LOS LAGOS GOLF COURSE – SAN JOSE'S FINANCIAL SAND TRAP

Issue

Why is Los Lagos Golf Course running a deficit which is costing the City of San Jose up to $800,000 per year out of the General Fund?

Summary

In September, 2007, a City of San Jose audit report concluded that although one of the City's municipal golf courses, Los Lagos, was generating enough income to cover its operating expenses, it was failing to cover the debt service associated with the bonds that were sold to fund the construction of the course.

The audit went on to state that based on net income projections, the City's General Fund would continue to subsidize the bond payment at an estimated $600,000 to $800,000 annually for the foreseeable future.

As a consequence of this audit, the City's Parks, Recreation and Neighborhood Services Department (PRNS) conducted an operational review of all three municipally owned golf courses in order to determine operating efficiencies and opportunities to increase overall economic performance. This report was completed in March, 2008.

Under city policy all projects, including Los Lagos Golf Course are to be financially self sustaining. The Grand Jury decided to inquire into the circumstances of the construction of Los Lagos Golf Course and the implications of the predicted adverse impact to the City's General Fund.

Background

The City of San Jose owns three golf courses:

- San Jose Municipal (18 holes, par 72, 6,700 yards): commonly understood by golfers to be of regulation size and distance. It was opened in 1968.
- Los Lagos (18 holes, par 68, 5,393 yards): often termed as "executive" and non-standard for its shorter length. It was opened in April of 2002.
- Rancho del Pueblo (9 holes, par 28, 1,418 yards): serves a community of golfers that desire "short" courses and serves as an entry-level course for beginning golfers and disadvantaged youth. It was opened in 2000.

In the 1990s the booming economy allowed the City of San Jose to address the recreational needs of the community. The small 9-hole Rancho del Pueblo course was built at the location of an aging 18-hole facility with the remainder of the site dedicated to residential construction. The City Policy Plan for PRNS (*Leisure and Life 2000)* defined the objective for levels of service for public golf courses as one per 150,000 residents. Given a population of 900,000 (c. 2000) and two existing golf courses, it was determined that an additional golf course would help address the deficiency in municipal facilities. In addition, the same policy identified "golfers" as a target population, as a distinct subgroup of the general population whose interests were unique and were intentionally addressed by the City Council.

The City policy is to develop capital projects (construction or improvement) that are financially self-sustaining. The City's Capital Improvement Plan Budget document provides that capital projects should be financed to the greatest extent possible through user fees where direct benefit to users results from the construction of the project. A high priority-ranking consideration is given to proposed projects that would have a positive impact on the operating budget (reduced expenditures, increased revenues).

In October, 1997, within a 15-mile radius of what was to become Los Lagos Golf Course, there were 20 total golf facilities: six municipal, eight private, with the remainder public.

It is noteworthy that during this time period six new golf facilities were under development in the region. However, all of these golf courses were private and operated for the benefit of their members. It was anticipated that all but one would offer general public access with higher green fees for non-members. A City staff observation was that these public access courses may eventually go completely private when membership goals were reached.

Thus, Los Lagos Golf Course, previously known as Coyote Creek and later Tuers-Capitol was conceived as a result of and based on the following factors:

1. The City of San Jose already owned the land and acquisition costs of purchasing private land was cost prohibitive.
2. It was the only available city-owned land suitable for an 18-hole golf course in San Jose.
3. It was one component of a planned larger sports complex partially in existence or to be constructed nearby to include soccer and baseball facilities.
4. It would be added to the City's recreational facilities to accommodate regional population and visitors' golfing recreational needs.
5. It improved the use of the vacant land, which in the 1980s was a dump site and viewed as a blight to the neighborhood.

6. Feasibility studies had noted there was a growing population of older citizens with greater disposable income.
7. Increasing population of high-salaried residents and growing employment in the surrounding area due to a booming economy.
8. There was an active golf market in the region.

Although the 180-acre site would normally be more than sufficient for a standard-sized golf course, 80 acres of land was considered by city policy to be a riparian corridor given the presence of Coyote Creek. As such, it was environmentally sensitive and required a setback and was restricted from development. This created a 2+ year environmental study before the final master plan for the golf course established the reduced size and shortened the fairways to accommodate the surrounding habitat.

It took over five years from the date of Los Lagos' original conception in January, 1997 until the golf course was completed and opened in April 2002.

Discussion

Under city policy, a project moves from the concept stage through the award of a construction contract. This process involves a number of steps, with each succeeding step raising the level of certainty as to the ultimate cost of a project. An important early component of the project budget policy is a feasibility study. In the context of a golf course this would include:

- Market and financial analysis to study the area's demographics and economics
- Golf demand and supply estimation
- Projected activity levels for the proposed golf facility
- Financial projections and project recommendation

The results of these studies are particularly important, given the City policy to develop capital projects that are financially self sustaining.

The Feasibility Study

The City retained National Golf Foundation Consulting, Inc. (NGF) to perform a feasibility study. NGF completed its Final Report in October of 1997. This report concluded that, based on their assumptions and projections, the proposed Los Lagos Golf Course would be profitable provided that the debt incurred to build the course did not exceed $9.8 million.

By the following October, an addendum was requested, based on design and management changes that were proposed for the project. The changes were not specified in the NGF report. The report focused on the financial performance of the project with new assumptions and projections. The net effect, however, did not alter the prior conclusion, i.e., the project would be profitable, as long as the debt incurred to build the project did not substantially exceed $10.07 million.

Eight months later, in June, 1999, NGF followed with a second addendum. This study projected golf fees that were competitive with the area's public access golf courses based on a 1999 survey of fees conducted by the City. Other adjustments were made based on a private management firm's proposals for operation and maintenance of another course in the region. Once again, the revenues and expenditures produced net operating income figures that supported NGF's conclusion that the golf operation would be profitable and financially successful, provided that the debt incurred did not substantially exceed $14.2 million.

Thus, in the space of 20 months, the project increased in supportable debt by $4.4 million, all based on revised assumptions and projections of costs vs. revenues.

In all the studies, the supportable debt level was based upon a 30-year amortization schedule with an interest rate of 6.5%.

Feasibility studies are only expected to be tools to be used during a decision-making process and based on detailed analysis of the best available information. They are made with reasonable assumptions and projections but there should be no presumption that they will be totally accurate. However, they should be reliable and produce updated information that should not substantially vary from study to study except for updates to account for inflation and for specifically identified factors that may alter information from the prior assumptions made.

It is interesting to observe the substantial differences from the figures in the original study of October, 1997, to the second amended study of June, 1999. Appendix A reflects projected adjusted gross income, projected expenses and net operating income over a five-year period. As an example, projected adjusted gross income was $1,980,800 in year one in October of 1997, but grew to $2,799,700 by the time of the June, 1999 study. This variance in projected income was $819,000 but swelled to over $1,000,000 by year five. Increases are noted in projected expenses and net operating income.

A closer examination of what accounted for these differences revealed a mixed bag of differing revenues and expenses of different components of a golf operation, such as green fees, driving range revenues, pro shop revenues, maintenance expenses, irrigation, etc. By the time of the final study of June, 1999, golf fees had increased at surrounding courses and the assumption was that the increase in fees would be accepted by golfers with no loss in demand. Through all of the studies the projections for total annual golf rounds remained a constant. Los Lagos never achieved the level of rounds of play projected in the feasibility studies.

The feasibility studies revealed that in the space of just 20 months, there was a substantial variance in projected revenue, expenses and net operating income. In addition, those calculations impacted the analysis of supportable debt which in this case increased by $4.4 million during the course of these studies. These variances suggest that reliability should at least be questioned when utilizing these studies as a decision-making tool.

The City Auditor's report in September, 2007, produced a rather glaring statistic which deserves to be highlighted. The report stated, "The feasibility study underestimated CourseCo employee wages by about $570,000 per year and significantly underestimated the number of labor hours by about 33,000." CourseCo is the City's contractor to operate and maintain the golf course. How these two figures relate is unknown but has been attributed to a miscalculation in the feasibility study. The problem may be related to NGF, Inc.'s methodology or a failure by City staff to supply or verify information to and from NGF. Equally plausible is that these increased labor costs and hours are an unforeseen necessity related to actual golf course operations. However 33,000 hours equate to 16 full-time employees over and above the projections in the feasibility study. It is hard to comprehend how such a sizeable error could be made. The City owes the public an explanation.

The auditor also found that the feasibility study did not account for the added cost of maintaining environmental mitigation areas within the Los Lagos property.

The Decision

The initial goal was to build the course and address impact to existing facilities for $12.4 million. Of this amount $10.4 million represented construction costs which were to be financed through a $13.5 million 30-year, tax-exempt bond issue. An additional $2,000,000 was required for addressing impacts to existing facilities such as the wildlife center that required relocation. This latter amount was to be paid out of existing City funds.

As project plans evolved, several desirable elements were added that had not been included in the initial budget. These included such items as a second tier to the driving range, a bar in the clubhouse, potable water to the greens, sod collars for the greens, among other things. These items were felt necessary to either reduce maintenance and operations expense or enhance revenue. In addition, one city council member stated that a high-quality golf course was especially desirable.

By the time this project came up for review and approval by the City Council in May of 2000 the total estimated cost to implement the master plan was about $18.7 million. This included:

- $15.0 million for design and construction of the course with all amenities
- $1.5 million for furnishings, fixtures, equipment and turf establishment
- $1.6 million was set aside for relocation of prior existing uses
- $600,000 for operations consultants and reserves

Of that total, $14,680,000 was earmarked from bond proceeds for the construction project fund with the balance of funds to come from other City sources. During the presentation by the Public Works Department to the City Council on May 30, 2000, excerpts of the June, 1999, second-amended feasibility study was attached and included a page where NGF concluded that the prospects for financial success were excellent, provided that the debt incurred did not substantially exceed $14.2 million. At this meeting the City Council approved both the master plan and financing program. Following approval of the Master Plan, the construction contract went out for bid.

When all construction bids were subsequently received, it was determined that the lowest acceptable bid, by Granite Construction, was for $14,178,900 with contingencies, or 31% higher than the original engineer's estimate of $10,792,000. The city staff described this as a complete surprise given the expected degree of certainty in the engineering estimate of +/-5% of the actual bid.

This stunning variance of actual bid vs. the engineer's estimate was attributed to the extremely high level of construction activity in the region. This had driven up costs, especially in the building trades and lower bids could not be expected due to the continuing and growing backlog of construction work in the region.

On June 22, 2000, after discussions between the Finance and Public Works Departments, a group representing several city departments recommended to the City Council to increase the bond size allocated to the golf course to $20,685,000. Of this amount $18 million, including interest earning, was for the construction fund, an increase of $3,320,000. When the actual bond was sold in August of 2000, the interest rate of 5.44% was favorable when compared to the 6.5% assumed in the feasibility study.

Piecing all of this information together, the preliminary budget for Los Lagos for all construction elements was $12.4 million. The June, 1999, feasibility study concluded that a bond debt of $14.2 million could be supported by the net operating income. Instead, the final bond debt incurred for the project was $20.7 million, of which $18 million was for the project construction fund.

When the project and financing were finally approved by City Council in late June of 2000, the feasibility studies were a year old, several desirable amenities had been added to the project, and actual construction costs had increased by 31%. The inescapable conclusion was that this project ultimately required bond debt $6.3 million higher than originally thought, without any consideration of whether operations could generate enough income to cover both the cost of operations and the bond debt service.

This was one example of what one interviewee described as "scope creep" which has appeared in other city projects. This, combined with construction cost increases in the region, appears to account for the significant increase in the ultimate cost of the project.

The Aftermath

Following the 2007 City audit of Los Lagos, the City Council made a decision to review the performance of all three municipal golf courses. That study was entrusted to Economics Research Associates (ERA) and the final report was delivered in March, 2008. The ERA report delivered the following information with respect to the predicted operations of Los Lagos from FY 2009:

	Net Operating Income	Debt Service Payments	Deficit
2009	$662,000	$1,432,000	$770,000
2010	752,000	1,444,000	692,000
2011	808,000	1,460,000	652,000
2012	821,000	1,474,000	653,000
2013	1,015,000	1,486,000	471,000
2014	1,050,000	1,501,000	451,000

(The report provides figures through 2017)

As of April 2009 PRNS reports that the projected FY 2009 net operating income for Los Lagos is $624,000, which will result in increased debt service payments out of the City's General Fund by in excess of $800,000. It is reasonable to expect that projected net operating income anticipated prior to the current economic downturn will be even lower for the foreseeable future.

The City of San Jose is experiencing a deficit last reported to be in excess of $78 million. Because of this, the City is looking at its performing assets as a group to see if they can be disposed of or put to alternate uses. PRNS referred this matter to the Structural Budget Deficit Stakeholders Group (since disbanded). The City reports that decisions related to certain other priority assets are being made and that any decisions regarding Los Lagos and other golf courses have been deferred until at least 2010.

The ERA report offered some interesting observations regarding all of the city golf course operations taken as a whole. San Jose Municipal is leased to Rawitser Golf for operations and maintenance after which Rawitser pays the City "rent." This rent was established at 2% of total gross revenue through 2007, increasing to 8.5% thereafter through the remaining term of the contract. The lessee also contributes 1-1½% of total gross revenue to the capital improvement reserve fund. This agreement ends in 2012 but has an operator option of extending the agreement to 2022. The City has no debt service on this 40-year-old course and has a positive net income. According to the ERA report, the last 20 years have distorted the equity of this agreement in favor of the lessee. Thus the current market rent, as compared to similar golf operations in the local area, should be in the range of $1.3 million annually, rather than the subpar "rent" of $114K in FY 2007. San Jose Muni expects to generate $493K for the City in FY 2009 because of the percentage increase to 8.5%, but this still remains inequitable. The prospect of re-evaluating and addressing this market shortfall is unlikely until this contract terminates.

Meanwhile, Los Lagos and Rancho del Pueblo combined have a total debt service obligation of $1.9 million annually. In addition, Rancho del Pueblo has a projected $176K shortfall in net operating income for FY 2009. When combined with the expected net operating income of $624K for Los Lagos, and the San Jose Municipal lease revenue of $493K, the total golf operation is expected to total $963K in net losses. (Rancho del Pueblo was never viewed as a revenue generator as it addressed the needs of a necessary market segment of golfers including senior, entry-level, and junior players.)

The ERA report has concluded that the prospects for alternate uses at the site, including sale of the land, may simply not be feasible. The value of the underlying land exceeds its value under the golf course use. A sale for commercial/residential use may produce gross proceeds that would easily cover the outstanding debt. However, this would also produce entitlement and land use issues, along with other potential legal and public policy constraints. Converting the site to other recreational uses would likely require substantial operating subsidies, which is not a problem for the golf course as a revenue-generating enterprise.

ERA notes that Los Lagos has consistently received favorable ratings and awards and should be viewed as a recreational asset to the City. It is particularly important to appreciate that when the debt service on the bonds ceases in 2032 (2027 for Rancho), the combined golf operations will provide substantial revenues and will be in a position to finance other recreational needs of the City.

Conclusion

Every viable and vibrant city must balance the primary needs of its citizens, as well as the needs for arts, entertainment and recreation, which make the community livable. In 2000, a healthy economy allowed the city leaders to make the choice to construct another golf course when in other times prudence would have played a greater role. However, the negative consequences of those choices have an impact on the resources available to deal with more urgent and necessary needs when those “other times” ultimately arrive.

Los Lagos Golf Course is failing to meet its expectation to be a financially self-sustaining and potentially revenue generating enterprise. Los Lagos will drain $600,000 to $800,000 annually out of the General Fund into the foreseeable future.

Capital improvement decisions should be made with a sober analysis, during both good times and bad times. Established policy and procedure should be followed utilizing the most current information available in order that intelligent decisions can be made. The full knowledge of all potential risks and a reasonable recovery (or corrective action) plan should always be developed.

Findings and Recommendations

Finding 1

The City decided to construct another municipal golf course at a time when six other golf courses were under construction and the surrounding communities already had municipal or public access courses. The expected total annual rounds of golf to be played have fallen short of the expectations contained in the original feasibility studies.

Recommendation 1

Prior to making critical decisions the City Manager must furnish the City Council with current feasibility studies. The information should include a City staff review of all assumptions made in the study for accuracy and conformance to existing City policy and procedures (e.g., living and prevailing wage rates, labor hours, cost-of-borrowing, etc).

Finding 2

The cost of labor for operations and maintenance of the golf course was found to have been underestimated by the feasibility studies by about 33,000 labor hours resulting in $570,000 annually. The City Manager has failed to provide an explanation whether this was the fault of the original study, failure of verification by City staff, or lack of operational oversight.

Recommendation 2

The City Manager should investigate the reasons behind the increased labor costs of the project, which has had a significant impact on the structural deficit. The City Manager should change and apply policy to reflect any lessons learned.

Finding 3

At the time the construction bids were opened, an unanticipated 31% increase in construction cost was revealed.

Recommendation 3

The City Manager should ensure that all departments develop and rigorously follow policies that require:

- Project studies to be updated to reflect the impact of “scope creep” on cost
- Additional approval cycle if cost increases exceed a predetermined percentage of the total

Finding 4

At the time a decision was reached to approve the master plan, the feasibility study was one year old and had not been updated.

Recommendation 4

Prior to making critical decisions the City Manager must furnish the City Council with current feasibility studies. The information should include a City staff review of all assumptions made in the study for accuracy and conformance to existing City policy and procedures (e.g., living and prevailing wage rates, labor hours, cost-of-borrowing, etc).

Finding 5

Although there were significant increases of amenities and construction costs, the City Council and City Manager failed to readdress whether or not the golf course would be financially self-sustaining.

Recommendation 5

The City Manager should ensure that all departments develop and rigorously follow policies that require:

- Project studies to be updated to reflect the impact of “scope creep” on cost
- Additional approval cycle if cost increases exceed a predetermined percentage of the total

Finding 6

The City Council and City Manager have failed to identify any viable solutions to mitigate the ongoing golf course deficit.

Recommendation 6

The City Manager should provide information to the public as to proposed alternatives or solutions to the golf course deficits at Los Lagos and Rancho del Pueblo.

Appendix A

National Golf Foundation, Inc., Feasibility Study

	Year One 2002-2003	Year Two 2003-2004	Year Three 2004-2005	Year Four 2005-2006	Year Five 2006-2007
Adjusted Gross Income (After cost of sales)					
October, 1997	$1,980,800	$2,127,000	$2,281,800	$2,413,400	$2,552,600
October, 1998	$2,217,600	$2,379,100	$2,550,200	$2,695,600	$2,849,600
June, 1999	$2,799,700	$2,993,200	$3,199,100	$3,372,200	$3,556,100
Actual Performance	$3,330,000	$3,289,000	$3,244,000	$3,121,000	$3,267,000
Projected Expenses					
October, 1997	$1,169,240	$1,218,113	$1,259,582	$1,302,596	$1,347,004
October, 1998	$1,389,000	$1,449,000	$1,492,500	$1,537,500	$1,584,100
June, 1999	$1,592,600	$1,669,000	$1,725,000	$1,782,200	$1,841,500
Actual Performance	$2,522,000	$2,703,000	$2,604,000	$2,636,000	$2,733,000
Net Operating Income (Before capital improvement reserves)					
October, 1997	$811,560	$829,887	$937,018	$1,020,204	$1,109,396
October, 1998	$828,000	$843,000	$964,000	$1,058,000	$1,160,000
June, 1999	$1,207,100	$1,222,700	$1,365,300	$1,474,900	$1,592,900
Actual Performance (ERA report)	$808,000	$586,000	$640,000	$486,000	$534,000
Actual Performance (City Auditor Exhibit Sept., 2007)	$747,524	$505,188	$590,893	$409,895	
Total Projected Rounds of Golf					
Entire Study w/addendums	70,000	73,000	76,000	78,000	80,000
Actual Rounds	69,460	68,781	68,544	65,843	67,590

This report was **PASSED** and **ADOPTED** with a concurrence of at least 12 grand jurors on this 19th day of May, 2009.

Don Kawashima.
Foreperson

June Nishimoto
Foreperson pro tem