

Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Edward Shikada
Jennifer A. Maguire

**SUBJECT: CONVENTION AND CULTURAL
AFFAIRS FUND FORECAST AND
TEAM SAN JOSE SPENDING
REDUCTION PLAN**

DATE: February 4, 2011

COUNCIL DISTRICT: #3
SNI AREA: N/A

RECOMMENDATION

It is recommended that the City Council:

1. Accept report and updated Team San Jose Spending Reduction Plan and Convention Center and Cultural Affairs Fund Forecast for the proposed Convention Center expansion and direction to the City Manager to proceed accordingly.
2. Approve changes to Team San Jose performance and incentive measures for 2010-2011.
3. Adopt the following Appropriation Ordinance Amendments in the Convention and Cultural Affairs Fund:
 - a. Establish an appropriation for Center for Performing Arts Improvements in the amount of \$700,000.
 - b. Establish an appropriation for Convention Facilities Industry Advisor in the amount of \$50,000.
 - c. Increase the appropriation for the Team San Jose Executive Management Fee by \$62,500.
 - d. Decrease the appropriation for the Team San Jose Management Fee for Performance by \$62,500.
 - e. Decrease the Unrestricted Ending Fund Balance by \$750,000.

OUTCOME

Approval of this report provides the City Council with an update on the Convention and Cultural Affairs Fund (Fund 536) to ensure the City can proceed with the Convention Center expansion and renovation while ensuring that the fund has a sufficient Unrestricted Ending Fund Balance and will not require a General Fund subsidy; aligns the Team San Jose (TSJ) performance and

incentive measures for 2010-2011 to reflect the changes to Fund 536; and provides funding for the Center for Performing Arts Improvements and an Industry Advisor.

BACKGROUND

Operating revenue and expenditures related to TSJ operations are accounted for in Fund 536. On January 13, 2009 and May 19, 2009, the City Council accepted a status report on a plan to ensure Fund 536 would not require a General Fund subsidy during the Convention Center expansion and renovation. The Forecast presented to the City Council in May 2009 included a projected Unrestricted Ending Fund Balance in the amount of \$1.5 million in 2012-2013, when the newly expanded and renovated Convention Center was scheduled to open its doors after a three year construction period. This May 2009 forecast assumed that during the Convention Center expansion and renovation period operating revenues as well as Transient Occupancy Tax (TOT) receipts would decline.

In August 2010, the City issued a Notice of Default to Team San Jose, because TSJ exceeded the 2009-2010 Non-Personal/Equipment appropriation for Fund 536, which covers the majority of TSJ's operating expenses. After completion of an audit by the City Auditor, in December 2010, based on recommendations from the City Auditor, the City Council directed the City Manager to submit a spending reduction plan to address the overage in the 2009-2010 Non-Personal/Equipment appropriation to the City Council for approval before a contract for the expansion and renovation of the Convention Center is executed. Specifically, the Administration was tasked to work with TSJ to reduce expenditures in 2010-2011 in order to restore the Unrestricted Fund Balance in Fund 536 that was reduced as a result of the over-expenditure.

ANALYSIS

As detailed in this section of this memorandum, the City has experienced improvement in TOT projections as compared to the May 2009 forecast. In light of these changes, the Administration is presenting a revised Fund 536 Forecast which includes expenditure reductions from TSJ to address the December 2010 Council direction.

Revised Transient Occupancy Tax Projections

Through December, the average hotel occupancy rate at the 14 major hotels was 57.5%, a significant improvement from the 52.1% occupancy rate for the same period in 2009-2010. For the same 14 hotels, however, the average daily room rate through December was \$117.42, essentially unchanged from the \$117.29 room rate for the same period in 2009-2010. As of December, the trailing 12-month average revenue-per-available-room (RevPAR) declined to \$66.64. Although this is the first drop in the 12-month average RevPAR since January 2010, it still represents a significant improvement from the \$61.45 level experienced in December 2009.

Based on the actual TOT receipts as tracked through December 2010, the Administration revised its TOT projections for the next three fiscal years. The revised assumptions, which are more conservative than projections developed by Horwath HTL, an independent consultant that

reviewed the City's historical TOT collections, assume continued growth in TOT collections between 7% - 8% while adjusting for the anticipated negative impact of the construction project.

Assessment of Fund 536 Performance during the Construction Period and Appropriation Recommendations

Following the same methodology than the May 2009 forecast and based on the revised TOT projections and certain additional annual expenditures as detailed below, it is anticipated that by 2013-2014, the Unrestricted Ending Fund Balance will be between \$1.5 and \$2.0 million despite the anticipated negative impact of the convention center construction activity. The impacts are anticipated to include a decline in occupied room nights; a reduction in TSJ's operating revenues due to fewer events at the Convention Center; and a consequent reduction in spending by events participants.

In response to the December Council direction, TSJ forecasts that the Non-Personal/Equipment appropriation will realize approximately \$340,000 in savings in 2010-2011 due to lower than anticipated contract labor expenses and other TSJ cost monitoring initiatives. For 2011-2012, the revised Forecast assumes \$2.0 million in TSJ Personal Services savings in 2011-2012 through a mandatory furlough, adjusted PTO benefits and/or staffing adjustments (\$300,000), as well as additional savings (\$1.7 million) resulting from lower activity level projections.

It should be noted, that the Administration's projections for operating revenue and expenditures are more conservative than the TSJ figures. For example, TSJ forecasts additional revenues and Non-Personal/Equipment expenditure savings in the current year. While the administration supports this goal, it is adopting a more cautious approach before assuming these results can be achieved. For the current fiscal year, any additional expenditure savings or revenue will be brought forward for Council consideration as part of the 2010-2011 Year-End Clean-Up Memorandum in June 2011.

As part of this memorandum, staff recommends appropriation actions for the Center for the Performing Arts Improvements, an Industry Advisor, and the alignment of the Team San Jose Executive Management Fee and the Team San Jose Management Fee for Performance with recommended contract amendments for the contract between the City and TSJ as outlined in the companion memorandum titled "Amendments to Team San Jose Management Agreement."

- **Center for Performing Arts (CPA) Improvements** – Late in 2010 the City and TSJ became aware that the fire monitoring system at the CPA required a major overhaul. Not moving forward with these improvements now could hinder the ability of the City and Team San Jose to program the CPA. At this time, it is expected that the cost for this improvement will be approximately \$700,000.
- **Industry Advisor** – The current relationship between the City and TSJ requires a significant level of oversight and ongoing interaction. To support this oversight, staff recommends the hiring of an Industry Advisor who will provide industry-specific knowledge as a resource in monitoring and analysis of the convention center financials, marketing and operations. The City is currently in the process of developing a Request

for Qualifications (RFP) and has assumed an annual cost of not more than \$100,000 annually. The cost for the Industry Advisor for the current fiscal year is assumed to be no more than \$50,000.

- **Alignment of the Team San Jose Executive Management Fee and the Team San Jose Management Fee for Performance** – Consistent with the recommended amendments to the Team San Jose Management Agreement, there is to be no base or fixed incentive fee paid to TSJ. Funds originally used for the base incentive fee have been transferred to the “Executive Management Fee” to cover overhead expenses. TSJ must surpass expectations to receive any incentive payment.

In addition to the recommended appropriation actions in this memorandum, the Forecast includes recommendations, as outlined below, which will be presented for City Council consideration as part of the 2011-2012 Proposed Budget process.

- **Miscellaneous Improvements** – Over time, the Miscellaneous Improvements allocation in Fund 536, which supports urgent and critical repairs at the City’s convention and cultural facilities, has been reduced in response to higher operating costs and declining revenues. This allocation, which as recently as 2008-2009 was set at \$570,000, is budgeted in 2010-2011 at \$125,000. Additionally, during the last few years, the Redevelopment Agency provided funding for some urgent needs. The Administration recommends increasing this allocation, especially considering the budgetary situation of the Redevelopment Agency. As such, this forecast assumes a forthcoming recommendation to the City Council to increase the allocation from the current level of \$125,000 to \$500,000 as part of the 2011-2012 Budget process.
- **Capital Replacement Reserve** – In contrast to the Miscellaneous Improvement appropriation which supports urgent and critical repairs at the convention and cultural facilities, as part of the 2011-2012 Budget process, staff will recommend establishing a reserve in the Ending Fund Balance for unidentified costs associated with major repairs/replacement of assets which have reached its useful life. Starting with completion of the renovation project, staff recommends an annual funding at 2.5% of gross operating revenues. Staff estimates construction to be completed mid 2012-2013. During the construction period, funding in this allocation will increase from 1.25% to 2.5%.
- **Revenue Stabilization Reserve** – As part of the 2009-2010 Annual Performance Audit of Team San Jose’s Management of the City’s Convention and Cultural Facilities the City Auditor recommended an “Economic Uncertainty Reserve” be created. As part of the 2011-2012 Budget process, staff will recommend establishing a Revenue Stabilization Reserve to ensure that funding is available in the future in the event that revenues do not perform as projected and that any possible future shortfalls to TOT and TSJ revenue will not jeopardize the plan to expand the Convention Center.

It should be noted that operating revenue figures included in the Forecast are largely driven by TSJ. It will be extremely important to proactively monitor the performance of this fund in the

coming year, as there are several variables which may impact the ability of TSJ to achieve these projections.

Team San Jose 2010-2011 Performance and Incentive Measures

The current Management Agreement between the City and TSJ requires both parties to develop annual targets. On December 7, 2010 the City Council directed the City Manager to negotiate amendments to the Management Agreement. For the purposes of setting these performance measures, staff has assumed that the City Council has approved the recommended "Weights" as discussed in the companion memorandum on the Council Agenda titled "Amendments to Team San Jose Management Agreement"

The performance measures outlined below are weighted as follows: Economic Impact: 40%, Gross Operating Profit 40%, Theater Performance 10%, and Customer Service 10%. In June 2010, the City Council approved TSJ Performance and Incentive measures for 2010-2011. However, based on City Auditor recommendations the Administration is recommending the measures for Return on Investment and Gross Operating Profit/Revenue to be aligned with the 2010-2011 Adopted Budget for Fund 536.

The purpose of the performance measures is to provide a quantifiable way of evaluating TSJ's management of the convention and cultural facilities. The purpose of the incentive fee measures is to provide a quantifiable way of calculating the actual Incentive Fee earned by TSJ, and paid from the Convention and Cultural Affairs Fund.

The targets for the performance measures assumed the downturn in the economy will last through the entire fiscal year, and also accounts for the potential Convention Center expansion plans. A brief summary of each of the performance measures is included below, with footnotes detailing any variation between the performance measures and incentive measures:

Economic Impact = 40%

Return on Investment (ROI) Formula¹: The ROI formula is based on the investment into the Convention Center and Cultural Facilities and the return on this investment.

FY 07/08	FY 08/09	09/10 Target	09/10 Projected	10/11 Target
NA	\$4.08	\$2.73	\$2.19	\$2.21

- ROI Formula calculates the return for every \$1 invested into the Convention Center and Cultural Facilities.
- Formula is calculated by dividing the monies generated by TSJ by the expense of the City's investment in the facilities. Per the City Auditor's recommendation and amendments to the Management Agreement, Convention and Visitor Bureau funds are no longer used in the calculation.
- The numerator consists of: TSJ Revenues, and Economic Impact.

¹ In order to comply with IRS Revenue Procedure 97-13, ROI is not a component of the incentive fee measures.

- The denominator consists of: above the line TSJ Expenses and Debt Service.
- For 2010-2011, the Return on Investment target was initially set at \$2.08.

Gross Operating Profit = 40%

09/10 Target	09/10 Projected	10-11 Target
(\$6,800,000)	(\$5,800,000)	(\$5.1 million)

- The Gross Operating Profit (GOP) target was originally set at (\$7.1 million). It is recommended at this time to increase the target to (\$5.1 million) to ensure the measure is consistent with expenditure and revenue levels as outlined in the 2010-2011 Adopted Budget.
- In order to comply with IRS Revenue Procedure 97-13, incentive fee measures include Gross Operating Revenue rather than GOP. For 2010-2011, the Gross Operating Revenue target was initially set at \$13,100,000. It is recommended at this time to increase this target to \$13.9 million to ensure the measure is consistent with the revenue level as outlined in the 2010-2011 Adopted Budget.

EVALUATION AND FOLLOW-UP

The City Manager will continue to closely monitor Fund 536 and Team San Jose performance during the remainder of the contract with TSJ.

PUBLIC OUTREACH/INTEREST

- Criterion 1:** Requires Council action on the use of public funds equal to \$1 million or greater. **(Required: Website Posting)**
- Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

Although this memorandum does not meet any of the above criteria, it will be posted on the City's website as part of the February 15, 2011 Council Agenda.

HONORABLE MAYOR AND CITY COUNCIL

February 4, 2011

Subject: Convention and Cultural Affairs Fund Forecast and Team San Jose Spending Reduction Plan

Page 7

COORDINATION

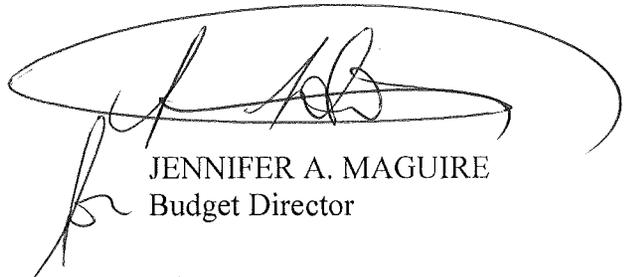
This staff report has been prepared by the City Manager's Office in coordination with the City Attorney's Office and the Finance Department.

CEQA

Not a Project, File No.PP10-066 (e), Agreements/Contracts.



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For questions please contact Lee Wilcox, Downtown Manager, at 408-535-8172.