



Office of the City Auditor

**Report to the City Council
City of San José**

**2009-10 ANNUAL
PERFORMANCE AUDIT OF
TEAM SAN JOSE'S
MANAGEMENT OF THE
CITY'S CONVENTION AND
CULTURAL FACILITIES**

**Report 10-12
November 2010**

November 24, 2010

Honorable Mayor and Members
of the City Council
200 East Santa Clara Street
San Jose, CA 95113

2009-10 Annual Performance Audit of Team San Jose's Management of the City's Convention and Cultural Facilities

Since 2004, the San José McEnery Convention Center, two other convention facilities, and four other cultural facilities have been operated on the City's behalf by Team San Jose, Inc. (TSJ), with subsidies from the City's Transient Occupancy Tax Fund and General Fund. TSJ also receives revenue from the General Purpose Parking Fund associated with convention center parking. Under the terms of the Management Agreement between TSJ, a private, non-profit corporation, and the City, the City Auditor's Office annually audits TSJ's performance metrics. This report is our first under the new Management Agreement signed in 2009. Because of concerns that TSJ violated one of the terms of the Management Agreement in FY 2009-10 (not to incur expenses beyond the adopted budget), we also reviewed significant variances to revenue and expenses, changes to TSJ's business model, TSJ's board governance, and the timeline of events leading to TSJ's overspending its budget.

In spite of cost-cutting, TSJ's operations of City facilities lost \$6.9 million in FY 2009-10. In 2008, the United States fell into a recession that impacted both the type and amount of business that convention centers could attract. Although TSJ achieved a weighted performance of more than 100 percent, TSJ generated the largest net loss in its six years managing the City's convention and cultural facilities. As a result, the fiscal health of the Convention and Cultural Affairs Fund (Fund 536) continued to deteriorate in fiscal year 2009-10. TSJ's net operating loss of \$6.9 million was \$1.5 million over the prior year's \$5.4 million loss due largely to a decline in convention activities and the introduction of the concerts line of business. FY 2009-10 operating results included:

- \$7.1 million in losses on Convention Center events (the number of events decreased 16 percent from the prior year)
- \$1.0 million in losses on a series of concerts TSJ promoted with Nederlander Concerts (Nederlander) at the Civic
- \$0.9 million in losses on events at cultural facilities
- Net income of \$1.6 million from in-house food and beverage service
- Net income of \$0.5 million from event production and staging

In light of the continuing difficult economic conditions, we believe TSJ should be prepared to reduce spending below budgeted levels, and should renegotiate its contract with Nederlander as soon as possible.

TSJ's losses on operations are primarily subsidized by transfers of Transient Occupancy Tax (TOT). In 2009-10, the \$4.6 million in TOT and other revenue transferred to Fund 536 was not sufficient to cover TSJ's operating losses. As a result, the ending balance in Fund 536 dropped from \$10.3 at the beginning of the year to \$6.8 million at the end of the year. The adopted FY 2010-11 operating budget shows the ending balance in Fund 536 dropping to \$5.3 million by year end. We are concerned that further depletion of fund balance could jeopardize the City's plans to subsidize operations during the upcoming Convention Center expansion. To ensure the fiscal health of the City's Convention and Cultural Facilities and protect their ability to generate economic impact, we recommend that the City should (a) review its estimates of how much funding will be needed to subsidize continued operation during the upcoming Convention Center expansion, (b) on an on-going basis ensure that Fund 536's budget is balanced without use of fund balance to subsidize operating losses, and (c) once the economy improves, create a reserve for economic uncertainty in Fund 536.

On balance, TSJ met its performance and incentive targets, but some of those targets should be more rigorous. In 2009-10, TSJ drew nearly 1 million people to events at the Facilities, resulting in more than 183,000 hotel night bookings. TSJ was successful in meeting its goals for economic impact, gross revenue, hotel room nights, customer satisfaction and theater utilization, but missed its attendance goal by less than one percentage point, gross operating profit target by one percentage point, and return on investment goal by 12 percentage points.

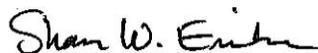
The TSJ corporation is paid an incentive fee based on how it performs during the year. In FY 2009-10, TSJ achieved an incentive fee of \$400,000 out of a possible \$500,000, in spite of having generated the largest net loss in its six years managing convention and cultural facilities. In our opinion, a tougher incentive fee structure should be considered—one that does not penalize TSJ for a poor economy, but incentivizes improved performance. To better incorporate the City's financial reality into Team San Jose's performance and incentive targets, we recommend that the City align financial targets to the budget, and amend the Management Agreement to: 1) explicitly specify that Hotel Business Improvement District and Convention and Visitors Bureau monies are to be excluded from the calculation of Gross Operating Revenues and Return on Investment; 2) revise the incentive fee payment structure such that TSJ receives incentive payments only if it achieves a specified threshold; 3) renegotiate the annual fixed management fee; and 4) revisit the weighting and tighten financial performance and incentive targets for the management of the City's convention and cultural facilities.

Changes to the TSJ business model were not always fully vetted through the Board of Directors and the City. Under the Management Agreement, Team San Jose is responsible for operating the Facilities, but the operation really is a joint effort between TSJ and the City. Not only does the City subsidize operations, but all the operating revenues and expenditures run through City accounts. Quite literally, when Team San Jose staff spends money operating the Facilities, they are spending City money out of City checking accounts. As a result, it is critical that both the City and Team San Jose have a clear understanding of important events that could have financial consequences for both parties. While the TSJ board approves the annual operating budgets which include information on TSJ's lines of business, board members told us they were not always fully aware of some business decisions until after the fact. In April 2010, TSJ's board adopted new practices to improve the board's governance of TSJ, including setting a \$250,000 revenue threshold for business decisions to come before the board. Likewise, we recommend the City amend the agreement with Team San Jose to clarify that Team San Jose must formally notify the City in advance of business decisions with potential revenue or budgetary impacts of \$250,000 or more. We further recommend that TSJ begin presenting quarterly performance reports to the Public Safety, Finance, and Strategic Support Committee per a prior City Council request.

TSJ overspent its budget in FY 2009-10. Operating within the adopted budget for Fund 536 is TSJ's responsibility. To comply with the Management Agreement, TSJ must recognize and communicate to the City whether its spending and the adopted budget are diverging irreconcilably. Although TSJ and City staff spoke regularly and met each month to review TSJ's financial and operational results, and despite repeated questions from City staff about TSJ's expenditure rate during these meetings, TSJ failed to notify staff that it had overspent its budget. Flawed reporting and an apparent misunderstanding of and miscommunication about the nature of the spending problem appear to have contributed to this outcome. Efforts are underway to improve communication and reporting, and we recommend further improvements in budget tracking and monthly reporting.

The City Auditor's Office would like to thank the management and staff of Team San Jose, Inc., the Finance Department, the Office of Economic Development, the City Attorney's Office, and the City Manager's Budget Office for their time, information, insight, and cooperation during the audit process. Team San Jose's response and the City Administration's response are shown in the yellow pages attached to this report. We plan to present this report at the December 7, 2010 City Council meeting. If you need any additional information, please let me know.

Respectfully submitted,



Sharon W. Erickson
City Auditor

finaltr
SE:bh

Audit Team: Steve Hendrickson
Avichai Yotam
Carolyn Huynh
Michael Houston

cc: Debra Figone Eric Bilimoria
Richard Doyle Brian Doyle
Ed Shikada Belinda Silvatici
Deanna Santana Grace Martinez
Jennifer Maguire Dan Fenton
Scott Johnson Janette Divoll
Lee Wilcox Board of Directors, Team San Jose

Table of Contents

| | |
|---|-----------|
| Cover Letter | i |
| Introduction | 1 |
| Background | 1 |
| Objective, Scope, and Methodology | 4 |
| Finding I | |
| In Spite of Cost Cutting, Team San Jose’s Operations of City Facilities Lost \$6.9 Million in Fiscal Year 2009-10 | 7 |
| Team San Jose Generated Operating Losses of \$6.9 Million in FY 2009-10 | 7 |
| TSJ Lost \$7.1 Million on Convention Center Events | 9 |
| San José Civic Concerts Lost \$1.0 Million; Overall Losses on the Operation of Cultural Facilities Totaled \$1.9 Million | 12 |
| Net Revenue of \$2.1 Million from Food and Beverage and Event Production | 15 |
| Gross Operating Revenues Have Increased, but so Have Net Losses | 16 |
| Further Depletion of Fund Balance Could Jeopardize the City’s Plans to Subsidize Operations During the Upcoming Convention Center Expansion | 17 |
| Finding II | |
| On Balance, Team San Jose Met Its Performance and Incentive Targets, but Some of Those Targets Should be More Rigorous | 21 |
| Team San Jose Met Most Performance and Incentive Targets | 21 |
| Gross Operating Revenue Requires Clarification | 23 |
| The City Should Refine Its Approach to TSJ Performance and Incentive Targets | 24 |
| Finding III | |
| Changes to the Team San Jose Business Model Were Not Always Fully Vetted Through the Board of Directors or the City | 29 |
| Team San Jose Is Improving Its Governance Structure | 29 |
| Business Decisions Were Not Always Fully Vetted Through the Board | 30 |
| Improvements Are Needed to Ensure the City Is Notified in Advance of Key Business Decisions | 34 |
| Improved Communications Between TSJ and the City Council | 35 |
| Finding IV | |
| Team San Jose Overspent Its Budget in FY 2009-10 | 37 |
| Timeline of Events Leading to Team San Jose’s Overexpenditure and the Notice of Default | 37 |

| | |
|--|---------------------|
| Efforts Are Underway to Improve Communication and Reporting..... | 41 |
| Conclusion..... | 43 |
| Administration’s Response..... | yellow pages |
| Team San Jose’s Response | yellow pages |
| Appendix A | |
| Explanation of Key Variances in Revenue and Expense Categories..... | A-1 |
| Appendix B | |
| Methodology for Calculating the Performance and Incentive Measures..... | B-1 |

Table of Exhibits

| | |
|--|-----------|
| Exhibit 1: Flow of Funds to and from the Convention and Cultural Affairs Fund..... | 3 |
| Exhibit 2: Performance and Incentive Measures, with Relative Weights | 4 |
| Exhibit 3: Operating Profit and Loss for the Facilities from 2004-05 to 2009-10 as Calculated in Accordance with the Management Agreement | 8 |
| Exhibit 4: Transient Occupancy Tax Fund Revenue Compared to the Facilities' Net Loss | 10 |
| Exhibit 5: Event Attendance at Convention and Cultural Facilities from 2004-05 to 2009-10 | 11 |
| Exhibit 6: Profit and Loss for the Operation of the City's Cultural Facilities (Millions)..... | 15 |
| Exhibit 7: Food and Beverage Profit in 2008-09 and 2009-10..... | 16 |
| Exhibit 8: Revenues and Net Losses from the Operation of the Facilities from 2001-02 to 2009-10 | 17 |
| Exhibit 9: Budgeted Sources and Uses for the Fund 536 (Convention and Cultural Affairs Fund) from FY 2005-06 through 2009-10 | 18 |
| Exhibit 10: Scores for Team San Jose's FY 2009-10 Performance and Incentive Measures..... | 22 |
| Exhibit 11: Incentive Measure Payment Schedule..... | 22 |
| Exhibit 12: Gross Operating Profit Based on TSJ's FY 2009-10 and 2010-11 Budget..... | 24 |
| Exhibit 13: Timeline of Key Events Leading to TSJ's Overspending Its 2009-10 Budget..... | 38 |

Introduction

In accordance with the City Auditor's fiscal year (FY) 2010-11 Audit Work Plan, we have completed an audit of Team San Jose, Inc.'s (TSJ) management of the City's convention and cultural facilities to determine whether TSJ met the performance measures specified in the Agreement for the Management of the San José Convention Center and Cultural Facilities between the City of San José and Team San Jose, Inc. (Management Agreement) for FY 2009-10.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient and appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions. We limited our work to those areas specified in the Objective, Scope, and Methodology section of this audit report.

The City Auditor's Office would like to thank the management and staff of Team San Jose, Inc., the Finance Department, the Office of Economic Development, the City Attorney's Office, and the City Manager's Budget Office for their time, information, insight, and cooperation during the audit process.

Background

The City of San José has a host of Convention and Cultural Facilities, including three convention facilities and four cultural facilities (Facilities) that are operated on the City's behalf by Team San Jose, Inc. (TSJ), a private, non-profit corporation. The convention facilities operated by TSJ are: San José McEnery Convention Center, South Hall, and Parkside Hall. The cultural facilities are Center for the Performing Arts, Montgomery Theater, San José Civic, and California Theater.

Team San Jose is a unique partnership of TSJ staff, the San José Convention & Visitors Bureau (CVB), City employees, and other contracted employees. It was created in December 2003 specifically to manage and operate the Facilities. Its board includes representatives from local hotels, arts, business, and labor.

The 2004 and 2009 Management Agreements

The City began contracting with TSJ on June 22, 2004, when the City Council approved a Management Agreement with TSJ to manage and operate the Facilities for a five-year period, beginning July 1, 2004 and ending June 30, 2009. That agreement included performance measures that were audited annually by the City Auditor's Office.¹

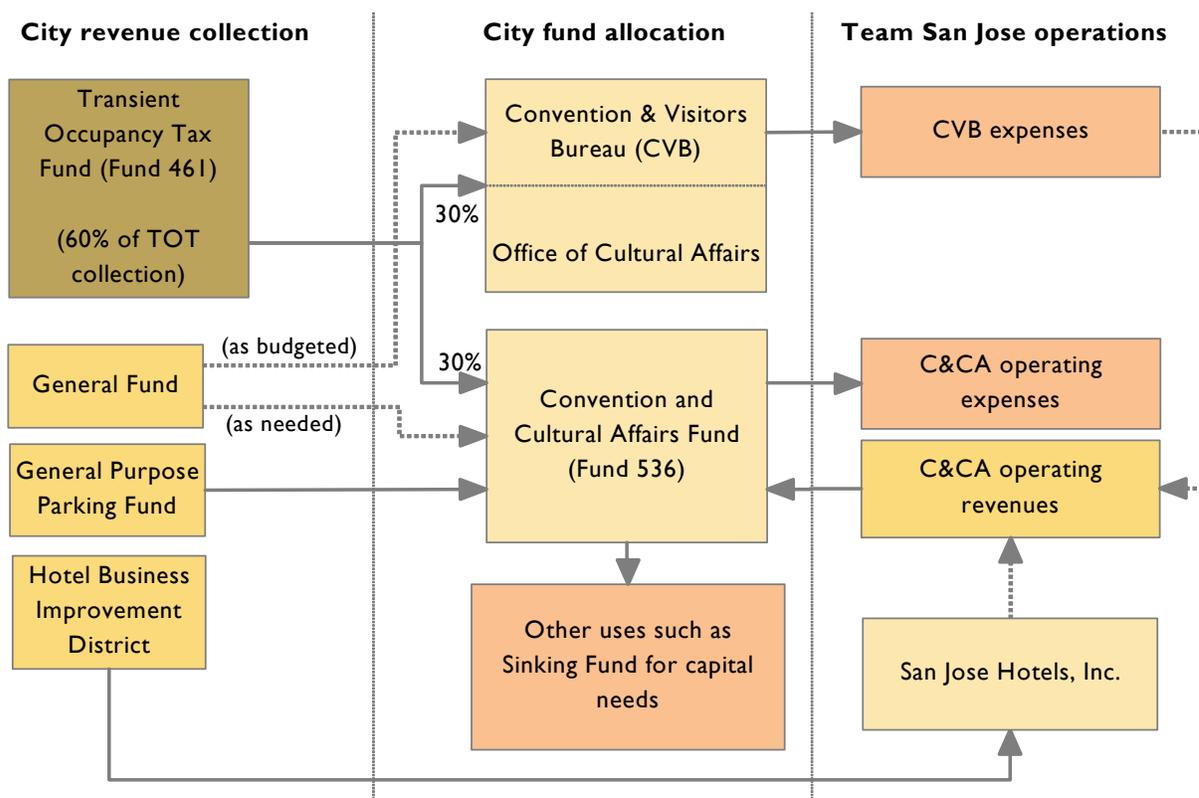
In January 2009, the City Council approved a new five-year Management Agreement beginning July 1, 2009 and ending June 30, 2014, with two additional three-year options. In February 2009, TSJ merged with the CVB, which also receives City funding through the Transient Occupancy Tax (TOT) Fund and General Fund to promote San José as a destination for meetings, conventions, tradeshow, and pleasure travel. Currently, CVB staff provide sales and marketing support for Team San Jose's operation of the Facilities.

TSJ's Operation of the Facilities Relies on Contributions of TOT and Other Revenues

The Facilities, under the management of TSJ, generate revenues which help fund the operations. However, to continue its operations, TSJ relies on operating contributions from the TOT Fund (currently, approximately 30 percent of TOT collections are transferred to Fund 536 and approximately 30 percent are split between CVB and the Office of Cultural Affairs—the remaining 40 percent of TOT collections go to the City's General Fund), the General Purpose Parking Fund (net revenue from Convention Center parking facilities), and the General Fund. Exhibit I shows the flow of these funds.

¹ These previous reports are online at <http://www.sanjoseca.gov/auditor/>.

Exhibit I: Flow of Funds to and from the Convention and Cultural Affairs Fund²



Source: Interviews with Finance Department and TSJ staff, and review of San José Municipal Code and the Civil Grand Jury Report issued May 2010

Related Parties Also Contribute Revenue to TSJ

Exhibit I also shows that Team San Jose receives income from related parties—the CVB and San Jose Hotels, Inc. In FY 2009-10, the CVB received \$1.7 million from the General Fund and \$2.1 million from the TOT Fund to promote San José as a tourist and convention destination. Team San Jose used a small portion of these CVB funds—about \$70,000—to provide discounts to convention groups.

In addition, Team San Jose received funds from San Jose Hotels, Inc. to support convention groups. San Jose Hotels, Inc. is a non-profit corporation that administers the City's Hotel Business Improvement District Fund, which is made up of fees levied on hotel guests to support efforts to increase occupancy rates in City hotels. In FY 2009-10, Team San Jose received revenue of nearly \$148,000 from San Jose Hotels, Inc. According to TSJ, these spending decisions were made by the San Jose Hotels, Inc. Board of Directors, who are representatives from the hotel industry, based on suggestions from Team San Jose and CVB staff.

² Per the San José Municipal Code, the amount of TOT revenue allocated to the Office of Cultural Affairs and Convention & Visitors Bureau is to be a base amount, set in the early 1980s, plus 50 percent of the dollar increases to TOT tax receipts. The Convention and Cultural Affairs Fund is to receive the remaining 50 percent.

Current TSJ Performance and Incentive Measures

In June 2009, the City and TSJ entered into an addendum to the Management Agreement, clarifying performance measures and incentive pay. Because construction of the facilities managed by TSJ was financed through tax-exempt debt, the management contract cannot, according to the City Attorney’s Office, have an incentive pay provision that is based on return on investment or gross operating profits; hence, the incentive measures used to determined TSJ’s incentive pay differ slightly from the general performance measures. The 2009 Management Agreement requires TSJ to submit annual targets for the following performance and incentive measures for City review, and joint agreement. Exhibit 2 shows how these measures are to be weighted.

Exhibit 2: Performance and Incentive Measures, with Relative Weights³

| Performance Measure | | Incentive Measure | |
|---|-----|---|-----|
| Economic Impact | | Economic Impact | |
| Hotel Room Nights | 10% | Hotel Room Nights | 15% |
| Attendance | 10% | Attendance | 10% |
| Estimated Economic Impact (EEL, a proxy for visitor spending) | 10% | Estimated Economic Impact (EEL, a proxy for visitor spending) | 15% |
| Return on Investment | 10% | | |
| Total Economic Impact | 40% | Total Economic Impact | 40% |
| Gross Operating Profit | 35% | Gross Operating Revenue | 35% |
| Theater Performance | 15% | Theater Performance | 15% |
| Customer Service Survey Results | 10% | Customer Service Survey Results | 10% |

Source: Addendum to the Management Agreement

The 2009 Management Agreement also requires TSJ to submit information on the following new special reporting metrics: Theatre Operations, Benchmark Convention Business, and Impressions, Marketing/Branding.

Objective, Scope, and Methodology

The objective of our audit was to determine whether TSJ met its performance measures as specified in the Management Agreement for FY 2009-10. Because of concerns that TSJ violated one of the terms of the Management Agreement in FY 2009-10 (not to incur expenses beyond the adopted budget), we also reviewed significant variances to FY 2008-09 revenue and expense information, changes to TSJ’s business model, TSJ’s board governance, the timeline of events leading to TSJ’s overspending its budget, and to a limited extent, TSJ’s related-party transactions.

³ The weighting approved by the City Council differs from the weighting City staff had negotiated with TSJ in that the proposal to the City Council, which included only performance measures, weighted Gross Operating Profit at 45 percent and Economic Impact measures at 30 percent.

To determine whether TSJ met its performance measures for economic impact, gross operating profit/revenues, theater performance, and customer service results, we:

- Reviewed the Management Agreement and its Addendum for descriptions of performance and incentive measures, and the Council-adopted targets for FY 2009-10;
- Obtained and reviewed the audited financial statements for the Facilities for FY 2009-10;
- Interviewed the external auditor for the Facilities, Macias, Gini, & O'Connell, LLP (MGO), Finance Department, Budget Office, Office of Economic Development and TSJ staff;
- Observed testing on accuracy of attendance reporting data for FY 2009-10;
- Obtained and reviewed TSJ's customer service surveys for FY 2009-10; and
- Reviewed TSJ's FY 2009-10 monthly and annual reports.

To identify the cause for significant variances in TSJ's financial results from FY 2008-09 to FY 2009-10, we interviewed TSJ finance and accounting staff and obtained detailed break-downs of TSJ performance by line of business (e.g., convention activities, concerts, food and beverage services, etc).

To review TSJ's board governance, we interviewed some members of the Board, and obtained and reviewed Board (including executive committee) agendas and minutes from FY 2008-09 and 2009-10.

To identify the timeline of events leading to TSJ's overspending of its budget, we interviewed Finance Department, Budget Office, Office of Economic Development, and TSJ staff. We also obtained and reviewed TSJ's monthly reports, communication between the City and TSJ, and City and TSJ planning documents.

To determine the nature of related-party transactions, we interviewed TSJ finance and accounting staff and reviewed TSJ financial records.

Concurrent with our review, the City's Finance Department engaged the services of Macias, Gini, & O'Connell to apply agreed-upon procedures specified by the City and to expand the scope of testing the operating revenues and expenses of the facilities managed by TSJ on behalf of the City. The purpose of the engagement was to assist the City in evaluating TSJ's response to the Notice of Default issued by the City on August 18, 2010. In addition to revenues and expenses, procedures were tested for internal controls over TSJ's budget process, stand-alone revenue tracking systems, and potential duplication of recording of financial transactions between TSJ and CVB.

This page was intentionally left blank

Finding I In Spite of Cost Cutting, Team San Jose's Operations of City Facilities Lost \$6.9 Million in Fiscal Year 2009-10

TSJ increased its operating revenue in 2009-10 to \$18.0 million, an increase over 2008-09. However, this was not enough to offset \$24.9 million in TSJ expenses in fiscal year 2009-10, resulting in an operating loss of \$6.9 million that was subsidized by TOT, City transfers, and fund balance. Team San Jose experienced a dramatic increase in operating expenses over the previous year, in spite of decreased spending on City employees due to lay-offs and savings related to TSJ employees agreeing to take pay and benefit cuts in fiscal year 2009-10. TSJ's operations suffered a \$7.1 million loss in its convention center business, that is, the staging of conferences, business meetings, and exhibits at the Convention Center in FY 2009-10. Added to that was a \$1.0 million loss on TSJ's involvement in a new line of business, the staging of concerts and entertainment acts in the San José Civic. TSJ also incurred \$0.9 million of losses related to other events at cultural facilities. These losses were offset by profitable components of TSJ's operation—the food and beverage operation and the staging of cultural events, such as the Broadway Series events at the City's cultural facilities.

Team San Jose Generated Operating Losses of \$6.9 Million in FY 2009-10

Fiscal year 2009-10, the sixth that TSJ has operated the Facilities, brought changes to TSJ's business model. Although the facilities continue to be operated by a combination of City and TSJ staff, the number of City staff was dramatically reduced. Also, effective June 24, 2009, TSJ terminated its relationship with Centerplate, which was previously the food and beverage concessionaire for the Facilities, and started to provide food and beverage services to its customers directly. In addition, TSJ signed contracts with Nederlander to host concerts at the San José Civic and Broadway productions at the Center for the Performing Arts. According to TSJ, new revenue streams including ticketing, Broadway shows, and food and beverage redesign were intended to offset the effects of the downturn in the economy.

Exhibit 3 displays TSJ's revenues and expenses over the past six years, showing that TSJ losses have increased dramatically over the past two years, from \$3.0 million in FY 2007-08 to \$6.9 million in FY 2009-10. In past years these losses have been covered by monies that the City transferred each year to the City's Convention and Cultural Affairs Fund – Fund 536. In FY 2008-09, for example, the \$6.7 million in TOT revenue that was transferred to Fund 536 was enough to cover TSJ's operating losses that year.

Exhibit 3: Operating Profit and Loss for the Facilities from 2004-05 to 2009-10 as Calculated in Accordance with the Management Agreement⁴

| | 2004-05 | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 | % Variance from 08-09 to 09-10 |
|--|----------------------|----------------------|----------------------|----------------------|----------------------|----------------------|--------------------------------|
| Operating Revenues | | | | | | | |
| Food and beverage services | \$1,209,721 | \$2,048,213 | \$2,521,900 | \$2,760,809 | \$2,008,242 | \$6,461,076 | 221.7% |
| Building rental | 4,194,140 | 4,489,668 | 5,078,075 | 5,855,214 | 5,281,338 | 4,548,200 | -13.9% |
| Labor/Event Production Labor Revenues | 14,669 | 40,138 | 59,070 | 474,399 | 2,331,468 | 3,497,422 | 50.0% |
| Ticketing Services | | | | | 123,865 | 1,485,611 | 1,099.4% |
| Heat and power services charges | 551,427 | 520,262 | 771,870 | 794,488 | 580,649 | 536,231 | -7.6% |
| Event electrical/utility services | 460,927 | 619,297 | 737,676 | 834,180 | 695,084 | 504,287 | -27.4% |
| Audio/visual services | 266,438 | 298,588 | 431,674 | 475,843 | 446,967 | 394,437 | -11.8% |
| Other revenues | 59,772 | 140,084 | 294,046 | 184,369 | 364,404 | 277,410 | -23.9% |
| Networking services | 245,000 | 481,584 | 482,964 | 450,086 | 380,334 | 215,807 | -43.3% |
| Equipment rentals | 56,988 | 46,262 | 59,977 | 65,773 | 58,159 | 62,551 | 7.6% |
| Telecommunications services | 99,731 | 90,226 | 117,310 | 118,295 | 80,465 | 56,417 | -29.9% |
| Total Operating Revenues | \$7,158,813 | \$8,774,322 | \$10,554,561 | \$12,013,456 | \$12,350,975 | \$18,039,449 | 46.1% |
| Operating Expenses | | | | | | | |
| Team San Jose employee salaries | 645,366 | 872,271 | 1,237,668 | 1,972,234 | 1,923,319 | 6,107,273 | 217.5% |
| City shared employee charges | 6,228,160 | 5,820,023 | 6,645,397 | 6,754,513 | 6,662,719 | 5,023,569 | -24.6% |
| Cost of event production labor | | | | | 1,967,629 | 2,973,411 | 51.1% |
| Utilities | 2,335,139 | 2,467,647 | 2,535,946 | 2,595,186 | 2,561,984 | 2,425,746 | -5.3% |
| Ticketing costs | | | | | | 1,344,386 | 100.0% |
| Food and beverage costs | | | | | | 1,305,813 | 100.0% |
| Other expenses | 317,857 | 668,446 | 763,447 | 869,202 | 645,780 | 1,067,439 | 65.3% |
| Overhead - City of San José | 542,368 | 555,116 | 865,262 | 911,940 | 883,727 | 808,813 | -8.5% |
| Contracted outside services | 516,980 | 714,818 | 461,066 | 421,067 | 535,234 | 622,234 | 16.3% |
| Professional Services | | | | | 509,676 | 594,281 | 16.6% |
| Operating supplies | 302,600 | 410,711 | 420,768 | 455,786 | 469,809 | 453,497 | -3.5% |
| Bad debt expense | | | | | 567,751 | 423,457 | -25.4% |
| Repairs and maintenance | 231,123 | 392,837 | 394,565 | 375,380 | 299,702 | 412,585 | 37.7% |
| Team San Jose Management Fee (prior contract) | 150,000 | 150,000 | 150,000 | 150,000 | 150,000 | | -100.0% |
| Team San Jose Management Incentive Fee (new contract) | | | | | | 400,000 | 100.0% |
| Workers' compensation insurance premiums | 124,820 | 226,559 | 130,268 | 175,612 | 219,996 | 357,269 | 62.4% |
| Equipment Rentals | | | | | 117,100 | 318,934 | 172.4% |
| Insurance | 276,064 | 280,854 | 282,330 | 287,093 | 257,948 | 284,834 | 10.4% |
| Contracted services - City of San José | 117,403 | 83,939 | | | | | 0.0% |
| Total Operating Expenses | \$11,787,880 | \$12,643,221 | \$13,886,718 | \$14,968,013 | \$17,772,374 | \$24,923,541 | 40.2% |
| Gross Operating Profit / (Loss) | \$(4,629,067) | \$(3,868,899) | \$(3,332,156) | \$(2,954,557) | \$(5,421,399) | \$(6,884,092) | 27.0% |
| Team San Jose Executive Management Fee (new contract)* | | | | | | 663,321 | 100.0% |

Source: Auditor analysis of audited financial statements for the San José Convention and Cultural Affairs Fund

* Beginning FY 2009-10, the Executive Management Fee for Team San Jose's management salaries is not included in the calculation of gross profit. Previously, Team San Jose's management salaries were paid by the CVB.

⁴ The loss numbers presented in this exhibit do not include all costs that the City incurs to operate the Facilities. Specifically, we do not include TSJ's fixed management fee, depreciation expense, City contract oversight costs, fire insurance, City-funded repairs and maintenance, capital outlay, or the City's free use of the Convention Center. Altogether, these costs totaled about \$2 million in FY 2009-10. The total expenses shown in Exhibit 3 differ from those discussed in Exhibit 13 in Finding IV because the latter includes only the amount of TSJ's spending authority within the Convention and Cultural Affairs Fund.

The largest revenue increase was in food and beverage services, and was related to TSJ bringing that operation in-house as described below. The largest expense increase was in TSJ salaries. More than \$3.3 million of the \$4.2 million increase in this cost category is attributable to the cost of TSJ staff hired to provide food and beverage services at convention center and theater events. As discussed above, a contractor previously supplied food and beverage service at TSJ convention center and theater events. Much of the remaining increase is due to the conversion of several staff that previously had worked at the convention center as City employees, but in FY 2009-10 were converted to TSJ staff, and to the addition of staff for the San José Civic concert series. Appendix A provides additional explanations of why key revenue and expense line items increased or decreased from FY 2008-09 to FY 2009-10.

The losses shown in the table do not include TSJ's management fee or the Convention & Visitors Bureau's (CVB) sales and marketing for the Facilities. In addition, they do not include depreciation or debt service on the Facilities. For example, in FY 2009-10 the Redevelopment Agency's debt service for the construction of the Convention Center was \$14.7 million.⁵

In the following sections, we describe the operational results of some of TSJ's business lines.

TSJ Lost \$7.1 Million on Convention Center Events

An important source of revenue to TSJ is the rental of exhibition and meeting space to the organizations and corporations that sponsor conventions, professional meetings and exhibits at San José's convention center. In FY 2009-10, however, gross revenue from the rental of building space was down 14 percent to \$4.5 million (including rental of the cultural facilities). The decline in revenue from renting the convention center was due to fewer events at the convention center, especially corporate conventions. TSJ saw a decline in building rental along with revenue related to other ancillary services, such as event electrical/utility, networking and telecommunication services that TSJ typically provides at conventions. Altogether, TSJ managed to draw nearly 1 million people to events at the convention facilities, resulting in about 183,000 hotel room nights, however the events resulted in a \$7.1 million operating loss.⁶

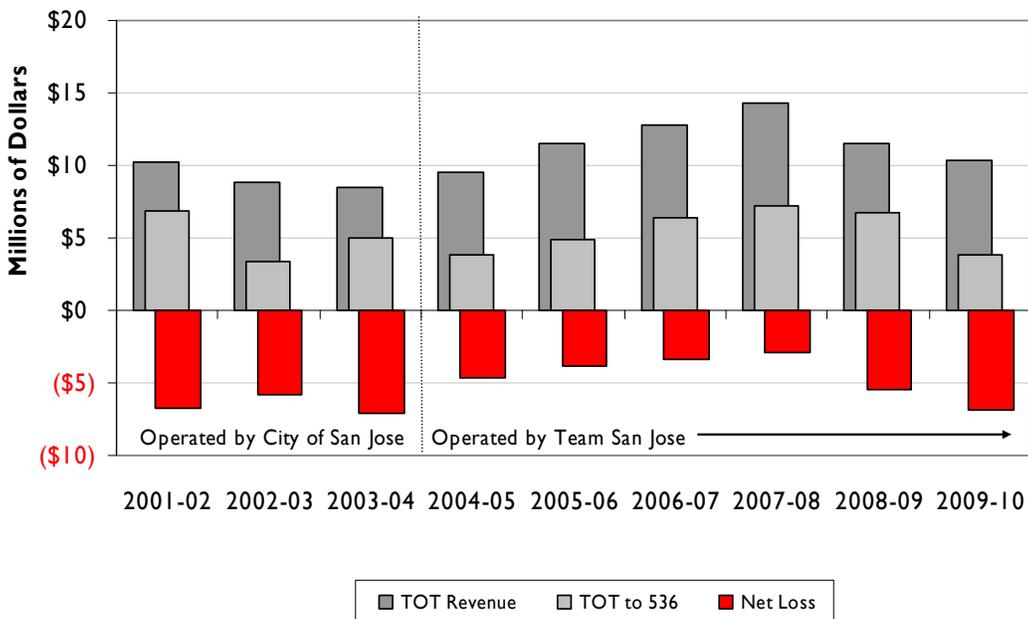
⁵ It is generally assumed that if the Redevelopment Agency were unable to make the debt service payments, the City would become responsible for this cost.

⁶ The loss associated with convention center events includes the full cost of the City's overhead and bad debt expenses charged to the Convention and Cultural Affairs Fund, as well as nearly all of the cost for TSJ's administrative personnel.

A Tough Time to be in the Convention Business

FY 2009-10 saw continued impacts of the economic recession on the convention business. These impacts are apparent in the City’s Transient Occupancy Tax Fund revenues, which, once as high as \$14.3 million per year, declined to \$11.5 million in FY 2008-09, and declined even further to \$10.4 million in FY 2009-10.⁷ Exhibit 4 shows the TOT Fund revenue, the amount of that TOT revenue that is transferred into Fund 536, and the net loss from the operations of the Facilities by the City from 2001-02 to 2003-04, and by TSJ from 2004-05 onwards.

Exhibit 4: Transient Occupancy Tax Fund Revenue Compared to the Facilities’ Net Loss



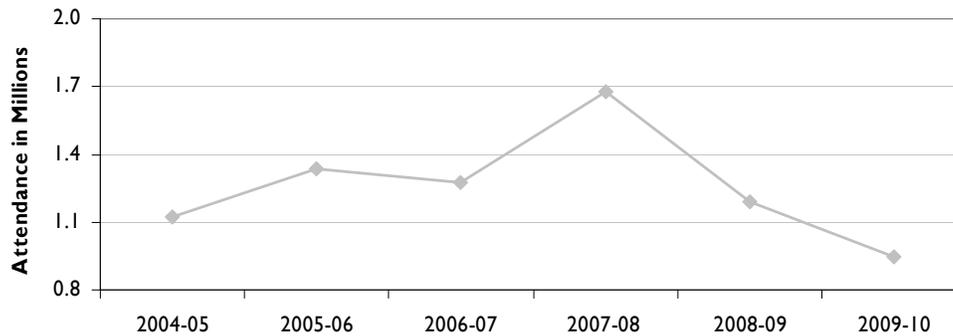
Source: Auditor analysis of Budget Office documents and audited financial statements for the Convention and Cultural Affairs Fund

Event Attendance

TSJ experienced the impacts of the recession on the convention business during FY 2009-10 with another year of declining overall attendance at fewer convention center events. In FY 2009-10, TSJ booked 288 events into the Facilities, a decrease of 16 percent from the prior year, FY 2008-09, when TSJ booked 344 events. Exhibit 5 displays attendance at events from FY 2004-05 to FY 2009-10. In 2007-08, attendance totaled 1.7 million and operating losses totaled \$3 million; whereas in FY 2009-10, when attendance declined to 947,000, operating losses totaled \$6.9 million.

⁷ These amounts represent the 60 percent of TOT tax that goes to the City’s Transient Occupancy Tax Fund; as noted earlier, 40 percent of collected TOT tax goes to the City’s General Fund.

Exhibit 5: Event Attendance at Convention and Cultural Facilities from 2004-05 to 2009-10



Source: Auditor analysis of audited financial statements for the San José Convention and Cultural Facilities Fund, and TSJ attendance records

According to Team San Jose, the Sacramento Convention Center, a center that is comparable to San José's, in 2010 also reported a decline of 14 percent in the number of events held at its convention center over the prior year. Furthermore, according to surveys by the Professional Convention Management Association, an association of convention industry leaders, 27 percent of meeting planners surveyed cut meetings and events in 2008, and 38 percent in 2009. Similarly, the national average of hotel rooms "picked up," that is, consumed by convention attendees, dropped 21 percent from 2008 to 2009.

To boost attendance at Convention Center events and profitability, TSJ offers discounts to potential customers. During 2009-10, TSJ discounted building rental rates, relative to what TSJ says it would charge in a good economy, to prevent customers from scheduling their events at other convention centers. TSJ plans to continue offering deeply discounted rates to convention center customers in the future.

Because of concerns about decreasing attendance, we interviewed a small sample of long-time customers who had recently moved their annual event to a different convention center—the Santa Clara Convention Center.⁸ Although two of the four customers we interviewed had moved their convention business elsewhere because they were dissatisfied with the rates charged at the San José McEnery Convention Center, there were a variety of reasons for their moves. The customers we interviewed switched because:

- Free parking was available at the other convention center
- Their preferred date was not available in San José
- Too little time to move in/out was given by San José, which drives up labor costs

⁸ Our sample included the YWCA of Silicon Valley, the Tech Museum of San Jose, the Harker School, and the Silicon Valley Leadership Group.

- A more competitive rate was offered by the other convention center, in a straight-forward fashion
- Their event had grown out of the ballroom space available in San José.

Team San Jose Cut Costs in 2009-10

The City's FY 2009-10 adopted operating budget for the Facilities eliminated positions for 30 City employees who had worked at the Convention Center, which resulted in savings of \$1.6 million. To further stem financial losses during fiscal year 2009-10, Team San Jose made the following spending cuts during the year:

- Eliminated TSJ employee incentives (bonuses) for the second half of FY 2009-10, which resulted in savings, according to TSJ, of \$202,000
- Implemented a one week furlough that impacted all TSJ employees resulting in savings, according to TSJ, of \$63,000
- Reassigned a production manager to a job that had previously been filled by a consultant, creating savings, according to TSJ, of \$31,500
- Suspended the concert series at the Civic in January 2010, because the first dozen concerts had not been profitable, until such time as the City and TSJ can plan how to pay for improvements that, according to TSJ, need to be made to the Civic to make the building more suitable for concert-goers and artists.

To further reduce spending, as part of its 2010-11 budget, the City eliminated 42 positions under TSJ's management due to declining economic conditions and lower business demand, which is projected to save the Convention and Cultural Affairs Fund \$2.8 million in FY 2010-11.

Recommendation #1: In light of the continuing difficult economic conditions, and taking into account that TOT transfers are projected to remain well below previous amounts, we recommend Team San Jose be prepared to reduce spending below the budgeted level during difficult economic times.

San José Civic Concerts Lost \$1.0 Million; Overall Losses on the Operation of Cultural Facilities Totaled \$1.9 Million

In FY 2009-10, Team San Jose initiated a new line of business in which concerts and other entertainment acts would be staged at the Civic. TSJ had no prior experience in putting on concerts, so its management identified a promoter to handle the scheduling and managing of the concerts. In February 2009, TSJ entered into a contract with Nederlander in which Nederlander would schedule concerts into the Civic and would handle most of the work associated with putting on the concerts. The contract split the financial risk of these concerts

between Nederlander and TSJ. After several concerts, however, it was clear to TSJ that the concerts had not been profitable. After staging the first 15 concerts in Fall/Winter 2009, TSJ had lost about \$1 million for the Convention and Cultural Affairs Fund.⁹

According to Team San Jose, the concert series drew nearly 22,000 people to downtown San José. Nonetheless, because of these losses and because the improvements that were scheduled to be made at the Civic to accommodate concert-goers and the artists had not occurred, TSJ decided to suspend booking concerts into the Civic. The last concert that Nederlander staged took place in December 2009. In the second half of 2009-10, TSJ held several events at the Civic that generated net revenues of \$300,000. However, those profits were insufficient to offset previous losses.

TSJ and Nederlander are currently in the midst of renegotiating Nederlander's contract to reflect the current status of concerts, which is that over the past 10 months, TSJ and Nederlander have not been involved in scheduling and managing concerts at the Civic. In response to our inquiries, TSJ management pointed out that they have not abandoned the plan to stage concerts at the Civic, but that the plan to restart the concert series is uncertain until funding can be secured to complete the renovations planned for the Civic.

Given the financial challenges of producing concerts at the Civic last year and given the fact that, according to staff at Team San Jose, the Civic has still not been renovated to be a more suitable concert venue, in our view TSJ should proceed cautiously before it restarts the concert series. The first item of business would be for TSJ to renegotiate its contract with Nederlander. The current contract has been referred to as a "shared risk" contract in which TSJ and Nederlander share the financial rewards and risks of producing concerts at the Civic. However, in reviewing the contract and last year's financial results, it appears that TSJ is sharing a disproportionate share of the risk in the current arrangement.

Provisions in the current contract shield part of Nederlander's risk by requiring an offset to the amount of loss that Nederlander shares with the City if the TSJ food and beverage concession (and other revenues such as parking) at the concerts does not achieve a contractually-specified level of sales per patron. According to TSJ, only 1 of the 15 concerts came close to achieving the contractually-specified minimum food and beverage sales per patron. This provision of the contract significantly reduces Nederlander's downside risk, and partly explains why Nederlander will only share in \$149,000 of the losses in FY 2009-10.

⁹ According to TSJ, this loss includes about \$200,000 that it spent on improvements at the San Jose Civic.

In addition, in accordance with the contract, the loss Nederlander shares has been further offset by the \$300,000 of TSJ-generated profits at the Civic during the second half of 2009-10, after TSJ had suspended the concert series, mainly by holding convention events at the site.¹⁰ Thus, because of the contract's disproportionate risk-sharing, a portion of the profitable results of TSJ's management of the Civic, from January to June 2010, are not available to benefit the City's Convention and Cultural Affairs Fund. This means TSJ required a larger subsidy from the City than it would have otherwise.

More troubling, TSJ's August 2010 monthly financial report shows that Nederlander is still sharing profits from TSJ's events at the Civic. Specifically, the report showed that, as of August 2010, Nederlander was to share \$17,000 of profit from those events even though no concerts were scheduled to take place at the Civic. This profit-sharing is in addition to Nederlander's base management fee. Thus, despite the absence of current or planned concert activity, Nederlander is benefiting from the contractual arrangement.

Recommendation #2: To reflect the current reality which is that because the concert series at the Civic have been suspended and that Nederlander is currently not providing the services Team San Jose originally contracted with it to do, Team San Jose should renegotiate its contract with Nederlander as soon as possible and modify the terms of the contract to better balance the financial risk of doing concerts between Team San Jose and the promoter.

Overall Losses on Events at Cultural Facilities

A profitable component of the cultural facilities was the Broadway musical series at the Center for the Performing Arts. However, it is important to note that, overall, TSJ's operation of the cultural facilities resulted in a \$0.9 million loss on top of the \$1 million loss from the San José Civic concert series—a \$1.9 million overall loss. Exhibit 6 shows the profit and loss by cultural facility, including the San José Civic concert series, but excluding the profits from Team San Jose's event production services (discussed below).

¹⁰ According to TSJ, Nederlander provides consultation on TSJ's non-concert events.

Exhibit 6: Profit and Loss for the Operation of the City’s Cultural Facilities (Millions)

| | San José Civic | Center for the Performing Arts | California Theater | Montgomery Theater | Total |
|---------------|----------------|--------------------------------|--------------------|--------------------|---------|
| Revenues | \$1.4 | \$1.1 | \$0.3 | \$0.2 | \$3.0 |
| Expenses | \$3.0 | \$1.0 | \$0.5 | \$0.4 | \$4.9 |
| Profit (Loss) | (\$1.6) | \$0.1 | (\$0.2) | (\$0.2) | (\$1.9) |

Source: Auditor analysis of Team San Jose accounting records

Net Revenue of \$2.1 Million from Food and Beverage and Event Production

Some of TSJ’s lines of business had a positive impact on the bottom line for the operation of the Facilities. We describe the successes of food and beverage and event production services in the following sections.

Team San Jose’s First Year of Operating the Food and Beverage Service Has Been Profitable

In FY 2009-10, TSJ profitably operated catering operations at the convention center and food and beverage concessions at the cultural facilities. In spite of reduced attendance at convention center events in FY 2009-10 over the prior year, TSJ had a net profit of \$1.6 million, on gross revenue of \$6.5 million, operating the food operation with TSJ staff.

In previous years, as stipulated in its contract with Centerplate, TSJ was paid a fixed fee of 24 percent of gross revenue from the food service activity. For example, in 2008-09, Centerplate paid TSJ a commission of about \$2.0 million on gross revenue of over \$8.3 million.

Under the new arrangement, TSJ’s net profit in FY 2009-10, as a percent of gross sales, was slightly higher at 24.2 percent. So it appears that, at least after one year of operation, the food and beverage operation can be marginally more profitable when operated in-house. Also, according to TSJ management and at least one board member, having TSJ staff deliver the food service allows TSJ to more easily customize the food service to the needs of the customers holding events at the convention center. Exhibit 7 compares food and beverage operations in FY 2008-09 and FY 2009-10.

Exhibit 7: Food and Beverage Profit in 2008-09 and 2009-10

| | 2008-09 Centerplate | 2009-10 Team San Jose in-house operation¹¹ |
|-------------|--------------------------------|--|
| Revenues* | \$8.38 million | \$6.54 million |
| Expenses | n/a | 4.96 million |
| Net Income* | \$2.01 million | \$1.58 million |
| Margin | 24% | 24.2% |

Source: Team San Jose financial records

* Centerplate provided Team San Jose a commission of 24 percent of its gross revenue for food and beverage operations. Revenues are estimated based on the commission paid.

Other Team San Jose Operations That Were Profitable

In staging a convention, business meeting, exhibit or cultural event, TSJ brings in extra workers to assist with the many tasks associated with putting on a convention, business meeting or exhibit. For instance, Teamsters transport materials for a special exhibits, and ushers and stagehands work at cultural events. These workers are paid by TSJ, who in turn passes along the cost of this labor with a mark-up, back to the customer sponsoring the event. In FY 2009-10, TSJ billed \$3.5 million for such labor, and had a profit of about \$0.5 million.

Gross Operating Revenues Have Increased, but so Have Net Losses

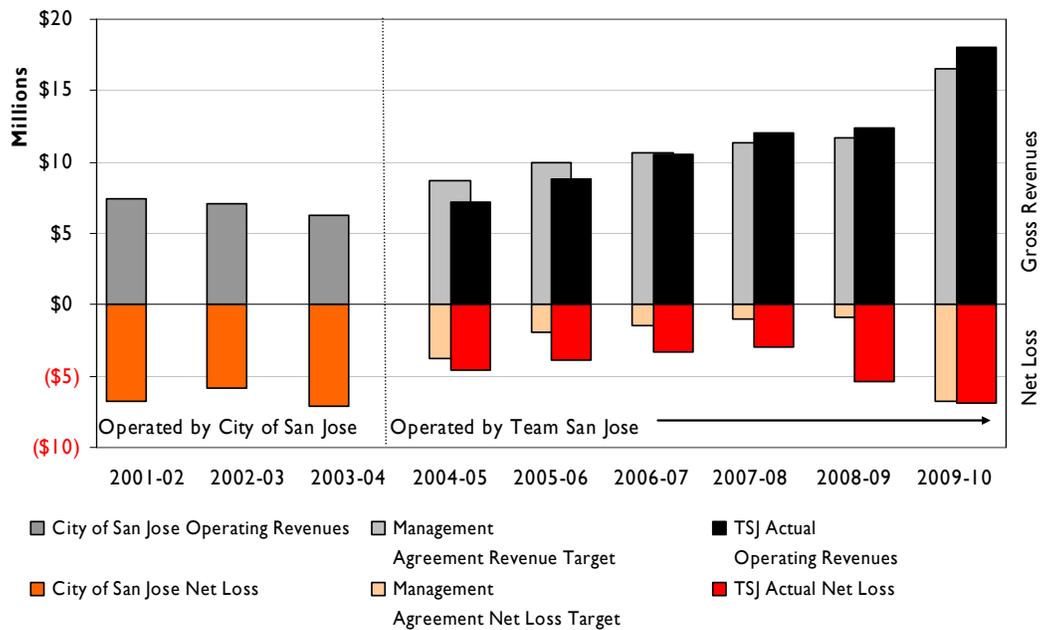
As shown in Exhibit 8 below, gross revenues are more than double what they were in the early part of the decade.¹² In FY 2009-10, \$10 million of this revenue was from TSJ bringing in-house new lines of business such as food and beverage services and event production services. In prior years, food and beverage services were accounted for on a net basis, whereas food and beverage is now presented on a gross basis.

Net losses have also increased dramatically and are now approaching the levels witnessed earlier in the decade. According to TSJ, the current economic environment coupled with an aging building has caused TSJ to spend more money to entice business to San José and has impacted business margins.

¹¹ This \$6.54 million revenue figure for TSJ's food and beverage services differs from the number presented in Exhibit 3 because it does not include rebates TSJ offered to entice clients to book their events in San Jose. We have applied those rebates in the \$7.1 million loss from convention center events because they were part of the package TSJ offered to obtain convention center business.

¹² It is important to note that Team San Jose operates more facilities than did the City's Convention, Arts, and Entertainment Department from 2001-02 to 2003-04, and that the mix of business is different.

Exhibit 8: Revenues and Net Losses from the Operation of the Facilities from 2001-02 to 2009-10



Source: Auditor analysis of audited financial statements for the San José Convention and Cultural Affairs Fund. Revenues and losses are calculated in accordance with the Management Agreement.

Further Depletion of Fund Balance Could Jeopardize the City’s Plans to Subsidize Operations During the Upcoming Convention Center Expansion

Exhibit 9 below illustrates the different funding sources for the operation of the Facilities from 2005-06 to 2009-10. According to the Office of Economic Development (OED), the operating transfer from the Transient Occupancy Tax (TOT) Fund is determined by using a formula where a portion of the TOT tax receipts are transferred to the Convention and Cultural Affairs Fund. As shown below, transfers from the TOT Fund to the Convention and Cultural Affairs Fund totaled \$3.9 million in FY 2009-10. The transfer from the General Purpose Parking Fund is based on the amount of revenue collected at the Convention Center garage, less the amount of any capital repairs at the garage. The General Fund transferred \$250,000 in 2009-10 in accordance with the Mayor’s June 2009 budget message.

Exhibit 9: Budgeted Sources and Uses for the Fund 536 (Convention and Cultural Affairs Fund) from FY 2005-06 through 2009-10

| | 2004-05 Actual | 2005-06 Actual | 2006-07 Actual | 2007-08 Actual | 2008-09 Actual | 2009-10 Estimated | 2010-11 Modified Budget |
|--------------------------------|---------------------|---------------------|---------------------|---------------------|---------------------|----------------------|-------------------------------|
| Sources of Funds | | | | | | | |
| Beginning Fund Balance | \$(491,171) | \$(101,660) | \$728,779 | \$4,418,788 | \$8,295,598 | \$10,338,062 | \$6,831,691 |
| Revenues* | 6,719,861 | 8,753,997 | 10,257,058 | 11,544,681 | 11,612,668 | 17,829,414 | 13,940,121 |
| Transfers from | | | | | | | |
| General Fund | 1,725,000 | | 1,145,857 | | | 250,000 | 47,967 |
| General Purpose Parking | 620,000 | 892,823 | 583,000 | 1,249,973 | 833,000 | 450,000 | 450,000 |
| Transient Occupancy Tax | 3,813,083 | 4,922,103 | 6,338,040 | 7,213,565 | 6,732,085 | 3,889,922 | 5,017,865 |
| Total | \$12,386,773 | \$14,467,263 | \$19,052,734 | \$24,427,007 | \$27,473,351 | \$32,757,398 | \$26,287,644 |
| Uses of Funds | | | | | | | |
| Expenditures | \$12,279,487 | \$13,541,254 | \$14,419,553 | \$15,883,037 | \$16,891,421 | \$25,638,685 | \$20,615,787 |
| Transfers | 208,946 | 197,230 | 214,393 | 248,372 | 243,868 | 287,023 | 334,179 |
| Total | \$12,488,433 | \$13,738,484 | \$14,633,946 | \$16,131,409 | \$17,135,289 | \$25,925,708 | \$20,949,966 |
| Ending Fund Balance | | | | | | | |
| Unrestricted | \$39,371 | 150,320 | 4,080,356 | 7,106,113 | 8,845,012 | 5,275,476 | 3,781,463 |
| Facilities Maintenance Reserve | - | - | - | 500,000 | 1,000,000 | 1,000,000 | 1,000,000 |
| Other | (241,031) | 578,459 | 338,432 | 689,485 | 493,050 | 556,215 | 556,215 |
| Total | \$(101,660) | \$728,779 | \$4,418,788 | \$8,295,598 | \$10,338,062 | \$6,831,691 | \$5,337,678 |

Source: San José Convention and Cultural Facilities Fund statements of source and use from the City Manager's Budget Office
 * Includes minimal interest revenue.

As discussed earlier, like other convention centers, TSJ has been battling a nationwide downturn in convention business. TSJ and the City have had long-standing plans to improve the Facilities, and have been striving to set aside funding in Fund 536 to sustain operations during construction.

We have a concern that the \$4.6 million that the City transferred to Fund 536 to cover TSJ's FY 2009-10 operating losses did not come close to covering TSJ's actual \$6.9 million loss. In fact, FY 2009-10 is the first year since FY 2004-05 where Team San Jose had an operating loss that exceeded the annual transfer. Because TSJ's loss exceeded the annual transfer, the Fund 536 fund balance made up the difference.

If the City allows this scenario to continue, it would deplete the Fund Balance in Fund 536, which is needed as a contingency reserve to offset an anticipated reduction in convention center business that could occur while the Convention Center is partially closed during the planned expansion. Already, as shown above, in FY 2009-10, the Convention and Cultural Affairs Fund suffered a \$3.5 million loss to its fund balance, which decreased from \$10.3 million at the beginning of FY 2009-10 to \$6.8 million at year end. According to the 2010-11 operating budget, this fund balance is projected to deteriorate further to \$5.3 million as of June 30, 2011.

In a December 2008 memorandum to the Council, the City and TSJ outlined a plan to reduce Fund 536's balance—by allowing losses to exceed the TOT revenue transferred into Fund 536. However, in our opinion, with TOT collections down from the levels of previous years and with its own budget

problems, the City can ill afford to continue to subsidize sizeable operating losses that have reached a combined \$12 million during the last two years. Our concern here is that further deterioration of the fund balance will jeopardize the City's plans to go forward with the plan to expand the Convention Center.

Recommendation #3: To ensure the fiscal health of the City's Convention and Cultural Facilities and protect their ability to generate economic impact, we recommend that the City (a) review its estimates of how much funding will be needed to subsidize continued operation during the upcoming Convention Center expansion, (b) on an on-going basis ensure that Fund 536's budget is balanced without use of fund balance to subsidize operating losses, and (c) once the economy improves, create a reserve for economic uncertainty in Fund 536.

This page was intentionally left blank

Finding II On Balance, Team San Jose Met Its Performance and Incentive Targets, but Some of Those Targets Should be More Rigorous

The 2009 Management Agreement and addendum require Team San Jose to report annual performance measures and to adhere to agreed-upon targets for its incentive measures. These incentive targets are the basis for the City's payments to TSJ. The City's annual incentive payment grows as TSJ approaches and exceeds targets. In FY 2009-10, TSJ drew nearly 1 million people to events at the Facilities, resulting in more than 183,000 hotel night bookings. Overall, it achieved a weighted performance of more than 100 percent, earning an incentive fee of \$400,000 out of a possible \$500,000 (the largest it has ever earned), in spite of generating the largest net loss in its six years managing the City's convention and cultural facilities.¹³ In our opinion, tougher incentive and performance targets should be considered – ones that do not penalize TSJ for a poor economy, but incentivize improved performance.

Team San Jose Met Most Performance and Incentive Targets

Based on our review of Team San Jose's attendance reports and other records, and of audited financial statements for the Convention and Cultural Affairs Fund, we found that Team San Jose:

- Met targets for five of eight performance measures, resulting in a total weighted performance score of 101.51 percent; and
- Met targets for six of seven incentive measures, resulting in a total weighted incentive fee score of 106.49 percent.

Generally, Team San Jose was most successful in meeting its targets for the Gross Operating Revenue, Theater, and Customer Satisfaction metrics; it was less successful in meeting targets related to Gross Operating Profit, and Economic Impact. Some of the effects of the economic downturn may have contributed to Team San Jose falling short on targets. Exhibit 10 details FY 2009-10 measures, targets and results. The exhibit also shows the weighted scores for incentive payment based on the weights given to each incentive measure as described in Exhibit 2. Appendix B describes each of the individual measures and explains how the scores are calculated.

¹³ FY 2009-10 was the first under a new Management Agreement that included an incentive fee based on a sliding scale. The prior Management Agreement had a fixed management fee of \$150,000 that, in years four and five of the agreement, were contingent on TSJ's accomplishment of three of four performance measures.

Exhibit 10: Scores for Team San Jose’s FY 2009-10 Performance and Incentive Measures

| Measures | Target | Result | Goal Met? | Performance | | Incentive | |
|--|---------------|---------------|-----------|----------------|--------|----------------|--------|
| | | | | Weight | Score | Weight | Score |
| Economic Impact | | | | | | | |
| Hotel Nights | 180,000 | 183,451 | Yes | 10.00% | 10.19% | 15.00% | 15.29% |
| Event Attendance | 953,250 | 946,779 | No | 10.00% | 9.93% | 10.00% | 9.93% |
| Estimated Impact | \$88,750,000 | \$88,796,347 | Yes | 10.00% | 10.01% | 15.00% | 15.01% |
| Return on Investment | 2.77 | 2.44 | No | 10.00% | 8.82% | n/a | n/a |
| Gross Operating Profit/Revenue¹⁴ | | | | | | | |
| Gross Operating Revenue ¹⁵ | \$16,500,000 | \$18,039,449 | Yes | n/a | n/a | 35.00% | 38.27% |
| Gross Operating Profit ¹⁶ | (\$6,800,000) | (\$6,884,092) | No | 35.00% | 34.57% | n/a | n/a |
| Theater Performance | | | | | | | |
| Performance Days | 275 | 345 | Yes | 11.00% | 13.80% | 11.00% | 13.80% |
| Occupied Days | 625 | 655 | Yes | 4.00% | 4.19% | 4.00% | 4.19% |
| Customer Satisfaction | | | | | | | |
| Satisfaction Rate | 95% | 95% | Yes | 10.00% | 10.00% | 10.00% | 10.00% |
| Total Weighted Score | | | | 101.51% | | 106.49% | |

Source: Auditor analysis of addendum to Management Agreement, audited financial statements, attendance reports, and other Team San Jose records

Note: Weighted scores are the product of the measure weights listed in Exhibit 2 in the Background, and the percentage of actual performance with respect to the goal. For instance, the Hotel Nights measure is given a weighted score of 15.29 percent because hotel nights were 102.92 percent of target and it is assigned a weight of 15 percent. 101.92 percent * 15 percent = 15.29 percent.

Exhibit 11 below shows total incentive targets TSJ is to achieve for the City to make specific annual incentive payments.

Exhibit 11: Incentive Measure Payment Schedule

| Weighted Incentive Fee Score | Incentive Fee |
|----------------------------------|---------------|
| Less than 80% | \$150,000 |
| At least 80% but less than 90% | \$200,000 |
| At least 90% but less than 100% | \$300,000 |
| At least 100% but less than 110% | \$400,000 |
| 110% or Greater | \$500,000 |

Source: Addendum to Management Agreement between TSJ and City

¹⁴ The gross revenue target was set with the understanding that the introduction of food and beverage services would increase TSJ's gross revenues.

¹⁵ For the purpose of measuring performance, the gross revenue total we present includes all revenues generated by TSJ's operation of the Facilities. The financial audit of the Convention and Cultural Affairs Fund deducts the City's free use and power charges from gross revenue; however, for our purpose, we include those amounts.

¹⁶ For the purpose of measuring performance, the loss number we present does not include all costs that the City incurs to operate the Facilities. Specifically, we do not include TSJ's fixed management fee, depreciation expense, City contract oversight costs, fire insurance, City funded repairs and maintenance, or the City's free use of the Convention Center. Altogether, these costs totaled \$1.6 million in FY 2009-10.

Per the agreement between TSJ and the City, the Total Weighted Incentive Fee Score of 106 percent equates to a \$400,000 incentive payment from the City.¹⁷ This incentive payment is in addition to the management fee of \$663,321 the City pays TSJ for part of the executive team's compensation.

Gross Operating Revenue Requires Clarification

Team San Jose and the City use performance and incentive measures to provide a quantifiable way of evaluating TSJ's management of the convention and cultural facilities. For example, *Gross Operating Revenue* is defined as revenue from operation of the Facilities excluding revenue billed by TSJ on behalf of other vendors. Similarly, the calculation of *Return on Investment* is based on operating revenue and expense of both the Facilities and CVB.

For purposes of calculating its *Gross Operating Revenue*, TSJ reported about \$148,000 in convention subsidies from the City's Hotel Business Improvement District as part of the Facilities' gross revenues of \$18 million. These funds, which are collected from hotels for the purpose of increasing hotel occupancy rates, are administered by a non-profit corporation, San Jose Hotels, Inc., that is essentially staffed by TSJ. In addition to the HBID revenues, the \$18 million in gross revenues includes, according to TSJ, about \$70,000 expensed by CVB to sponsor events.

Although we do not believe that public funding of subsidies and sponsorships from these related-party organizations should be included in the calculation of performance measures such as gross operating revenue, the Management Agreement is not clear in this regard. As a result, we have not deducted these amounts from the gross revenues in Exhibit 10. It should be noted that such a deduction would not have impacted either the attainment of the incentive targets or TSJ's incentive fee.¹⁸ However, recognizing that any changes to what can or cannot be included in gross revenues will also have an effect on the calculation of gross operating profit and return on investment, and could require changes to how TSJ and the City set performance and incentive targets, we recommend the Management Agreement be clarified.

Recommendation #4: To make TSJ's performance and incentive measures more meaningful, we recommend the City amend the Management Agreement to explicitly specify that Hotel Business Improvement District and Convention and Visitors Bureau monies are to be excluded from the calculation of Gross Operating Revenues and Return on Investment.

¹⁷ The City has already advanced \$150,000 of this incentive payment to Team San Jose.

¹⁸ For more information on the methodology for calculating the performance and incentive measures, see Appendix B. As shown in Appendix B, we excluded TOT from CVB operating revenue in calculation of the *Return on Investment* performance measure.

The City Should Refine Its Approach to TSJ Performance and Incentive Targets

We believe performance and incentive measures are a useful tool for evaluating the management of the Facilities and holding TSJ accountable to agreed-upon expectations. However, as they are currently set, TSJ’s performance and incentive targets are not as rigorous as they could be.

Align Performance and Incentive Targets with TSJ’s Budget

The performance targets for 2009-2010 have been reduced as compared to the targets from the prior Management Agreement. According to the Office of Economic Development (OED),

The targets for the performance measures assumed that the downturn in the economy would last through the entire fiscal year, and also accounts for the potential expansion plans for the Convention Center... For example, for 2009-2010, the target for gross operating profit is a loss of \$6,800,000. Factors that contribute to this figure are low building rental revenues due to the economic downturn and construction impacts from the Convention Center expansion project.

We believe the financial targets should reflect these challenging economic conditions, but also reflect TSJ’s approved budget.

The addendum to the Management Agreement defines what costs shall and shall not contribute towards TSJ’s Gross Operating Profit. Exhibit 12 lists includable costs and calculates a Gross Operating Profit based on TSJ’s original and year-end budgets.

Exhibit 12: Gross Operating Profit Based on TSJ’s FY 2009-10 and 2010-11 Budget

| | 2009-10 | | | 2010-11 | |
|--------------------------------------|----------------------|-------------------------------|----------------------|----------------------|----------------------|
| | Targets | Original Budget ¹⁹ | Year-End Budget | Targets | Adopted Budget |
| Gross Operating Revenues | \$16,500,000 | \$17,021,000 | \$17,141,000 | \$13,100,000 | \$13,900,000 |
| Expenses | | | | | |
| City employee salaries and benefits | | 5,151,000 | 5,130,000 | | 1,883,000 |
| TSJ Budget | | 16,751,000 | 17,706,000 | | 16,897,000 |
| City Overhead | | 825,000 | 809,000 | | 249,000 |
| City-share of Workers’ Compensation | | 150,000 | 150,000 | | 100,000 |
| TSJ Incentive Fee | | 404,000 | 304,000 | | 300,000 |
| Total Expenses | | 23,265,000 | 24,099,000 | | 19,429,000 |
| Gross Operating Profit (Loss) | (\$6,800,000) | (\$6,260,000) | (\$6,958,000) | (\$7,100,000) | (\$5,529,000) |

Source: Auditor analysis of budgeted revenues and expenses for the Convention and Cultural Affairs Fund, rounded to nearest thousand

¹⁹ “Original Budget” refers to the budget as of October 2010, after TSJ had received a \$1.45 million increase to its portion of budgeted funds. “Year-end” refers to the budget as of June 30, 2010, before TSJ received a \$758,000 increase to cover its budget overage, as discussed in Finding IV.

In our opinion, the targets should align to the budget. Exhibit 12 also compares the Gross Operating Revenue and Gross Operating Profit incentive and performance measures, respectively, calculated based on budget figures, to the actual targets set for TSJ. The revenue target was lower than budgeted revenues. The gross operating loss performance target was greater (larger loss) than that called for in the budget.

The performance targets established for FY 2010-11 diverge from the adopted operating budget even further than 2009-10's targets did. Specifically, TSJ's goals are of \$13.1 million in gross revenue and a net loss of \$7.1 million, but the budget calls for \$13.9 million in revenue (after bad debt) and a net loss, calculated in accordance with the addendum to the Management Agreement, of \$5.5 million.

Furthermore, as discussed in Finding I, TSJ's operation of the Facilities in FY 2009-10 resulted in a net loss—calculated in accordance with the addendum to the Management Agreement—of \$6.9 million. This loss was, for the first time since FY 2004-05, greater than the subsidy of TOT funds in the Convention and Cultural Affairs Fund, meaning the net loss reduced the fund's ending fund balance. The net loss target for FY 2010-11 is, again, greater than the projected influx of TOT funds. The City budgeted TSJ's operations in this manner anticipating that impacts from the Convention Center expansion would hamper TSJ's business. Nonetheless, the trend of net loss exceeding TOT influxes could eventually require that the City stop supporting the operations of the convention and cultural facilities unless it is willing to turn to other funding sources such as the General Fund.

Moreover, according to the memorandum to Council that established these measures, the 2009-10 targets took into account lower building rentals due to the economic downturn and impacts from the proposed Convention Center expansion and renovation. The proposed construction did not begin in 2009-10 however, to our knowledge, the performance and incentive targets were not reconsidered.

Finally, as discussed later in Finding IV, the City granted several budget augmentations to TSJ in FY 2009-10. Performance and incentive measures, however, were not adjusted. Thus, TSJ could effectively spend more to try to achieve the same target for revenues. We believe financial performance and incentive goals should be modified when TSJ's budget is changed—the City should either hold TSJ accountable for greater revenues or accept a greater loss when it increases TSJ's budget.

Recommendation #5: We recommend the City amend the Management Agreement to require that financial performance and incentive targets be aligned with the budget. The targets should not be easier to achieve than the budget, and if the City approves changes to the budget during the year, it should modify the financial performance and incentive targets as well. In addition, the City should renegotiate the FY 2010-11 targets to align to the adopted operating budget.

Restructure Incentive Fee Payment Structure

Generally, incentive payments are intended to incentivize performance that exceeds expectations but under the Management Agreement, TSJ earns an incentive fee no matter how poorly or well it performs against expectations. The fact that the financial performance targets are easier to achieve than TSJ's budget means that TSJ can achieve its targets but still fail to adhere to the budget adopted by the City Council. As Exhibit 11 above illustrates, the current incentive fee structure provides for TSJ to collect from the City \$150,000 even if TSJ performs far below expectations; in fact, under the current agreement, a weighted score of between 0 and 79 percent could earn TSJ the minimum incentive fee payment of \$150,000.

In addition to potentially rewarding poor performance, the current incentive fee structure does not incentivize TSJ to avoid depleting the City's Convention and Cultural Affairs Fund. As discussed in Finding 1, operating losses that TSJ generated have depleted the Fund 536 balance to a level that could endanger the City's plans to subsidize convention activities during the expansion of the convention center. We believe the City should pursue structural changes to contractual terms of the incentive payments, and introduce more strict standards that better reflect the "incentive" concept.

Renegotiate the Annual Fixed Management Fee

In addition to a guaranteed incentive fee of \$150,000, TSJ earns a fixed management fee, per the terms of the Management Agreement, for operating the City's convention and cultural facilities. This fee was intended to pay for a portion of the executive team's salaries and benefits, with the remainder coming from the TOT transfers to and General Fund support of the CVB. In FY 2009-10, the fixed management fee for TSJ's seven-person executive team was set to \$663,321. Near the end of FY 2009-10, though, TSJ consolidated management functions and now manages its operations with a six-person executive team.

Despite the reduction in the size of the executive team, the fixed management fee has remained at \$663,321. According to TSJ, the fee covers less than half of actual executive management compensation. However, we believe that, all things being equal, the fixed management fee should be adjusted as the size of the executive team changes.²⁰

Recommendation #6: We recommend the City amend the Management Agreement with TSJ to: (a) renegotiate the annual fixed management fee; and (b) revise the incentive fee payment structure such that TSJ receives incentive payments only if it achieves a specified threshold.

Rethink the Process for Developing Performance and Incentive Targets

Under the prior management agreement, performance targets were set far in advance—up to four years before TSJ would try to achieve them. Under the new agreement, each year TSJ proposes targets for City review and approval. Specifically, TSJ submits to the City its preferred budget, and proposed performance and incentive targets, which according to TSJ, reflect trends in the convention industry. After TSJ submits its targets, City staff reviews them, and either approves the submissions or pursues revisions with TSJ.

We believe performance and incentive measures are a useful tool for evaluating the management of the Facilities and holding TSJ accountable to agreed-upon expectations. We also believe this new annual schedule for developing targets is an improvement, as it allows for the City and TSJ to create more achievable and realistic goals. However, as they are currently set, TSJ's performance and incentive targets appear to be not as rigorous as they could be as witnessed by the fact that TSJ achieved a weighted performance of 102 percent and weighted incentive score of 106 percent, earning an incentive fee of \$400,000 out of a possible \$500,000 in spite of generating the largest net loss in its six years managing the City's convention and cultural facilities.

In hindsight, it appears that the weighting of the performance and incentive measures shown in Exhibit 2, contributed to this outcome. Specifically, gross operating profit and gross operating revenue are only 35 percent of performance and incentive scores, respectively.

Clearly, the purpose of the convention center is to help stimulate the economy and further economic growth, and the weighting of the performance and incentive measures reflect that purpose. However, in our opinion, stronger consideration must be given to maintaining the fiscal health of the City's fund for convention and

²⁰ We discuss TSJ's process for setting executive salaries and compensation in Finding III.

cultural facilities. Furthermore, to avoid the appearance of conflict of interest, we believe the City should take a stronger lead in the annual development of TSJ's budget and performance and incentive targets.

In our opinion, the City should enter into the annual process of developing TSJ's operating budget and performance targets with limits in mind that reflect the City's financial reality and resources, and should review TSJ's proposals against objective, external experts' assumptions to ensure that targets are reasonable. This could entail reviewing research from the Professional Convention Management Association (PCMA) which TSJ reportedly uses to develop its performance and incentive targets. For 2010-11, the City and TSJ agreed to performance and incentive measures that were less ambitious than the 2009-10 targets in part because of the view that that "the downturn in the economy will last through the entire fiscal year." However, PCMA's projections suggest an improved meeting and convention outlook for the next two years.

The Management Agreement provides for a benchmarking study in year two of the Agreement – FY 2010-11. According to the Management Agreement

During the second and fourth years of the Initial Term, in coordination with City, will cause to be conducted a report (the benchmark survey) comparing the convention center operations to at least five of the Designated Convention Centers based on a set of comparison metrics to be mutually agreed to by City and Operator.

This study, in combination with other research and analysis, can provide the avenue for revised performance and incentive targets.

Recommendation #7: To better incorporate the City's financial reality into Team San Jose's performance and incentive targets, and to ensure targets are rigorous without penalizing TSJ for a poor economy, we recommend that the City revisit its weighting of performance and incentive measures and tighten the gross operating revenue and gross operating profit targets for management of the City's convention and cultural facilities.

Finding III Changes to the Team San Jose Business Model Were Not Always Fully Vetted Through the Board of Directors or the City

Under the Management Agreement, Team San Jose is responsible for operating the Facilities, but it really is a joint effort between TSJ and the City. Not only does the City subsidize operations, but all the operating revenues and expenditures run through City accounts. Quite literally, when Team San Jose staff spend money operating the Facilities, they are spending City money out of City checking accounts. As a result, it is critical that both the City and Team San Jose have a clear understanding of important events that could have financial consequences for both parties. While the TSJ board approves the annual operating budgets, which include information on TSJ's lines of business, board members told us they were not always fully aware of some business decisions until after the fact. In addition, the board members we interviewed were not aware of TSJ's overexpenditure beyond its appropriation until the notice of default was issued by the City in August 2010.

Team San Jose Is Improving Its Governance Structure

Team San Jose's Board of Directors is comprised of 28-members.²¹ The Board has established various committees which include the executive, financial oversight, audit, board governance, policy development, general manager's, cultural arts and entertainment facilities planning, personnel, San José vision, and client advisory committees. According to TSJ's bylaws board members have the power to:

- (a) ratify the acts or decisions of the executive committee and the officers of the corporation;
- (b) approve the annual budget;
- (c) approve the annual marketing plan;
- (d) approve any amendments to the these bylaws or the adoption of new bylaws;
- (e) elect directors and members of the executive committee;
- (f) appoint the executive officers of the corporation; and
- (g) fix compensation of the directors, if any, for serving on the Board of Directors or on any committee.

²¹ The board of directors from the San Jose CVB and TSJ combined after the merger of these two organizations.

The Board is composed of affiliates from labor unions, hotels, the business community, and cultural arts groups. The Board also meets on a quarterly basis; however special meetings may be called at any time.

The five-member Executive Committee is responsible for overseeing management of the corporation, including overseeing the duties and directing the performance of the president. The Executive Committee makes and directs all strategic (non-day-to-day) decisions other than those specifically reserved to the Board of Directors. The actual day-to-day operations of the corporation are managed and implemented by the President.

In April 2010, the TSJ board adopted new practices that would adhere to the new Form 990 disclosures²² specifically for the governance and compensation information of non-profit organizations. Some of these changes included forming personnel and audit committees. The personnel committee of the Board reviews and approves the CEO's and senior management's compensation. Other policies adopted were related to compensation, conflict of interest, whistleblower protection, and gift acceptance. The executive committee is also tasked to lead the creation of an approval process for all major initiatives.

Other changes include changes in communication of information between committees and the full board, new ways of voting (i.e. email), and setting a \$250,000 revenue threshold for business decisions that require board approval. They are also in the process of re-evaluating the size of board, the role of the executive committee, specific job positions of the officers, as well as the proportionate make up of four partners (hotels, arts, business, labor). A summary of board members' responses to certain TSJ business decisions are described below.

Business Decisions Were Not Always Fully Vetted Through the Board

Food and Beverage Services

In June 2009, Team San Jose terminated its relationship with its food and beverage concessionaire, Centerplate, and started to provide food and beverage services to its customers directly. Board minutes from April 29, 2009 stated that *"Food & Beverage Revenue will change from Centerplate Commission model to Team San Jose full Food & Beverage Operations. This will add \$300,000 to the bottom line in FY 2009/2010. There is an expectation of \$6.2 million in Food & Beverage Revenue to Team San Jose with income of \$1.8 million."* The minutes show the Board was informed but do not show any discussion or request for board approval. One board member stated that it was conducted as a "management decision," that is, without full board approval. He further remarked that the decision for TSJ to

²² Recommended IRS policies and practices on nonprofit governance that is reflected in the reporting required by the Form 990, effective beginning with 2008 tax years, and the Governance and Related Topics components included in the Life Cycle, an IRS educational tool for public charities.

take on a multi-million dollar contract, and assume all risks previously held by a third-party, changed the materiality of which business decisions needed to come to the board for approval.

Broadway San Jose and Civic Agreements

TSJ signed its Broadway San Jose contract with Nederlander in June 2009 to bring Broadway events to the Center for the Performing Arts. TSJ also signed a Civic agreement in February 2009 with Nederlander to promote concerts. We found that most of the board members we interviewed received little to no information on these business decisions prior to TSJ management executing the contracts. Board minutes stated that there was a big push to activate the theaters to improve TSJ's bottom line; however, there was no discussion of specific decisions or request for approval prior to the contracts being executed. Most board members became aware of these business decisions after these contracts were executed. However, one board member stated that more information was shared with the board on the Civic Agreement in which there had been a discussion on shared risk and responsibilities. Also, he stated, there was board awareness that TSJ needed to make improvements to the Civic so that it would better accommodate the needs of entertainers and concert patrons.

Teamsters Local 287

In August 2009, TSJ signed a labor agreement with Teamsters Local Union 287 in which Local Union 287 would provide the labor for transporting, setting up and taking down exhibits at the convention facilities. In general, interviewed board members stated that they were not fully aware that TSJ had signed into this contract until a conflict arose between Teamsters Local Union 287 and Teamsters Local Union 85 (San Francisco Local). The San Francisco-based decorators, who already had an agreement with Local Union 85, complained of TSJ's new exclusive agreement with Local Union 287. Faced with an unfavorable ruling by the National Labor Relations Board, TSJ ended its Agreement with Local Union 287.

When questioned whether the board knew the terms of the contract with Local 287, most members we interviewed stated that they did not become aware until after the conflict arose. One member stated that, "if anything happened, it was a mild announcement two to three months after the deal was effectively struck." Another board member stated that at one meeting, the board came to an agreement with the Teamsters to sign the contract with them. However, he had not seen the actual agreement. Another board member acknowledged that the decision was not presented to the full board. However, she stated that, "*The decision was done in the spirit to create more flexibility for the client.... The board gave staff direction to make that happen. This is a unique partnership. New ways of doing business are inherent in this process... The spirit was to create the best situation for the client and to position ourselves to be more competitive.*" Board minutes were in

agreement with board members responses in that discussion of the Teamsters contract occurred through special board meetings after the conflict arose.

Genghis Khan Exhibit at the Tech Museum

In April 2010 TSJ signed an agreement with Dino Don, Inc. to display the Genghis Khan exhibit at the Tech Museum. While it appeared that this decision was better vetted through the board than others, there seem to be conflicting recollections whether the information may only have been shared with certain committees or with the full board. One board member remarked that this was “the perfect example of how a board changed its ways and that everyone came forward in every sense of the word” and “there was full board approval and 100 percent were involved.” However, another board member stated that the decision needed to be made quickly and was only presented to the executive and financial committees for approval, and was not vetted through the full Board.

SJ Tix

In April 2009, TSJ purchased SJ Tix, formerly owned by the American Musical Theatre of San José. Most board members we interviewed were not aware of TSJ’s plan to take over SJ Tix. Some board members recall information shared with the board prior to the decision being made; however, they did not recall whether or not there was an official vote by the full board. Another board member stated that there was discussion about TSJ eventually assuming ticketing services as part of its business; however the decision to specifically take over SJ Tix was not presented to the board beforehand. Others could not recall this decision being presented to the board at all. Information related to this decision was not shown in the board minutes.

Budget Overexpenditure

Most Board members were in agreement that they were not aware of the overexpenditure until TSJ was issued a notice of default by the City. However, some board members were aware that TSJ was not going to “meet its numbers” in January/February 2010, and were aware of the proposals for cost savings such as the elimination of TSJ positions and furloughs. Some members stated that they were aware that TSJ staff was meeting with City staff on a regular basis and therefore had an assumption that the City knew TSJ’s financial status in relation to its budget. One member stated, however, “we all knew that poor communication was lending itself to these situations.” In general, board members were also not aware that TSJ would need to inform the City Council of any overspending beyond the appropriation. Board minutes from January 2010 shows that TSJ management presented to the board information that the organization was not meeting its projections and reviewed proposed budget reductions. Board minutes from throughout the year show discussion and concern about bottom-line results. However, board minutes from the June 29, 2010 meeting, at

the end of the FY 2009-2010 year, do not discuss TSJ spending beyond its appropriation. Neither TSJ management nor its board was aware of the City's imminent notice of default.

TSJ's Board Has Formed a Committee to Review Executive Management Compensation

As part of TSJ's adoption of the new Form 990 process in April 2010, a personnel committee was formed in order to have the responsibility and authority of supervising and reviewing the affairs of the organization as they relate to the compensation and benefits of officers and directors of TSJ. The TSJ Human Resources Director acts as a liaison to the personnel committee by providing salary surveys utilizing independent data sources specific to the hospitality industry to benchmark the CEO and senior management's compensation packages to that of others in similar work situations.

CEO Compensation

According to TSJ, prior to the new 990 process being implemented by the board in April 2010, the Chief Executive Officer's salary was the only one reviewed and approved by board members. According to TSJ, benchmarking information and performance results would be reviewed by the chair of the board of the executive committee, who would discuss with the CEO any change in compensation. The executive committee was charged with approving TSJ's CEO salary. Now, the personnel committee reviews TSJ's compensation policies, salary benchmark surveys, and reviews and approves the level of compensation of the CEO and senior management. This is subject to approval by the full Board in its discretion. Benchmarking data for the CEO's salary and benefits compensation will be obtained through *Searchwide*, a consulting firm specializing on senior and executive level salary compensation surveys and recruitment for the hospitality industry. The survey gathers data from comparable cities that manage convention facilities with a budget size over \$20 million.²³ The cities surveyed include Reno, St. Louis, San José, Charlotte and Atlantic City. The surveys requested information related to base salary, potential for obtaining a bonus and criteria and benefits offered.

Senior Team Compensation

Prior to the new 990 procedures being implemented, the CEO, based on performance, would determine the salaries of senior management. According to TSJ, the salaries of senior management would change very little year-to-year. Further, in December 2010, compensation of the senior management team will be reviewed by the personnel committee. Salary surveys are obtained from *Wagewatch Hospitality*, *IAAM (International Assembly of Managers and DMO*

²³ San José's Convention and Cultural Facilities became a \$20 million operation in FY 2009-10.

(Destination Travel Foundation). The salary benchmark surveys gather data from 66 convention centers, 68 arenas, hotels and casinos with a budget size over \$20 million.

TSJ Salary Changes

According to TSJ, in July 2009, TSJ staff, including executives, received a 5 percent reduction in salaries, reduced benefits, as well as elimination of staff bonuses (incentive payments). However, in July 2010, the board approved reinstating 3 percent to current salaries. At the present time, there is no review by City staff of TSJ executive compensation.

Recommendation #8: We recommend Team San Jose management and its Board improve transparency and governance processes so that its Board members are made aware of and formally approve all key business decisions.

Improvements Are Needed to Ensure the City Is Notified in Advance of Key Business Decisions

City Oversight Team

The City has a team of staff that meets monthly with TSJ executives to discuss TSJ's finances and operational results. In 2009-2010 the City's Chief Development Officer, with assistance from the Office of Economic Development, served as the administrator of the contract between the City and TSJ. In addition, the Finance Department and City Manager's Budget Office provided assistance on budget/financial monitoring and budget development.

Two meetings occur monthly between City and TSJ to discuss TSJ financial and operational results. The first meeting involves TSJ financial staff and City finance staff to review financial reports and budgetary information, and discuss any discrepancies. The second meeting involves TSJ's CEO and the OED director. Since the issuance of TSJ's default notice, the Finance Director has now been participating in these monthly oversight meetings. Both parties have reported that it is important to have the right people in the room.

Duty to Keep the City Informed

The Management Agreement requires that

Operator shall keep City's Director of Finance and Contract Administrator informed and advised of all material financial and other matters concerning the Facilities and the operation thereof, and give due consideration to suggestions which City's designees or consultants may offer with respect thereto from time to time.

TSJ has established a financial threshold of \$250,000 above which the item must be presented to the board of directors for the board's consideration and approval.

Recommendation #9: We recommend the City amend the agreement with Team San Jose to clarify that Team San Jose must formally notify the City in advance of business decisions with potential revenue or budgetary impacts of \$250,000 or more.

Recommendation #10: To improve on-going communications, we recommend that the City and Team San Jose work together to formalize the monthly review process and determine the appropriate composition of the staff teams to be involved in monthly financial oversight meetings, and when potential issues should be elevated for broader consideration.

Improved Communications Between TSJ and the City Council

In February 2010, the City Council requested that TSJ present to the Public Safety, Finance and Strategic Support Committee quarterly performance reports so that TSJ financial and performance information can be received by the Council in a timelier manner. To date those presentations have not been scheduled per City direction.

Recommendation #11: We recommend Team San Jose present quarterly performance reports to the Public Safety, Finance, and Strategic Support Committee.

This page was intentionally left blank

Finding IV Team San Jose Overspent Its Budget in FY 2009-10

The City's agreement with TSJ for the management of convention and cultural facilities states that TSJ "shall at all times comply with the applicable Adopted Operating Budget, and shall not deviate in any substantial respect therefrom." In July 2010, the City's Finance Director issued a notice of default against TSJ for spending more than \$750,000 beyond its approved spending authority—despite receiving early warnings by City staff and three budget adjustments during the year—and, as a result, failing to adhere to budget provision of the Management Agreement.

Operating within the adopted budget for Fund 536 is TSJ's responsibility. To comply with the Management Agreement, TSJ must recognize and communicate to the City whether its spending and the adopted budget are diverging irreconcilably. Although TSJ and City staff spoke regularly and met each month to review TSJ's financial and operational results, and despite repeated questions from City staff about TSJ's expenditure rate, TSJ failed to notify staff that it had overspent its budget. Flawed reporting and an apparent misunderstanding of and later miscommunication about the nature of the spending problem appear to have delayed recognition of the full scope of the problem. Since notification of the overage, TSJ management and the City oversight team have worked to improve communication and reporting. Further improvements are needed in budget tracking and monthly reporting.

Timeline of Events Leading to Team San Jose's Overexpenditure and the Notice of Default

The City first communicated concerns about TSJ's spending in October 2009. In an email to TSJ's CFO, City staff overseeing the TSJ contract (the City oversight team) warned that TSJ had spent nearly 50 percent of its budget (or about 45 percent after a soon-to-follow budget augmentation) through the first 3 months of FY 2009-10—a pace that, if unchanged, would result in a significant budget overage. A month later, the City oversight team again expressed concern about TSJ's spending rate, stating that TSJ had used over 55 percent of its budget in the first 4 months of the year.

As shown in Exhibit 13, City and TSJ staff communicated regularly during the 2009-10 year.

Exhibit I3: Timeline of Key Events Leading to TSJ's Overspending Its 2009-10 Budget

| Date | Action |
|-------------|---|
| Jan-09 | City and TSJ enter into an Agreement for the Management of the San José Convention Center and Cultural Facilities with an initial term of July 2009 to June 2014. |
| Mar-09 | City proposed 2009-10 operating budget for convention and cultural facilities (Fund 536), including revenues of \$17.3 million and spending authority for TSJ of \$16.8 million. ²⁴ |
| May-09 | Due projected decline in TOT receipts, City proposes amendments to TSJ's 2009-10 operating budget (Fund 536) to reduce TSJ's spending authority and anticipated revenues. |
| Jun-09 | City Council adopts TSJ 2009-10 operating budget. Highlights include: reduction of shared employee positions from 85.75 to 56 FTE, projection of \$17.0 million in revenues, and spending authority for TSJ of \$15.3 million—up from the prior year's \$8.2 million largely because of the introduction of ticketing and in-house food and beverage services. |
| Jun-09 | TSJ converts food and beverage services from being operated by Centerplate to being operated in house. Also, TSJ reactivates concerts at the San José Civic in partnership with Nederlander. |
| Oct-09 | City oversight team notifies TSJ that the organization spent nearly half of its budget during the first quarter of the year—a pace that, if unchanged, will result in a significant budget overage. TSJ responds that it is looking for cost savings. City staff also requests that TSJ complete a pre-formatted report to highlight TSJ's actual year-to-date spending against its budget. |
| Oct-09 | City increases TSJ budget appropriation by \$1.45 million to \$16.8 million, which was the amount originally proposed before the City proposed amendments in May 2010, to give TSJ the resources it felt it needed to operate the Facilities. |
| Nov-09 | City oversight team again expresses concern about TSJ's spending rate, stating that TSJ had used over 55 percent of its budget in the first 4 months of the year. |
| Dec-09 | TSJ and City oversight team work together to define magnitude of projected budget overage. TSJ produces plan to bridge the overage through spending reductions, revenue increases, and cash spending. City uses aspects of TSJ's plan to identify a \$950,000 year-end shortfall. |
| Dec-09 | The past Chair of TSJ's Finance Committee cautions TSJ's CFO about the rate at which TSJ was spending its budget. |
| Jan-10 | Mid-Year Budget Review reports that revenue on target, but non-personal expenses on pace to exceed budget by about \$950,000. To address problem, City authorized the expenditure of another \$355,000 to help cover improvements TSJ made to the Civic. According to the review, TSJ will reduce expenditures \$300,000 by eliminating incentive bonuses, instituting employee furloughs, and reducing a staff position. The review leaves another \$300,000 to be resolved, which TSJ wishes to do by further reducing the number of City employees working for the convention center—a proposal under review by City staff. As of January 2010, TSJ had spent \$11.2 of its revised \$17.1 million spending authority. |
| Jan-10 | City directs TSJ to begin to show actual cash draws in the monthly report because of ongoing concern over spending rate. TSJ begins to provide these in April 2010. |
| May-10 | After TSJ provides actual cash draws, first requested in January, in the April monthly report, City oversight team notes that TSJ's annual cash needs projection in its 2009-10 Forecast is still greater than its budget. According to City staff, TSJ assured them that stated projection was incorrect and spending would be at or below budget. |
| May-10 | On May 24, 2010, the City oversight team meets with TSJ management and reviews April 2010 monthly report. City oversight team understands, based on the meeting, that City and TSJ must address the remaining portion of the \$950,000 shortfall projected in December 2009 because it did not accept TSJ's proposal to further reduce the number of City employees during the year, and the anticipated spending on Genghis Khan exhibit. |
| Jun-10 | After consultation with TSJ, the City increases TSJ's budget by \$600,000, including \$350,000 to resolve the remaining portion of \$950,000 shortfall projected in December 2009 and another \$250,000 for the Genghis Khan exhibit (with \$120,000 in offsetting revenues). At this point, City staff believed that TSJ would finish the year under its revised spending authority of \$17.7 million. |
| Jun-10 | On June 28, 2010, the City oversight team meets with TSJ management and reviews May 2010 monthly report. City oversight team understands, based on the meeting, that TSJ is on pace to meet its budgeted revenue estimate and finish the year at or below its budgeted expense appropriation. However, documents from that meeting reveal that, through May 2010, TSJ had spent \$17.0 of its revised \$17.7 million authorization. Year to date, TSJ had spent on average a little more than \$1.5 million per month. |
| Jul-10 | The City notifies TSJ that operating transfers that occurred in June 2010 led to TSJ's overspending its appropriation for non-personal/equipment. |
| Jul-10 | TSJ transfers back the cash it had drawn in an attempt to align its cash draws to its year-end spending authority. |
| Jul-10 | TSJ's new CFO begins work to reconcile the overage. |
| Aug-10 | City serves TSJ with a Notice of Default. |
| Sep-10 | City increases TSJ FY 2009-10 budget by \$758,000 to \$18.5 million to account for TSJ's over-expenditure against its prior budget. |
| Year-End | TSJ finishes FY 2009-10 having generated revenue of \$17.6 million after bad debt is deducted (\$0.6 million more than its budget of \$17.0 million) and having directly spent \$18.5 million (\$3.2 million more than its original budget of \$15.3 million). |

Source: Interviews with TSJ and City staff, and review of TSJ monthly report and City documents

²⁴ Note that this presentation differs from Exhibit 3 in that TSJ's spending authority does not include \$6.8 million in City expenditures mainly for shared employees, overhead, and bad debt.

A Flawed Plan to Reduce Spending

As shown in the exhibit, around December 2009, City and TSJ staff together identified a budget shortfall of approximately \$950,000 if spending continued as anticipated. They also worked together to outline a plan to resolve the projected budget shortfall. Part of this plan was for TSJ to reduce spending, as discussed in Finding I, by suspending incentive payments to employees, implementing a one-week furlough, and eliminating positions. The plan also called for the City to augment TSJ's budget. In January 2010, the City accepted this plan from TSJ and incorporated its principles into the City's Mid-Year Budget Review.

However, TSJ's solution was flawed from the start. Specifically, TSJ and City staff expressed drastically different understandings of what problem the plan was created to solve. City staff understood that the plan was to reduce the occurrence of spending, whether in cash or on credit—in other words, that TSJ would basically lower costs the second half of the year. In contrast, TSJ staff explained that their plan was to reduce its requests for cash because, according to them, the City's warnings and concerns were about cash spending. Thus, TSJ's plan was to use money on hand and lower costs the second half of the year to enable it to operate with less cash from the City.

Continued Misunderstandings

During the audit, we attempted to understand how TSJ came to believe that the City's warnings were about using cash too quickly, rather than spending too much regardless of whether the spending was in cash or on credit. We learned that the City's October and November 2009 warnings about TSJ spending were actually mainly based not on TSJ's books and accounts, but rather on the transfer of cash into the City's operating account for the convention and cultural facilities. City staff said that they use cash transfers to estimate actual spending because, according to them, TSJ was not timely in providing the City-required, detailed expense report. This should not be an issue in the future because TSJ will provide City staff live, read-only access to TSJ's accounting records.

City staff resurfaced their concerns about TSJ's rate of spending throughout the second half of the 2009-10 year. For instance, once TSJ began to provide its actual cash draws in monthly reports beginning April 2010, City staff questioned why the projected cash requirement was higher than the budget. According to City staff, TSJ's response at the time was that the projection was in error.

The Rate of Actual Spending

TSJ's actual spending rate throughout the year was fairly stable at an average of about \$1.5 million per month (no more than \$1.8 million and no less than \$1.2 million in any month). In hindsight, this would suggest that, especially as the year progressed, the budget would be overspent. However, on June 28, 2010, TSJ and City staff met to review TSJ's May monthly report and concluded that meeting

with assurances that TSJ was on track to finish the year within budget. According to City staff, TSJ informed them that, in the convention industry, spending slowed down towards the end of the fiscal year.

Improvements Are Needed to Ensure Accurate Forecasts and to Avoid Potential Overages

In early July 2010, City staff realized that, contrary to verbal assertions by TSJ, the organization had overspent its budget. Despite repeated questions by City staff about TSJ's spending rate, TSJ had not communicated the impending budget overage to City staff. By analyzing TSJ's monthly reports, it is clear that TSJ's forecasts did not provide actionable information for City staff.

TSJ's forecasts of its spending increased from \$16.8 million in mid-February 2010, to \$17.0 million in mid-March, \$17.3 million in April, \$18.1 million in May, and finally \$18.5 million in June 2010. However, this did not align with the TSJ's spending authority. The City had increased TSJ's spending authority three times during the year, from \$15.3 million in June 2009 to \$17.7 million in June 2010. City staff told us that, after the June 2010 adjustment, they thought they had fully resolved problems with TSJ's budget for operating the Facilities. In September 2010, however, the City had to increase the appropriation, again, to \$18.5 million to account for TSJ's over-expenditure. This suggests that TSJ has room to improve its forecasting of actual spending compared to its revised spending authority, and its communications with City staff.

Flawed Monthly Reports

Even if TSJ's forecasts had been better, it would still have not communicated its spending clearly because its monthly reports were poorly designed. The reports neither highlighted in their Executive Summary, nor stated in the detailed financial section how much TSJ had spent against its budget. Instead, the reports provided overall spending in an unclear format that did not highlight the difference between costs under TSJ's spending authority, and other costs such as City payroll expense for employees under TSJ's management. Also, the reports were not updated timely to reflect the City's approval of budget adjustments for TSJ.

Flaws in the monthly report formats, which had been in place since the start of the Management Agreement, made a difficult year more difficult. According to City staff, they repeatedly asked TSJ for a variance report to compare TSJ's actual year-to-date spending against its budget. Such a report, if provided, could have enabled City staff to foresee the impending budget overage despite TSJ statements that spending would slow down, and that projections were in error. However, according to City staff, TSJ did not provide the requested report until July 2010, well after it was needed. That report is now a regular part of TSJ's monthly reporting.

Efforts Are Underway to Improve Communication and Reporting

Poor forecasting and communication did not cause the budget overage—TSJ’s spending did. The Notice of Default outlines several corrective actions that TSJ is in the midst of putting in place to ensure that this sort of overspending does not re-occur. TSJ and City staff appear to be headed in the right direction, improving the relevance of information reported from TSJ to City staff and providing the information in a format that helps staff for both parties understand TSJ’s year-to-date operational results and projected future results.

Recommendation #12: We recommend that the City amend the Management Agreement with Team San Jose to require that no later than the close of the third quarter of the fiscal year, Team San Jose conduct a detailed analysis of TSJ’s actual spending to date and projected spending for the last three months, compared to the budget appropriation (as adjusted during the course of the fiscal year), and present any needed adjustments for City consideration.

Recommendation #13: We recommend Team San Jose (a) improve its monthly report format to provide a highlighting of its monthly results, including spending against the City’s approved budget; (b) update its monthly reports for adjustments that the City makes during the year to Team San Jose’s budget appropriation; (c) refine its expense forecasts so that Team San Jose and City staff can better predict year-end spending; and (d) provide separate forecasts for cash flows and actual spending against budget.

This page was intentionally left blank

Conclusion

The City of San José contracts the operations of its convention and cultural facilities (Facilities), including the San José McEnery Convention Center and San José Civic, to Team San Jose, Inc. (TSJ). In spite of cost-cutting in FY 2009-10, Team San Jose's operations of the Facilities resulted in the largest net operating loss in its six years managing them—mainly because of a sharp fall in Convention Center activity—and the health of the Convention and Cultural Affairs Fund continued to deteriorate. Another key reason Team San Jose's operation of the Facilities resulted in its largest-ever loss was that the concert series at the San José Civic proved to be unsuccessful. TSJ's decision to contract with the concert promoter that ran the concert series, like some other key decisions, was not fully vetted through its Board of Directors in advance of the decision. In addition, despite cutting costs mid-year and repeated questions by City staff about its spending rate, Team San Jose overspent its budget. In spite of this, Team San Jose met its performance and incentive measures, on balance, and in so doing earned the largest incentive fee in the company's history.

RECOMMENDATIONS

Recommendation #1: In light of the continuing difficult economic conditions, and taking into account that TOT transfers are projected to remain well below previous amounts, we recommend Team San Jose be prepared to reduce spending below the budgeted level during difficult economic times.

Recommendation #2: To reflect the current reality which is that because the concert series at the Civic have been suspended and that Nederlander is currently not providing the services Team San Jose originally contracted with it to do, Team San Jose should renegotiate its contract with Nederlander as soon as possible and modify the terms of the contract to better balance the financial risk of doing concerts between Team San Jose and the promoter.

Recommendation #3: To ensure the fiscal health of the City's Convention and Cultural Facilities and protect their ability to generate economic impact, we recommend that the City (a) review its estimates of how much funding will be needed to subsidize continued operation during the upcoming Convention Center expansion, (b) on an on-going basis ensure that Fund 536's budget is balanced without use of fund balance to subsidize operating losses, and (c) once the economy improves, create a reserve for economic uncertainty in Fund 536.

Recommendation #4: To make TSJ's performance and incentive measures more meaningful, we recommend the City amend the Management Agreement to explicitly specify that Hotel Business Improvement District and Convention and Visitors Bureau monies are to be excluded from the calculation of Gross Operating Revenues and Return on Investment.

Recommendation #5: We recommend the City amend the Management Agreement to require that financial performance and incentive targets be aligned with the budget. The targets should not be easier to achieve than the budget, and if the City approves changes to the budget during the year, it should modify the financial performance and incentive targets as well. In addition, the City should renegotiate the FY 2010-11 targets to align to the adopted operating budget.

Recommendation #6: We recommend the City amend the Management Agreement with TSJ to: a) renegotiate the annual fixed management fee; and b) revise the incentive fee payment structure such that TSJ receives incentive payments only if it achieves a specified threshold.

Recommendation #7: To better incorporate the City's financial reality into Team San Jose's performance and incentive targets, and to ensure targets are rigorous without penalizing TSJ for a poor economy, we recommend that the City revisit its weighting of performance and incentive measures and tighten the gross operating revenue and gross operating profit targets for management of the City's convention and cultural facilities.

Recommendation #8: We recommend Team San Jose management and its Board improve transparency and governance processes so that its Board members are made aware of and formally approve all key business decisions.

Recommendation #9: We recommend the City amend the agreement with Team San Jose to clarify that Team San Jose must formally notify the City in advance of business decisions with potential revenue or budgetary impacts of \$250,000 or more.

Recommendation #10: To improve on-going communications, we recommend that the City and Team San Jose work together to formalize the monthly review process and determine the appropriate composition of the staff teams to be involved in monthly financial oversight meetings, and when potential issues should be elevated for broader consideration.

Recommendation #11: We recommend Team San Jose present quarterly performance reports to the Public Safety, Finance, and Strategic Support Committee.

Recommendation #12: We recommend that the City amend the Management Agreement with Team San Jose to require that no later than the close of the third quarter of the fiscal year, Team San Jose conduct a detailed analysis of TSJ's actual spending to date and projected spending for the last three months, compared to the budget appropriation (as adjusted during the course of the fiscal year), and present any needed adjustments for City consideration.

Recommendation #13: We recommend Team San Jose (a) improve its monthly report format to provide a highlighting of its monthly results, including spending against the City's approved budget; (b) update its monthly reports for adjustments that the City makes during the year to Team San Jose's budget appropriation; (c) refine its expense forecasts so that Team San Jose and City staff can better predict year-end spending; and (d) provide separate forecasts for cash flows and actual spending against budget.



Memorandum

TO: Sharon Erickson
City Auditor

FROM: Edward K. Shikada

**SUBJECT: RESPONSE TO ANNUAL
PERFORMANCE AUDIT OF
TEAM SAN JOSE'S MANAGEMENT**

DATE: November 24, 2010

Approved

Date

11-24-10

This memorandum is the response to the recently completed audit of Team San Jose, Inc. (TSJ). We appreciate the hard work, efforts and comments made by the City Auditor in the completion and documentation of the audit. We appreciate and recognize that the City needs to better clarify performance and incentive measures, amend the current Management Agreement and direction TSJ to prepare a cost-cutting plan.

The comments below address the recommendations and related opportunities suggest in the report.

Recommendation #1 – In light of the continuing difficult economic conditions, and taking into account that TOT transfers are projected to remain well below previous amounts, we recommend Team San Jose be prepared to reduce spending below the budgeted level during difficult economic times.

The Administration agrees with the recommendation and will recommend that the City Council direct TSJ to prepare an expenditure reduction plan intended to restore by June 30, 2011, the amount of fund balance reduced from the fund as a result of the 2009-2010 over-expenditure. This action will be recommended to preserve funding in the Convention and Cultural Affairs Fund, which will help in preventing the City from looking to the General Fund in order to subsidize Team San Jose operations throughout the convention center expansion/renovation construction period when TOT levels and operating revenues may decline. It is anticipated that this adjustment will be proposed for City Council consideration as part of the Mid-Year Budget Review in February 2011. With that said, the Administration believes TSJ should be prepared to reduce spending, not only in difficult economic years, but when directed by the City.

Recommendation #2 – To reflect the current reality which is that because the concert series at the Civic have been suspended and that Nederlander is currently not providing the services Team San Jose originally contracted with it to do, Team Jose should renegotiate its contract with Nederlander as soon as possible and modify the terms of the contract to better balance the financial risk of doing concerts between Team San Jose and the promoter.

The Administration agrees with the recommendation. Because TSJ has no actual assets, any losses from contracts/agreements entered into by TSJ, such as the Nederlander contract, will result in shortfalls to TSJ Operating budget which in turn could result in increase demands on the Transient Occupancy Tax receipts transferred to the Convention and Cultural Affairs Fund. The Administration is requesting that TSJ renegotiate the Nederlander contract, and will recommend City Council direction to amend the current Management Agreement to ensure the City has an opportunity to review significant TSJ agreements prior to execution.

Recommendation #3 – To ensure the fiscal health of the City’s Convention and Cultural Facilities and protect their ability to generate economic impact, we recommend that the City (a) review its estimates no how much funding will be needed to subsidize continued operation during the upcoming Convention Center expansion, (b) on an on-going basis ensure that Fund 536’s budget is balanced without use of fund balance to subsidize operating losses, and (c) once the economy improves, create a reserve for economic uncertainty in Fund 536.

The Administration agrees with the recommendation. The Administration will incorporate this recommendation into performance targets in future years.

Recommendation #4 – To make TSJ’s performance and incentive measures more meaningful, we recommend the City amend the Management Agreement to explicitly specify that Hotel Business Improvement District and Convention and Visitor’s Bureau monies are to be excluded from the calculation of Gross Operating Revenues and Return on Investment.

The Administration partially agrees with the recommendation. The Hotel Business Improvement District (HBID) is an annually self imposed tax from the hotel community. Staff would like additional time to understand how these revenues are used to attract conventions/events before making a decision regarding a revised calculation for Gross Operating Revenue and Return on Investment; however, staff will recommend City Council direction to amend the current Management Agreement to reflect the changes in the calculation for Gross Operating Revenue and Return on Investment to ensure City funds, such as the Convention and Visitor’s Bureau monies are not used.

Recommendation #5 – We recommend the City amend the Management Agreement to require that financial performance and incentive targets be aligned with the budget. The targets should not be easier to achieve than the budget, and if the City approves changes to the budget during the year, it should modify the financial performance and incentive targets as well. In addition, the City should renegotiate the FY 2010-11 targets to align to the adopted operating budget.

The Administration agrees with the recommendation. Staff will recommend City Council direction to work with TSJ to amend the 2010-2011 Performance and Incentive targets so that incentives only apply when performance exceeds budget expectations. In the future, if budget adjustments happen during the course of the year, TSJ targets may be adjusted accordingly.

Recommendation #6 – We recommend the City amend the Management Agreement with TSJ to: a) renegotiate the annual fixed management fee; and b) revise the incentive fee payment structure such that TSJ receives incentive payments only if it achieves a specified threshold.

The Administration agrees with the recommendation. Staff will recommend City Council direction to amend the current Management Agreement with TSJ to reflect this recommendation.

Recommendation #7 – To better incorporate the City’s financial reality into Team San Jose’s performance and incentive targets, and to ensure targets are rigorous without penalizing TSJ for a poor economy, we recommend that the City revisit its weighting of performance and incentive measures and tighten the gross operating revenue and gross operating profit targets for management of the City’s convention and cultural facilities.

The Administration agrees with the recommendation and will recommend City Council direction to negotiate amendments to the current Management Agreement with TSJ to reflect this recommendation. Originally, the Administration had proposed different weighting for performance and incentive targets; however targets were adjusted during the approval process of the new Management Agreement.

The Administration will continue to work with TSJ on the development of the Convention and Cultural Affairs Fund budget to ensure that the budget for TSJ operations are supported by revenue generated at the convention and cultural facilities and are not subsidized by City funds. In addition, the process for approval of the performance and incentive measures needs to be re-addressed. While setting targets five years in advance, as was done under the original agreement with TSJ, is not feasible the current process does not properly allow for the City to develop and recommend targets that relate to the City’s budget. Currently the Management Agree requires the City and TSJ agree to performance and incentive targets prior to Council consideration. The Administration is responsible for bringing recommendation forward for Council consideration.

Recommendation #8 – We recommend Team San Jose management and its Board improve transparency and governance processes so that its Board members and City Oversight Team members are made aware of and approve all key business decisions.

The Administration agrees with the recommendation. Staff will recommend City Council direction to amend the current Management Agreement regarding a) liaison membership for the City Administration on the Board of Directors, and b) Board notification to the City, in advance whenever possible, of key business decisions such as contracts, staffing changes and new business endeavors.

Recommendation #9 – We recommend the City amend the agreement with Team San Jose to clarify that Team San Jose must formally notify the City in advance of business decision with potential revenue or budgetary impacts of \$250,000 or more.

The Administration agrees with the recommendation and believes knowledge of key business decisions need to be communicated prior to execution. See response to Recommendation #8.

Recommendation #10 – To improve on-going communications, we recommend that the City and Team San Jose work together to formalize the monthly review process and determine the appropriate composition of the staff teams to be involved in monthly financial oversight meetings, and when potential issues should be elevated for broader consideration.

The Administration agrees with the recommendation, but does have a concern with the level and cost of City resource dedication required to monitor TSJ operations and financials. In conjunction with negotiating an amendment to the current Management Agreement, the Administration will clarify the purpose and role of the monthly oversight meetings in the context of the overall communication framework between the City and TSJ.

In addition, the Administration believes that if the City continues this partnership with TSJ, that the City should hire an Asset Manager to provide an independent “subject matter expertise” to assist staff on assessing TSJ’s operational and financial performance, and implementing best practices in operating the City’s Convention Center and Cultural Facilities. Through a Request for Qualifications (RFQ) process, the City would seek a consulting firm to assist and coordinate the City’s efforts in monitoring TSJ’s sales and marketing performance and strategies of the City’s Convention Center and Cultural Facilities. Services would include:

1. communicate with the City on a regular basis to remain current regarding all of the activities related to the management of the facilities;
2. recommend to the City proposed operational enhancements;
3. review and evaluate the sales and marketing plans and operating budget prepared by TSJ;
4. review, analyze and evaluate booking and backlog reports developed by TSJ;
5. review the financial performance of the Facilities in sales and marketing and compare the performance to the approved budget; and,
6. meet with key on-site representatives to review marketing strategies and other organizational matters.

The City employs an asset manager for the Hayes Mansion and duplicating this model with our agreement with TSJ could prove to be a valuable, independent voice on behalf of the City relating to the City’s Convention Center and Cultural Facilities operations. This option will be evaluated through the City’s budget process.

Recommendation #11 – We recommend Team San Jose present quarterly performance reports to the Public Safety, Finance, and Strategic Support Committee.

The Administration agrees with the recommendation and will work with TSJ to ensure reports are submitted in a timely fashion.

Recommendation #12 – We recommend that the City amend the Management Agreement with Team San Jose to require that no later than the close of the third quarter of the fiscal year, Team San Jose conduct a detailed analysis of TSJ’s actual spending to date and projected spending for the last three months, compared to the budget appropriation (as adjusted during the course of the fiscal year), and present any needed adjustments for City consideration.

The Administration agrees with the recommendation. TSJ is a contract operator for the City and the City should recommend expenditure appropriation/revenue adjustments to the City Council based on anticipated expenditure and revenue levels, with input provided by Team San Jose.

HONORABLE MAYOR AND CITY COUNCIL

November 24, 2010

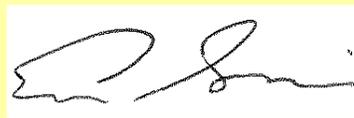
Subject: Response to Team San Jose Annual Performance Audit

Page 5

While the City is obligated to communicate the adopted budget to TSJ, it is TSJ's responsibility to understand and monitor its budget and exercise accountability for it by reporting back to the City. Nevertheless, the City will continue to monitor expenditures against the budget and communicate status to the City Council through bi-monthly financial reports prepared for the Public Safety, Finance, and Strategic Support Committee and other documents such as the Mid-Year Budget Review.

Recommendation #13 – We recommend Team San Jose: a) improve its monthly report format to provide a highlighting of its monthly results, including spending against the City's approved budget; b) update its monthly reports for adjustments that the City frequently makes during the year to Team San Jose's budget appropriation; and c) refine its expense forecasts so that Team San Jose and City staff can better predict year-end spending; and d) provide separate forecasts for cash flows and actual spending against the budget.

The Administration agrees with the recommendation and has been requesting these changes from TSJ since November 2009. TSJ has recently worked on improving the format of its monthly reports. It should be noted, however, that City requests for new reports, specifically, spending against the City's approved budget, were not met until after the Notice of Default was issued.

A handwritten signature in black ink, appearing to read 'Ed Shikada', is centered on a white rectangular background.

ED SHIKADA
Assistant City Manager



TEAM SAN JOSE’S RESPONSE

2009-2010 ANNUAL PERFORMANCE AUDIT OF TEAM SAN JOSE’S MANAGEMENT OF THE CITY’S CONVENTION AND CULTURAL FACILITIES

INTRODUCTION

This interim response is our initial comments to the Auditor’s recommendations related to the facts. Due to the short turn-around time on this report, reflecting the Sunshine rules and the Thanksgiving weekend, further comments will be provided after Team San Jose does due diligence with our Board of Directors.

Team San Jose appreciates the opportunity to respond to the Annual Performance Audit (“Audit”) completed by the Office of the City Auditor and we look forward to working with the City Manager on these recommendations.

The Audit reviewed FY 2009-2010 results and highlights Team San Jose’s solid performance results despite balancing the worst economic downturn since September 11th. The lack of city capital investment in the facilities and continued deteriorating building conditions has made it a challenging year to meet many of our performance measures. Despite economic declines, revenues have dramatically increased since Team San Jose assumed operations six years ago. In addition, Team San Jose attracted close to an estimated 1 million visitors to our facilities last year, boosting not only City revenues but traffic to local restaurants, hotels, museums, nightclubs and more.

Team San Jose, a non-profit corporation, has a direct and positive impact on San Jose’s local economy and impacts business downtown through a unique local partnership between hoteliers, labor, the arts community, and the convention bureau. Team San Jose and their close to 1000 employees have served the City of San Jose and the local community through an innovative approach to customer service. This model has received national acclaim in industry publications and other destinations are beginning to model themselves after San Jose’s approach.

EXECUTIVE SUMMARY

Team San Jose is proud of its accomplishments to date, managing city’s assets and look forward to continuing to stimulate the local economy and being good fiscal managers for the City of San Jose. While our report highlights each Audit recommendation and provides additional thoughts or recommendations for City Council consideration, the executive summary provides highlights of our report.

Budget Results

Due to misunderstandings and miscommunications between TSJ and City Oversight a deviation from budget occurred within the Adopted Operating Budget related to Non-Personal Expenses.

While the Notice of Default, sent by the City of San Jose, referenced an overage of \$755k related to Non-Personal Expenses, the overage was actually much less at \$441k. As reflected in more detail, on page 4.

Team San Jose takes responsibility of recognizing the overage in expenses and communicating budget tracking in a more direct way. **One hundred percent of the expense overage is offset by the increased revenues of \$470K, generated by Team San Jose. Therefore, TSJ does not feel the overage warranted a Notice of Default. It was clearly identified to City Oversight that the overage was offset by revenue and that there was no impact to Fund 536.**

Results and Performance Measures

Team San Jose achieved 102% of the performance targets and achieved 5 of the 8 performance measures established to stimulate the local economy and balance the fiscal needs of the City of San Jose.

Highlights of FY 2009-2010 Team San Jose Results include:

- **183,000 Hotel Room Nights, 102% of goal**
- **946,000 Visitors to San Jose, 99.3% of goal**
- **Estimated visitor spend achieved is \$88.8 million, 100% of goal**
- **Ranking of 95% satisfaction rate for Customer Service, 100% of goal**
- **Gross Operating Profit of \$6.884 million, 99% of goal which was \$6.80 million**
- **Total Gross Revenues of \$18 million, of a goal of \$16.5 million, or 109% of goal**

Managing through Proposed Construction and Current Economic Downturn

Realizing that an economic downturn was inevitable, TSJ pursued alternate revenue sources to stay competitive, support a loss in building rental and provide better service for customers. Food and Beverage and ticketing were brought in house to maximize profitability and flexibility for customers. In an effort to re-energize the Civic and per the City Council's direction to create the San Jose Civic as a concert and special events venue, TSJ began working with Nederlander a concert promoter. Nederlander also worked with TSJ to bring Broadway to the Center for the Performing Arts.

Results were as follows:

- Team San Jose's Food and Beverage reported a higher margin, with an expanded menu offering and more challenging mix of sales, than the formerly contracted Centerplate.
- Ticketing services was extremely profitable which help offset losses related to Nederlander concerts. TSJ is currently in the process of renegotiating the Nederlander concerts contract for FY 2010-2011
- Nederlander Broadway was profitable improving operating results for the Center for the Performing Arts

Recognizing Building Condition and Potential Expansion and Renovation

The Auditor mentions Team San Jose’s loss however does not give recognition to the fact that the City agreed to and approved a plan in January of 2009 that provided clear direction related to Fund 536 operations and the local economic downturn.

This plan provided a roadmap to keep Fund 536 whole through construction to safeguard the General Fund from having to invest in convention center and theater operations. In FY 2007-2008 as part of the construction planning the City of San Jose commissioned Horwath to analyze both the impact of the construction as well as the impact of the economic downturn. **Team San Jose performed better than projected by the City’s roadmap based on Horwath and Team San Jose’s projections.**

| | | Horwath Fund Balance Estimates | | | | | |
|-----------|-------------|--------------------------------|-----------|-------------------|-------------|------------------------|----------|
| | | Without City Layoffs | | With City Layoffs | | Fund Balance | |
| Beg Bal | Senerio A | Change to Fund B | Senerio B | Change to Fund Ba | Actual Fund | Change to Fund Balance | |
| 2007-2008 | 7,106,113 | | | | 8,295,958 | | |
| 2008-2009 | 7,512,457 | 406,344 | 8,378,514 | 1,272,401 | 10,338,062 | 2,042,104 | |
| 2009-2010 | 3,706,973 | (3,805,484) | 5,571,926 | (2,806,588) | 6,831,691 | (3,506,371) | |
| 2010-2011 | (136,424) | (3,843,397) | 2,767,382 | (2,804,544) | 5,337,678 | (1,494,013) | **Budget |
| 2011-2012 | (2,161,986) | (2,025,562) | 1,822,227 | (945,155) | | | |

CITY AUDIT FINDING: TEAM SAN JOSE OVERSPENT ITS BUDGET FOR FY 2009-2010

SUMMARY

Misunderstandings and miscommunications between TSJ and City Oversight resulted in a deviation from the Adopted Operating Budget related to Non-Personal Expenses. However, Team San Jose provided monthly reports to the City Finance Team reflecting actual expenses incurred and forecasts. Although discussions occurred on a regular basis, it has become apparent that the right level of City oversight representatives be engaged in our discussions moving forward. The Notice of Default highlighted an overage of \$755k related to Non-Personal Expenses. The audited overage has since been identified as \$441,891, as reflected on page 4 and highlighted below.

- \$160K was previously expensed and should have been capitalized.
- Per the Budget Office request, a change in accounting related to Genghis Khan occurred in FY 2010-11. This required, for consistency to make a change in FY 2009-2010. Expenses were reduced by \$147K and revenue of \$175K was also reduced. This is a \$28K reduction to GOP.
- An augmentation by the City Council was made related to Genghis Khan of \$255K.

100% of the overage is offset by the increased revenues of \$470K.

Therefore, TSJ does not feel the overage warranted a Notice of Default. It was clearly identified to City Oversight that the overage was offset by revenue and that there was no impact to Fund 536.

In the table below TSJ highlights increased revenues of over \$470,159 when compared to budget. **Taking into consideration the additional TOT collected that will favorably impact the fund in FY 2010-2011, the Fund was favorably impacted by \$178,515 when compared to the appropriations stated in the Sources and Uses of the Fund 536.**

TSJ worked diligently to protect the balance of the fund and continue to act as good stewards of the operating fund. TSJ also worked to increased rooms nights; attendance and visitor spend with positive results. TOT reported improved collections in FY 2009-2010 of an estimated \$500,000 in total collections with an estimate balance of \$250,000 to be transferred to the fund in FY 2010-2011 related to the efforts of TSJ in FY 2009-2010.

TEAM SAN JOSE - FY 2009-2010 PERFORMANCE

| | <u>Sources & Uses</u> <u>Modified Budget</u> | <u>Actual</u> | <u>Variance</u> |
|--|---|---------------------|-----------------|
| TOT Collections | 3,889,922 | 3,889,922 | - |
| Add'l Collections to be recognized if FY 2010-11 | | 250,000 | 250,000 |
| Parking Revenue | 450,000 | 450,000 | - |
| Revenue | 17,140,831 | 17,610,990 | 470,159 |
| Non-Personal/Equipment | (17,706,134) | (18,148,025) | (441,891) |
| Personal Services | (5,129,549) | (5,023,569) | 105,980 |
| City Worker's Comp Claims | (150,000) | (114,675) | 35,325 |
| Overhead | (808,813) | (808,813) | - |
| TSJ Management Fee - fixed | <u>(150,000)</u> | <u>(150,000)</u> | <u>-</u> |
| GOP before incentive fee based on performance | (6,803,665) | (6,634,092) | 169,573 |
| TSJ Management Fee - based on performance | <u>(153,623)</u> | <u>(250,000) **</u> | <u>(96,377)</u> |
| GOP | (6,957,288) | (6,884,092) | 73,196 |
| OED Personal Services | (45,319) | - | 45,319 |
| Insurance Expenses | (130,000) | (130,000) | - |
| TSJ Executive | (663,321) | (663,321) | - |
| Misc Capital Improvements | (200,000) | (406,000) | (206,000) |
| City Free Use | <u>(216,000)</u> | <u>(200,000)</u> | <u>16,000</u> |
| Net Income | (8,211,928) | (8,283,413) | (71,485) |
| Impact to the Fund | (3,872,006) | (3,693,491) | 178,515 |

** Per the Mid-Year budget the TSJ Management fee based on performance was reduced by \$100,000 and is pending payment

| | | | |
|---|---------------|---------------|------------|
| Attendance of all events | 953,250 | 946,838 | (6,412) |
| Cost per attendee (based on impact to the fund) | \$ (4.06) | \$ (3.90) | \$ 0.16 |
| Estimated Visitor Spend in Downtown SJ | \$ 88,750,000 | \$ 88,923,376 | \$ 173,376 |
| Estimated Spend per Attendee | \$ 93.10 | \$ 93.92 | \$ 0.81 |

AUDIT Recommendation 12: The City Auditor recommends that no later than the close of the third quarter of the fiscal year, Team San Jose conduct a detailed analysis of TSJ’s actual spending to date and projected spending for the last three months, compared to budget appropriation and present any needed adjustments for City Consideration.

TEAM SAN JOSE RESPONSE: TSJ Agrees

TEAM SAN JOSE RESPONSE TO AUDIT RECOMMENDATION #12

With regards to Auditor Recommendation #12, TSJ agrees that no later than the close of the third quarter of the fiscal year. TSJ has presented to City Oversight a detailed analysis of TSJ actual spend compared to budget appropriation and will continue to provide this analysis monthly.

TSJ will also present a formal written request for needed budget adjustments for City Consideration.

AUDIT Recommendation 13: Auditor recommends Team San Jose a) improve its monthly report format to provide a highlighting of its monthly results, including spending against the City’s approved budget, b) update its monthly reports for adjustments that the City makes during the year to Team San Jose’s budget appropriation, c) refine its expense forecasts so that TSJ and City can better predict year-end spending; and d) provide separate forecasts for cash flows and actual spending against budget.

TEAM SAN JOSE RESPONSE: Team San Jose agrees on all aspects of Recommendation 13. We further recommend a revision to the Management Agreement to allow for City Council consideration of more than one change to the budgeted appropriation on an annual basis.

TEAM SAN JOSE RESPONSE TO RECOMMENDATION #13

Upon recognizing a communication issue occurred and prior to the Notice of Default, TSJ began working with City Oversight to produce a report that clearly identifies variances directly related to the approved budget. We have submitted revised budget and financial formats to the City Oversight Team. The new format clearly identifies variances related to the approved appropriation balances. A sample of the new reporting tool below is Appendix 2.

TSJ will formally request City Oversight approval relative to the new format. We also agree that the monthly budget will be adjusted for all approved appropriation adjustments made throughout the year.

TSJ will continue to refine the forecasting process to better predict year-end spending and will continue to work with City Oversight to develop a cash flow forecast that is separate and apart from the budget spending related to the appropriation. **The Management Agreement restricts Team San Jose from asking for changes to the appropriation more than once each fiscal year. Team San Jose recommends a revision to the contract to allow for changes to the appropriation in the year be considered by the Mayor and City Council.**

AUDIT FINDING : OPERATING LOSS IN FY 2009-2010 OF \$6.9 MILLION

SUMMARY

An annual budget was approved by the Mayor and City Council as part of the normal City budgeting process. This approved budget projected an operating loss of \$6.9 million. The results for the fiscal year are exactly what the Mayor and City Council approved and take into consideration projections from the City's TOT expert and economic conditions we forecasted together two years ago. **Team San Jose performed better than budget by \$90K.**

Mid-Year Budget Challenges

In attempt to mitigate budget shortfalls, as early as November, we approached the City Oversight Team to request staffing changes to help offset budget issues. Although challenging, if the City's decision had been to move forward with our recommendation at that time, we wouldn't have needed a budget adjustment later in the year and would have saved the fund \$115,000 every month from January to August 2009. This had an unfavorable impact to Gross Operating Profit, requiring Team San Jose to increase their loss by \$400,000. If these reductions in workforce had been taken when proposed, Team San Jose would have been well below the GOP target of \$6.9 million, approved by the City Council. We recognize this was a sensitive situation to work through. However, the delays of these decisions negatively impact Team San Jose's performance as well as depleting the fund balance.

Current Economic Trends

In the current economic environment all convention centers have been faced to provide deeper discounts in order to remain competitive. In San Jose, however, one contributing factor is the condition of the building. An aging building has made it difficult and sometimes impossible to compete with newer, larger facilities for corporate business.

The operating loss is attributed to San Jose's drop in building rental and Transient Occupancy Tax revenues. This can be seen in the Team San Jose Performance by Facility report, including highlights of: *

- Convention center revenue is down 20% a \$1,148m decline when compared to prior fiscal year 2008-2009 and down 27% a \$1,764 decline when compared to Fiscal year 2007-2008.
- Expenses not related to generating labor revenue were reduced by 4% in the convention center when compared to FY 2009-2010 and reported a 1% decline when compared to FY 2007-2008.
- Food and Beverage revenue declines can also be attributed to the decline in attendees. Food and Beverage reported a revenue decline of 16% when compared to FY 2008-2009 and a 42% when compared to FY 2007-2008.
- Center for the Performing Arts results are due to Team San Jose's leadership in securing the Nederlander Broadway Series.
- San Jose Civic results include the new launch of the concert series and include the fact that renovations are not complete. Results include 22,000 visitors to the venue in six months with \$400,000 economic impact.

**See Appendix 1 for more details.*

The economic downturn has caused all meeting and convention destinations in the nation to rethink their strategy to incent customers to visit their community. The highlights below, reflects competing business levels and all have seen a decline in business, attendees and other operational impacts. Primarily all competitors have renovated or expanded their Convention Centers within the last few years. San Jose is at a considerable disadvantage compared to competing centers, as San Jose's facilities have not seen any capital upgrades since it was built in 1989.

Competitor Information

A few highlights from competing destinations include: *

- Phoenix: Booking pace is down 30% from 2009
- Dallas: down 20%
- Vegas: down 10.4% with number conventions, number of visitors down by 27%
- Virginia Beach: room night bookings down by 40%

**See Appendix 3 for reference data.*

Recommendation #1: In light of the continuing difficult economic conditions, and taking into account that TOT transfers are projected to remain well below previous amounts, auditor recommends Team San Jose be prepared to reduce spending below the budgeted level as needed.

TEAM SAN JOSE RESPONSE: TSJ agrees. Team San Jose further recommends continuing to manage budget levels appropriately to carry the facilities through construction and bad economic times.

TEAM SAN JOSE RESPONSE TO RECOMMENDATION #1

Team San Jose agrees that there is a continued need to manage budget levels appropriately and recommend re-evaluating the financing plan with the city to carry the facilities through construction and bad economic times. Team San Jose will continue to evaluate and provide an analysis to balance economic and fiscal results and are prepared to react to economic conditions. Our analysis regarding reducing spending will balance budget reductions with impacts to business levels, ability to increase revenue and the ability to generate TOT tax revenue to support operations and other beneficiaries of the TOT funding including the General Fund.

Recognizing Building Condition and Potential Expansion and Renovation

In FY 2007-2008 as part of the construction planning the City of San Jose commissioned Horwarth to analyze both the impact of the construction as well as the impact of the economic downturn.

A memorandum was submitted to City Council on 1/13/09 summarizing the Assessment provided from Keyser Marston Associates dated 1/2/09. The was prepared with the expectation that ...”the construction documents are expected to be completed by June 2010, and the current schedule anticipates completion of the project by November.” (pg. 3 of the Memorandum dated December 18, 2008 Subject: Convention center expansion Plan of Finance and Cost Benefit Analysis Information) Key results highlighted in the memo on pages 6 and 7 related to Horwath’s projections from the report are as follows:

- TSJ operating revenues decrease from \$11.576 million in FY 2008-2009 to as low as \$8.095 million in FY 2009-10, before growing back to \$10.395 million in FY 2011-12, the year prior to the opening of the expansion.
- The TSJ Operating Deficit funded from Fund 536 increases from \$3.708 million in FY 07-08 to a high of \$8.297 million in FY 2010-11
- TOT Collections decline from \$23.669 million in FY 2004-08 to \$18.964 million in FY 2008-09. Collections do not increase to above the 2007-08 level until after FY 2011-12
- TSJ’s allocated portion of the TOT declines from \$7.213 million in FY 2007-08 to a low of \$5.689 million in FY 2009-10

Team San Jose performed better than projected by Horwath and Team San Jose’s projections. Team San Jose recommends the need to manage budget levels appropriately and recommend creating a plan with the city to carry the facilities through construction and bad economic times. We agree with the City Auditor’s recommendation and suggest developing a five- year road map with regular annual updates to protect Fund 536.

Economic Strategy: Utilize TOT to Support Economic Value

Similar to many convention centers, Transient Occupancy Taxes have been established through approved ordinances in order to develop a reserve during economic growth times that can be utilized during difficult economic conditions. Without the ability to utilize the reserve funds from prior years to incent convention groups to select San Jose, there would be a dramatic loss in convention business.

Loss of convention business would result in a loss in hotel room nights and tax generation that is gained with room nights, lost attendees, and lost attendee spend as well as many other economic impacts that support the General Fund and city services. In addition, if TSJ is forced to reduce spending below the current budgeted level, TSJ will be forced to not only review the expense structure but also the revenue structure. This would make it impossible for TSJ to achieve the budgeted revenue projections to support business opportunities.

Recommendation #2: To reflect the current reality which is that because the concert series at the Civic have been suspended and that Nederlander is currently not providing the services Team San Jose originally contracted with it to do, Team San Jose should renegotiate its contract with Nederlander as soon as possible and modify the terms of the contract to better balance the financial risk of doing concerts between Team San Jose and the promoter.

TEAM SAN JOSE RESPONSE: Team San Jose partially agrees. Note budget challenges below regarding the Civic renovations.

TEAM SAN JOSE RESPONSE TO RECOMMENDATION #2

San Jose Civic Renovation Issues and Impacts to Team San Jose's Budget

The initial investment of \$13 million was approved in 2009 to lead the renovation of the venue. This budget was subsequently reduced to \$11 million and then \$10 million due to State budget issues and it was decided to complete the renovations in two Phases.

Since the start of Phase II renovations, all elements of the project have been proceeding on schedule, with the exception of the new concession and equipment build out. This area of the project has been delayed due to ongoing permitting and licensing challenges from both the County Health and City Building Departments and has subsequently resulted in an estimated 120 to 180 day delay of the project.

To further complicate the renovations, on October 4th, 2010, TSJ received a call from the RDA indicating that it was facing a significant funding shortfall and would be unable to complete the concessions program as designed. Since that time, TSJ has been working the RDA and City Staff to better understand the funding challenges and has requested a budget reconciliation to fully understand where the overall funding fell short.

Prioritization of remaining items will result in several key items being dropped from the program that will prevent the Civic from becoming one of the premier entertainment venues and will limit its ability to profitability complete with similar sized venues in the Bay Area.

If the concessions are not built out, the following are the high level impacts to concert/special events operations at the San Jose Civic:

- Civic special events and concert revenue is already impacted by an estimated \$292,400 due to the delays of opening the venue, which were originally scheduled for January 2011, but now could be as late as April.
- Revenue per person will be significantly impacted, due to less concession opportunities to serve patrons. This will also affect the longer term financial model of the Civic.
- Patron experience impacts will limit the Civic from booking quality concerts.

Mayor Reed and Councilmember Pete Constant included direction to RDA staff to include funding in the RDA's budget to build out the concessions at the San Jose Civic. We appreciate their leadership in highlighting the Civic as a funding priority. A gap in funding continues to exist which impacts the current Team San Jose operating budget approved by the City Council in June 2010.

Nederlander Concert Agreement Negotiation

Team San Jose agrees with the Auditors recommendations and as a result, we have suspended concerts due to the renovations delays. Per our Management Agreement, Team San Jose has the sole obligation to negotiate with subcontractors and we will keep the City informed.

Recommendations 3: To ensure the fiscal health of the City's Convention and Cultural Facilities and their ability to generate economic impact, Auditor recommends that the city a) review its estimates of how much funding will be needed to subsidize continued operation during the upcoming Convention Center expansion and b) on an ongoing basis ensure that Fund 536's budget is balanced without use of fund balance to subsidize operating losses, and c) once the economy improves, create a reserve for economic uncertainty in Fund 536.

TEAM SAN JOSE RESPONSE: Agree.

TEAM SAN JOSE RESPONSE TO RECOMMENDATION #3

Team San Jose agrees that a continued evaluation of the overall finance plan for expansion is an important step to ensure ongoing understanding of the impacts of the proposed expansion and renovation project.

To clarify, Team San Jose believes the Auditor's recommendation included in recommendation number 3, that they are recommending no further draw downs except to subsidize operations during construction. The previous financing plan or roadmap, assumes a depletion of Fund 536 as part of the construction project and the Auditor's recommendation to re-evaluate the current plan should also take into account current economic and business trends.

TSJ also agrees that the fund be protected to ensure that it remains solvent, which is why in the economic growth years, Team San Jose working with the City Team, recommended keeping a positive ending fund balance that is now being utilized as part of the overall financing plan for the proposed expansion and renovation project.

San Jose Municipal Code requires uses of Transient Occupancy Tax revenues, including funding for cultural grant program and fine arts division programs, expenses of the fine arts division of the convention and cultural department, and the city's operating subsidy to the convention and cultural facilities of the City of San José.

In analyzing the road map prepared by Horwarth and developing conservative estimates going forward, TSJ feels confident that Fund 536 will be successful in completing the objective of both sustaining through economic down turns and the projected construction downturn (estimated to begin 3/2012 with estimated construction time-line of 24 months).

Team San Jose’s budget results include the following annual additions to the positive ending fund balance:

| | <u>Fund Balance</u> | <u>Net Change</u> | <u>Ending Balance</u> |
|----------------------------------|---------------------|-------------------|-----------------------|
| Beginning Fund Balance 2005-2006 | (101,660) | 830,439 | 728,779 |
| 2005-2006 | 728,779 | 3,690,009 | 4,418,788 |
| 2006-2007 | 4,418,788 | 3,876,810 | 8,295,598 |
| 2007-2008 | 8,295,598 | 2,042,464 | 10,338,062 |
| | | 10,439,722 | |

As mentioned above, the road map approved by City Council was developed in anticipation of an economic downturn as well as the impact related to construction. In the good economic years, due to City and TSJ fiscal management, the Fund grew by over \$10.4m in reserves.

| | <u>Fund Balance</u> | <u>Net Change</u> | <u>Ending Balance</u> |
|---------------------|---------------------|-------------------|-----------------------|
| 2009-2010 **Actual | 10,338,062 | (3,506,371) | 6,831,691 |
| 2011-2012 ** Budget | 6,831,691 | (1,494,013) | 5,337,678 |

Road Map for Fiscal

| | | | |
|-----------------------|-----------|-------------|-----------|
| 2012-2013 **Estimate | 5,337,678 | (1,800,000) | 3,537,678 |
| 2013-2014 ** Estimate | 3,537,678 | (2,200,000) | 1,337,678 |
| 2014-2015 ** Estimate | 1,337,678 | (1,200,000) | 137,678 |

Team San Jose recommends that as part of the development of the 5-year roadmap, that these estimates be quantified and reviewed on an annual basis. This will ensure the fund will successfully sustain operations through proposed construction, as well as economic downturn, is accomplished.

CITY AUDIT FINDING: TSJ MET ITS PERFORMANCE MEASURE AND INCENTIVE TARGETS

SUMMARY

Team San Jose is responsible for attracting visitors to the city and working with the Office of Economic Development, two calculators are utilized to measure the visitor spending at each event. The calculator utilized is based on event type and is laid out in the management contract and agreed to by both TSJ and the City.

When calculating Economic Impact, we seek to use the most conservative method for calculation. The calculation for convention, meetings and tradeshow are based on formulas developed by DMAI and a nationwide benchmarking of delegate and exhibitor spending.

The calculation for public performances, festivals and art events is based on a calculator developed for the City of San Jose and are based on surveys of actual San Jose events.

Team San Jose's measures are based on research accumulated by the organization, including: comparative studies of national centers, study of national convention/concert/ event booking trends, analysis of TSJ's past performance and historical trends regarding booking pace, pick-up and rotation patterns.

The audit report asserts that although Team San Jose met 5 of its 8 performance measures, those measures need to be more rigorous. The report points to the fact that TSJ "overspent" and missed its GOP target as proof that all targets need to be more rigorous. When comparing the drop in performance year over year for the economic impact measures and the corresponding drop in available city funding for sales and marketing efforts to drive these activities, one could further argue that TSJ's measures are appropriately set.

While overall city funding for TSJ's facilities and CVB contracts dropped by 38% over the past two years, TSJ has made much smaller drops in gaining Out of Town attendees, room night production and visitor spending.

AUDITOR Recommendation 4: To make TSJ's performance and incentive measures more meaningful, we recommend the City amend the Management Agreement to explicitly specify that Hotel Business Improvement District and Convention and Visitors Bureau monies are to be excluded from the calculation of Gross Operating Revenues and Return on Investment.

TEAM SAN JOSE RESPONSE: Disagree.

TEAM SAN JOSE RESPONSE TO RECOMMENDATION #4:

The San Jose Hotel Business Improvement District (San Jose Hotels Inc.) is led by the San Jose Hotel community. San Jose Hotels Inc. is a non-profit corporation that is lead by thirty-five San Jose hotels that opt into a hotel district. San Jose Hotels, Inc formed the HBID by deciding to self assess a fee and the distribution of the collection and distribution of these funds is at their sole discretion. They may, on an annual basis, decide to discontinue the district.

Local hotels engaged Team San Jose to execute their sales and marketing strategy, which leverage private funding to support San Jose's meeting and convention business efforts. Without HBID dollars, we would not only lose the ability to offer sponsorships to secure business, but we would also lose the majority of funding for our sales and marketing programming. We would most likely see our room night sales production drop by a minimum of 25%.

The HBID funds are used to offset costs for a planner, allowing San Jose to strategically support business based on expected room night production.

The board of San Jose Hotels (made of the hotel community), Inc reviews and approves all subsidies based on guidelines for sponsorship and expected return. The hotel community can at any time decide that these funds not go to the city's efforts in bringing conventions to San Jose. If these funds were not available to San Jose, Team San Jose would charge clients more for their business in San Jose to make up the difference, the City of San Jose would lose this leveraging asset and San Jose would lose business opportunities that generate hotel room nights and tax revenue.

For example, in order to win the League of California Cities contact, we offered to host via HBID subsidy an opening reception worth \$20,000. The client had an option to hold this reception at any venue in the city (or outside of the city for that matter) and considered other locations such as the Tech, SJMA and City Hall rotunda. They decided to hold the event at the SJCC. Thus, expenses were incurred around the event – F&B, staff, décor, etc.- to match the amount of the subsidy. In other words, \$20,000 in expenses were undertaken to fulfill our contractual obligations. If we are unable to count the \$20,000 off-setting HBID funds as revenue, then we show a loss of \$20,000 for hosting the event within our own facilities. Facilities like City Hall Rotunda, Tech Museum or Museum of Art would show this \$20,000 as revenue.

These funds should be reflected as revenue to the facilities as result.

San Jose's Hotel Improvement District was the third district of its kind in the State of California. The first was Sacramento. The Sacramento Tourism Business Improvement District (STBID) was created in 2001 to provide additional marketing funds from a hotel room assessment. This room night fee provides funds to help attract Convention business for the City. It can be used to provide concessions and incentives such as off-setting Convention Center meeting room rental, transportation, VIP amenities, as well as contributions to help off-set food & beverage costs, scholarships and various other requests that today's customer frequently requests in the competitive bid process.

As in Sacramento and San Francisco, these funds are recognized as revenue to their Convention Centers. San Jose should not be penalized for leveraging other assets to attract additional business. These funds should be treated as revenue for the facilities managed by Team San Jose.

AUDITOR Recommendation 5: Auditor recommends the City align the financial performance and incentive targets including gross revenues and ROI to the budget. The targets should not be easier to achieve than the budget, and if the City approves changes to the budget during the year, it should modify the financial performance and incentive targets as well. In addition, the City should renegotiate the FY 2010-11 targets to align to the adopted operating budget.

TEAM SAN JOSE RESPONSE: Partially Agree.

TEAM SAN JOSE RESPONSE TO THE AUDIT RECOMMENDATION #5

Team San Jose objects to the city's suggestion that targets were low and easily achievable. There is no basis or analysis completed to suggest that the performance measures created were established so that Team San Jose automatically reaches them.

Team San Jose over the last six years has demonstrated their expertise in the industry to establish fair and reasonable performance targets based on industry trends, economic trends. The City and Team San Jose recognized the difficulty of selling the destination due to the lack of ongoing investment in the facilities by the City of San Jose. While competitors have expanded and renovated their centers two and in some locations, three times over the last twenty years, San Jose continues to be at a disadvantage.

Team San Jose does not feel the City should re-evaluate targets in the year for the year. That is suggesting turning a ship in a different direction during a heavy storm. Changing economic and financial measures now would be unfair and impossible to achieve, as the fiscal year is almost half over.

The City of San Jose two years ago, in 2008, recognized the tough economic times ahead and the impacts of evaluating a proposed expansion and renovation at the convention center. In 2009, for example, we lost one of our major clients due to the city's discussions around expansion. Photonics West, a client for over 13 years, moved to San Francisco due to the threat of expansion. As we all know, the project construction did not begin in 2009, but this discussion by the City was enough for clients to look elsewhere.

Team San Jose agrees that the performance measures should be aligned with the budget. However, the City of San Jose will need to ensure that any changes in the year to the fiscal results ultimately also impact the economic results and changes to these measures would also need to be considered.

AUDITOR Recommendation 6: We recommend the City amend the Management Agreement with TSJ to: a) renegotiate the annual fixed management fee; b) revise the incentive fee payment structure such that TSJ receives incentive payments only if it achieves a specified threshold.

TEAM SAN JOSE RESPONSE: Partially Agree.

TEAM SAN JOSE RESPONSE TO AUDIT RECOMMENDATION 6:

Team San Jose agrees to evaluate this recommendation with City Oversight Team and agree in concept to a fixed management fee as well as an incentive fee structure.

Team San Jose disagrees with the Auditor's assertion that the current fee structure does not incentivize Team San Jose to avoid depleting Fund 536. Team San Jose not only worked within the fund, Team San Jose ended the year providing positive variance to the ending fund balance of Fund 536. In addition, the current performance measure structure requires that Team San Jose meet budget targets but also receive an incentive based on 35% weighted score to support fiscal results including managing expenses.

Recommendation 7: To better incorporate the City’s financial reality into TSJ’s performance and incentive targets, and to ensure targets are rigorous without penalizing TSJ for a poor economy, we recommend that the City revisit its weighting of performance and incentive measures and tighten the gross operating revenue and gross operating profit targets for management of the Convention and cultural facilities.

TEAM SAN JOSE RESPONSE: Partially agree.

TEAM SAN JOSE RESPONSE TO RECOMMENDATION #7:

Per City Council direction, when the Team San Jose contract was renewed last year for an additional five years, the City Council revised the contract to include the creation of performance measures on an annual basis through the budget process. This was to incorporate external factors like national, regional economic conditions, City of San Jose budget decisions that directly impact the performance of the Convention Center and theater operations and other impacts into performance conversations. This direction provided the City and Team San Jose a way to tailor performance measures based on factors outside of Team San Jose’s control.

Overarching Constraints that tie to performance measures include the following:

The proposed performance measures take into account the following factors:

- Economic downturn and trends associated.
- Less attendee attending all event types and less visitor spending based on economic downturn.
- San Jose Convention Center has not been renovated or significant capital investment since 1989, which will continue to impact overall customer satisfaction and business opportunities.
- Potential Expansion and other construction impacts will affect customer satisfaction levels.
- With a reduction in TSJ workforce, lower levels of staffing resources are available to handle all event needs.

The approved measures balance historical results that Team San Jose has demonstrated over the last five years, while taking into account economic challenges facing the tourism and hotel community.

During the FY 2009-2010 budget process, Team San Jose and the City’s Office of Economic Development deferred the completion of Team San Jose’s performance measures until the budget was final. This process is outlined within our new contact with the City of San Jose to respond to the challenges of our previous agreement that required TSJ and the City to agree to a five year proforma that dictated performance measures.

The new agreement requires TSJ to submit its annual targets for the following performance measures to be weighted as follows: Economic Impact Measures 40%, Gross Operating Profit 35%, Theatre Performance 15%, and Customer Service Survey Results 10%. What this demonstrates is the City Council’s already strict direction to focus on fiscal results. While we agree with revisiting a fixed fee for services, we feel incentive targets and structure already incorporate the City’s focus on fiscal results.

AUDIT FINDING: TSJ BUSINESS MODEL AND BOARD OF DIRECTORS AND CITY INVOLVEMENT

AUDITOR Recommendation 8: Auditor recommends TSJ management and its Board of Directors improve transparency and governance process so that its Board of Directors and city oversight team members are made aware of and approve key business decisions.

TEAM SAN JOSE RESPONSE: Agree.

TEAM SAN JOSE RESPONSE TO AUDIT RECOMMENDATION #8

Board of Directors Transparency and Governance

Since its establishment over six years ago, Team San Jose's corporate mission has been to support the local economy through a unique community-based partnership with local hotel, arts, labor and business industries. Twenty months ago, the corporation's two Board of Directors, merged to one-streamlined governance board. This Board since that time has implemented a number of new governance practices to support efficiencies, increase governance and engagement.

Councilmember Sam Liccardo's memorandum asked the City Auditor to understand Board of Directors involvement around specific business decisions. The Auditor reviewed board minutes and interviewed a small percentage of the Board around a few specific business decisions.

The Board has specific oversight responsibilities including approving an annual budget and approving a marketing plan. Per the bylaws and governance practices, operational decisions have been discussed and reviewed by our executive board. In addition, it is important to note that the strategy behind having a strong board of directors is they are people who have a direct stake and involvement in the visitor industry and understand the industry and business operations. The Board of Directors approves budget and operational business decisions as part of their annual budget approval and reviewed operational decisions including the food and beverage transition, Civic concerts, Broadway agreement, SJ Tix, and Genghis Khan opportunity.

In April 2010, the Team San Jose Board of Directors implemented a number of actions to improve governance and strengthen communication and Board of Directors engagement. This includes oversight over changes to the budget of \$250,000, multiple year contracts/agreements. It also includes additional communication requirements, establishing an Audit Committee, Compensation Committee, and other responsibilities for the Finance Oversight Committee.

New revisions to the Team San Jose Board structure are being considered this November to further streamline, create efficiencies, increase communication and engagement.

City Involvement

In addition to monthly meetings with the City Oversight Team, Team San Jose recently implemented the following actions to increase the City's involvement:

- Revised financial reporting to track to budget and forecast
- Written notification on any business changes
- City finance staff invited to the Team San Jose Finance Committee meetings
- City Finance Team and Team San Jose Finance Team monthly meetings
- Monthly performance measure reporting to the Mayor and City Council to track financial and economic results
- Variance to budget reports are provided in the monthly report package and reviewed monthly
- Formal requests will be provided to City oversight with regard to budget adjustments
- Per City Council request, Team San Jose has provided City Oversight access to all financial and accounting software systems

AUDITOR Recommendation 9: We recommend the City amend the agreement with TSJ to clarify that TSJ must formally notify the City in advance of business decisions with potential revenue or budgetary impacts of \$250,000 or more.

TEAM SAN JOSE RESPONSE: Agree.

TEAM SAN JOSE RESPONSE TO RECOMMENDATION #9:

Team San Jose agrees to recommendation number 3. We currently have established financial thresholds required for Team San Jose Finance and Board approvals. Notifying the City in advance of business decisions with potential revenue or budgetary impacts of \$250,000 is in line with our Board governance practice.

This recommendation is already implemented as Team San Jose provides notification to the City of San Jose Director of Finance on business decisions that impact budget.

AUDITOR Recommendation 10: To improve ongoing communications, we recommend that the City and TSJ work together to determine the appropriate composition of the staff teams to be involved in monthly financial oversight meetings and when potential issues should be elevated to a broader consideration.

TEAM SAN JOSE RESPONSE: Agree.

TEAM SAN JOSE RESPONSE TO RECOMMENDATION #10:

Team San Jose agrees to this recommendation and has already made a number of changes to the oversight meetings, including additional reporting and process around communicating operational issues.

AUDITOR Recommendation 11: we recommend TSJ present quarterly performance reports to the Public Safety, Finance and Strategic Support Committee.

TEAM SAN JOSE RESPONSE: Agree.

TEAM SAN JOSE RESPONSE TO RECOMMENDATION #11:

Team San Jose agrees to this recommendation and look forward to presenting our performance results in the year to the Public Safety, Finance and Strategic Support Committee. Starting in September, Team San Jose began reporting monthly results to the Mayor and City Council. Team San Jose will continue to refine this report and include quarterly information to the council committee.

CONCLUSION

Team San Jose is proud of its accomplishments to date, managing city’s assets and look forward to continuing to stimulate the local economy and being good fiscal managers for the City of San Jose.

Team San Jose looks forward to implementing a number of these recommendations in partnership with the City to strengthen our position in the meetings and convention industry.

Team San Jose achieved 102% of the performance targets to stimulate the local economy and balance the fiscal needs of the City. We look forward to continuing these good solid results and with the City’s evaluation of the proposed convention center expansion and renovation and the Hotel’s investment in ongoing capital improvements of the facility, the future of San Jose’s meeting and convention industry looks bright.

Team San Jose’s mission is to stimulate economic development in San Jose. This mission statement ties to the City’s priorities within the Economic Strategy to support economic growth in downtown San Jose.

Appendix 1

Team San Jose Performance by Facility for FY 2010

| | FY 2010 | FY 2009 | FY 2009 vs 2010 | % | FY 2008 | FY 2008 vs 2010 | % |
|-----------------------------------|---------------|---------------|-----------------|--------------|---------------|-----------------|-------------|
| Convention | | | | | | | |
| Revenue | 4,695 | 5,843 | (1,148) | -20% | 6,459 | (1,764) | -27% |
| Labor revenue | 1,998 | 1,478 | 520 | 35% | 257 | 1,741 | |
| Labor COS (expense) | 1,730 | 1,227 | 503 | 41% | - | 1,730 | |
| Expenses | <u>11,547</u> | <u>12,090</u> | <u>(543)</u> | <u>-4%</u> | <u>11,672</u> | <u>(124)</u> | <u>-1%</u> |
| GOP | (6,584) | (5,997) | (588) | 10% | (4,955) | (1,629) | 33% |
| Montgomery | | | | | | | |
| Revenue | 210 | 300 | (89) | -30% | 202 | 8 | 4% |
| Expenses | <u>409</u> | <u>420</u> | <u>(11)</u> | <u>-3%</u> | <u>321</u> | <u>88</u> | <u>28%</u> |
| GOP | (199) | (121) | (78) | 65% | (119) | (80) | 68% |
| Center for Performing Arts | | | | | | | |
| Revenue | 2,186 | 1,182 | 1,004 | 85% | 858 | 1,328 | 155% |
| Expenses | <u>1,845</u> | <u>1,331</u> | <u>515</u> | <u>39%</u> | <u>1,095</u> | <u>751</u> | <u>69%</u> |
| GOP | 340 | (149) | 489 | -329% | (237) | 577 | -244% |
| California | | | | | | | |
| Revenue | 343 | 430 | (88) | -20% | 328 | 15 | 4% |
| Expenses | <u>569</u> | <u>986</u> | <u>(417)</u> | <u>-42%</u> | <u>960</u> | <u>(391)</u> | <u>-41%</u> |
| GOP | (226) | (555) | 329 | -59% | (632) | 406 | -64% |
| Civic | | | | | | | |
| Revenue | 1,582 | 582 | 1,000 | 172% | 508 | 1,074 | 211% |
| Expenses | <u>3,120</u> | <u>1,123</u> | <u>1,997</u> | <u>178%</u> | <u>716</u> | <u>2,404</u> | <u>336%</u> |
| GOP | (1,538) | (541) | (997) | 184% | (208) | (1,330) | 640% |
| Food and Beverage | | | | | | | |
| Revenue | 6,598 | 1,968 | 4,629 | 235% | 2,745 | 3,853 | 140% |
| Expenses | <u>5,008</u> | <u>75</u> | <u>4,933</u> | <u>6580%</u> | <u>-</u> | <u>5,008</u> | <u>100%</u> |
| GOP/Commission | 1,590 | 1,893 | (303) | -16% | 2,745 | (1,155) | -42% |
| Combined | | | | | | | |
| Revenue | 17,611 | 11,783 | 5,828 | 49% | 11,358 | 6,253 | 55% |
| Expenses | <u>24,228</u> | <u>17,252</u> | <u>6,976</u> | <u>40%</u> | <u>14,763</u> | <u>9,465</u> | <u>64%</u> |
| GOP/Commission | (6,617) | (5,469) | (1,148) | 21% | (3,405) | (3,212) | 94% |

Appendix 2

Team San Jose Operating Results for the period July 2010 to October 2010

| | Actual | | |
|--|---------------------|---------------------|-----------|
| | 2010-2011 Actual | 2010-2011 Budget | Var. |
| Net Revenue | 4,867,630 | 4,882,430 | (14,800) |
| Total Non-Personal Expenses related to appropriation | 5,530,655 | 5,797,298 | 266,643 |
| Management Fees | 50,000 | 50,000 | - |
| City Overhead | 82,895 | 82,896 | 1 |
| City Worker's Comp | 75,691 | 33,333 | (42,358) |
| Total Personal Exp -Shared Employee Salaries | 901,811 | 781,550 | (120,261) |
| Total Per Personal Appropriation | 1,110,397 | 947,779 | (162,618) |
| Gross Operating Profit | (1,773,422) | (1,862,647) | 89,225 |

APPENDIX 3

| Competitor Information | | | |
|------------------------|---|---|---|
| City | Attendance | Comparisons for 2010 & Future | Source |
| Phoenix | Down 15% at national conventions | Booking pace down 30% from 2009 | http://www.azcentral.com/news/articles/2009/05/10/20090510convention0510.html |
| Virginia Beach | Attendance is down overall | Room Nights booked are down 40-50% and won't be back to 2007 levels until 2013/2014; Number of events flat, but convention bookings are down and being replaced with non-room night producing events | http://www.insidebiz.com/news/regions-centers-are-quite-conventional |
| Austin | | Due to political backlash about corporate meetings, lost \$14M in cancelled meetings in 2008 and led to a challenging 2009/2010 market; 2010 was down 25% from 2009 when the marketing plan was written | http://www.ci.austin.tx.us/edims/document.cfm?id=130442 |
| Memphis | Down 10% | 2010 could be down 40-50% | http://www.commercialappeal.com/news/2010/mar/04/2010-convention-calendar-thin/ |
| Hawaii | Down 99,000 (approx. 16%) in 2010 | # of Bookings & Events going up, but average size going down for corporate meetings; | http://www.bizjournals.com/pacific/stories/2010/01/11/story1.html |
| Philadelphia | | | http://www.philly.com/philly/business/breaking/20100927_Challenge_Booking_the_bigger_convention_center.html |
| Dallas | | Down 20% in 2010 from 2008. | http://www.publicbroadcasting.net/kera/news.newsmain/article/5/0/1679705/Business/Mary.Kay.Annual.Convention.Keeps.Dallas.In.The.Pink |
| Las Vegas | | # of Conventions down 10.4% in 2008 | http://www.aproundtable.org/news.cfm?NEWS_ID=2219&issuecode=casino |
| Las Vegas | # of Convention Visitors in 2009 down 27% | | http://www.nbj.com/issue/1209/1/2146 |

APPENDIX A

Explanation of Key Variances in Revenue and Expense Categories

Team San Jose provided the following explanations for increases or decreases to key revenue and expense categories in Exhibit 3 in Finding 1.

Revenues

Food and beverage: Most of the \$4.4 million increase in this revenue category was the result of a change in the way that TSJ delivered the food concession and catering at the convention center and cultural facilities. In June 2009, TSJ began to provide the food concessions and catering at convention center events with its own staff—a change from previous years in which TSJ had contracted out the food concession to the catering company, Centerplate Inc. Under its contract with Centerplate, Centerplate paid TSJ a fixed percent of its gross sales. In 2008-09, this fee totaled about \$2 million. In 2009-10, with TSJ operating the food operation with its own staff, TSJ brought in over \$6.5 million in gross revenue, but it would be misleading to compare this \$6.5 million to the \$2 million fee that Centerplate paid to TSJ in 2008-09. As discussed in the expenses section below, the \$6.5 million gross revenue must be offset by \$4.9 million in expenses that TSJ incurred for food, labor, and administrative costs associated with providing the food service in-house, which means TSJ earned a net profit of about \$1.6 million from its food and beverage operations. It is important to note that in 2009-10, TSJ catered fewer events and to a lower number of convention and meeting-goers than did Centerplate in 2008-09. Despite this lower volume, TSJ's food and beverage operation had a profit margin comparable to the commission it earned when it contracted with Centerplate.

Building rental: Due to the economic downturn and fewer events at the convention center, TSJ saw a \$700,000 decline in building rental along with other ancillary services, such as event electrical/utility, networking and telecommunication services. Also, during 2009-10, TSJ discounted building rental, relative to what TSJ says it would charge in a good economy, to prevent customers from scheduling their events at other convention centers.

Labor/event production revenues: The cost to TSJ of the stagehands, teamsters, and ushers who set up for and stage an event at the convention and cultural facilities is passed along to the customer sponsoring the event. TSJ marks-up these labor costs and bills them to event sponsors. Most of the \$1.2 million increase in this line item is due to the Broadway series of musical plays that took place at the Center for the Performing Arts during 2009-10, with the remainder coming mainly from increased event production services at convention center events.

Ticketing Services: In late 2008-09, TSJ signed a new business contract in which it took over ticketing services from the American Musical Theatre of San Jose. In 2009-10, TSJ experienced a full year's worth of this new category of revenue of \$1.5 million, with nearly all of the revenue coming from the concert series at the San José Civic or the Broadway series at the Center for the Performing Arts.

Expenses

TSJ employee salaries: More than \$3.3 million of the \$4.2 million increase in this cost category is attributable to the cost of TSJ staff hired to provide food and beverage services at convention center and theater events. As discussed above, a contractor previously supplied food and beverage service at TSJ convention center and theater events. Much of the remaining increase is due to the conversion of several staff that previously had worked at the convention center as

City employees, but in FY 2009-10 were converted to TSJ staff, and to the addition of staff for the San José Civic concert series.

City shared employee charges: In fiscal year 2009-10, the adopted operating budget for the Convention and Cultural Facilities reduced the number of City employees that work at the convention center or the cultural facilities, accounting for a \$1.6 million reduction in this item. A few City employees who lost their City positions were retained as TSJ staff and contributed to the increase discussed above.

Cost of Event/production labor: As discussed in the revenues section, TSJ passes along the cost of stagehands, teamsters, and ushers who set up for and stage an event at the facilities to the customers sponsoring the event. The increase in this line item, thus, relates to the increased revenue for labor/event production that resulted from the Broadway series at the Center for the Performing Arts, and events at the convention center.

Ticketing costs: As discussed above, TSJ held a concert series at the San José Civic in 2009-10. The artist fees for those concerts, totaling more than \$1.1million, account for most of this new expense category.

Food and beverage costs: As discussed in the revenue section, TSJ began to provide the food concessions and catering at convention center events with its own staff—a change from previous years in which TSJ had contracted out the food concession to the catering company, Centerplate Inc. TSJ's in-house operation of food and beverage services means that it must also purchase the food and beverages that it serves. This new expense category accounts for those costs.

Other expenses: Much of the \$400,000 increase in this expense can be attributed to new expenses associated with the decision to do concerts at the Civic and to do the Broadway series at the Center for the Performing Arts with the help of Nederlander. TSJ incurred expenses for advertising, equipment rental, and production royalties that it had not incurred in fiscal year 2008-09 because this was the first year that TSJ was engaged in this line of business.

APPENDIX B

Methodology for Calculating the Performance and Incentive Measures

| Measures | Type of Measure | Basis for Calculations |
|---------------------------------------|------------------------|---|
| Gross Operating Profit/Revenue | | |
| Gross Operating Revenue | Incentive only | <p>Those revenues from operation of the Facilities excluding revenue billed by TSJ on behalf of other vendors providing services to clients of the Facilities.</p> <p>At the time the management agreement was drafted, revenues from “ticketing services” were not contemplated. In our opinion they should be treated as other revenues generated from the operation of the facilities, and therefore we have included them in calculating gross operating revenue, which consequently affects our calculation of gross operating profit and return on investment.</p> <p>In calculating gross operating revenue, we have included \$148,000 subsidized by the City’s Hotel Business Improvement District and \$70,000 expensed by CVB to sponsor events, even though going forward, we believe these revenue sources should be excluded.</p> |
| Gross Operating Profit | Performance only | <p>Revenues (as described above) minus direct and indirect expenses related to the operation of the Facilities. Per the agreement, we did not include the following expenditures in calculating gross operating profit: the fixed management fee, depreciation expense, City contract oversight costs, fire insurance, City funded repairs and maintenance, or the City’s free use of the Convention Center. Altogether, these costs totaled \$1.6 million in FY 2009-10.</p> |
| Economic Impact | | |
| Hotel Nights | Performance, Incentive | <p>Measured as the total number of hotel room nights sold by the CVB over the course of the Fiscal Year and the total number of hotel room nights sold that can be directly or indirectly attributed to activities at the Facilities.</p> |
| Event Attendance | Performance, Incentive | <p>Number of local/social visitors, out of town visitors, and exhibitors.</p> |
| Estimated Impact | Performance, Incentive | <p>Average daily spending rates multiplied by event attendance. Average daily spending rates may vary depending on if the attendees are local/social visitors, out of town visitors, or exhibitors. This methodology was mutually agreed upon by the City and TSJ as a means to estimate consumer spending related to events.</p> |
| Return On Investment | Performance only | <p>[gross revenues from the operation of the Facilities] + [gross revenues from the operation of the CVB] + [estimated economic impact]</p> <p>divided by</p> <p>[expenses paid for the operation of the Facilities] + [expenses from the operation of the CVB] + [Facilities debt service]</p> <p>In its monthly summary reports for FY 2009-10, TSJ included about \$4 million in City funding to the Convention and Visitors Bureau (CVB) as part of its calculation of Return on Investment. These funds included General Fund subsidies and Transient Occupancy Tax (TOT). TSJ staff believe these funds, particularly TOT funds, reflect TSJ’s performance because TSJ staff help generate additional TOT funds by promoting San José as a destination. However, the Management Agreement and addendum outline that the Return On Investment performance measure include “aggregate accrued gross revenues from the operation of the CVB”—City contributions to the CVB are not revenue generated from operations. Therefore, for the purpose of calculating ROI, we have excluded “public revenues.” Including CVB public revenues in our calculation of the ROI would have resulted in a ROI of 2.53 – 91 percent of the measure target of 2.77. Our exclusion of these revenues does not impact TSJ’s incentive payment.</p> |

| Theater Attendance | | |
|------------------------------|------------------------|--|
| Performance Days | Performance, Incentive | All days that the City and the operator mutually agree are both available and suitable for a scheduled performance or event. |
| Occupied Days | Performance, Incentive | Days that a theater is utilized. |
| Customer Satisfaction | | |
| Satisfaction Rate | Performance, Incentive | The results of the operator's surveys that ask the event coordinators to rate their overall satisfaction with the product and services provided. Satisfactory is considered "excellent," "very good," or "good." |

Source: Auditor summary of terms outlined in the Management Agreement and Addendum