PUBLIC/PRIVATE JOINT VENTURES: THE GOVERNMENT AS PARTNER—BANE OR BENEFIT?

by M.J. Brodie

The concept of public/private joint ventures is a very recent phenomenon in the long history of real estate development. But over the past three decades, the success of projects, ranging from Baltimore's Inner Harbor and Washington, D.C.'s Pennsylvania Avenue, to San Francisco's Yerba Buena and New York's Battery Park City, has demonstrated the potential of the public and private sectors joining forces. Certainly, the traditional public sector role was far removed from any vision of partnership. In the United States, the public sector's role represented regulation through law and administrative techniques. This stemmed from several sources and goals, such as the need to impose at least a minimum degree of order to the generally chaotic development in cities and in the undeveloped countryside. Governments hired surveyors to lay out streets, roads, farm dimensions and building lots, sometimes with a further design element, such as William Penn's "greene countrie towne" of Philadelphia or Pierre L'Enfant's Parisian-influenced forms for Washington, D.C.

Another factor for public sector involvement came from 19th- and early 20th-century concerns for public health and safety. Responding to high population densities, the lack of adequate air and light in tenement buildings, medical research on communicable diseases and a history of destructive fires, the 20th-century American concept of zoning evolved. This system is unconsciously but powerfully anti-urban in its too rigid segregation of uses.

A third more recent factor, usually inclusive of the previous two, was public sector planning through a department and/or commission. Typically involved was a set of detailed subdivision regulations and often a capital improvement program that quantified needs, identified sites and proposed financing methods for schools, parks, streets, bridges and water and sewer systems. The capital improvement program related to the public sector's historic role with infrastructure; this function was usually performed by a department of public works which, in addition to its own staff, employed private engineers, architects and contractors to assist in carrying out its responsibilities. All of these factors were useful, all relatively standard and all clearly within the American economic and

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political system which maximizes private initiative, decisions and financing of real estate development.

The Advent Of Suburbia And Urban Plight

In reaction to the post-World War II exodus of business and families from many of America's older cities to the suburbs, urban renewal provided the foundation for a more pro-active public sector role. Employing a variety of legal powers, e.g., eminent domain and combined federal and local funding, the public sector acquired large areas typically in the center of older cities where it often would demolish existing buildings, create new disposition lots and sell or occasionally lease the sites to private developers. The private development was often regulated with more detail than before with uses, locations of buildings and sometimes three-dimensional architectural concepts to be specified.

Nearly always a new public sector vehicle, the urban renewal agency, was created to implement the program. Sometimes it was part of local government and sometimes it was a more independent entity. The public sector role was also extended in terms of time. Use covenants, often for 40 years, were imposed on private development. Architectural changes beyond the originally approved design required a formal public review process. The basis of this additional public involvement in real estate was in the benefits the public actions provided to the private sector—almost a partnership or joint venture but not quite.

Increasing Demands On Public/Private Sector Partnerships

For many local jurisdictions, perhaps the decisive catalyst in creating public/private ventures, as defined today, was the federal government's passage in 1976 of the Urban Development Action Grant (UDAG). The concept, while built on the urban renewal experience, was significantly different. It outlined a set of criteria—ratio of public-to-private financing, job retention and/or creation, estimated increase in property tax revenues—that when taken together allowed a locality to compete for federal funds on a regular basis. The funds were intended to bridge the project's demonstrated economic gap in order to create financial feasibility. The idea of public/private venture now had a financial incentive and a set of official, nationwide rules. Localities deemed eligible on the basis of a need formula could compete for federal funding. At about the same period, based on a pragmatic reflection on past experience, some localities concluded that the traditional public/private sector relationship was inadequate to address a lengthening list of public goals and objectives within a declining pool of traditional public financial resources. While desirable, none of the following goals and objectives was easy to achieve or without cost:

- mixed-use developments, usually with such uses as housing or art space that produced lower economic returns, particularly in the short term;
- historic preservation;
- higher quality in both architecture and landscape design and construction;
- high-quality, long-term operation and maintenance of buildings and public open spaces; and
- additional public income, particularly in the creation of an ongoing revenue stream if the projects were profitable.

If the public sector expected to realize the goals and objectives, it needed to:

- develop a deep and clear understanding of the economics of the private and public sides of the development process, the costs and benefits and the risks and rewards for each party;
- develop fair, open and professional methods to select private partners;
- create the conditions for a relationship based on understanding and mutual trust that would survive the vicissitudes of time;
- identify and, if possible, quantify what it would bring to the partnership in the way of land or public improvements; financial incentives such as grants, loans, tax abatements, and mechanisms, e.g., Transfer of Development Rights; expedited processing of required approvals; or neighborhood relationships;
- provide an organizational entity staffed with knowledgeable and creative individuals prepared to operate in a business-like environment with the appropriate combination of authority and responsibility to make timely decisions and deliver on the public sector commitments.

The private developer also was expected to hold to a set of clearly articulated standards. For example, the private partner had to protect the public interest by allowing its books to be audited and often by sharing with the public sector its profits above a negotiated amount.

Although meeting these aspirations is difficult and, to a large extent, non-traditional, they have been achieved in many projects by the public and private sectors. What is critical is to establish a process and a structure that allows all partners to be dealt with fairly and professionally and where the product meets both public policy goals and the test of the marketplace. The following illuminates some of the challenges and the opportunities I experienced as director of two public agencies, one municipal and one federal, in administering revitalization programs through public/private partnerships.

The Baltimore Experience

The Development Of Inner Harbor

The rebirth of downtown Baltimore began in 1959 when the plan for the 33-acre urban renewal project for the Charles Center first brought private business and the city government into a cooperative relationship. By the early 1960s, with the Charles Center's $200 million effort well on its way to success, the city turned to redevelopment of the adjacent 240-acre Inner Harbor area. By the end of World War II, the once thriving port had fallen into disuse becoming a badly decaying assemblage of piers, warehouses, wholesale produce markets and railroad yards. Yet, the harbor's human scale and shorelines on three sides offered potential for new activity and a strong sense of identity for the city.

Framed by new office towers, Baltimore's rejuvenated Inner Harbor draws millions of visitors annually to the Harborplace retail pavillions, National Aquarium in Baltimore and Maryland Science Center. *photo credit: David Whitcomb/ RTKL*

Early in the renewal effort, the city began an important idea of administrative methodology, organizing a non-profit corporation (initially Charles Center Management and later Charles Center-Inner Harbor Management, Inc.) to manage the downtown projects on its behalf. The corporation, reporting to the mayor through the city's Department of Housing and Community Development, was created as a special entity with significantly greater flexibility than the typical public agency. The city, which provides the corporation's operating funds, retains ultimate control and therefore maintains its responsibility for the use of public powers.

In 1963 the mayor of Baltimore identified the renewal of the Inner Harbor as his top priority. The next year, voters approved the first $2 million city bond issue for the development of Inner Harbor. Soon, more than $14 million in city bond issues and $47 million in federal grants were approved for the acquisition and clearing of land surrounding the harbor basin. By 1966, an urban renewal plan for the first 110-acre phase of the Inner Harbor program was approved. A key element of the plan was to establish the harbor as a public amenity, bringing all the property around the water's edge into public ownership or public control. The demolition and clearing of land began in 1968. Subsequently, the city built a bulkhead and a 35-foot-wide brick promenade around the water which connected a variety of new public spaces such as playgrounds, playing fields and picnic areas.

Following these years of infrastructure improvements, including some new buildings, e.g., the Maryland Science Center, and with market studies identifying a population of three million people within a 45-minute drive of the Inner Harbor, the city of Baltimore nationally advertised its sites for commercial development on the harbor's west shore. There was no response until the summer of 1977 when the Rouse Company of Columbia, Maryland, a nationally known retail developer, submitted a proposal to develop the sites. As commissioner of the Department of Housing and Community Development and in accordance with city policies, I announced that the proposal had been received and other developers were invited to submit alternative proposals by a specified date. No other proposals were received.

Controversy Mounts Over Land Use

When the elements of the Rouse Company's proposal were made public, reaction was mixed. The proposal included about 150,000 square feet of special retail uses in two low-rise buildings. Some noted that the project could be the key to the Inner Harbor's long hoped-for vitality. Notwithstanding that the Inner Harbor Urban Renewal Plan called for commercial use, others concluded that no private development was desirable and that the sites should be used exclusively for a public park. Nearby restauranteurs in Little Italy and merchants in the South Baltimore commercial areas felt threatened by future Inner Harbor competition, and they voiced their opposition.

In a short time, enough signatures were obtained to place a referendum on the ballot for the upcoming election. The referendum called for the creation of a public park and no private development. In response, the city administration proposed, on the same ballot, a charter provision limiting private commercial development to two specific sites totaling 3.1 acres and committing approximately 29 acres around the Inner Harbor to public park use. If accepted, the provision would be placed in the city charter and could be changed only with a future vote by the electorate and not by actions of either the mayor or city council.

As a result of cooperative City of Baltimore/ Rouse Company studies, the proposed commercial

sites were replanned to create a larger contiguous park area along the west shore. Citizens groups were formed for and against the two propositions, and extensive public debate, well-reported by the media, took place. The private developer, the Rouse Company, was placed in a difficult position. It would have been understandable if, as a prudent developer, it had ceased work until after the election. However, it seemed clear that the project had a better chance of voter approval if there were commitments to an exciting architectural design and to definite business terms between the city and the company. Negotiations were accelerated, and both the design (within strict city guidelines) and basic business terms were made public several months before the November election. On election day, the city's ballot proposition was approved, and the all-public park proposition was defeated.

By the following February, groundbreaking took place on a fast track basis. Detailed negotiations were completed, including considerable public discussion on affirmative action policy. This resulted in the city's commitment to apply Community Development Block Grant (CDBG) funds to assist minority businesses. Construction was carefully coordinated between adjacent public and private work. The Harborplace project opened on July 2, 1980.

Business Terms Finalized For City And Developer

Apart from the Rouse Company's experience in Boston with the Faneuil Hall Marketplace (a historic building renovation in a city and region with a much larger market area and a higher income population than Baltimore), there was no precedent for the Harborplace development. The developer's risks, both financial and reputation-wise, were considerable. Based on market studies, the potentials seemed substantial but were unprovable. And, from the city's point of view, a failure of this key project could diminish the confidence of other developers for nearby sites which would slow or halt the momentum of renewal.

The basic business terms agreed to by the Rouse Company and the City of Baltimore were:

- A market-rate land lease covering the two parcels (with a total of 136,867 square feet or approximately 3.1 acres);
- An unsubordinated ground rent of $100,000 which the developer would pay the city, based on a single-phase development of 150,000 square feet of gross leasable floor area;
- Full real estate taxes estimated at $368,000 for the first full year of operation to be paid by the developer;
- The city would receive 25% of the net profits after payment of operating expenses, fixed costs such as ground rent, taxes and debt service and a return to the developer of 10% of gross revenues and cash equity;
- At the end of the 75-year lease term, the buildings would become the property of the city at no additional cost;
- The developer's plans and specifications for buildings, landscaping, lighting and signs were subject to city approval; and
- The developer would be required to operate the project at a standard of quality comparable to its Faneuil Hall Marketplace project in Boston.

The total revenue to be received by the city in ground rent, profit sharing and real estate and personal property taxes was estimated at $628,000 in the first full year of operation, $868,000 in the fifth year and $1,167,000 in the tenth year. (These estimates did not include revenue to be received by the city from income, sales, utility and parking taxes.)

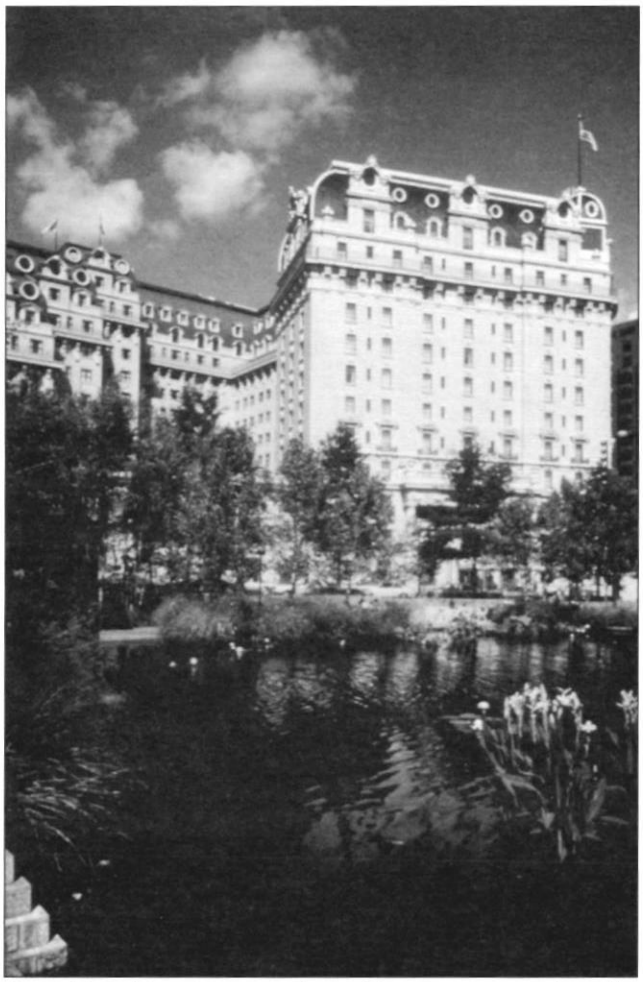
Reflecting 90% tenant ownership from the Baltimore/Washington area, Harborplace's 138 small shops, restaurants and other eating places were an immediate success. It's continued success accelerated the pace of the Inner Harbor effort, providing a major attraction and positive image for Baltimore and receiving national and international acclaim. Businesses in the adjacent neighborhoods have benefited from the expanded number of customers drawn to the Inner Harbor, and the new Oriole Park at Camden Yards provides an additional draw. Approximately 16 million tourists visit the Inner Harbor area annually, spending more than $500 million.

One billion dollars in private investment was leveraged from the city's $200 million investment. The success of the Inner Harbor development is due to several factors. First, its overall plan was strong and exciting in concept and design so it could be implemented in increments with public open space as a key integrating element. Second, the city took responsibility for providing top quality design to improve the infrastructure and public environment of the Inner Harbor—its walkways, public spaces and many parking areas. This demonstration of the city's commitment created an attractive framework for subsequent private investment. Third, the city became an innovative public partner, creating Charles Center-Inner Harbor Management Inc. as an effective, non-bureaucratic entity.

The Pennsylvania Avenue Development Corporation (PADC) Experience

As the seat of the federal government since the 1790s, Washington, D.C. has served as a magnet to those seeking to influence public policy. The presence of the federal government helped protect the city from the severity of economic downturns over the years. However, even post-World War II Washington was not immune to the suburban pressures

that affected neighboring Baltimore, 35 miles to the north. By the 1960s, the mile-long stretch of Pennsylvania Avenue from the White House to the U.S. Capitol was a paradox. The stable southern side of Pennsylvania Avenue was lined with federal government buildings developed in the 1920s and 1930s, while the north side was a chaotic and dilapidated mixture of buildings and parking lots, hardly reflecting the image of America's Main Street.



Combining historic restoration with new construction, the Willard Inter-Continental Hotel and Office Building project was a milestone in the revitalization of Pennsylvania Avenue. *photo credit: Carol Highsmith/PADC*

In 1961, John F. Kennedy was dismayed at the condition of Pennsylvania Avenue as he rode from the Capitol to the White House following his presidential swearing-in ceremony. After many studies, but little action, legislation was enacted in 1972 creating the Pennsylvania Avenue Development Corporation (PADC) as an independent corporation of the federal government charged with rejuvenating the 110-acre Pennsylvania Avenue area. Under PADC's leadership, Pennsylvania Avenue has been almost totally revitalized, leveraging $1.5 billion in private development from a $150 million investment in public funds (in streets, sidewalks, public plazas and parks and historic preservation work).

Today, Pennsylvania Avenue is lined with new and renovated buildings of high design quality including, for example, the Willard Inter-Continental Hotel and Office Building, The Evening Star Building and the Canadian Embassy. Other significant projects—Market Square and The Pennsylvania, both residential/office/retail complexes, and The Lansburgh, a residential/retail project including The Shakespeare Theatre—are making major contributions to Washington's new 24-hour-a-day downtown living.

The Rehabilitation Success Of The Willard Hotel

The Willard Hotel, two blocks east of the White House and a grand and authentic part of both local and national history, was a key public/private partnership success story. The hotel was in decay and had been closed for more than a decade when it and the adjacent property was acquired in 1978 by PADC for slightly over $10 million. The team of Stuart Golding and the Fairmont Hotel with Hardy Holtzman Pfeiffer Associates, Architects, was selected in a national design and development team competition to develop the site. After several years of intense but unsuccessful efforts to finance the project, the Oliver Carr Company of Washington was added as general partner to the Willard Associates team. The mix of uses was refined to encompass a 395-room hotel, 222,000 square feet of office space, and 24,000 square feet of retail and underground parking for 218 cars.

By the beginning of negotiations with the developer, PADC's investment in the property totaled $11.4 million. The site, which consists of nearly 60,000 square feet and includes the shell of the old hotel, is leased by PADC to the developer on the basis of a fixed rent of $800,000 per year (this recognizes a $5 million write down as a result of PADC's historic preservation requirements). Based on a 25/75 percent ratio for PADC/developer, PADC also participates in the gross income (not to exceed $400,000 per year) and net rental income (after a 20% return to the developer on its equity). The base rent is subject to adjustment based on reappraisal at various times as specified in the lease. Financing for this $115 million project consisted of a $75 million construction loan which became a mini-permanent loan for a five-year term after the project's completion.

The developer, with the assistance of PADC, sought and obtained an Investment Tax Credit (ITC) of approximately $12 million for the historic restoration work. The quality and detail of the extensive restoration in the hotel's public areas were clearly enhanced by the ITC. After an extensive

design review process by PADC and the Commission of Fine Arts, construction began in the summer of 1983. The hotel was officially opened on September 22, 1986. Permanent financing was secured by 1987 for $90 million at a 15-year term, interest-only for five years and then amortizing on a 35-year schedule. The balance of the financing was raised through private individuals, the hotel operators and the Oliver Carr Company.

Both the developer and PADC estimated that the revenue from the office space would carry the hotel through the expected slow early years; in point of fact, both the hotel and the office building have exceeded economic expectations. Just as the Willard's decline reflected the deterioration of the Pennsylvania Avenue area, its re-opening represented, both physically and symbolically, the revitalization of America's Main Street and subsequently assisted PADC in advancing many other developments.

Other PADC Projects

The Willard represents one of the three methods PADC employs to work with private developers: public assembly of a major site through negotiations and/or condemnations followed by a development/design team competition. Other projects developed by this method are:

- National Place—Completed in 1984, this mixed-use project consists of the 774-room, J.W. Marriott Hotel, 74,000 square feet of shops and 418,000 square feet of office space around the restored National Theatre. PADC's ground lease was purchased in an open-bid competition several years after project completion, for over $40 million.
- Market Square—Completed in 1990, these twin 13-story towers house 210 residential condominiums, 104,000 square feet of retail and 584,500 square feet of office built around Market Square Park, a major public open space featuring the Navy Memorial. PADC acquired the site for $21 million and sold it, in fee simple, for approximately $26 million.
- The Lansburgh—Completed in 1992, this complex of 385 rental apartments, 36,000 square feet of retail space and the 475-seat Shakespeare Theatre combines new construction with the preservation of the terra-cotta facades of the former Lansburgh department store. Recognizing that the housing use could not carry full land costs, PADC sold the site for $1.6 million, the estimated value of the retail uses, with a provision for sharing in future profits derived from sale and/or refinancing of the project.

Mixed-Use Jenifer Building

A second public/private relationship is based on private ownership of a site and/or building, with PADC working with the private owner and sometimes providing financial assistance for historic preservation. On the mixed-use Jenifer Building, PADC assistance enabled the owner to add a two-story rooftop addition, thus providing a total of 30,000 square feet of office, 2,500 square feet of retail and 10,900 square feet of space for the Washington Project for the Arts. PADC provided $300,000 in historic preservation funds; the District of Columbia provided $100,000 worth of streetscape improvements for the $8.5 million private investment.

With its 210 condominium units, ground-level retail and eight floors of office space, Market Square is a key element of the new Pennsylvania Quarter neighborhood. *photo credit: Carol Highsmith/PADC*

Market Square North Project

A third public/private relationship is represented by the Market Square North project which will provide 201 condominium residential units in two towers and an office/retail building with 397,000 square feet of office space and 25,000 square feet of retail space. PADC had acquired several sites in the block where a single private developer owned more than 50% of the block, and the remainder was in several other private ownerships.

As permitted by PADC's enabling legislation, the more than 50% owner, unable to buy the remaining parcels, turned to PADC to purchase the PADC sites and to avail itself, if necessary, of PADC's eminent domain power to assemble the complete block by contracting to design and build a development in accord with the PADC plan.

The Pennsylvania Quarter Neighborhood Association

Beyond direct partnership in individual projects with private developers, PADC helped create a nonprofit 501(c)(6) organization, the Pennsylvania Quarter Neighborhood Association, to enliven the new Pennsylvania Quarter neighborhood. Each of the private developers, whose mixed-use projects contain a residential component, joined PADC in founding an association whose activities include cooperative retail planning, joint marketing, promotion, events and activities sponsorship.

What It Takes For Public/Private Ventures

The experience of Baltimore's Inner Harbor and Washington's Pennsylvania Avenue redevelopment exemplify the characteristics critical to the success of these and other public/private ventures:

- A clear and comprehensive revitalization strategy and plan, in which the project is an integral part, with timely and visible infrastructure improvements;
- A strong public entity, well-organized and targeted to the accomplishment of particular tasks within a sensible time frame;
- A thorough and realistic assessment of the costs and benefits involved and the ability of the parties to articulate these elements to elected public leaders, the public and the media;
- A project concept that is both innovative and based on local conditions and characteristics; and
- A private developer who appreciates long-term asset development and value as more important than short-term profit and is willing and able to commit the necessary resources of time, energy and funds to overcome known (and often unknown) obstacles.

On the other hand, the most common mistakes that lead either to failure or to unsatisfactory results of public/private ventures are:

- An overly optimistic view of market demand most often predicated on a belief that success from one project can transfer to another location with different conditions;
- Inexperienced public-sector staff who lack understanding and negotiating experience with the public sector;
- An over dependence on public finance to compensate for weak private market economics;
- Public-sector demands for more benefits than the development economics can support; and
- Private-sector unwillingness to share fairly the rewards of a successful project with the public sector.

Conclusion

Not every real estate development requires a public/private joint venture. But in complex projects, particularly in urban situations, where land assembly, infrastructure and citizen participation complications exist, a properly structured and implemented public/private partnership can play an important and often decisive role. At a time when public confidence in government has perhaps never been more skeptical, the success of projects, such as those described in this article, demonstrate that public and private sectors can both benefit from working together to create developments of a scope and quality that neither, acting alone, could produce.