SHOULD THE CITY COUNCIL CONTINUE TO SUBSIDIZE TEAM SAN JOSE'S INCREASING LOSSES?

Issue

Can the City of San Jose afford to continue subsidizing the escalating operating losses of Team San Jose, Inc. (TSJ)? TSJ lost $20.2 million during its first five years of managing San Jose's Convention Center and six other cultural facilities (the San Jose Civic Auditorium, Center for the Performing Arts, Montgomery Theater, Parkside Hall, South Hall, and California Theater) (collectively, the Facilities), and is projecting a $6.8 million loss in fiscal year 2009 – 2010.

Summary

The 2009 – 2010 Santa Clara County Civil Grand Jury (Grand Jury) investigated TSJ's operating losses and found that TSJ's $20.2 million operating loss from fiscal year 2005 through fiscal year 2009 was more than double the $9.8 million loss the City agreed to subsidize, and that TSJ's losses are growing at an increasing pace. Despite these losses, which contribute to the City's growing financial burden, San Jose's City Council (City Council) renewed TSJ's contract in 2009 and rewarded TSJ with more advantageous terms than in the prior contract, to the City's detriment.

The City subsidizes TSJ's losses by transferring to TSJ a portion of the City's Transient Occupancy Tax (TOT) and in several cases, money from the City's general fund.

The Grand Jury is primarily concerned about three issues: (1) TSJ's escalating net operating losses, while the City faces a $116 million budget deficit, which could force it to slash services to residents and eliminate hundreds of jobs; (2) the selection of performance measures in the new contract that do not seek to aggressively reduce TSJ's operating losses; and (3) the funding for TSJ's operation which relies heavily on City subsidies rather than on revenues generated by TSJ.

Methodology

The Grand Jury reviewed:

- The Agreements for the Management of the San Jose Convention Center and Cultural Facilities between the City of San Jose and Team San Jose, Inc., effective as of July 1, 2004 and July 1, 2009, respectively, and the San Jose City Council agenda items related to those contracts.
- The annual audit of TSJ for fiscal year 2009, which also recaps the results of the four previous years.

- The San Jose fiscal year 2010 budget for TSJ and information on salaries and benefits of shared employees.
- The 2006 – 2007 Grand Jury Report titled "City Fails to Hold Team San Jose Accountable" which examined the selection process of TSJ for the original five year contract.
- The C.H. Johnson Consulting Report (October 2007) which compares the San Jose Convention Center to centers from peer cities.

The Grand Jury interviewed officials from TSJ and the City's Office of Economic Development and reviewed council meeting minutes.

Background

The First Five-Year Contract

Citing a desire to improve efficiencies and reduce costs, in 2003 the City issued a request for proposal to find a new operator for the Facilities. At that time, the City Arts and Entertainment Department (CAE) operated the Facilities.

In 2004, San Jose awarded TSJ a five-year contract to manage and operate the Facilities. TSJ is a private, nonprofit corporation that was formed in December 2003 specifically to respond to the City's request for proposal to find a new operator for the Facilities. Despite its inexperience compared to the three other bidders – two with national and international facility management experience – TSJ obtained the contract.

As part of the contract, TSJ agreed to absorb 86 City employees who worked for CAE. The City also agreed to subsidize a total loss of $9.8 million (approximately $2 million annually) during the five-year term of the contract. Routinely other large cities accept an affordable level of loss in operating their cultural facilities in exchange for bringing business opportunities to their residents.

The contract specified four performance measures to ensure that TSJ was meeting its obligations to the City. The contract specified that if TSJ, in any year, did not meet at least three of the four performance targets, the City had the right to terminate the contract with TSJ. These performance measures established targets for:

- Gross revenue.
- Net operating loss.
- Economic impact.
- Customer satisfaction.

The contract also required annual performance and financial audits. The City's first annual performance audit, published in October 2006, revealed that the gross revenue and net operating loss targets were not met; the economic impact target was met but was set very low; and there was not enough data collected to determine if the last target, customer satisfaction, was met. Moreover, annually, TSJ was losing money at more than double the rate stipulated in the contract.

The 2006 – 2007 Santa Clara County Civil Grand Jury investigated TSJ's management and operation of the Facilities and concluded that the contracting process that selected TSJ to manage the Facilities was flawed and that the City failed to hold TSJ accountable for failing to achieve the performance targets. That Grand Jury recommended that the City find another operator for the Facilities when the contract expired in 2009.

City Council Authorizes a Second Five-Year Contract with TSJ

On December 17, 2007, the City Council authorized the city manager to negotiate a new agreement with TSJ to manage the Facilities for a five-year term beginning July 1, 2009, and continuing through June 30, 2014. In December 2008, the City Council added the directive that the new agreement also provide for: (1) two three-year options to renew; (2) a set of performance measures of which the highest weight is given to the economic benefit to San Jose; and (3) streamlining processes with regard to shared City employees working for TSJ.

According to the July 2009 contract, the City Council decided to renew the TSJ contract because it found, "…that the primary objectives of the Original Agreement have been advanced in that the City's cost of operations of the cultural facilities has decreased, and the occupancy and revenue-producing capabilities of the City's cultural facilities have increased."

Discussion

TSJ's Escalating Net Operating Losses

The first contract between the City and TSJ set targets for four performance measures; two of which were to (1) increase revenues and (2) decrease TSJ's operating losses. As shown in Table 1, TSJ's revenues modestly exceeded target by 6% and 5% only in the last two years of the contract. TSJ's operating loss, however, gradually exceeded the target at a rate ranging from 24% to 548%. In fiscal year 2009 alone, TSJ lost 5.5 times its targeted loss.

Table 1: TSJ's Operating Losses vs. Revenues

Comparison Between Targeted and Actual Revenue/Expenses

	2004-05 Actual	2005-06 Actual	2006-07 Actual	2007-08 Actual	2008-09 Actual	2009-10 Projected
Targeted Revenue	$8,698,000	$9,943,000	$10,600,000	$11,303,000	$11,739,000	(1)
Revenue	$7,158,813	$8,774,322	$10,554,562	$12,013,456	$12,350,975	$17,270,831
Revenue Variance	-18%	-12%	0%	6%	5%	
Total Expenses	$11,787,880	$12,643,221	$13,886,717	$14,968,013	$17,772,374	$23,218,054
Targeted Loss	($3,745,000)	($1,966,000)	($1,432,000)	($975,000)	($836,000)	Note 1.
Loss	($4,629,067)	($3,868,899)	($3,332,155)	($2,954,557)	($5,421,399)	($5,947,223)
Loss Variance	-24%	-97%	-133%	-203%	-548%	

(1) This performance target was eliminated in the current contract.

City Employees Working for TSJ

A major component of TSJ's operating expenses is the salaries and benefits of 86 City employees it inherited from the City (Shared Employees) when it became the operator of the Facilities. When TSJ was awarded the contract, TSJ agreed to keep the Shared Employees under an arrangement by which the Shared Employees keep their status as City employees with commensurate salaries and benefits but work directly for TSJ.

During the first five years of the contract, the Shared Employees' salaries and benefits, as well as an allocated share of the City's overhead costs for indirect support and services, ranged from $5.8 million in fiscal year 2006 to $6.8 million in fiscal year 2008. This represented approximately 46% of TSJ's total expenses. During the same period, the salaries and benefits of the non-civil service employees working for TSJ ranged from $872,271 in 2006 to $1,972,234 in 2008, which represented approximately 13% of TSJ's expenses.

TSJ Shared Employees: Salaries, Benefits and Overhead Costs

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Number of Employees	86	86	86	86	86
Salaries, Benefits and Overhead	$6,228,160	$5,820,023	$6,645,397	$6,745,513	$6,662,719

The total cost of the Shared Employees far exceeds the total for non-civil service employees because the former are full-time employees and their compensation and working conditions are governed by memoranda of understanding between the City and its labor unions. Non-civil service employees are mostly part-time workers whose hiring is dictated by the schedule of events at the Facilities. Through negotiations, the compensation package for civil service employees has become very expensive; for example, the cost of the benefits skyrocketed in the last few years to approximately 50% of the employees' salary in San Jose.

The new contract signed in July 2009 includes a process called "Convention Facilities Staffing Right-Sizing" which reduces the number of Shared Employees to 56, down from the original 86; the estimated savings included in TSJ's 2010 budget is a little over $3 million.

The Grand Jury believes TSJ has taken an important first step towards cutting costs but that it is not aggressive enough. TSJ eliminated 30 positions and stated in its 2010 budget that: "This action should have minimal impact on the quality of events for customers as the reductions align with anticipated reductions to activity at the convention facilities. In the event that activity levels increase, TSJ has the ability to quickly react through usage of contract labor."

The same rationale could be used for the remaining 56 employees. TSJ could hire workers with the same set of skills, on a full-time or part-time basis, at a much reduced cost. There is no credible reason for keeping City employees in a private corporation. Appendix 1 compares the 56 remaining Shared Employees' salaries and benefits and the cost of similar employees in the private sector.

<u>Increased Salary and Benefits Costs and Higher Management Fees</u>

After eliminating 30 full-time civil service positions in July 2009, TSJ is still projecting an operating loss of $6.8 million in fiscal year 2010, which is 25% more than its 2009 operating loss and far more than the annual $2 million loss the City agreed to subsidize in the original contract. The increasing losses are due to the rapid growth of TSJ's salaries and benefits, and higher management fees, which negates the effect of reducing civil service positions.

Table 2: TSJ's Costs for Salary and Benefits, and Management Fees

	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010 (Budgeted)
TSJ Salary & Benefits (1)	$645,366	$872,271	$1,237,668	$1,972,234	$1,923,319	$3,172,887
Executive Management Salaries and Benefits	--	--	--	--	--	$663,321
Subtotal	$645,366	$872,271	$1,237,668	$1,972,234	1,923,319	$4,836,108
Management Incentive Fee	$150,000	$150,000	$150,000	$150,000	$150,000	$259,062
Totals	$795,366	$1,022,271	$1,387,668	$2,122,234	$2,073,319	$4,095,270

(1) Excludes Shared Employees.

As shown in the table above, TSJ's salaries and benefits (excluding the Shared Employees and executive team) grew by 65% from fiscal year 2009 to 2010. Salary and benefits costs for Shared Employees and outside contractors in fiscal year 2010 are projected to be $4,766,316 and $444,318, respectively.

Also, beginning with the second contract, the City agreed to pay TSJ's seven-member executive team $663,321 annually for executive management salaries and benefits.

TSJ will also receive a management incentive fee, effectively a bonus, which is a percentage of TSJ's revenue. This incentive fee varies, depending on TSJ's revenue. At the lowest achievement level, the executive team still will be rewarded with an incentive fee of 0.5% of TSJ's total revenue. For example, the executive team would receive $100,000 if TSJ's revenues were $20 million. The percentage increases with the achievement level.

Under the first contract, TSJ was eligible to receive $150,000 annually if it met the performance targets. Under the current contract, TSJ is eligible to receive more if it increases its revenue even if it fails to decrease its operating losses.

Second Contract Provides New, Less Rigorous Performance Measures

In the last year of the first contract (2009), TSJ met three of its four performance measures targets: (1) increase revenues; (2) economic impact measured by the number of attendees; and (3) customer satisfaction. The performance target that TSJ fell far short of achieving was in reducing its operating loss. In fact, the loss doubled from 2008 to 2009 and is projected to grow larger in 2010.

The 2009 City audit notes that "since 2004 when TSJ took over management and operations of the facilities, it has performed better as compared to the City's past operation of the Facilities"; thus the City Council waived its right to delete the fixed payment of $150,000 in Year 5 of the contract, even though TSJ had not met the four performance metrics. The City Council did this despite the City's precarious financial state.

The current contract specifies a new set of weighted performance measures that establish targets for:

- Economic impact measures (includes hotel room nights, attendance and the City's return on investment - 40% weight).
- Gross operating profit (excess of revenues over expenses - 35% weight).
- Theater performance (measures activation and use of theaters - 15% weight).
- Customer service survey results (10% weight).

Unlike the first contract, the current contract does not establish targets for TSJ to increase revenues and to decrease its operating losses. Without such targets, there is little incentive for TSJ to control expenses.

Even the $259,000 budgeted for TSJ's incentive fee (See Table 2) is based on TSJ's revenues, not on profit or loss. This formula encourages TSJ to focus solely on increasing revenues even if this necessitates incurring additional expenses; its incentive fee depends on the gross revenues only. For example, in fiscal year 2010, TSJ's budget projects revenues of $17 million (an increase of 40% over the previous year's budget), and at the same time projects expenditures of $23.8 million (an increase of 37% over the previous year's budget), producing an operating loss of $6.8 million. This loss is subsidized by the City and does not affect TSJ's incentive fee. In TSJ's final approved budget, expenditures were re-budgeted at $20.5 million in anticipation of reduced revenues.

TSJ's Funding Sources

Although TSJ generates its own operating revenues, its revenues are not sufficient to cover its expenses. Therefore, TSJ depends on City subsidies from three primary sources to fund its operations:

- Revenues from the City's Transient Occupancy Tax (TOT).
- Transfers from parking fees.
- Transfers from the City's general fund.

Appendix 2 illustrates TSJ's funding sources.

According to the 2008 – 2009 City audit of TSJ: "In order for TSJ to continue its operations, it relies on the City for operating contributions…Accordingly, any significant changes in the TOT or parking garage revenues or decision to change the amount of support could greatly affect TSJ ability to continue as a going concern."

TOT Tax

Like many cities, San Jose collects a TOT, a 10% tax on each hotel bill; 4% of which is deposited in the City's general fund and the remaining 6% is deposited in a special fund – the TOT Fund. According to the San Jose Municipal Code Sections 4.72.060 and 4.72.065, TOT Fund revenues may only be used to: (1) fund the City's convention and visitors bureau; (2) fund the cultural grant program and fine arts division; and (3) fund the City's operating subsidy to its convention and cultural facilities.

The City relies heavily on the TOT Fund to subsidize TSJ's operating losses. During the first five-year contract, the City transferred $29 million from the TOT Fund to TSJ. However, the City is projecting lower TOT revenues, primarily as a result of the recession.

The City's Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program predicts the following for TOT revenues:

$M	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010 (2)	FY 2011 (2)
Total collected	$16.0	$19.2	$21.5	$23.9	$19.4	$16.3	$16.7
Allocated To General Fund (1)	$ 6.4	$ 7.6	$ 8.6	$ 9.5	$ 7.7	$ 6.5	$ 6.7
Allocated To TOT Fund	$ 9.6	$11.5	$12.9	$14.3	$11.6	$ 9.8	$10.0
Allocated To Cultural Affairs Fund(3)	$ 2.4	$ 2.8	$ 3.2	$ 3.5	$ 2.9	$ 2.4	$ 2.5

(1) The general fund receives 40% of the TOT collections.

(2) Numbers for FY 2010 and FY 2011 are estimates made by the City.

(3) 25% of the TOT Fund is allocated to the Cultural Affairs Fund.

In addition, the City has planned significant renovations for the Convention Center starting in 2012. This will have a negative effect on the number of conventions to be held during reconstruction and is reflected in the budget projections.

The City maintains a fund called the Convention and Cultural Affairs Fund (Fund 536) which contains (1) proceeds from the parking lots adjacent to the Facilities, and (2) a percentage of the estimated TOT revenues from the TOT Fund to cover TSJ's operating deficits. In the current contract, the City agreed to transfer 25% of the estimated TOT revenues to Fund 536. The contract also provides that if the actual TOT revenues decline, the City will decrease the amount it contributes to Fund 536.

The balance of Fund 536 has grown from a negative $101,000 in June 2005 to $10 million in June 2009. According to the City Office of Economic Development, the balance has been allowed to grow over the past five years (1) to support a proposed Convention Center expansion; (2) to build a sinking fund to support capital needs of various Facilities; and (3) to protect the general fund from having to transfer more money due to TSJ's operating deficits.

The balance of Fund 536 has grown because in each of the five years of the initial contract, the City transferred to Fund 536 a percentage of TOT revenues far greater than the 25% specified in the contract; from 40% of estimated TOT receipts in 2005 to 57% in 2009. See Appendix 3. If the City had not been so generous to TSJ and limited its contributions from the TOT Fund to 25%, the total amount transferred in five years would have been $15 million. Instead, the City chose to transfer funds at a much higher rate; $29 million for the same period. The growth in the fund balance to $10 million is directly attributable to overfunding by the City rather than to TSJ's operational management. When Fund 536 receives more than 25% of TOT revenues, the cultural and fine arts programs that are not managed by TSJ receive less than their 75% share and might be in jeopardy.

General Fund

If TOT revenues are insufficient to cover TSJ's losses, the City is obligated to transfer money from the general fund. The City has contributed general fund money to TSJ twice – at a total cost of $2.86 million.

Conclusions

Twice in the last six years, San Jose has negotiated a contract with TSJ which seems to be financially advantageous only to TSJ.

In the first contract, the City covered $20.2 million in losses when it had agreed to subsidize a loss of $9.8 million. Many decisions contributed to that loss, one of which was to place 86 City employees on TSJ's payroll when other, less-costly alternatives could have been chosen.

In the current contract, it appears that neither TSJ nor the City is focused on reducing TSJ's operating losses, which would reduce the City's subsidy. In fact, TSJ's operating losses are escalating, largely as a result of increased salary and benefits costs.

The San Jose Convention and Cultural Facilities Notes to Financial Statements for the Year Ended June 30, 2009 include the following statement:

"In order for [TSJ] to continue its operations, it relies on the City for operating contributions…Accordingly, any significant changes in the TOT or parking garage revenues or decision to change the amount of support could greatly affect [TSJ's] ability to continue as a going concern."

San Jose is facing the worst budget deficit crisis in its history. The City should be working with TSJ to aggressively reduce TSJ's operating losses, thereby reducing the City's subsidy.

Findings and Recommendations

Finding 1

The City has subsidized substantially higher than anticipated operating losses.

Recommendation 1

The current contract has a Termination for Convenience clause starting July 1, 2012. The City should make use of that clause to re-establish revenue and operating loss targets for TSJ. This will encourage cost control by TSJ in managing the Facilities.

Finding 2

A significant portion of TSJ's operating losses is attributable to the costs of the salaries and benefits of Shared Employees and overhead paid to the City for the use of those employees in TSJ's operation.

Recommendation 2

The City should reassign the Shared Employees currently working for TSJ and allow TSJ to replace those employees with private sector equivalents in order to reduce TSJ's operating loss.

Finding 3

The incentive fee in the current contract is based on revenues and contains no incentive for TSJ to rein in costs which continue to escalate. TSJ continues to receive an incentive fee while the City pays for its mounting costs.

Recommendation 3

The current contract has a Termination for Convenience clause starting July 1, 2012. The City should make use of that clause to negotiate an incentive fee based on TSJ's operating profit.

Finding 4

The budget for salaries and benefits paid to TSJ's employees (excluding the Shared Employees) has increased by 65% in the first year of the new contract with additional funding for TSJ's executive team.

Recommendation 4

The City should insure that the increased employee compensation costs are justified by a higher level of Facilities usage and higher revenues.

Finding 5

Although the City agreed in the TSJ contracts to transfer 25% of the estimated TOT revenues to Fund 536 to cover TSJ's operating losses, the City has consistently paid more than 25% of TOT revenues into Fund 536 to ensure that TSJ's losses are adequately covered, no matter how high they are. Overfunding Fund 536 has the effect of masking TSJ's losses and covering up its underperformance.

Recommendation 5

The City should adhere to the terms of the contract and transfer only 25% or less of the TOT revenues to Fund 536.

Appendix 1

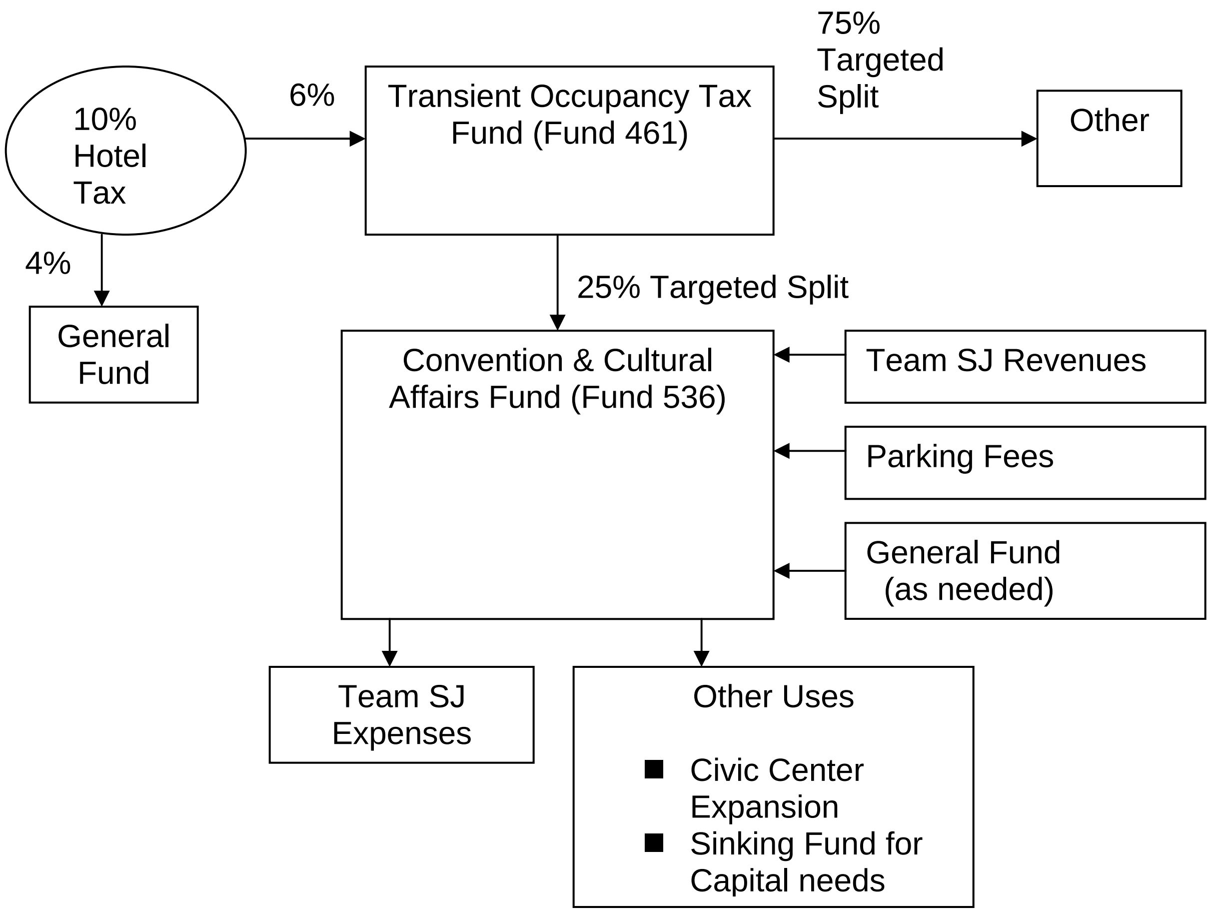
Comparison of Salaries and Benefits of Shared Employees and Their Private Sector Equivalents

Classification	Number of Employees	Hourly rate	TSJ annual salary per classification(1)	TSJ total annual salaries per classification	Private sector average annual salary per classification(2)	Private sector total annual salaries per classification
Air Conditioning Mechanic	2	$44	$90,522	$181,043	$63,000	$126,000
Air Conditioning Mechanic, Sr.	1	$47	$97,344	$97,344	$81,000	$81,000
Custodian	6	$23	$47,986	$287,914	$37,000	$222,000
Custodian, Sr.	1	$26	$54,787	$54,787	$44,000	$44,000
Electrician	2	$45	$94,390	$188,781	$81,000	$162,000
Facility Attendant	23	$24	$50,419	$1,159,642	$50,419(3)	$1,159,642
Facility Attendant, Sr.	5	$28	$57,450	$287,248	$57,450(3)	$287,248
Facility Repair Worker	4	$33	$68,120	$272,480	$60,000	$240,000
Security Officer	9	$27	$55,286	$497,578	$45,000	$405,000
Security Officer, Sr.	1	$32	$67,496	$67,496	$62,000	$62,000
Supervisor of Facilities	2	$46	$95,846	$191,693	$95,846(3)	$191,693
Totals	56			$3,286,005		$2,345,582
Retirement, Medical, Dental, & OPEB(4)				$1,643,002		$703,675
Total for TSJ Employees				$4,929,007		$3,049,257

(1) Annual cost (salaries and benefits) of Shared Employees at TSJ for fiscal year 2010.
(2) Private sector annual salaries taken from www.salary.com.
(3) No clear equivalent was found in the private sector; the public sector salary was repeated here.
(4) Benefit costs are calculated as 50% of annual salaries for TSJ and 30% for private sector.

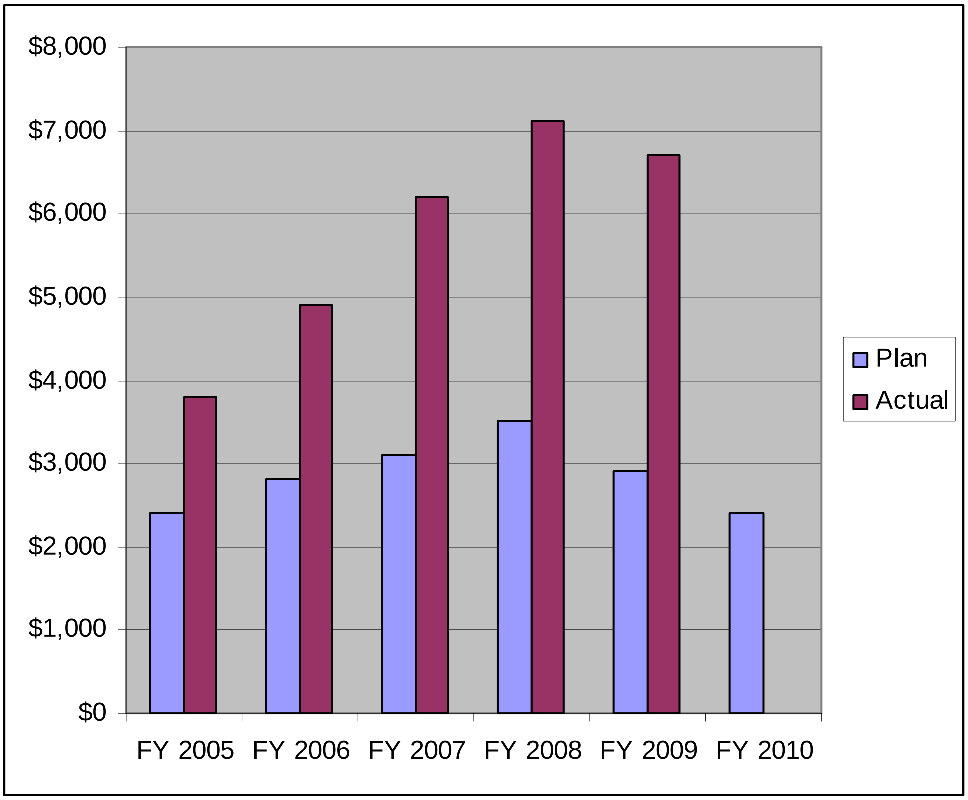
APPENDIX 2

Convention & Cultural Affairs Fund (Fund 536) Flow



APPENDIX 3

Funding of Convention and Cultural Affairs Fund (Fund 536)
Planned vs. Actual



This report was **PASSED** and **ADOPTED** with a concurrence of at least 12 grand jurors on this 6th day of May, 2010.

Angie M. Cardoza
Foreperson

Judy B. Shaw
Foreperson pro tem

Mary Nassau
Secretary