CITY AUDITOR'S OFFICE

SkySong Ground Lease Rent
Calendar Year 2010

November 7, 2011 **AUDIT REPORT NO. 1212**

CITY COUNCIL
Mayor W.J. “Jim” Lane
Lisa Borowsky
Suzanne Klapp
Robert Littlefield
Ron McCullagh
Vice Mayor Linda Milhaven
Dennis Robbins

November 7, 2011

Honorable Mayor and Members of the City Council:

Enclosed is the audit report, *SkySong Ground Lease Rent,* which was included on the Council-approved FY 2011/12 Audit Plan. This audit was conducted to exercise the City's right to audit the SkySong annual operating statement submitted by the ASUF Scottsdale LLC to calculate the amount of ground lease rent due the City. Under terms of the ground lease agreement, the ASUF Scottsdale LLC agreed to pay the City 50% of annual Net Revenue from operating certain facilities now known as SkySong. The ground lease defines how Net Revenue is to be calculated and specifies August 1 of each year as the due date for any payment.

For calendar year 2010, SkySong's operations resulted in a net loss; therefore, no rent was due. However, because certain expenses appear questionable, this audit recommends improvements to the City's oversight controls and clarification of certain lease terms.

If you need additional information or have any questions, please contact me at (480) 312-7867.

Sincerely,

Sharron Walker

Sharron Walker, CPA, CFE
City Auditor

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EXECUTIVE SUMMARY

This audit of *SkySong Ground Lease Rent* was included on the Council-approved FY 2011/12 Audit Plan. This audit was conducted to exercise the City's right to audit the SkySong annual operating statement submitted by the ASUF Scottsdale LLC to calculate the amount of ground lease rent due the City.

Under terms of the ground lease agreement, the ASUF Scottsdale LLC (ASUF) agreed to pay the City 50% of annual Net Revenue from operating certain facilities now known as SkySong. The ground lease defines how Net Revenue is to be calculated and specifies August 1 of each year as the due date for any payment. For calendar year 2010, ASUF reported a net loss of about $2.9 million for SkySong operations; therefore, no rent was due. To date, the City has not received any rent payments.

This audit recommends improvements to the City's oversight controls and clarification of certain lease terms. A contract administrator has not been assigned to monitor terms of the ground lease, such as tenant composition, revenue generation, and expenses. In addition, certain expenses paid to ASUF and affiliates appeared questionable. These included expenses such as termination/resignation payments to two ASUF affiliates, an administrative fee to ASUF and charitable contributions to ASU Foundation, and the calculation method used for an asset management fee. Further, allowable expense definitions, such as actual debt service, need further clarification to increase the likelihood the City will recognize the intended benefit from its investment.

BACKGROUND

In August 2004, the City entered into several transactions related to a project formally titled "The ASU/Scottsdale Center for New Technology and Innovation," which later became known as "SkySong." The City's Municipal Property Corporation purchased a 42-acre property southeast of McDowell and Scottsdale Roads for $41.5 million and transferred title to the City. The City then entered a ground lease agreement with the ASUF Scottsdale LLC (ASUF) for 37 acres of this property.

The City committed to make infrastructure improvements to the property, such as demolishing the existing structures and adding water, sewer, stormwater, electric, parking, public art and plaza improvements. The City agreed to a maximum cost of $44.5 million for these infrastructure improvements, which together with the leased 37 acres totaled an $81.4 million investment.

In return for a 99-year ground lease, ASUF agreed to construct approximately 1.2 million square feet of office space in phases over 24 years and to share with the City 50% of the Net Revenue from operating these facilities. SkySong facilities were to be leased to organizations and businesses that focus upon or advance "creativity, technology and/or innovation." While the lease does not specify a proportion to be met throughout the lease term, initially at least 51% of the first building's tenants were to meet this qualifying use.

Qualifying Use *for SkySong facilities—Organizations and businesses that have and maintain a character, orientation and focus upon creativity, technology and/or innovation. Qualifying subtenants include those that contribute to, advance, enhance or support the Qualifying Use.*

Source: Ground Lease 2004-119-COS

The original ground lease prohibited residential development on the leased property. In July 2006, the City agreed to an amendment allowing residential units to be constructed in return for reducing the City's infrastructure contribution. For the initial 325 units allowed, the City's infrastructure cap would be reduced by approximately $3 million. Additional units would be limited to a ratio of one residential unit per each 1,000 square feet of commercial space built, up to the maximum 805 units allowed by zoning and the City's infrastructure cap would potentially be reduced by a total of $7.4 million. As of June 30, 2011, the City has spent approximately $35.5 million, which is $9 million less than the original $44.5 million cap.

Ground Lease Rent Provisions

Once the City recoups its $81.4 million through the shared net revenue, the ground lease provides that all net revenues then belong to ASUF.[1] The Ground Lease Rent is to equal 50% of *Net Revenue,* which is defined as *Gross Revenues* derived from the facilities less *Operating Expenses*, *Actual Debt Service* and *Annual Reserve*. These terms are also defined in the Lease:

Gross Revenue is all consideration, rent, fees, charges and payments of any kind

[1] The amount, though stated in the Ground Lease agreement, would be reduced by any residential unit reduction, estimated to be $3 million for the initial 325 units. To date, no residential units have been constructed.

related to occupancy of the Premises and any net proceeds from insurance, refinancing, sale exchange or similar disposition of any part of the Premises, including the fair market value of any non-cash consideration received. The Lease recognizes that favorable or below-market rental rates may be used to attract the desired subtenants, but ASUF is not to enter into such arrangements for the purpose or with the effect of denying the City the anticipated benefits of the Lease. Similarly, while license fees, royalties, patent payments and the like are not included in Gross Revenues, ASUF is not to enter into those arrangements for the purpose of denying the City the anticipated benefits of the Lease.

Operating Expense is defined as all expenses incurred in operation and maintenance of the Premises typical in standard commercial leases, such as the following:

- Operation, maintenance and repair, such as cleaning; repair of sidewalks, curbs, gutters and signs; lighting; and painting.
- Electricity, water and related utility service.
- Capital improvements intended to reduce operating expenses; improve the Premises' utility, efficiency or capacity; or comply with legal requirements.
- Professional services, such as accounting, legal and other reasonably incurred in connection with operations.
- Leasing commissions, attorney fees and other expenses incurred in connection with leasing activities.
- Taxes and insurance premiums.
- Other charges "...which in accordance with generally accepted property management practices would be considered an expense of managing, operating, maintaining, insuring and repairing the Premises."

However, other categories are excluded, such as the following examples:

- Costs associated with negotiation and execution of the Ground Lease.
- Overhead and administrative costs not directly incurred in operation and maintenance of the facilities.
- Capital improvements other than the type allowed.
- Costs of special services to individual subtenants that are reimbursed.
- Interest, fines, fees or penalties due to violation of law or untimely payments.

Actual Debt Service is the principal, interest and customary impounds paid for funds borrowed for constructing the facilities, capital replacements, tenant improvements, or the like. However, ASUF has the right to recover construction costs only once. Any refinancing to withdraw equity is not a debt service expense. However, ASUF has the right to refinance to reduce interest rates or to obtain capital for additional construction.

Annual Reserve is defined as an amount retained in anticipation of tenant improvement costs or capital expenditures. Before the applicable lease year begins, ASUF would have to submit a statement of proposed annual reserve for the City's review and agreement.

The Ground Lease rent payment is due by August 1 (or the next business day) of each year.

Audit Rights Provision

The ground lease agreement provides that within 120 days after the Lease Year end, ASUF is to furnish the City with an operating statement showing Gross Revenue, Operating Costs, Actual Debt Service, the Annual Reserve and Net Revenue for the year. The City is allowed to audit all books and records relating to the Lease and/or the Premises, including all records relating to Net Revenue. Previously the Finance & Accounting Division exercised this right by comparing the annual SkySong operating statement to the SkySong Holdings financial report, which had been audited by a CPA firm, and the SkySong general ledger.

SkySong Holdings

In January 2005, ASUF formed SkySong Holdings LLC together with an affiliated partner. This organization serves as a holding company for the multiple building development projects, which currently include SkySong 1 LLC, SkySong 2 LLC, and SkySong 3 LLC. While SkySong 1 and 2 are currently in operation, SkySong 3 has not yet begun construction.

Calendar Year 2010 Net Revenue

On April 28, 2011, ASUF provided to the City's Finance & Accounting Division the following statement for the combined SkySong operations in Calendar Year 2010.

Table 1. SkySong Holdings LLC
Statement of Net Revenue – Calendar Year 2010
(amounts in millions)

	December 31, 2010 (unaudited)*	December 31, 2009 (audited)*
Income		
Rental & other income	$ 6.0	$ 5.1
Expenses		
Operating, utilities & maintenance	2.7	1.9
Depreciation & amortization	2.3	2.0
General, administrative & advisory	.3	.3
Debt service	3.6	3.4
Total Expenses	$ 8.9	$ 7.6
Net Revenue	**$ (2.9)**	**$ (2.5)**

* - The "audited" and "unaudited" labels were denoted on the statement submitted by ASUF. For calendar year 2009 and previous years, the SkySong Holdings statements were audited by a CPA firm. These labels do not refer to work performed by the Scottsdale City Auditor's office.

SOURCE: Auditor summary of ASUF's SkySong Holdings annual operating statement for calendar year 2010.

As of December 31, 2010, approximately 80% of SkySong office space was leased based on available square footage information.

OBJECTIVES, SCOPE, AND METHODOLOGY

This audit of SkySong Ground Lease Rent was included in the FY 2011/12 Audit Plan approved by the City Council to exercise the City's right to audit the SkySong annual financial statement that provides the basis for the amount of rent due. The most current annual financial statement submitted by the ASUF Scottsdale LLC (ASUF) covered Calendar Year 2010. The SkySong annual operating statement did not include any descriptive disclosures, which would be necessary to constitute a financial statement. Therefore, this audit was performed to review compliance with related terms of the Ground Lease and not to provide an opinion on the SkySong operating statement.

To obtain an understanding of ASUF's rent obligations, we reviewed the applicable Ground Lease agreement (*COS Contract No. 2004-119-COS*) and the related amendment (*COS Contract No. 2004-119-COS-A1*). In particular, we analyzed *Section 5, Rent and Additional Consideration*, of the Ground Lease which governs calculation of the applicable annual Rent. To gain an understanding of the City's monitoring and oversight controls for the lease, we interviewed the Finance & Accounting staff that monitors the periodic SkySong financial updates and annual financial statement and the Strategic Programs Director who serves as the City's liaison for the lease. In addition, we interviewed the Public Works Executive Director who oversees the City's Asset Management staff.

To obtain supporting documentation for the SkySong operating statement, we requested detailed records for selected income and expense balances and transactions. The records, which are maintained by a property management company, were provided through the ASUF. Most records were provided as requested, although support for ASU subleases was not. Through its lease with ASUF/SkySong, ASU is allowed to sublease a portion of its sub-leased space, but not more than 49%. ASU is required to share with SkySong 50% of any associated sublease rent that exceeds the amount it is otherwise obligated to pay.

We conducted this audit in accordance with generally accepted government auditing standards as required by Article III, Scottsdale Revised Code, §2-117 et seq. Those standards require that we plan and perform the audit to obtain sufficient, 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 based on our audit objectives. Audit work took place during the period of July through October 2011.

FINDINGS AND ANALYSIS

1. Responsibility for monitoring compliance with the Ground Lease Agreement terms has not been specifically assigned.

Typically with City contracts, a contract administrator is named to clearly designate who is responsible for monitoring compliance with contract terms. A contract administrator has not been named for the SkySong ground lease. Many of the City staff involved in developing the original ground lease are no longer with the City. As former staff left, responsibility for the ground lease was not specifically assigned. Given the 99-year lease term, this situation will be repeated in the future.

A Strategic Projects director currently serves as liaison, primarily maintaining communications between the City and ASUF/SkySong representatives. The Public Works Division's Capital Projects Management staff manages the City's infrastructure commitments, which will total as much as $44.5 million when completed. As well, Finance & Accounting staff tracks the City's related infrastructure spending and receives SkySong financial reports periodically and on an annual basis.

While emphasis has been placed on ensuring the City's commitments are met, little attention has been given to monitoring ASUF's obligations. For example, one intended benefit is increased revenues, such as transaction privilege tax, to the City. However, comparison of SkySong tenant records to the City's records indicated that SkySong tenants may not always obtain a City business license. Further, the ASU/SkySong lease allows ASU to sublease up to 49% of its space with any additional rent amounts to be shared with SkySong. Documentation was not provided to show this requirement is being met.

The City's Asset Management staff, which has the responsibility to track and coordinate most City leases, has not been involved with this particular ground lease. Nor has anyone else been assigned responsibility for monitoring the ground lease terms that were intended to assure the City will receive the desired benefit.

Recommendation:
The Public Works, Finance & Accounting, and City Manager staff should assign appropriate staff responsibility for monitoring key terms of the ground lease, including those related to revenue generation.

2. Some expenses appear questionable and clarification is needed for others.

Certain expenses included among the reported operating costs appear questionable, while terms of the Ground Lease may need further clarification for others.

A. The Ground Lease defines Operating Expenses to include the costs of managing, operating, insuring and repairing the Premises. Certain expenses recorded among the 2010 operating expenses may not violate the lease, but appear questionable, such as the following:

   1. An administrative fee paid to ASUF totaled $50,000. Section 5.4(iii) of the Ground

Lease provides that ASUF is not to be paid for administrative/overhead expenses except on a direct basis, such as actual time. However, the SkySong Holdings agreement between ASUF and its affiliated partner allows ASUF to be paid an administrative fee of at least $12,500 per quarter. This expense is claimed as an operating expense in the SkySong operating statement for 2010 and also was in 2007 through 2009. For 2006, ASUF was paid a prorated amount for the partial year of operation. No documentation other than the SkySong Holdings agreement was provided to substantiate the ASUF administrative fee.

2. SkySong paid ASU Foundation (not ASUF Scottsdale LLC) $5,000 during 2010. This amount was labeled as a charitable contribution, which does not appear to be a necessary operating expense.

3. An asset management fee of about $129,000 was paid to an affiliate in calendar year 2010 on the prior year's results. According to the underlying agreement, the fee is based on a valuation derived using the annual net operating income "as reflected on Owner's financial statements." Yet the fee was calculated using a "modified" operating statement rather than the SkySong operating statement included in the audited financial report and provided to the City. The modified operating statement excluded interest expense, depreciation and amortization, and certain other expenses, resulting in a net operating income of more than $2.9 million. In contrast, the SkySong operating statement submitted to the City for 2009 reflected a $2.5 million net loss. On this basis, a fee would not have been paid.

4. Affiliated companies provide property management, development and financing services and are also reimbursed for various operating expenses. However, SkySong paid two ASUF affiliates more than $680,000 in termination/resignation fees during 2010. It is questionable whether a payment to alter the relationship between ASUF and its affiliates should be considered an allowable operating expense for the purpose of determining Net Revenue.

5. Legal expenses submitted for reimbursement in 2010 that related to loan modification and affiliate/partnership agreement issues totaled approximately $56,000. Some of these legal expenses, although not material, were for work performed in calendar years 2008 and 2009. Without also auditing those years, it was not possible to determine whether these costs were accrued and reported in the earlier years. To provide appropriate revenue and expense matching, ASUF should ensure costs are submitted timely. However, it is questionable whether such expenses between ASUF and its affiliates should be considered an allowable SkySong operating expense for purposes of determining Net Revenue.

6. A public relations/media consultant was initially paid a monthly retainer. However, in later months when the billings were based on hours worked, the cost was less than half the monthly retainer that was previously being paid. While not material to total costs, the retainer payments appear questionable.

B. Further clarification is needed for certain expense types to protect the City's interest in recovering its investment.

1. Because debt principal is included in the definition of debt service, the cost of construction may be recovered twice. In Section 5.5 of the Ground Lease, Actual Debt Service is defined as "principal and interest, together with customary impounds … in connection with funds borrowed to construct (the facilities) … capital replacements, tenant improvements, and the like." The same section further states that ASUF has the right to recover construction costs only once.

   The annual operating statement also reports depreciation expense, which spreads the cost of assets over their expected life and in effect recovers the cost of construction. By also allowing the 'principal' portion of debt service to be expensed, the cost of assets will be recovered twice. Further, under generally accepted accounting principles, only the interest portion of debt repayment should be recognized as an expense; the principal amount is capitalized as an asset. Terms of the lease should be clarified to avoid allowing the cost of construction to be expensed twice.

   As of December 31, 2010, SkySong Holdings had more than $51 million in long-term debt, so this definition represents a very large potential expense. However, the 2010 operating statement appropriately reported only interest expense.

2. SkySong Holdings' current long-term debt carries rates substantially higher than current market rates, ranging from a minimum of 6% on 10-year variable rate notes to 10% on 30-year fixed rate notes. The rates are also substantially higher than the City's long-term debt issued at the same time that ASUF entered into the SkySong debt. While the ground lease allows debt refinancing to reduce interest rates, it does not require any such action. As the long-term debt is held by affiliated parties who benefit from the interest payments, there is little, if any, incentive to refinance the higher rates. Further, as of July 31, 2011, few principal payments have been made so interest expense will remain a significant cost to the facilities' operation.

3. The definition of Operating Expenses in the Ground Lease includes "…any other expense or charge, whether or not hereinbefore described, which in accordance with generally accepted property management practices would be considered an expense of managing, operating, maintaining, insuring and repairing the Premises." No authoritative reference has been found prescribing 'generally accepted property management practices' that would serve to clarify the limits the parties were agreeing to for SkySong expenses.

As originally drafted, the Ground Lease terms are not sufficiently clear regarding the allowability of certain expenses that are currently being deducted to arrive at Net Revenue.

Recommendation:
The Public Works Executive Director, together with the City Attorney's office and the Finance & Accounting Division, should seek to clarify terms of the Ground Lease agreement regarding allowable expenses.

MANAGEMENT ACTION PLAN

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1. **Responsibility for monitoring compliance with the Ground Lease Agreement terms has not been specifically assigned.**

   Recommendation:
   The Public Works, Finance & Accounting, and City Manager staff should assign appropriate staff responsibility for monitoring key terms of the ground lease, including those related to revenue generation.

MANAGEMENT RESPONSE: Management concurs with the recommendation. The Asset Management staff within the Public Works Division is the appropriate staff element to provide proper oversight of this lease agreement to insure both parties are fully complying with contractual obligations.

PROPOSED RESOLUTION: Public Works will assign a contract administrator and assume overall responsibility, and will coordinate as necessary with the Finance and Accounting Division for monitoring and evaluation of those terms of the lease related to revenue generation.

RESPONSIBLE PARTY: Public Works

COMPLETED BY: Public Works will assign a contract administrator by December 1, 2011. Public Works will evaluate resources required to execute proper management and oversight responsibility for this lease and for other existing leases for which they are assuming responsibility, and submit associated budget requests, if necessary, during the 2012/13 operating budget development process.

2. **Some expenses appear questionable and clarification is needed for others.**

   Recommendation:
   The Public Works Executive Director, together with the City Attorney's office and the Finance & Accounting Division, should seek to clarify terms of the Ground Lease agreement regarding allowable expenses.

MANAGEMENT RESPONSE: Management concurs with the recommendation.

PROPOSED RESOLUTION: As part of its contract administration responsibilities, Public Works will work with ASUF to clarify terms of the lease agreement identified in the audit report. Public Works will coordinate this effort with the Finance and Accounting Division, the City Attorney's Office, and the Community and Economic Development Division. The resolution of this issue could potentially be in the form of a lease amendment providing additional detail to existing terms.

RESPONSIBLE PARTY: Public Works

COMPLETED BY: JULY 1, 2012

City Auditor's Office
4021 N. 75th St., Suite 105
Scottsdale, Arizona 85251
(480) 312-7756
www.ScottsdaleAZ.gov/departments/City_Auditor

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