authority), there would be no internal funding stream to cover initial debt service; revenue would flow only from Hudson Yards project sources. Borrowing from external sources would be required to cover debt service payments until project revenues could cover these payments.

The plan notes that zero-coupon bonds, which require no payment of interest or principal until retirement, might be used instead of some or all of the commercial paper. The choice would depend on market conditions. The choice of commercial paper over zero-coupon bonds in the current plan reflects significant estimated savings under current market conditions.

The Revenue Plan. The revenue plan, which covers the years 2005 to 2035, includes several sources. Most important are "payments in lieu of taxes" (PILOTs) for new commercial development and residential property taxes. Together these provide over three-fourths of total revenue. Additional revenue sources are also related to development of Hudson Yards. They include sale of development rights for the Eastern Rail Yard, contributions to a District Improvement Fund (DIF) in exchange for bonus development rights, land sales and ground leases for publicly owned parcels, and payments in lieu of sales taxes on construction materials.

Commercial Payments in Lieu of Taxes. Approximately 44 percent of revenue is expected to flow from PILOT payments for new commercial development in Hudson Yards. According to the plan, a developer planning to build within the Hudson Yards district would have the option of entering a PILOT agreement with the New York City Industrial Development Agency (IDA). Under such an agreement, IDA would buy the land to be developed from the developer for a token amount, which would take the land off the property tax rolls, and the developer would then make PILOT payments to IDA for the term of the agreement (probably 30 years). Generally, the developer would enter the PILOT agreement when making other financing arrangements. At the end of the term, the IDA would return the land to the developer for a token amount and the land would return to the city's property tax rolls.

Projected Revenues from Hudson Yards: 2005-2035

Revenue Source:	Current Dollars	% Share of Total	2003 dollars	% Share of Total
Commercial PILOT Payments	7,239.1	44.7	3,986.7	44.4
Residential Property Taxes	5,391.3	33.3	2,784.4	31.0
Eastern Rail Yard				
On-Site Development Rights	812.1	5.0	494.2	5.5
Transferred Development Rights	911.6	5.6	533.7	5.9
Land Sale & Ground Lease Payments for Publicly Owned Parcels	110.6	0.7	90.0	1.0
DIF Bonus Payments for FAR	1,327.6	8.2	822.7	9.2
PILOST	415.1	2.6	267.5	3.0
Total Revenue	**16,207.4**		**8,979.2**	

SOURCES: Hudson Yards Powerpoint Presentation, New York City Economic Development Corporation, and New York City Office of Management and Budget, February 11, 2004.

The IDA would establish a uniform PILOT payment schedule for Hudson Yards. The revenue plan assumes a basic PILOT rate of $12 per square foot in 2010, based on a 15 percent to 20 percent discount of expected Midtown tax levies per square foot, escalating at 2.5 percent per year thereafter. For initial deals in 2010-2013, however, the plan assumes that the basic rate would be further discounted to encourage development—by 40 percent in 2010, 30 percent in 2011, 20 percent in 2012, and 10 percent in 2013.[9] Also, although access to low-cost financing would not be part of the PILOT program, the plan leaves open the possibility that IDA could offer it to developers in Hudson Yards.

The goal is to have the PILOT program offer better long-term incentives than alternative economic development programs, such as the Industrial and Commercial Incentive Program, which are available elsewhere in the city but would not be available in Hudson Yards.[10] In contrast to these other programs, however, a developer using the Hudson Yards PILOT program would owe payments in a project's early years.

Development Forecast for Hudson Yards

Millions of square feet

Type	2005-2009	2010-2014	2015-2019	2020-2025	2026-2035	2005-2035
Office	0	5.00	7.00	6.00	10.00	28.00
Hotel	0.48	0.48	0	0	0.48	1.44
Retail	0.06	0.15	0.15	0.14	0.17	0.68
Residential						
"80/20"	3.00	3.00	3.00	3.60	0	12.60
Market						2
Total	**3.54**	**8.63**	**10.15**	**9.74**	**10.65**	**44.72**

SOURCES: IBO; "Request for Proposals: Financing of Hudson Yards Project by the Hudson Yards Finance Corporation,"December, 2003
NOTE: No schedule is provided for the development of the market rate housing.

Based on demand studies by Cushman and Wakefield and Economic Research Associates, project planners expect commercial development in the Hudson Yards area over the period 2005-2035 to include 28 million square feet of office space, 1.4 million square feet of hotel space, and 680,000 square feet of retail space, assuming the proposed rezoning occurs. They expect construction of about 4 million square feet by 2012, a growth spurt of 1.4 million square feet per year between 2015 and 2019, and about 1 million square feet per year thereafter.

Given this projection of commercial development and the proposed PILOT rate schedule, the level of commercial PILOT revenue is expected to grow strongly after 2010. By 2015, PILOTs are expected to be the main revenue source and contribute over 40 percent of total revenue; in 2017 and from 2020 to 2025, more than half of total revenue is expected to come from PILOTs.

Residential Property Taxes. About 31 percent of total revenue over the plan period is expected to come from residential property taxes. Exactly how this revenue would be received has yet to be decided. One possibility is a residential PILOT program, comparable in structure to the commercial PILOT program and administered by the Housing Development Corporation.

The plan expects 14.6 million square feet of new housing to be developed in the Hudson Yards area during the plan period, based on proposed rezoning and a residential demand study done by Cushman and Wakefield. The plan assumes that 12.6 million square feet of this space (12,000 units) would be developed by 2025 and it would qualify for both the 421-a Affordable Housing Program and the "80/20" program.[11]

Under these programs, in exchange for a promise to reserve 20 percent of new apartments for low-income tenants, developers can receive 20-year tax abatements from the 421-a Affordable Housing Program (full abatement of property taxes on improvements for 12 years, followed by an eight-year tax phase in) and low-cost financing from the 80/20 program.

Alternatively, new programs with essentially the same rules and benefits as these programs might be created specifically for Hudson Yards. Although residential developers would not be required to participate in these programs, the Bloomberg Administration assumes that most would choose to do so, based on experience elsewhere in Manhattan.

The remaining 2 million square feet of housing is expected to be market-rate only.[12] Specifically, developers are expected to purchase development rights from both the Eastern Rail Yard and the District Improvement Fund —a pool of zoning bonuses (described below)—in order to build luxury housing at the very tops of the new office buildings along 11th Avenue. The plan assumes that this market-rate housing would receive the equivalent of a 10-year 421-a property tax exemption (full abatement on improvements for two years, followed by an eight-year tax phase in).

Because of strong housing demand in Manhattan, residential development is expected to start quickly in Hudson Yards and remain strong through 2025. Because property tax revenue for most residential projects would be limited to the tax on land for several years, and payments on new construction would then phase in over several more years, less than 10 percent of total revenue per year is expected from residential property taxes from 2012 through 2019. After that, as exemptions phase out, residential property tax revenues are expected to rise steadily. By 2025, they are projected to exceed 25 percent of total project revenue in current dollars. By 2033, they are projected to reach 45 percent and exceed the contribution of commercial PILOT payments. However, because of this delayed receipt, revenue from residential property taxes is less than a third of the total revenue, measured in 2003 dollars, for the plan period.

Eastern Rail Yard On-Site Land Value. Construction of a 570,000 square foot platform over the Eastern Rail Yard greatly increases the amount of space that can be developed in the area. If rezoned to allow high density development (floor area ratio, or FAR, of 19) on the platform, as proposed by the project planners, development rights for the site will total 10.8 million square feet. Payments for the rights to develop 5.1 million square feet on the platform are expected to contribute just 5.5 percent of total revenue for the plan period. This development is expected to include three commercial towers, a 200,000 square foot cultural center, and 200,000 square feet of retail space. If the city's 2012 Olympic bid is successful, the platform would serve as the site of the Olympic Park before this development and part of the park would be preserved.

Three types of payments are expected to comprise the total contribution from on-site development: a lump sum payment from sale of development rights to build the first commercial tower; ground lease payments for the second and third towers; and platform cost reimbursements. The lump sum payment is expected in 2014 and the other payments are expected to start in 2016. This early receipt makes these payments particularly important to the plan. The plan relies on ground lease payments for development beyond the first tower, rather than proceeds from upfront sales, because of the large scale of the full Eastern Rail Yard site. The plan assumes that the sale price for development rights would be $100 per square foot and the annual ground lease rate would be 7 percent of the current year sale price, with a two-year discount during construction. The platform cost reimbursements of $10 per square foot are presented as a substitute for foundation costs that developers would normally face when building on the ground, because the platform would function as the foundation for the new buildings.

Sale of Transferred Eastern Rail Yard Development Rights. While the platform and zoning changes would allow 10.8 million square feet of development over the Eastern Rail Yard, the plan is to use only 5.1 million square feet over the rail yard. The unused portion of the development rights, 5.7 million square feet, would be sold for use elsewhere in Hudson Yards and is expected to generate about 6 percent of total revenue for the plan period. The plan assumes that an initial price of $100 per square foot would be adjusted annually using a proposed real estate index that the Department of Finance would calculate. Developers would purchase these development rights when arranging their financing. For the current calculations, the plan assumes that development rights would be transferred in equal annual increments between 2010 and 2035 and the value per square foot would grow at an annual rate of 2.5 percent.

District Improvement Fund Payments. Approximately 9 percent of total revenue is expected from payments to a District Improvement Fund in exchange for bonus development rights. Specifically, on a parcel zoned for high density, a developer would have the option of building more than the base zoning allows if they make these DIF payments.

The plan assumes that a total of 8 million square feet of such bonus floor space would be purchased in equal annual increments between 2005 and 2035, including 6.7 million square feet of commercial space and 1.2 million square feet of residential space. As noted, these DIF development rights would be required for the luxury housing on the top floors of office buildings. The plan assumes that an initial value of $100 per square foot would be adjusted annually based on the proposed Department of Finance real estate index. For the current calculations, the plan uses an annual growth rate of 2.5 percent.

DIF revenue is projected to contribute a substantial share of total annual revenue in the first 15 years of the plan. Through 2012, the DIF share of revenue exceeds the contribution of commercial PILOT payments; most of this is expected to come from residential development. Through 2019, it exceeds the contribution of residential property tax revenue.

Land Sales and Ground Leases for Publicly Owned Parcels. About 1 percent of total revenue is expected from sales and leases of publicly owned parcels in Hudson Yards. Some of this land is currently city-owned and acquisition of additional parcels will be necessary for construction of the subway extension and other infrastructure in the area.[13] The plan counts on two lump-sum payments for city-owned property: payment for 400,000 square feet on block 705 (between 33rd Street and 34th Street between 10th Avenue and 11th Avenue) in 2008 and payment for 500,000 square feet on block 706 (between 34th Street and 35th Street between 10th Avenue and 11th Avenue) in 2014. The projected revenues are based on an assumed price of $100 per square foot in 2003 and subsequent annual growth of 2.5 percent.

Payments in Lieu of Sales Tax. Finally, the current plan also calls for developers to make "payments in lieu of sales tax" (PILOST) on construction materials to the Hudson Yards Infrastructure Corporation. The revenue from the PILOST is not expected to be large—3 percent of the total for the period. However, much of it would be received early in the plan period, when little other revenue is expected.

ASSESSING THE FINANCING PLAN

We consider three related questions about the proposed financing plan: What are the expected benefits and costs of using the proposed borrowing plan rather than financing Hudson Yards through the city's capital plan? Will revenues reach projected levels? What are the additional risks of the financing plan to the city's budget?

Benefits and Costs of the Proposed Borrowing Plan. The Bloomberg Administration has argued consistently that the proposed public investment in infrastructure in Hudson Yards—the subway extension, the platform, the boulevard, and the other open space—is critical to New York City's economic future. Yet the Bloomberg Administration also has argued against putting the project in the city's capital budget.

The Bloomberg Administration's approach requires significant tradeoffs, in terms of both additional costs and the city's fiscal decision-making process. To avoid paying debt service through the city's general operating budget, the project would amass large long-term obligations. The use of short-term borrowing—the commercial paper—is a step the city does not normally take with its capital investments. It comes at a high known monetary cost and additional potential risk to general fund revenues. The approach also takes financing of Hudson Yards outside the city's capital budget review process.

Benefits. The main idea underlying the proposed borrowing plan is "value capture": use property tax revenue and the proceeds from the sale of new development rights that result from public investment in infrastructure to pay for the infrastructure. In the case of Hudson Yards, revenue resulting from rezoning of the area would also help pay for the infrastructure.

According to the Bloomberg Administration, because the Hudson Yards Redevelopment Area is now underdeveloped and revenue from development resulting from public investment and rezoning could therefore be identified, Hudson Yards provides an opportunity to take a value capture approach to capital financing in New York City. Thus, the argument goes, Hudson Yards can be financed outside the city's capital plan—using project revenue to cover debt service, without drawing directly on general fund revenue for debt service or counting the project borrowing toward the city's limit on general obligation (GO) debt. The commercial paper program presents a way to bridge the period when project revenues cannot cover debt service. Competition with school construction and other city capital projects for scarce city resources will be avoided, they argue. This is presented as the main benefit of the borrowing plan.

Relative Cost of Borrowing. IBO estimates that the proposed financing mechanism would cost $1.3 billion (26 percent) more than if the city simply borrowed the funds through its regular capital budget.[14] The higher cost for the HYIC approach would result from higher interest rates, postponement of principal payments, the need to borrow most of the early debt service, and higher issuance costs. (Details on how this difference is derived are shown on page 7.)

Covering debt service payments for 2005 to 2013 and 2015, when debt service is expected to exceed project revenues, would not be costless for the city if the project were included in the city's capital plan. Hudson Yards GO debt would count toward the city's debt limit, although estimates by both IBO and the Mayor's budget office indicate that there is more than sufficient room under the limit to cover this debt. Adding the Hudson Yards investment would raise the city's capital commitments significantly, if no other adjustments were made. The Executive Budget Capital Commitment Plan projects $17.9 billion (nominal dollars) in city-funded capital commitments for 2005-2008 (excluding projects financed by the Municipal Water Finance Authority). The $2 billion (nominal dollars) in bonds scheduled to be sold in 2005-2008 represents an 11 percent increase above this $17.9 billion, and additional borrowing for Phase 1 and Phase 2 would add to capital commitments in subsequent years. If the city wanted to maintain the current level of debt service payments in the operating budget, adding the Hudson Yards project would require reductions elsewhere in the capital plan.

Costs of Borrowing under the Hudson Yards Plan versus the City Capital Plan

IBO estimates a cost differential of approximately $1.3 billion for borrowing under the proposed plan, as compared to borrowing using general obligation bonds under the city's capital plan. The Bloomberg Administration's assumptions for financing terms for both approaches are used to obtain this estimate. For Phase 1, the difference is estimated to be $1.26 billion, due to differences in costs for project bonds and the use of the commercial paper program under the proposed plan. Phase 2 project bonds add $71.7 million to this total. These amounts are obtained as follows:

Phase 1 Project Bonds: IBO estimates a difference of $627.5 million in the cost of project bonds for Phase 1. For HYIC bonds, the estimated cost equals the sum of debt service payments minus the sum of the reserve fund principal and interest earnings. For GO bonds, no reserve fund is required.

One major source of the estimated gap is the difference in assumed interest rates for long-term borrowing. The Bloomberg Administration hopes to obtain a BBB rating—the lowest investment grade—for the HYIC bonds, while the city's most recent GO bonds have had an A rating. The Hudson Yards plan assumes that the interest rate for HYIC bonds would start at 6.5 percent in 2005 and then rise to 7.5 percent in 2007 and stay there. IBO assumes that the interest rate for GO debt would be 0.5 percentage points (50 basis points) below the HYIC interest rate, based on current projections by the Mayor's Office of Management and Budget.[15] Failure to achieve the BBB rating would increase the costs of the HYIC bonds. Of course, improvement in the rating of HYIC bonds over time could also lower costs.

The proposed delay in the repayment of principal to 2018 also widens the gap, as the base on which interest is calculated does not decline until then under the HYIC approach. In contrast, principal payments for the GO bonds are assumed to begin at 18 months, as usual. The costs of maintaining a 10 percent reserve fund (interest paid minus interest earned, assumed by the Mayor's budget office to be 4 percent) also adds to the HYIC total. Costs of issuance are assumed to be 1 percent for both HYIC and GO bonds. The estimates in our table comparing the costs of HYIC and GO bonds ignore any cost of bond insurance for both approaches.

Commercial Paper: The cost of the proposed plan is raised substantially by the use of commercial paper to cover debt service on project bonds in the first several years of the plan.[16] IBO estimates that the commercial paper program would add $630.8 million to the total cost of Phase 1.

Between 2005 and 2019, $382 million from project revenues and reserve fund earnings would be used to retire some commercial paper and pay some costs for its issuance and thus reduce the amount ultimately retired in 2020. If using GO bonds instead, excess project revenue of $368 million would be available for alternative uses.

The cost of the long-term bonds issued in 2020 to finance the final retirement of outstanding commercial paper would be $249.1 million. These bonds are assumed to be 25-year bonds with an interest rate of 7.5 percent, a 10 percent reserve fund, and issuance costs of 1 percent. The estimated cost of using these bonds equals the sum of the debt service payments minus the sum of the reserve fund principal and interest earnings and the project bond debt service paid with commercial paper; the project bond debt service is already included in the project bond cost.

Comparison of HYIC and GO Borrowing Costs

Dollars in millions, constant 2003 dollars

	HYIC Plan	GO	Difference
Phase 1			
Project bonds	$ 4,772.9	$ 4,145.4	$ 627.5
Commercial Paper			
Outlays 2005-2019	381.6	0	
Bonds to retire CP in 2020	249.1	0	
Commerical Paper Subtotal	*630.8*	*0*	*630.8*
Total for Phase 1	***$ 5,403.7***	***$ 4,145.4***	***$ 1,258.3***
Phase 2			
Project bonds	970.9	899.1	71.7
Total for Phases 1 and 2	***$ 6,374.5***	***$ 5,044.5***	***$ 1,330.0***

SOURCES: IBO; Mayor's Office of Management & Budget; Economic Development Corporation.

Phase 2 Project Bonds: We assume that borrowing for Phase 2 would be done in 2014 for construction of the 41st Street subway stop and in 2024 for construction of the mid-block boulevard, using 30-year bonds with interest rates of 7.5 percent for HYIC and 7 percent for GO, the estimated difference in total costs for Phase 2 is $71.7 million.

Financing the project through the city's ongoing capital program provides an important benefit, however: it avoids the more expensive use of external funds for debt service. Debt service is included in the expense budget, drawing partly on revenue generated by past capital investments. In turn, if the Hudson Yards investment were included in the city's ongoing capital plan, it could ultimately provide revenues to finance other capital projects.

The HYIC approach leaves three-fourths of the debt service for the Phase I infrastructure investments to be paid after 2020, long after the subway extension and the platform are built and beyond the "useful life" of some of the assets being financed. Some payments will continue through 2054. By comparison, 43 percent of GO debt service would be paid by 2020. When using long-term debt to finance infrastructure, the public sector is responsible for safeguarding the welfare of future generations as well as the current generation. Under the HYIC plan, because much of the debt service costs from 2005 to 2019 will be borrowed and then refinanced in 2020, users of the new infrastructure in the first decades of the project will enjoy the benefits of the investment while leaving much of the cost to be borne by future taxpayers.

Potential for Wider Cost Differences. The cost estimates presented above are based on assumptions that construction of the subway, Eastern Rail Yard platform, and other infrastructure would proceed on schedule and without cost overruns, revenue would reach projected levels on schedule, and the commercial paper would be retired in 2020. Failure of any of these assumptions could be very costly for the city.

The most critical period for the plan is the first 15 to 20 years. By the late 2020s, revenues are expected to be more than double the level of debt service. But even under the plan's projections, there is essentially no room for slack before 2020. And this is when the city would have its greatest exposure through the Transitional Finance Authority's credit support.

For example, if interest in development in Hudson Yards is less than expected and revenues equaled just two-thirds of the projected total, the commercial paper program— including TFA credit support—would have to continue until at least 2026. Although revenue could cover debt service on the project bonds by 2021, it could not cover the additional debt service on bonds used to retire outstanding commercial paper until 2026. As of 2026, about $1.28 billion would be required to retire the outstanding balance, about $630 million more than if the commercial paper program ended in 2020. A similar scenario would arise if revenues reached projected levels, but with a two-year delay. This might be caused by a lull in the economy or project delays, for example. Cost overruns also seem probable in a project of this magnitude. A significant increase in project costs to the city would not reduce revenue, but it would raise project debt service and reduce excess revenue available to retire commercial paper. Again, the result could be a delay in the end of the commercial paper program and higher costs over the long run. The need to roll over commercial paper every 270 days also exposes the city to fluctuations in interest rates.

All of the above assumes that the commercial paper program would have no difficulties. Although it seems reasonable to assume that investors would continue to buy the HYIC commercial paper as long as the credit support exists, there is some chance that they might stop buying. In this case, TFA would use revenue from the city's personal income tax to buy outstanding commercial paper. In turn, this money would not be available to cover expenses in the city's operating budget.[17] Under the plan's revenue assumptions, the outstanding balance on the commercial paper would vary from year to year, peaking at $766.5 million in 2013 and averaging $660 million between 2012 and 2020. To put this in perspective: $660 million represents 12.2 percent of projected personal income tax revenue and 2 percent of the projected city-funded expense budget for the 2004 fiscal year. If project revenue came in below assumed levels, the outstanding balance of commercial paper could reach much higher levels.

The consequences of a collapse of the commercial paper program for those holding the long-term project bonds are less clear. Legally, these bondholders would bear the risk of nonpayment if the proceeds from commercial paper were not available to pay debt service not covered by project revenue, because the bonds would not have official backing of the city. However, under such circumstances, the city might step in and make the project bondholders whole. Indeed, rating agencies may regard the Hudson Yards project bonds as city debt, even if they are issued by another agency. This risk to the city for uncovered debt service cannot be ignored.

Some have also expressed concern about the use of TFA for credit support, arguing that it goes beyond the intended use of TFA to finance the city's appropriated capital budget. Using TFA for credit support can be viewed as a way to commit city resources outside of the budget process.

In general, the financing plan avoids having the Hudson Yards project compete with other capital spending priorities in the capital decisionmaking process. It seems appropriate to ask:

should it? The city's legislators typically help determine our capital priorities. In this case, the decision to invest in the Hudson Yards improvements would be outside their review—yet the investment in Hudson Yards could affect the city's general operating budget.

Even if all goes smoothly in terms of revenues and costs, there are other potential risks to the city capital plan. If the rating agencies view HYIC debt as city debt, the existence of HYIC's large obligation alone could be considered as a negative, whether or not there is room under the city's debt limit and any problems with repayment could also jeopardize the city's currently strong borrowing position.

Will Project Revenue Reach Projected Levels? The success of the proposed revenue plan will hinge critically on the accuracy of the development projections used as its basis. Of greatest importance—and least certain today—will be the demand for office space in Hudson Yards, particularly in the first 20 years of the plan when residential property tax revenue from the project will be low. In addition to PILOT payments, much of the revenue for this period is expected to flow from the sale of development rights, DIF payments, and ground leases for commercial development.

Projected Office Space Development and Implied Employment Levels in Hudson Yards

	2005-2009	2010-2014	2015-2019	2020-2025	2026-2035	Total
Office Development (millions sq. feet)	0	5	7	6	10	28
Office Employment per Period	0	20,000	28,000	24,000	40,000	112,000

SOURCES: IBO; "Request for Proposals: Financing of Hudson Yards Project by the Hudson Yards Finance Corporation," December, 2003.
NOTE: No schedule is provided for the development of the market rate housing.

The Plan Projections for Office Development. The plan's projection for office space development in Hudson Yards is derived from an office employment forecast for the New York region done by Cushman and Wakefield and Economic Research Associates.[18] The plan projects that the region will regain its 2000 office employment position by 2005 and then gain an additional 443,450 office jobs over the next 20 years—which represents an average annual growth rate of about 0.9 percent between 2005 and 2025. Assuming that each new office job will require 250 square feet of office space, the plan translates the regional gain of 443,450 jobs into demand for roughly 111 million square feet of new office space (its "base case"). Extrapolating to 2035 at the 0.9 percent employment growth rate for the region, the total gain in office employment in the region would be about 732,000 jobs. This employment level translates into 183 million square feet of office space if each job requires 250 square feet.

Using data for average annual net absorption of office space by areas within the New York region between 1987 and 2000, the plan estimates that 40.7 percent of the projected increase in regional office employment could go to Midtown if sufficient office space were available.[19] But the plan claims that available space in Midtown will be insufficient to satisfy this demand, even if potential Midtown sites get developed. The plan projects that as an alternative, Hudson Yards could absorb 35 percent to 40 percent of the demand for new office space in Midtown during the period. This translates into 28 million square feet of new office space in Hudson Yards by 2035. At 250 square feet per job, it would take 112,000 new office jobs to fill this space in Hudson Yards.

A Closer Look at Employment. For New York City as a whole, the plan's assumptions on office employment growth for the region translate into restoration of 128,800 office jobs by 2005 and a subsequent gain of 388,600 office jobs by 2035. Historical evidence on office employment growth suggests that these projections could be too optimistic.

To start, the city is not likely to regain the 128,800 office jobs lost between 2000 and 2003 by 2005. To accomplish this would require average annual growth of 5.5 percent for this year and next. To put this in perspective, consider that the highest one-year growth rate for office employment in New York City since 1975 (the period for which complete data are available) was 5.1 percent, and this level was reached just once in the year 2000.

Of course, if the city falls short of the goal of restoring the 128,800 office jobs lost since 2000 by 2005, space now available and under construction will need tenants. IBO expects a return to the 2000 peak level of office employment by about 2010, which after accounting for projects expected to be completed should restore office vacancy rates to 8 percent. Because the plan assumes that Hudson Yards office development would not take off until 2010, one might think that a delay in the start of new office employment growth to 2010 would be inconsequential. However, for construction to proceed on schedule, Hudson Yards would have to absorb a larger share of new office employment within the city and the region than the plan assumes.

The annual growth rate of 0.9 percent assumed for subsequent office employment growth also seems high. Estimates of past trend growth rates for office employment are very sensitive to choice of measurement period and assumptions about missing data, but IBO estimates of the growth rate for New York City do not reach this level under any reasonable assumptions. For the 1988-2000 peak-to-peak period (when no data are missing), IBO estimates a trend annual growth rate of 0.5 percent. For the long-term 1969-2000 peak-to-peak period, our estimates range from 0.37 percent to 0.76 percent, depending on assumptions about missing data. Our midrange estimate is 0.6 percent. (See IBO's "Supply & Demand: City and State Plans May Be Planning Too Much Office Space" for more details on employment and office space projections.)

If the long-term average annual growth rate for office employment in the city were to fall short of the Bloomberg Administration's assumed rate of 0.9 percent, the demand for office space in Hudson Yards could fall far short of the level projected in the plan. For example, if office employment growth averaged 0.6 percent (our middle estimate), this would be just two-thirds the projected rate of 0.9 percent. Even assuming that the city regained all of the office jobs lost since 2000 by 2005, the consequence of this slower subsequent growth could be little demand for office space in Hudson Yards.

The plan projects demand for 28 million square feet of office space in Hudson Yards based on an assumption that Midtown will be able to accommodate just 60 percent to 65 percent of its demand. Turning this reasoning around, if the quantity of office space demanded in Midtown is just two-thirds of the projected quantity, the plan's assumptions imply that new Midtown construction could satisfy the full demand—leaving no excess demand for Hudson Yards to fill. With new office employment growth starting in 2010, the situation would be worse. The number of new office jobs created in the city by 2035 would be 203,700—just over half the projected number.

Deep discounts in PILOTs and other incentives for development in Hudson Yards might lure projects that would otherwise be developed elsewhere, thereby offsetting the effects of slower office employment growth. But some shortfall of demand seems likely with slower than projected growth.

Space per Worker. A separate issue is the space required per office job. The plan translates its employment projection into a demand for office space using a base case requirement of 250 square feet per office job. However, recent data suggest that this could be too high for industries expected to grow.[20] If the space required per new job is actually 225 square feet, the total amount of office space required for projected employment growth would be 90 percent of the amount projected under the base case in the plan. Thus, even if projected employment growth for the city is realized, the space needed citywide for new office jobs would be 10 percent less than the projected amount. New construction in Midtown could accommodate 11 percent more office jobs than projected in the plan, as could new construction in Lower Manhattan and other areas. Existing office space could be reorganized to accommodate more workers, as well. The consequence for Hudson Yards could be significantly lower demand for office space than projected in the plan.

Competing Locations. Competition for development from other locations both inside and outside of New York City also could reduce demand for office space in Hudson Yards. The plan acknowledges the potential for 13 million to 15 million square feet of office space downtown (including the World Trade Center site) and assumes that demand will be sufficient to fill this space. The plan also anticipates development in New Jersey and the rest of the region outside the city. But the plan has no mention of the 4.5 million square feet planned for Downtown Brooklyn or the 2 million square feet planned for Atlantic Yards. Demand in these and other parts of the city could be hurt by what Hudson Yards absorbs—and vice-versa.

Developer Response. Whether the office space gets built in Hudson Yards will depend on private developers' responses to the incentives offered there, real estate market conditions, and their judgment of Hudson Yards' appeal to tenants in the near and distant future.

The Bloomberg Administration assumes that developers will find the 30-year certainty about PILOT payments attractive, which seems reasonable. Current property tax laws limit year-to-year changes in levies for existing properties by phasing in market value appreciation.[21] Property tax exemptions and abatements, which are often provided as development incentives, can also limit potential changes in tax levies between years. But even with these provisions, levies can rise or fall significantly. The phase-in of assessment changes can leave landlords facing relatively large tax bills when their market is weak and vice-versa. The PILOT schedule would reduce this inconsistency between the market and tax liabilities. And, of course, the schedule would protect property owners from changes in tax rates, which can be significant. One downside of the PILOT program for developers is that payments would be payable immediately.

Even an attractive property tax deal and good prices on development rights may not be enough to get 28 million square feet of office space built in Hudson Yards. Many of New York City's major developers responded hurriedly to timed incentives in the late 1980s, only to suffer heavy losses when the commercial real estate market took a huge dive in the early 1990s. New buildings stood empty for years. Developers also know about the financial difficulties at London's Canary Wharf in the early 1990s—caused largely by delays in the construction of public transportation. With these experiences in recent memory, developers were generally unwilling to engage in large-scale projects on speculation during much of the 1990s. At this point, developers appear reluctant put a shovel in the ground until half of the new space has been leased to a creditworthy tenant.

Potential office tenants may want to see the subway actually running before making a commitment. Also, if the New York Sports and Convention Center will be constructed on the Western Rail Yard and the Jacob Javits Convention Center will be expanded, potential tenants may want to observe what these additions to the neighborhood will mean generally for traffic and neighborhood ambience. Research on the impact of multi-use facilities on economic activity in immediately surrounding areas is extremely limited.

Finally, although major commercial development is not expected to get underway until 2010, the plan assumes that a large share of revenue in the early years of the planning period will come from DIF payments for bonus development rights. DIF revenue is expected in equal increments between 2005 and 2035. Given the anticipated development schedule, DIF revenue could fall short of projections in the early years of the plan period.

Nonprofit Development. Under current law, nonprofit organizations pay no property tax. Consequently, if a private university, hospital, or other organization acquires land in the Hudson Yards area for development, no PILOT payments would be received for that land. Given that Group Health Incorporated, a health insurance provider, already owns a tax-exempt building within the area (with a property tax savings of $2.2 million in fiscal year 2004), and nonprofit industries are expected to be a major source of New York City's employment growth in the decades ahead, concern about the impact of nonprofit development on Hudson Yards project revenues seems valid.

Additional Risk to the City Budget. One risk to the city budget not discussed above is the cost of municipal services and capital required for Hudson Yards as the area develops. If the development plan is realized, there will be 112,000 workers in 28 million square feet of office space, residents in over 12,000 units of housing in Hudson Yards, and 23 acres of new parkland and open space. Residents, workers, and visitors to the area will need police, fire, transportation, and various other services. The *Draft Generic Environmental Impact Statement* issued by the Department of City Planning and the Metropolitan Transportation Authority in June indicates that several capital projects will be required, including a new firehouse, a new school or equivalent space, and possibly a new day care center. The 23 acres of new parks and other open space will need to be maintained. The cost of these capital projects and municipal services is not addressed in the plan.

Under the finance plan, all project revenue would be directed first to pay for the public investment in the subway extension, boulevard, and open space. In the event that revenue exceeds scheduled debt service, the excess might be transferred to the city's general fund. But the current plan includes no obligation to do this. Such excess revenue could be used to cover unanticipated expenses or retire some debt early.

The city would continue to collect property taxes on all parcels in Hudson Yards that are not in special agreements. Thus, new property tax revenue from appreciation of a parcel—caused by zoning changes, infrastructure improvements, or other factors—would go to the city's general fund as long as the parcel remains outside Hudson Yards programs. The Bloomberg Administration says that this incremental tax revenue from appreciation of these properties will more than cover the revenue lost on parcels in Hudson Yards programs when they are taken off the regular tax rolls. Sales and income taxes would also be generated. However, the Bloomberg Administration has not said that revenue receipt will coincide with expenditures for the additional capital and municipal services used in Hudson Yards as the area develops.

Potential Loss to the Metropolitan Transit Authority. The plan acknowledges that the Metropolitan Transportation Authority owns the development rights over the Eastern Rail Yard and describes the construction of the #7 extension as compensation for these rights. However, given the transportation authority's financial difficulties, they might prefer to use the proceeds from sale of their air rights for other priorities. Negotiations over how the Eastern Rail Yard revenues will be split are now in progress, according to the Bloomberg Administration.

Is the Proposed Financing Plan TIF? Although the proposed financing plan does not employ tax increment financing (TIF), as it is commonly defined, the proposed approach shares both positive and negative characteristics with TIF.

In theory, TIF works as follows: a geographic area is designated (the TIF district); a plan for improvements is developed; bonds are issued and the proceeds are used to pay for the planned improvements; the improvements spur private development and raise property values above where they would have been without the improvements; the property tax revenue from the increased assessments over and above the level before TIF is used to pay debt service; property taxes on assessed values that existed before the TIF project continue to go to the municipality or other taxing entities.

This is somewhat different from the proposed financing plan. While incremental tax revenue for all parcels in Hudson Yards would go to HYIC under TIF, the proposed plan would direct *all* PILOT revenue for parcels in PILOT agreements (not just incremental revenue) to HYIC, and all tax revenue for non-PILOT properties would continue to go to the city's general fund. All property in Hudson Yards would also be subject to changes in property tax rates under TIF, while properties in PILOT agreements would not.

Like the proposed plan, however, TIF is generally presented as a way to use new property tax revenue from new development to finance public investments, separate from a municipality's capital plan and, thus, out of direct competition with schools, hospitals and other capital projects for funding under a municipality's debt limit. These are the features stressed by TIF proponents.

Keeping a capital project apart from a municipality's capital budget is not without some potentially negative consequences, however. Some have been discussed for the proposed plan already. These include payment of uncovered debt service in the event of revenue shortfalls, cost spillovers to the city for new municipal services required by new development, and expensive borrowing. Some TIF projects have suffered from one or more of these problems.

Another issue is fragmentation of the property tax base. Currently, Hudson Yards is the only project for which PILOT financing has been proposed in New York City. However, its use might spread and thereby fragment the city's property tax base. Designated districts might retain all growth in their property tax collections for their own development, rather than contributing part of this growth to citywide investments and assistance for less prosperous neighborhoods. Such fragmentation is a growing concern in Chicago, which has more than 100 TIF districts.[22]

CONCLUSION

The risks to the city of the proposed finance plan will depend critically on the pace of construction of the subway, platforms, and other infrastructure, and on the response of private developers to this public investment, additional changes in the area (the expansion of the convention center and the New York Sports and Convention Center, in particular), and the local economy. Projections may be too optimistic. And even if all proceeds as expected, the cost of the Hudson Yards Infrastructure Corporation project bonds will exceed the cost of using general obligation bonds to fund the project, and the costs of using the proposed commercial paper program to cover debt service in the early years will be large. Although keeping the commercial paper program in operation until 2020 will reduce risk for project bondholders and thereby reduce the cost of long-term borrowing, it will also leave the city exposed to significant risk until then through the TFA credit support. And if the commercial paper cannot be sold publicly, the city's personal income tax and sales tax revenues will be used to buy it.

Written by Theresa J. Devine

ENDNOTES

[1] In "Request for Proposals: Financing of Hudson Yards Project," released on February 11, 2004, Hudson Yards is defined "approximately as the area bounded by the south side of West 43rd Street on the north, the east side of Eleventh Avenue on the west, generally, the north side of West 27th Street and West 30th Street on the south, and the west side of Seventh and Eighth Avenues on the east" (p. 1). The document also refers to the area as the "Hudson Yards Redevelopment Area" or "HYRA". Throughout this paper, the term "financing plan" refers to the information in this document and the additional briefing materials presented on February 11, 2004.

[2] Expansion of the Jacob Javits Convention Center, construction of a platform over the Western Rail Yards, and construction of a roof on the New York Sports and Convention Center proposed for the Western Rail Yards are included in the Bloomberg Administration's development plan for the Far West Side, but financing of these components has been kept separate from the financing of public investment in Hudson Yards.

[3] Unless otherwise noted, all dollar amounts have been deflated to 2003 dollars using the same 2.5 percent annual inflation assumed in the Bloomberg Administration's plan. By presenting the value of future payments and revenues adjusted only for inflation rather than calculating present values, we maintain consistency and comparability with the presentation in the administration's documents which also use inflation-adjusted constant dollars. The present value of a future payment accounts not only for the fact that inflation makes a dollar paid in the future worth less today, but also for the fact that a dollar invested today will earn a real return.

[4] Essentially all parts of the financing plan are conditioned on rezoning of the Hudson Yards Redevelopment Area. This paper assumes that the Bloomberg Administration succeeds in this effort.

[5] About $100 million of construction costs would be covered directly by project revenues and reserve interest earnings rather than borrowed.

[6] Chapter 16 of the Laws of 1997.

[7] The debt limit is a limit on long-term borrowing imposed by the state Constitution and the Local Finance Law. The total amount of outstanding city debt cannot exceed 10 percent of the five-year average full value of the city's taxable real estate as calculated by the state. All capital funds financed by debt issued by New York City itself are counted toward the debt limit.

[8] Chapter 16 of the Laws of 1997 authorizes TFA "to invest any funds held in reserves or sinking funds, or any funds not required for immediate use or disbursement, at the discretion of the authority" and this money might be used to purchase the commercial paper before turning to personal income tax revenue. At the end of 2003, TFA held $254 million in cash and investments. Also, if personal income tax revenue was insufficient to cover the cost, TFA could use sales tax revenue.

[9] The Bloomberg Administration is currently considering smaller discounts for early development, with a maximum of 20 percent for development in 2010.

[10] ICIP provides "as-of-right" tax incentives (exemptions, deferrals, and abatements from real property taxes) for up to 25 years for new construction and modernization of industrial, commercial, and mixed-use structures that satisfy certain geographic and other eligibility criteria.

[11] For new construction of multiple dwellings on certain lots outside the area between 14th Street and 96th Street in Manhattan and certain areas within these boundaries (including parts of HYRA), the basic 421-a program fully exempts increases in assessed value during construction and for several years thereafter, and then phases out the exemption over several more years. The lengths of the full exemption and phase-out periods depend on location and other criteria. The Affordable Housing program offers the same benefits, but requires construction of affordable housing units in exchange.

[12] No timetable is provided for construction of the 2 million square feet of market rate housing.

[13] Note that the development plan does not assume any condemnation of property for purposes other than construction of parks, roads, and transportation. The plan assumes that developers will acquire the newly rezoned property on their own and then voluntarily enter agreements with the city.

[14] Using a discount rate of 5 percent, IBO estimates that the difference in present value terms discounted to 2003 is over $550 million.

[15] Current differentials between BBB and A GO 30-year bonds have been smaller than 50 basis points. If this smaller differential persists, the cost differential between HYIC and GO bonds would be smaller.

[16] For the commercial paper itself, the interest rate is assumed to be 4.75 percent and the cost of issuance is assumed to be 0.15 percent. These are assumptions by the Mayor's budget office. The amount of project debt service covered by commercial paper is estimated to be $798 million.

[17] If it appears that the commercial paper program is encountering difficulty, the city might choose to step in and restructure the debt without drawing on TFA resources.

[18] According to the Economic Development Corporation for New York City, the plan defines the New York Region as: New York City, Long Island, and Westchester County in New York; Fairfield County in Connecticut; and Bergen, Essex, Hudson, Middlesex, Mercer, Monmouth, Morris, Pasaic, Somerset, and Union counties in New Jersey.

[19] In real estate, the term "absorption" refers to the change in occupied space.

[20] See Terry Pristin, "A New Office Can Mean Making Do With Less," *New York Times*, May 26, 2004. Also, an assumption of 200 square feet per job was used by the New York City Partnership in their 2003-2004 report, *Transportation Choices and the Future of the New York City Economy*, available at www.nycp.org.

[21] For all Class 4 properties and most Class 2 properties, changes in assessed values due to market value appreciation or depreciation are phased in over five years to determine taxable property values. For Class 2 rental buildings, condominiums, and cooperatives with 10 or fewer units, increases in assessed value are limited to 8 percent per year and 30 percent over five years.

[22] For additional discussion, see *Learning from Experience: A Primer on Tax Increment Financing*, IBO Fiscal Brief, September 2002.