DELTA ASSOCIATES
A TRANSWESTERN COMPANY

September 19, 2005

Mr. Richard Bradley, Executive Director
Downtown DC Business Improvement District
1250 H Street, NW, Suite 1000
Washington, DC 20005

Mr. Stanley Jackson, Deputy Mayor of Planning and Economic Development
District of Columbia Government
1350 Pennsylvania Avenue, NW, Room 317
Washington, DC 20004

Re: Downtown Washington Office Market Study
Our project # 24268

Dear Mr. Bradley and Mr. Jackson:

This report contains the results of our office market analysis of the District of Columbia, pursuant to our contract dated August 24, 2004. This study focuses on the strengths and weaknesses of the office market in the District of Columbia to keep pace with other jurisdictions in retaining its economic base and competing for and successfully obtaining office new tenants over the next 20 or so years. The purpose of our study is to explore the District's vulnerabilities in this regard, with recommendations to improve the competitive position of the District's office market.

The tasks involved in this analysis include the following:

1. Retrospective and prospective look at demand for office space from 1980 through 2030, based on employment growth and office space absorption trends and projections, including a look at demand/absorption by submarket, and by tenant type/industry.
2. Examination of the special role of the Federal government as an office tenant, including a look at the "60-40 Rule", Federal employment and office space use in the District and the suburbs, and the pattern of procurement spending in the District and the suburbs.
3. Competitive analysis of the District's office submarkets, compared to neighboring jurisdictions and newly emerging submarkets in the District on the basis of tenants, land prices, rents, operating costs, amenities, and the like.
4. Examine the Downtown DC BID's analysis of developable FAR left in the District compared to demand estimates.
5. Summarize the District's exposure in the period ahead to losing (and gaining) tenants by tenant/industry type and price range.
6. Make recommendations on how to maintain/improve the health of the District office market.

Our findings are detailed following. The data on which these findings are based are found in the attached appendices. Please note that the Base Realignment and Closure Commission's report was released after our work was completed, so its recommendations are not considered in this report.

DELTA ASSOCIATES ▲ 500 MONTGOMERY STREET ▲ SUITE 600 ▲ ALEXANDRIA, VA 22314 ▲ (703) 836-5700 ▲ FAX (703) 836-5765
EMAIL: INFO@DELTAASSOCIATES.COM ▲ WEB SITE: WWW.DELTAASSOCIATES.COM

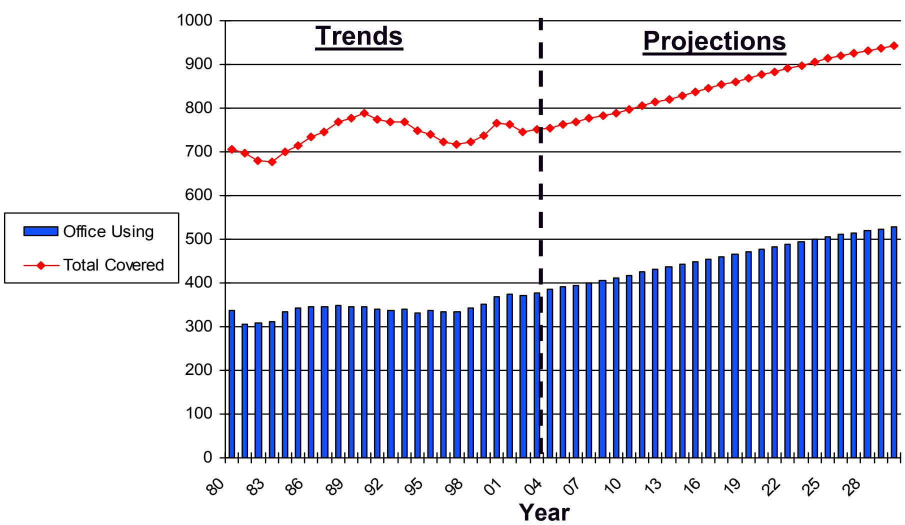
SUMMARY OF FINDINGS AND RECOMMENDATIONS

1. The District economy has the potential to add 7,200 jobs per year, including 5,500 office-using jobs, through 2030.

- Its strong base of law firms, government agencies, and membership organizations have created a strong base of non-cyclical employers that account for more than 75% of recent office leasing activity. Membership organizations, for example, are a stable industry that has created jobs at an average of 2.8% annual growth over the last 10 years.
- The District is blessed with a well-managed, financially sound city government that is responsive to its citizens and the business community. This has not always been the case. Should this change in the period ahead, our projections of job growth would be at risk.
- The District is at the focal point of the nation's second most heavily utilized subway system, in a metro area choking on auto traffic. This represents a competitive advantage for certain employers for certain employment categories.
- The District is the headquarters of three of the region's four core industries: the Federal government, international business, and hospitality/tourism. Only the tech industry is suburban in its orientation.

GRAPH 1

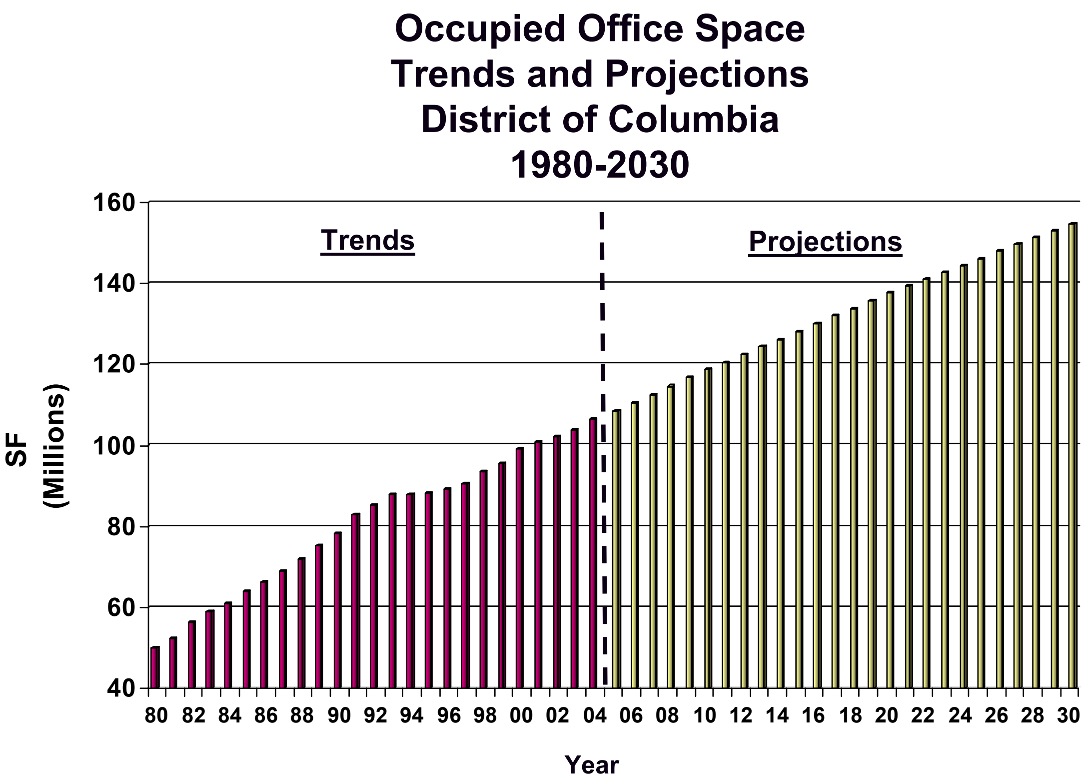
Total Public & Private Office-Using Vs. Total Covered Employment Trends and Projections District of Columbia 1980-2030



Source: Dr. Stephen Fuller and Delta Associates; May 2005.

2. To accommodate these employment gains, the occupied office inventory of the District would grow from 106 million SF currently to 154 million SF in 2030 – a 48 million SF increase.

GRAPH 2

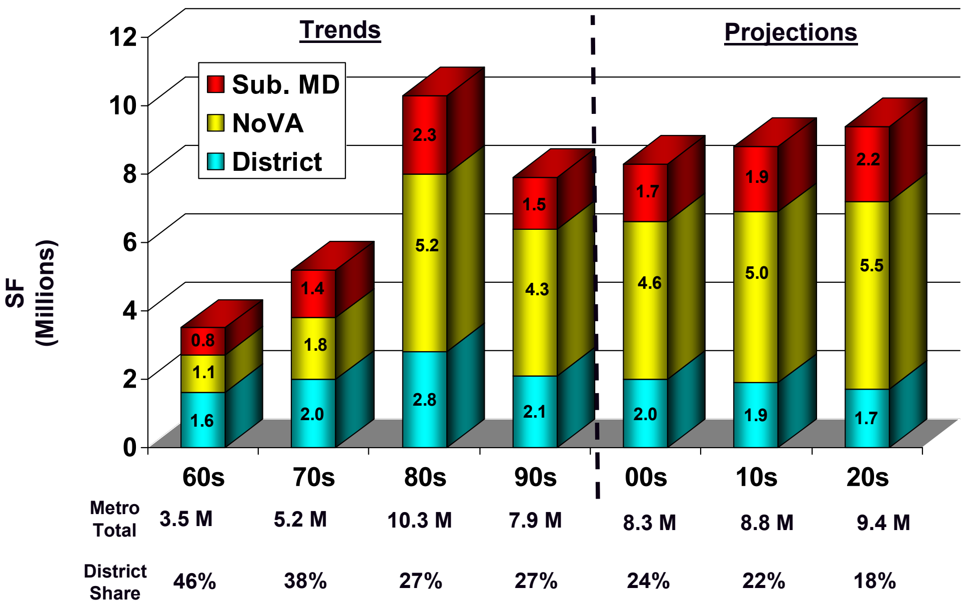


Source: Delta Associates; May 2005.

3. Notwithstanding these robust absorption estimates – 1.85 million SF per annum – the District will continue to lose metro market share, but at a much slower rate than most U. S. center cities. The District is better positioned to compete with its suburban counterparts, with a strong economic base and transportation infrastructure.

GRAPH 3

Office Space Net Absorption Trends and Projections
Washington Metro Area
1960 - 2030



Source: Delta Associates; May 2005.

4. Despite this glowing picture of the future, there are two issues to address:

A. Do we want a Center City so concentrated in a few industries? Is it smart to have an increasingly more narrowly focused economic base in the District? As the cost of doing business in the District goes up, tenants that do not have to be in the District move to the suburbs. This sorting process leaves a concentration of those that have to be in the District or those that want to be in the District – law firms; certain business service firms; some larger, well financed associations; government agencies; lobbyists; and the media. Not bad, so long as the government wants to maintain a concentration of activities in the District (see our discussion of the "60/40 Rule" elsewhere in this report), but worrisome if, like the recent base realignment decision, the government decides to disperse "the target" or change location to reduce costs.

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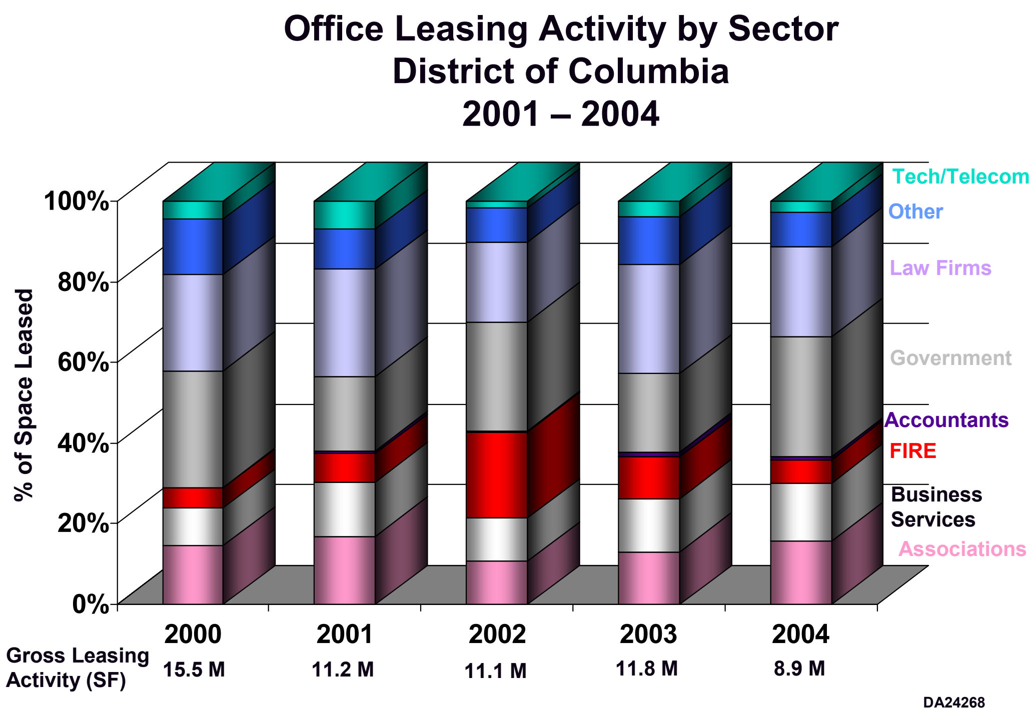
EMAIL: INFO@DELTAASSOCIATES.COM ▲ WEB SITE: WWW.DELTAASSOCIATES.COM

GRAPH 4



Source: CoStar, Delta Associates; May 2005.

B. Practically speaking, can we accommodate all this development in the District?

- Is there sufficient land so that both the demand for housing and the demand for offices can be accommodated without driving land prices so high that affordability is not further exacerbated? In the short run, we think so. In the intermediate and longer run, we think not.
- Can Metro invest enough money quickly enough to keep up with demand from/to the suburbs? A recent study suggests that the system will be at capacity in 15 years without more tunnels. If so, that suggests the answer is no. That, in turn, suggests more and more District employers will need to rely on District residents for their hiring needs.
- That in turn will put more pressure on dwindling land resources. And what about the school system in the District? How will we actually get families to live in the District in meaningful numbers without a real investment in the District schools?

5. Our research shows that the cost of doing business in the District compared to neighboring jurisdictions puts it at a competitive disadvantage, particularly for cost-sensitive tenants. Although certain tenants, such as industry trade groups, law firms, and the like, will continue to need a Washington address or proximity to the government, tenants that have moved out of the District most often cite cost as the main reason, outweighing any advantages that the District may have.

6. In our estimation, the District has enough development capacity to meet projected office demand through the year 2030. But the capacity is, in some cases, at secondary locations and may not meet the needs of users in all cases. As a result, land prices will escalate dramatically in the period ahead. Development opportunities in the core of the city are finite, and some future new development will likely have to shift to nontraditional locations, but the total development capacity of vacant land parcels and redevelopment sites/areas could meet or exceed the District's requirements over the projection period by as much as 41 million FAR square feet.

7. The main factors affecting the District's potential exposure to losing (or gaining) office tenants in the period ahead include the following:

- Metro's ability to meet future transit requirements, given the need for more maintenance and repair, new/additional rail cars, extension of the system, and additional track and tunnel capacity.
- The growing cost and difficulty of doing business in the District, including not only office occupancy costs, but also employee recruitment and retention, commuting time and cost, housing costs, etc.
- An increasingly less diverse office tenant base that is concentrating in just a few industries, as cost-sensitive tenants move out of the District.
- Reliance on Federal employment and procurement, which could be disrupted by changes in Federal policy, as the main drivers of the office market in the future.
- The ability of the District to maintain a well-managed, financially sound city government that is responsive to its citizens and the business community.

8. We recommend the following actions to maintain and improve the health of the District's office market.

- Assure that WMATA increases the number of subway cars now and, in the future, that it addresses the issue of track and tunnel capacity.
- Increase the size of the resident labor force and reduce the District's dependence on suburban workers by making the city more livable – starting with fixing the school system.
- Promote a more diverse office tenant base through programs to reduce occupancy costs and to recruit new or underrepresented industry sectors.
- Try to attract government contractors to the District by competing with the suburbs on cost and providing assistance in finding affordable space.
- Maintain a well-managed, financially sound city government that is responsive to its citizens and the business community.

OFFICE SPACE DEMAND, 1980-2030

We have examined total employment and office-using employment growth trends from 1980 through 2004 and compared them to occupied privately-owned office space and office space demand (or net absorption) over the same period. Likewise, we have projected office space demand through 2030 based on projected total employment and office-using employment. This work is a collaborative effort of the authors: The employment data are provided by Dr. Stephen Fuller and the occupied office space and office absorption data are from Delta Associates.

Covered employment includes regular full-time, year-round jobs, self-employed and contract workers, uniformed military personnel, part-time and undocumented workers, and employees of start-up firms in the first year of operation. Public and private office-using employment is defined as a combination of private sector workers in industry sectors that use office space and civilian employees of the Federal government that work in leased, privately-owned office space.

1980-2004 Employment and Office Demand Trends

Employment growth in the District of Columbia, as measured by total "covered" employment, has averaged 2,035 jobs per year since 1980. There were about 706,600 covered jobs in the District of Columbia in 1980 and 755,400 such jobs as of yearend 2004 or an increase of 48,840 jobs. (See Figure 1 below and Table A-1 in Appendix A.)

Office-using jobs are largely responsible for total employment growth in the District of Columbia since 1980. Public and private sector office-using employment has increased by 48,200 jobs since 1980, or an annual average of 2,008 jobs. Compared with total employment growth, office-using employment has accounted for about 99% of all new jobs in the District of Columbia since 1980. (See Figure 1 and Tables A-1 and A-2.)

Office-using jobs have increased in importance to the District of Columbia's economy since 1980. The share of total employment represented by office-using jobs has grown from 47.8% in 1980 to 51.1% in 2004. Although there have been periods in which the share of office-using employment has declined – due to economic conditions or to reductions in the Federal workforce – the long-term trend is upward. This trend has also accelerated since the early 1990s. (See Figure 1 and Tables A-1 and A-2.)

Figure 1
Employment Trends
District of Columbia
1980-2004

Year	Total Covered Employment	Public & Private Office-Using Employment	Office-Using Employment Share
1980	706,560	337,500	47.8%
2004	755,400	385,700	51.1%
Change	48,840	48,200	98.7%
Annual Average	2,035	2,008	98.7%

Demand for office space in the District of Columbia has averaged more than 2.3 million square feet per annum since 1980. As a result, the amount of occupied office space in the District has more than doubled in size in that time, from a base of 50.1 million square feet of occupied privately-owned space in 1980 to 106.3 million occupied square feet as of December 2004. This represents total absorption of 56,212,000 square feet, or annual average demand of 2,342,167 square feet of office space over the 1980-2004 period. (See Figure 2 and Tables A-1, A-3, and A-4.)

Since 1980, demand for office space has been driven by employment growth, but even more so by changing patterns of office space utilization. As Figure 2 illustrates, the amount of occupied office space has grown by 112% since 1980, while the number of office-using jobs grew by only 14% over the same period. As a result, the average amount of office space per worker has increased from 148 square feet in 1980 to an estimated 276 square feet in 2004 – an increase of 127 square feet or about 86%. (See Tables A-1 and A-5.)

Figure 2
Office Space Absorption and Office-Using Employment
Compared to Office Space per Worker
District of Columbia
1980-2004

Year	Occupied Office Space	Public & Private Office-Using Employment	Office Space per Worker
1980	50,105,000	337,500	148
2004	106,317,000	385,700	276
Change	56,212,000	48,200	127
Annual Average	2,342,167	2,008	5.3
% Change	112.2%	14.3%	85.7%

The growth in the amount of space per worker in the District of Columbia from 1980 through 1995 is due largely to three simultaneous trends (See Tables A-1 and A-5.):

- Since the early 1980s changes in Federal standards for office space utilization and in the nature of the Federal workforce. During the 1980s and much of the 1990s, the Federal government sought to improve working conditions by increasing the size of its employees' workspaces in order to be more competitive with the private sector. In addition, Federal government jobs were becoming more professional or executive in nature, requiring more private offices with more space for each employee.
- An increase in the concentration of employers that tend to use more space per worker – law firms and associations.
- Since the early 1990s, the rate of increase in the average amount of space per worker has actually slowed, however, due to technology's impact on document duplication and storage needs as well as a real-dollar rise in the cost of office space.

<u>2004-2030 Employment and Office Demand Projections</u>

Total covered employment is projected to increase by an average of 7,224 jobs per year through 2030. Covered employment is projected to be about 943,200 jobs by the year 2030, which represents an increase of 187,800 jobs, or about 25%. (See Figure 3 and Tables A-6 and A-7.) This rate of increase is greater than experienced for the whole period of 1980 through 2004, but more consistent with the gains seen in the period 1995-2005.

Office-using jobs are expected to continue driving the lion's share of employment growth in the District of Columbia through 2030, albeit at a lower share of total growth than in the past. Public and private sector office-using employment is projected to increase by 142,900 jobs, or an annual average of 5,496 new jobs, which accounts for about 76% of total projected employment growth. Despite a lower share of total growth in the future, office-using employment is projected to represent 56% of total covered employment in the District of Columbia by 2030, compared to 51.1% in 2004. (See Figure 3 and Tables A-6 and A-7.)

Figure 3
Employment Projections
District of Columbia
2004-2030

Year	Total Covered Employment	Public & Private Office-Using Employment	Office-Using Employment Share
2004	755,400	385,700	51.1%
2030	943,220	528,600	56.0%
Change	187,820	142,900	76.1%
Annual Average	7,224	5,496	76.1%

We estimate that demand for office space in the District of Columbia will average 1.85 million square feet per annum through 2030. The amount of occupied office space in the District of Columbia is projected to grow by 45%, from 106.3 million square feet in 2004 to 154.3 million square feet in 2030. This represents a total of 48 million square feet of office space demand, or an annual average of 1,846,154 square feet. We project that demand will average about 2 million square feet per year through the end of this decade, 1.9 million square feet per year from 2010 to 2020, and 1.7 million square feet per year in the 2020-2030 period. (See Figure 4 and Tables A-6, A-8, and A-9.)

Growth in select private sector office jobs and the tendency of the Federal government to lease rather than own office space will be the primary drivers for future office demand in the District. The amount of space per worker is projected to grow at a slower rate than in the past, because the Federal government has largely corrected the past imbalance with private sector standards. We also expect the Federal government to continue its trend toward leasing more space in the future. Total occupied office space is projected to grow by 45% between 2004 and 2030, while the number of office-using jobs is projected to grow by 37%. As a result, the amount of occupied office space per worker is projected to grow from 276 square feet in 2004 to 296 square feet in 2030, or less than 6%. (See Figure 4 and Table A-10.)

Figure 4
Projected Office Space Absorption, Office-Using Employment, and Space per Worker
District of Columbia
2004-2030

Year	Occupied Office Space	Public & Private Office-Using Employment	Office Space per Worker
2004	106,317,000	385,700	276
2030	154,317,000	528,600	292
Change	48,000,000	142,900	16
Annual Average	1,846,154	5,496	0.6
% Change	45.1%	37.0%	5.6%

<u>Office Space Demand by Submarket Area</u>

Three submarkets – the East End, the CBD, and Capitol Hill – accounted for 86% of total office absorption in the District of Columbia over the past ten years. Total absorption averaged about 1.6 million square feet per year during the 1994-2004 period. The East End submarket, which became the focus of intense office development due to the lack of available sites and high land costs elsewhere, absorbed an average of 705,000 square feet of space per annum, or 43% of the total. The CBD and Capitol Hill submarkets absorbed 383,000 square feet (23%) and 323,000 square feet (20%), respectively. Most of the remaining absorption was divided between Southwest (6%), Uptown (4%), and Georgetown (3%), while the West End captured less than 1%. (See Figure 5 and Table A-21.)

Figure 5
Average Annual Office Demand By Submarket Area
District of Columbia
1994-2004

Submarket	Average Annual Net Absorption (SF)	%
CBD	382,909	23.4%
East End	705,000	43.1%
Capitol Hill	322,818	19.7%
Southwest	93,273	5.7%
Georgetown	53,545	3.3%
West End	6,091	0.4%
Uptown	71,091	4.3%
Total	**1,634,727**	**100.0%**

We expect that as the East End and Capitol Hill become more built out, this geographic pattern of office absorption will shift somewhat in the period leading up to 2030. First, there will be some redirection of development activity back to areas like the CBD and the West End, where older, obsolete buildings and underdeveloped sites will present redevelopment opportunities. In addition, the availability of land in emerging submarkets, such as the Southwest Waterfront, South Capitol Street, Southeast Federal Center, and possibly even Petworth and the St. Elizabeth's area, are likely to draw the attention of some developers to those areas eventually. In the near term, however, they will be able to compete only in terms of price, in all likelihood.

Demand by Industry and Tenant Type

The composition of the District's private sector job growth drives the type and quantity of needed commercial office space. Although private sector employment grew by 26% since 1980 and is projected to grow another 22% by 2030, the District's private sector employment base has remained highly specialized in the Services industry, which generates most of the office-using employment growth and demand for office space. In 1980, 55% of private sector jobs were in the Services industry. This share had increased to 76% by 2004, and by 2030, the dominance of Services industry jobs will have increased to 80% of the District's total private sector. Including the Finance, Insurance, and Real Estate industry (FIRE), which is projected to have a 6% share in 2030, the job base in the industries that are the primary users of office space (FIRE and Services combined) will account for 86% of the District's private sector workforce by 2030. (See Tables A-11 and A-12.)

The job growth pattern determines which economic sectors produce most of the demand for office space and drive the office market, as illustrated by the distribution of employment and leasing activity among tenant types, as shown in Table A-31 for example.

The District of Columbia has seen a significant increase in the share of employment represented by Business Services tenants and to a lesser degree by Associations, Legal, and Health/Medical since 1990. According to data from the Bureau of Labor Statistics, Business Services employment grew from 16% to 21% of total employment in the District from 1990 to 2003, and only FIRE and Government declined during the same period. (See Table A-13.)

The District's office market is driven largely by four tenant types: Government, Law Firms, Associations, and Business Services. Together, they accounted for 75% of the 51.9 million square feet of gross leasing activity in the District from 2000 through 2004. Not surprisingly, these same four tenant types also occupy the largest share of the District's commercial office space. As of 2004, 28% of the office space in the District was leased by Government tenants, followed by Law Firms at 19%, Associations at 12%, and Business Services at 11%. The remainder was split among tenants in FIRE (9%), Tech/Telecom (4%), Health/Medical (2%), and Other (14%). (See Tables A-25, A-27, and A-28.)

We project that office space absorption through 2030 will be led by Government, Legal, Business Services, and Associations, which together represent 71% of the forecasted net absorption. (See Figure 6 and Tables A-25 and A-26.)

Figure 6
Forecasted Share of Net Absorption by Tenant Type
District of Columbia
2005-2030

Tenant Type	Demand Share
Associations	13.0%
Legal	21.0%
Government	24.0%
Tech/Telecom	4.5%
FIRE	8.5%
Business Services	13.0%
Health/Medical	2.5%
Other	13.5%
Total	**100.0%**

THE ROLE OF THE FEDERAL GOVERNMENT AS AN OFFICE TENANT

The 60/40 Rule

Federal employment has been concentrated in the District of Columbia since the District was established, but the District's share of Federal jobs in the region has steadily declined over time as Federal agencies have expanded or moved to Washington's suburbs. By 1963, only 63% of the region's federal civilian and military jobs were located in the District, according to the National Capital Planning Commission, compared to 23.3% in Virginia and 13.4% in Maryland.

In 1968, a new policy, known as the "60/40 Rule", was adopted in the Federal Elements of the Comprehensive Plan that stated that 60 percent of the Federal jobs in the region should be located in the District of Columbia. Therefore, the Federal government's important role in the economy of the District of Columbia and the Washington region has been officially recognized in Federal policies for almost four decades. The new update of the Federal Elements of the Comprehensive Plan (August 5, 2004) has restated the 60/40 Rule again in the discussion of the regional distribution of Federal workplaces:

> "The federal government should . . . achieve within the District of Columbia a relative share of the region's federal employment (civilian and military) that is not less than 60 percent of the region's."

The 60/40 Rule has never had the force of law, however, and the Congress has overridden it on occasion with regard to the location of Federal facilities in the region. As a result, the long-term pattern of decentralization of Federal jobs out of the District has continued since the Rule was adopted in 1968. In fact, the District's share of the region's Federal jobs (excluding those that are security-related) declined to 53% by 2002, the most recent year for which NCPC figures are available. Furthermore, the District would have an even smaller share if security-related jobs that are mostly found in suburban locations are included in the calculations. (See Figure 7 and Table B-13.)

Figure 7
Distribution of Federal Employment
Washington Metro Area
1980 and 2002

	Total Federal Employment, Excluding Security Related Jobs						
	District of Columbia		Northern VA		Suburban MD		Region
Year	#	%	#	%	#	%	Total
1980	224,985	56.1%	78,181	19.5%	98,097	24.4%	401,263
2002	193,835	53.4%	74,618	20.6%	94,358	26.0%	362,811
Change	**-31,150**	**81.0%**	**-3,563**	**9.3%**	**-3,739**	**9.7%**	**-38,452**

The District of Columbia has borne the brunt of the downsizing of the Federal government's workforce in the metro area since 1980. As Figure 7 above indicates, 81% of the 38,500 Federal jobs that the metro area lost between 1980 and 2002 had been located in the District.

Federal Employment and Office Space

The Federal government occupies 88.1 million square feet of office space in the Washington metro area, 50.6 million square feet of which, or 58%, are located in the District of Columbia. Northern Virginia accounts for 26% of Federal office space, and Suburban Maryland has the remaining 16%. About 65% of the space that the Federal government occupies in the District of Columbia, or 32.8 million square feet, is in government-owned buildings, and the remaining 17.8 million square feet, or 35%, are leased in privately-owned office buildings. In the Washington suburbs, the Federal government leases a much larger share of the office space that it occupies – 39% in Suburban Maryland and 70% in Northern Virginia. (See Figure 8 and Tables B-1 and B-2.)

The amount of office space occupied by the Federal government in the District grew by an average of 933,000 square feet per year between 1981 and 2001, including 310,000 square feet per year of leased space. This occurred during essentially the same period of time in which the government revised its office space utilization policies and cut its workforce in the District by more than 31,000 jobs, which generated much of the rapid growth in the overall amount of office space per worker that was observed in the 1980s and 1990s. (See Table B-1.)

The District's share of the office space occupied by the Federal government in the metro area has declined since 1980 at about the same rate as its share of Federal employment. From 1980 to 2002, the District's share of the region's Federal jobs dropped from about 56% to 53%, as shown in Figure 7 above. Figure 8 on the following page shows that the District's share of Federal office space in the region, both leased and owned, declined from 60.3% in 1981 to 57.5% in 2001. (See Table B-1.)

Figure 8
Federal Office Space Inventory
Leased and Owned
District of Columbia
1981 and 2001

	1981		2001		Change	
Tenure	**SF**	**%**	**SF**	**%**	**SF**	**%**
Owned	20,321,660	63.6%	32,783,234	64.8%	12,461,574	61.3%
Leased	11,649,398	36.4%	17,841,289	35.2%	6,191,891	53.2%
District Total	**31,971,058**	**100.0%**	**50,624,523**	**100.0%**	**18,653,465**	**58.3%**
Metro Area Total	53,047,680	--	88,094,636	--	35,046,956	66.1%
District Share	60.3%	--	57.5%	--	53.2%	--

<u>Federal Procurement</u>

Federal procurement, or the purchase of goods and services from the private sector, has helped to counterbalance the declining number of government workers in the District and the region. Recent estimates indicate that Federal procurement supports more than 315,000 private sector jobs – about 80% of the size of the Federal workforce in the region.

Procurement is the most important element of Federal spending in the region. Federal procurement dollars have a much greater secondary economic impact than salary dollars spent on Federal payroll. Procurement spending has grown substantially in recent years and has exceeded the Federal payroll since 1996. Procurement in the Washington metro area rose to about $44.2 billion in

2003, accounting for 46% of all Federal funds flowing into the area economy. (See Figure 9 and Table B-21.)

Since 1990, jurisdictions that host firms receiving the largest share of Federal procurement spending have experienced the fastest economic growth. Local procurement spending totaled approximately $242 billion in the period from 1995 to 2003, with Northern Virginia firms capturing more than half of the total. Northern Virginia is likely to remain a leader in the receipt of Federal dollars, as many government contracts are technology-dependent, and Northern Virginia is the regional leader in technological innovation. (See Figure 9 and Table B-21.)

Procurement spending in the District now represents one-third of all Federal dollars spent there and more than one-quarter of total procurement in the region. Of the $34.75 billion in Federal spending in the District in 2003, $11.38 billion (33%) was spent on procurement, a figure exceeded only by salary and wages, which totaled $14.76 billion (42%). In comparison, procurement represented only 11% of Federal spending in the District and 26% in the region in 1983. Northern Virginia continues to capture a majority of the region's Federal procurement dollars, but procurement in the District grew by 749% between 1983 and 2003 – slightly more than Virginia (736%) and significantly more than Maryland (248%). On an absolute dollar basis, procurement rose by about $10 billion in the District, compared to $20 billion in Virginia and $7 billion in Maryland. (See Figure 9 and Tables B-19, B-20, and B-21.)

Figure 9
Federal Spending by Type
Washington Metro Area
1983 and 2003
(Billions of Current Dollars)

Year	Substate Area	Salary & Wages $	Salary & Wages %	Procurement $	Procurement %	Other 1/ $	Other 1/ %	Total $	Total %
1983	***District***	***$6.76***	***56.7%***	***$1.34***	***19.3%***	***$3.65***	***43.8%***	***$11.75***	***43.2%***
	Maryland	$2.11	17.7%	$2.87	41.2%	$2.77	33.2%	$7.75	28.5%
	Virginia	$3.05	25.6%	$2.75	39.5%	$1.92	23.0%	$7.72	28.4%
	Total	**$11.92**	**100.0%**	**$6.96**	**100.0%**	**$8.34**	**100.0%**	**$27.22**	**100.0%**
2003	***District***	***$14.76***	***53.9%***	***$11.38***	***25.7%***	***$8.61***	33.7%	***$34.75***	***35.8%***
	Maryland	$6.21	22.7%	$9.88	22.5%	$9.28	36.4%	$25.37	26.1%
	Virginia	$6.41	23.4%	$22.98	51.8%	$7.63	29.9%	$37.02	38.1%
	Total	**$27.38**	**100.0%**	**$44.24**	**100.0%**	**$25.52**	**100.0%**	**$97.14**	**100.0%**
Change	***District***	***$8.00***	***118.3%***	***$10.04***	***749.3%***	$4.96	135.9%	***$23.00***	***195.7%***
	Maryland	$4.10	194.3%	$7.11	247.7%	$6.51	235.0%	$17.62	227.4%
	Virginia	$3.36	110.2%	$20.23	735.6%	$5.71	297.4%	$29.30	379.5%
	Total	**$15.46**	**129.7%**	**$37.38**	**537.1%**	**$17.18**	**206.0%**	**$69.92**	**256.9%**

1/ Includes grants, direct payments to individuals, and other.

We expect that procurement will continue to rise in the Washington metro area, along with the growth in Federal spending on defense and national security. These trends will build upon established government initiatives to increase outsourcing and the continued concentration of government contractors in the Washington area. Also of note is the passage of legislation in January 2004 that prevents Federal contractors from offshoring work for the government.

COMPETITIVE ANALYSIS OF THE DISTRICT'S OFFICE SUBMARKETS

In the course of our work, we conducted a competitive analysis of the District's seven existing office submarkets, comparing them to existing submarkets in neighboring jurisdictions in Virginia and Maryland. The comparison factors include tenants, land prices, rents, operating costs, amenities, crime, and business-friendly government posture.

The existing office submarkets in the District include the CBD, the East End, Capitol Hill, Southwest, Georgetown, the West End, and Uptown. Submarkets studied in the neighboring jurisdictions include Bethesda/Chevy Chase, Silver Spring, and Prince George's County in Maryland and the Rosslyn/Ballston Corridor, Crystal City/Pentagon City, I-395/Eisenhower Ave., Old Town Alexandria, Tyson's Corner, and Reston/Herndon in Virginia.

Using the same factors, we have also examined six newly emerging submarket areas in the District where future office development is projected or desired. These include the NOMA Corridor, Southeast Federal Center, South Capitol Street, Southwest Waterfront, Petworth, and St. Elizabeth's.

In addition, a survey of twenty-three tenants that have made recent office location decisions was conducted by the D.C. Marketing Center in conjunction with this study. The tenants surveyed included those that are new to the District, that decided to stay in the District at their current or a new location, and that decided to relocate outside of the District. The survey asked these tenants to rank certain factors that may have played a role in their decisions, such as proximity to clients or the government, rent and other costs, quality of the area and amenities, transportation, parking, and public incentives.

Our observations on the most significant findings from the submarket analysis follow below. The comparative submarket data that were collected are presented in tabular form in Appendix C, and detailed profiles of all submarkets are presented in Appendices H, I, and J in Volume 2 of this report. The tabulated results of the tenant survey are presented in Appendix D. Finally, a summary of the competitive advantages and disadvantages of the District's office market are presented in Appendix E.

It is clear from our research that the District of Columbia office market is appreciably more expensive, and thus less competitive, than the region's suburban submarkets. As the data presented in Appendix C demonstrates, land and building prices, rents, operating expenses, taxes, and other business expenses are significantly higher across the board in the District than they are in the suburbs. This puts the District at a competitive disadvantage in attracting and retaining office tenants, particularly those that are cost-sensitive or that want to own their own buildings.

On other more subjective measures than cost, the District seems to be holding its own in some areas, but those factors are less important than cost to many tenants. The tenant surveys show that the tenants that left the District placed greater weight on economic considerations than they did on factors such as Metro access, shopping, and quality of the immediate area. Furthermore, new tenants and those that decided to stay in the District most often cite the value of a prestigious Washington address or proximity to their clients as the main reason for their decision. In other words, they chose a District location, cost notwithstanding, because they believe that they need to be there, not necessarily because they want to be there. If the motivations that caused them to choose a District location should change in the future, then they could become candidates to move.

Downtown Washington in general offers several competitive advantages that attract certain types of tenants. Associations and trade groups, law firms, international business, the Federal government, and government contractors will always place a high value on being near their clients and/or their peers, proximity to Congress and Federal agencies, access to the national and international press/media, or simply a prestigious Washington address. For more cost-sensitive tenants with no compelling reason to be in the District, the cost of doing business – including not only occupancy costs, but also employee recruitment/retention, commuting time, and housing costs – is making it increasingly difficult to locate there.

It is likely to be decades before some of the emerging submarkets can compete for tenants on an equal footing with the District's established submarkets. As a result, they will have to compete during the early years of the 2005-2030 projection period based on price, for those tenants that are price-sensitive. With land prices of $100 per FAR square foot or more in downtown Washington and $35 to $40 per FAR square foot in the suburbs, some of the emerging submarkets could be a viable alternative for price-sensitive tenants that want or need to be located in the District, particularly with the help of public incentives. It is difficult to say exactly how competitive the emerging submarkets are now, because there has not been any action in those areas, but in order to become competitive, land prices there will have to be below those in the suburban "edge cities" such as Tysons Corner.

We believe the NOMA Corridor submarket is in the best position to become competitive with the District's established office submarkets, given its proximity to Capitol Hill and the East End, good transportation services and infrastructure, public amenities, and strong existing tenant base. Similarly, the Southeast Federal Center and the Southwest Waterfront submarkets are proximate to Capitol Hill and the Federal agencies in the city core, and they have positive factors such as the riverfront to build on. Projects like the DOT headquarters and Waterside have generated some momentum for these submarkets, and planned public investments in the riverfront area along the Potomac and Anacostia Rivers will help to speed up the process. Although South Capitol Street will certainly benefit from the new baseball stadium, it remains to be seen whether the stadium will help or hinder office development there, particularly if the planning and construction of new highway and bridge infrastructure for the South Capitol Street Gateway initiative is too lengthy. The Petworth and St. Elizabeth's Hospital areas are likely to require the longest time to evolve into competitive office submarkets, because they are isolated and distant from the city center, they lack convenient retail and other amenities, and they are perceived as "pioneering" locations. That being said, they have the city's largest tracts of vacant land, which suggests campus-like office development for large users such as government agencies with high-security requirements.

Accordingly, we have grouped the District's existing and emerging submarkets based on our best judgment as to their respective levels of competitiveness. Each submarket is also ranked against the others within its group. (See Figure 10 on the following page.)

Figure 10
How DC's Office Submarkets Compare

Solidly Competitive	Emerging Competitive	Future Competitive
1 CBD	***1 Southeast Federal Center***	***1 South Capitol Street***
2 East End	***2 Southwest Waterfront***	***2 Petworth***
3 Capitol Hill		***3 St. Elizabeth's***
4 Southwest		
5 Georgetown		
6 West End		
7 NOMA Corridor		
8 Uptown		

Note: Emerging submarkets are in bold italics.

THE DISTRICT'S OFFICE SUPPLY OUTLOOK

The Downtown DC BID estimates that there are 58.8 million square feet of developable FAR left in the District of Columbia. The BID has identified developable FAR totaling 58.8 million square feet in undeveloped sites in twelve areas of the city. The largest concentration, estimated at 20 million square feet, is in the Union Station North area, which represents 35% of the total. Another 15 million square feet are located in the Anacostia Waterfront Initiative Area in Southeast and Southwest D.C., and 6.2 million square feet are within the Downtown. The remaining eight areas have smaller amounts ranging from 0.3 to 3.3 million square feet. (See Table F-1.)

Although not the result of an exhaustive study, we estimate that underdeveloped sites and sites that were previously developed with uses other than office represent perhaps another 30 million square feet of additional development capacity. We estimate that there are up to 10.4 million square feet of unutilized FAR contained in older office buildings, alleyways, etc. that could be recaptured through redevelopment. In addition, potential office sites that are developed with other uses could add up to 20 million square feet if they are redeveloped with office space. Significant past examples of such sites include the old D.C. Convention Center in downtown Washington and the old George Washington University Hospital on Washington Circle. See Appendix F for a summary of the estimates from Delta and the Downtown DC BID. (See Table F-1.)

With nearly 90 million square feet of potential developable FAR available for future office development, it appears the demand for 48 million square feet of office space through 2030 can be met. More importantly, we believe, is the fact that land resources will be challenged and land costs will be rising throughout this period.

THE DISTRICT'S EXPOSURES IN THE PERIOD AHEAD

Given the advantages and disadvantages of the District's office market noted elsewhere, there are several points of exposure to losing (and gaining) office tenants.

1. ***Transportation.*** The health of the Metro system is especially important for the District, which depends heavily on WMATA to get workers into the city each day. WMATA is faced today with limited funds to buy new equipment and to address increasing maintenance and repair needs, while at the same time there is growing pressure to expand the system further into the suburbs. It has been estimated that Metro will reach its full service capacity by 2020 or so unless additional tunnel capacity is added under the Potomac River.

2. ***Rising costs and difficulty of doing business in the District*** — and relatively higher office rents and other business costs — are just part of the problem. With moderate household growth and fewer qualified resident workers, the District is becoming more dependent on suburban employees, who tend to be more difficult to recruit and retain. In addition, with housing costs rising throughout the region, more people are choosing to live downtown, where increased housing demand is generating competition for land between office and residential developers and driving up land costs.

3. ***Increasing specialization of the office tenant base.*** As the cost differential between the District and the suburbs increases, there is a sorting out of the type of tenant that stays in the District, and the tenant base is becoming more "specialized" or concentrated in just a few sectors. This increases the District's exposure, because each sector represents a relatively large share of the office market/demand. Tenant types that are most likely to leave are those that are already leaving – those that are most cost-sensitive such as membership organizations, nonprofits, and small businesses. The growth industries that drive the District's office market are government contractors, associations and trade groups, law firms, international business, and, of course, government. These are the types of office tenants that the District will continue to attract, albeit with increasing difficulty as costs continue to rise.

4. ***Federal employment and procurement.*** Federal employment and procurement policies will be the main engine driving the office market. If current Federal outsourcing policies continue, government employment in the District will continue to decline. The rate of this decline could accelerate dramatically, however, if Federal policies change with regard to security or occupancy costs, leading to agency relocations and/or reductions in the amount of space leased.

RECOMMENDATIONS

We recommend the following actions be taken to maintain and improve the health of the District of Columbia's office market.

1. ***Transportation.*** Although the Metro system is operating under its potential capacity today, due in part to a shortage of subway cars, various studies and articles in the press have warned that track and tunnel capacity could run out as early as 2020. With the region's traffic congestion rated as the third-worst in the nation and commuting times becoming longer and even more unpredictable, a fully functioning mass transit system is crucial for the continued success of the District's office market. The District should make every effort to ensure that WMATA increases the number of subway cars in the Metro system now and that it addresses the issue of track and tunnel capacity soon enough to avert a future transit crisis.

2. ***Labor Force.*** The District of Columbia needs more qualified resident workers, because its economy is too dependent on suburban workers, who are more difficult to recruit and retain for jobs in the District. While the Mayor's housing policy will help the situation, the District must work to make the city more livable, starting with fixing the school system.

3. ***Diversification.*** The District's office tenant base is too specialized and becoming more so as rising costs force cost-sensitive tenants to move. In addition to efforts to reduce occupancy costs, the District should identify and recruit new industry sectors that are not here now or those that are underrepresented but could expand significantly under the right circumstances. Two that come to mind are media and financial services. The prospects for diversification are not good for Washington, or any other major city for that matter, but an increasing concentration of the office market among a few tenant types is adding to the District's exposure. An association hotel has been suggested to serve the needs of the association sector. This is another good idea -- if it is accompanied by efforts to create less costly office space in general so that as the associations graduate from the "hotel" they have reason to stay in the District.

4. ***Federal Procurement.*** If government contracting and procurement continues to be a growth industry, we recommend trying to attract contractors to the District by competing with the suburbs on cost and providing assistance in finding affordable space. Government contracts are typically short in relation to office leases (1 to 3 years as a rule), which limits the contractors' ability to lease office space.

* * * * *

It has been a pleasure undertaking this assignment for you. Please do not hesitate to contact us if you wish to discuss these matters further or if you have any questions regarding our findings.

Sincerely,

DELTA ASSOCIATES

Gregory H. Leisch, CRE
Chief Executive

David Weisel
President, Consulting Division

David W. Parham
Senior Vice President and Project Manager

NOTICE

Delta Associates (DA) considers that it is essential to the reader's examination of this document, and projections contained herein, to understand the use of data, the methodology involved, the role of judgments as distinct from calculations in the methodology, factors which affect current projections, and the impact, if any, of change over time.

The purpose of market, economic and financial projections, together with the basis for the projections, is to make available a considered opinion on potential economic returns from the project so that those who utilize these results can evaluate them in terms of methodology employed, data applied as well as judgments made and identified. All prospective data are subject to uncertainties. As actual market and economic factors affecting the project materialize, they may differ somewhat from the basis projected herein. Unforeseen changes in laws may also affect real estate market performance and value. Accordingly, although the projections in this report are those one would reasonably expect to occur given the conditions existing at the time of this writing, actual market and financial results may differ from the projections.

Similarly, projections herein have been prepared utilizing the information, assumptions and calculations outlined in this report. Select information utilized in the projection process is on occasion from sources other than DA; where such information is from published sources, DA has identified the source and assumed such information to be accurate as presented. Where such information is from unpublished sources, DA has reviewed the information for reasonableness and consistency before including same herein. No representations are made by DA as regards property ownership, size, zoning conformance, occupancy and lease terms, availability of utilities, soil conditions, flood hazard, environmental problems, or any other matters. All such property specific data has been supplied to DA by the property owner and/or its agents and DA has assumed this data to be accurate as provided.

DA's principal business activity is the evaluation of real estate development economics, including the analysis of market potentials, evaluation of projected operating and financial results, and valuations. In the course of each year the firm typically performs more than a hundred assignments for building and development organizations, financial institutions, property owners and the like. The firm considers that it is "expert" in this field, and it is DA's belief that the methodology and other procedures employed by it constitute valid and accepted methods of evaluating and valuing real estate. However, it is pointed out that procedures used herein rely on judgments dependent on the accuracy of data and influenced by external circumstances which can change quickly with time and substantially affect the project and hence its value. DA recommends that its clients recognize these limitations inherent in using the projections of this report when making business decisions.

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