CITY AUDITOR'S OFFICE

Fairmont Scottsdale Princess Lease Agreement

June 9, 2015

AUDIT REPORT NO. 1505

June 9, 2015

Honorable Mayor and Members of the City Council:

Enclosed is the audit report for *Fairmont Scottsdale Princess Lease Agreement*, which was included on the Council-approved FY 2014/15 Audit Plan.

Our audit found that former City staff elected to forgo about $134,000 in lease rent for calendar year 2011 by allowing a different rent calculation than was in the Council-approved lease agreement. Additionally, management can improve lease agreement monitoring by formally designating a Contract Administrator and ensuring timely and complete compliance with the agreement terms.

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

Sincerely,

Sharron Walker

Sharron E. Walker, CPA, CFE, CLEA
City Auditor

Audit Team:

Cathleen Davis, CIA - Senior Auditor
Brad Hubert - Internal Auditor

TABLE OF CONTENTS

EXECUTIVE SUMMARY

This audit of *Fairmont Scottsdale Princess Lease Agreement* was included on the Council-approved FY 2014/15 Audit Plan. This audit was conducted to review compliance with contractual requirements and contract administration of the Fairmont Scottsdale Princess lease agreement.

In December 1985, the City entered into a ground lease agreement with the Scottsdale Princess Partnership (Princess), to develop a major resort on City-owned property. The initial 99-year agreement required the Princess to develop and operate a full-service, first class resort hotel facility. In return, the Princess was to pay the City an annual rent of 2% of gross sales.

The most recent amendment, in March 2012, changed the rent calculation from 2% of gross sales to a fixed annual amount plus an additional percentage if the Princess reaches a specified gross sales threshold. This amendment also allowed wireless communication facilities on the property, subject to a required rent of 50% of all wireless gross sales. Our audit primarily reviewed contract administration and compliance with terms effective as of this amendment.

Our audit found that former City staff elected to forgo payment of about $134,000 from the Princess for calendar year 2011 by allowing a change to the rent calculation that was not approved by City Council. Additionally, a Contract Administrator has not been formally assigned to monitor and enforce this agreement. Staff primarily fulfilling the Contract Administrator role can improve compliance with contract terms, including ensuring timely payments, identifying when additional rent payments are required, and obtaining sinking fund and insurance documentation. As well, staff designated as the Contract Administrator should direct all payments to the City’s remittance processing section to maintain proper separation of duties.

BACKGROUND

In December 1985, the City entered into a ground lease agreement with the Scottsdale Princess Partnership, currently FMT Scottsdale Owner LLC (Princess), to develop a major resort on City-owned property at Scottsdale Road and Frank Lloyd Wright Boulevard. The initial 99-year agreement required the Princess to develop and operate a full-service, first class resort hotel facility at this location, next to the TPC Scottsdale golf course. In return, the Princess was to pay the City an annual rent of 2% of its gross sales.

From 2009 until 2012, a Parks & Recreation Manager from the Community Services Division served as contract administrator for this agreement. In February 2012, the Real Estate section of the Public Works Division began assisting with contract administration duties. However, staff in the former Community & Economic Development Division negotiated the most recent amendment, which occurred in early 2012.

Original Agreement

Under the initial agreement, the Princess agreed to construct a hotel containing at least 400 but no more than 600 rooms, including meeting areas of at least 10,000 square feet. Additional conditions included construction of:

- Two restaurants of at least 10,000 square feet
- Bars, lounges and/or nightclubs of at least 2,000 square feet
- A health spa of at least 1,500 square feet
- Retail areas of at least 1,000 square feet
- Tennis facilities and swimming pool

> Built on City land, the Fairmont Scottsdale Princess is owned by FMT Scottsdale Owner LLC, a subsidiary of Strategic Hotels and Resorts, a real estate investment trust specializing in luxury hotels and resorts.
>
> The owner contracts with FRHI Hotels & Resorts to operate the property under the Fairmont brand.

The Princess was also required to establish a separate sinking fund equaling at least 3% of annual gross sales starting in the 5th lease year.[1] Use of this fund is restricted to purchasing and replacing furniture, fixtures and equipment and making capital expenditures. While the agreement only requires 3%, the Princess funds this account with 4% of annual gross sales and stated that this is industry practice.

Amendment Nos. 1 - 3

In November 1986, an amendment granted the right of first refusal to the Princess to purchase the property in the event the City desired to sell its interest. Another amendment in April 1995 allowed the hotel to enlarge the hotel to a maximum of 794 rooms.

A third amendment in May 2003 allowed certain real property improvements, including landscaping and a decorative wall, that the Princess constructed in 1987 to remain on a

[1] Sinking fund amounts ranging from 1% to 2.5% were required during the first 4 years of the agreement.

corner parcel owned by the federal Bureau of Reclamation (BOR).[2] This amendment requires the Princess to pay the City rent for this corner parcel at least 30 days prior to the date the City is required to pay its rent to the BOR.

Figure 1. Fairmont Scottsdale Princess Location

SOURCE: Map on the left is from the City's Land Information System; inset map and photo from www.fairmont.com/scottsdale.

[2] Rather than enter into an agreement directly with the Princess, the BOR preferred to amend its existing agreement with the City and allow the City to amend its contract with the Princess.

Amendment No. 4

The fourth amendment, effective in March 2012, required the Princess to construct a large ballroom and allowed wireless communication facilities on the property. Specific amendment provisions included the ballroom project requirements, a parking easement dedication, a revised annual rent calculation, and permitted uses related to wireless communication facilities.

As summarized in Table 1, the amendment provided that, starting July 1, 2011, the annual rent calculation changed to a fixed annual amount plus an additional percentage should the Princess reach specified gross sales. On January 1, 2021, the rent calculation reverts back to 2% of hotel gross sales.

Additionally, this amendment permits limited wireless communication facilities to be located on the property. The Princess is required to pay the City 50% of all gross sales received from the rental of real property for wireless communication facilities. This amendment also extended the original 99-year agreement for an additional 25 years after the ballroom was completed, which was in October 2012.

Table 1. Ground Lease Rent Calculations

Period Covered	Annual Fixed Rent	Hotel Gross Sales Percentage	Wireless Gross Sales Percentage
January 1986 to June 2011	None	2%	2%
July 2011 to December 2014	$1,500,000	1.25% of sales over $75 million	50%
January 2015 to December 2020	$1,500,000	1.5% of sales over $100 million	50%
January 2021 to January 2110	None	2%	50%

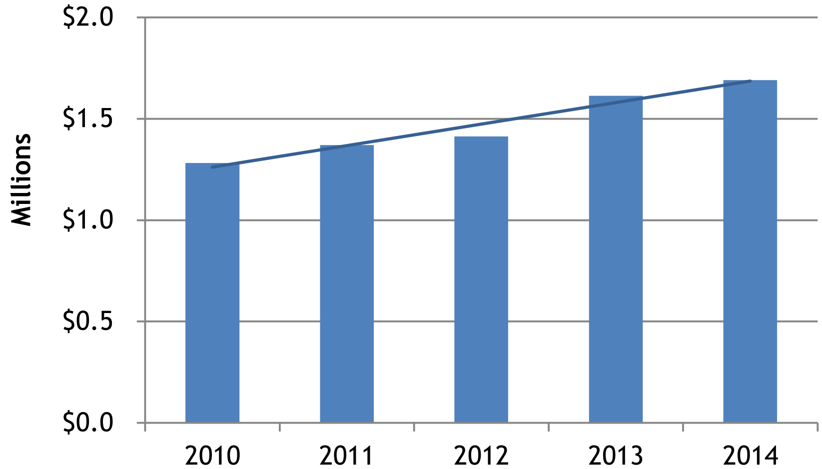
SOURCE: Auditor analysis of ground lease agreement and related amendments.

The Princess hotel currently has 649 guest rooms and 156,000 square feet of meeting space, and an expansion to construct 102 additional rooms is now underway.

Over the past five years, the City has received annual rents of almost $1.3 million in 2010 to nearly $1.7 million in 2014, as illustrated in Figure 2 on page 6.

(Continued on next page.)

Figure 2. Ground Lease Rents Received, 5-year Trend



SOURCE: Auditor analysis of Fairmont Scottsdale Princess rent payments to the City.

OBJECTIVES, SCOPE, AND METHODOLOGY

An audit of the *Fairmont Scottsdale Princess Lease Agreement* was included on the City Council-approved fiscal year (FY) 2014/15 Audit Plan. The audit objective was to review compliance with contractual requirements and contract administration of the Fairmont Scottsdale Princess lease agreement.

To gain an understanding of the City's contract administration of the Fairmont Scottsdale Princess (Princess) lease agreement, we interviewed Public Works' personnel, including the Senior Real Estate Manager and a Real Estate Management Specialist. In addition, we interviewed City personnel from Business Services, Parks & Recreation, Risk Management and Tourism & Events, and the Controller for the Princess.

We reviewed recent audit reports issued by this office relating to contract compliance, administration and lease/licensing agreements. We also reviewed Administrative Regulation (AR) 215 *Contract Administration* to gain an understanding of authoritative policies.

To gain an understanding of the agreement, we reviewed the Ground Lease, original contract no. 860224 (re-numbered as 860225-E1), four amendments and the associated council action reports.

To assess compliance with key contract requirements and evaluate whether the City has adequate controls to ensure effective administration of the agreement, we:

- Compared the revenue and revenue adjustments presented in the *Schedule of Gross Sales,* which was prepared by the Princess and audited by Deloitte & Touche LLP, to the Princess' chart of accounts and transaction privilege tax reporting for calendar years 2011 through 2014.
- Reviewed the City's accounts receivable records and the Contract Administrator's files to determine if the Princess' rent and BOR rent reimbursement payments to the City were timely.
- Recalculated the gross sales amounts, included in the *Schedules of Gross Sales* and supporting documents, and the application of contract rates to ensure the Hotel Gross Sales, Wireless Gross Sales, and total due to the City were calculated correctly.
- Reviewed four wireless agreements to determine that the City's 50% share was properly calculated, including testing the Consumer Price Index to verify contracted lease increases.
- Verified that the Princess maintained the required sinking fund of at least 3% of annual gross sales, and reviewed sinking fund expenditures to determine if expenditures were for allowable purposes - the replacement of furniture, fixtures and equipment, maintenance, repair and/or capital expenditures.
- Determined that the Princess fulfilled the ballroom construction specified in the fourth amendment.
- Reviewed key contract documents to determine if the contract files, including payment documentation, were reasonably maintained and if the Contract

Administrator had an active role in identifying and resolving issues with the contract's terms and conditions. We also confirmed the City's Contract Administrators Academy training was completed.

- Evaluated, with the assistance of the City's Risk Management Director, whether certificates of liability insurance and evidence of property insurance provided by the Princess complied with the agreement.

Our audit found that former City staff elected to forgo rent payment of about $134,000 from the Princess for calendar year 2011 by allowing a different rent calculation than was in the Council-approved lease agreement. Additionally, current contract administration and oversight of the lease agreement can be improved.

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 from April through May 2015.

FINDINGS AND ANALYSIS

1. City staff did not collect about $134,000 in rent due from the Fairmont Scottsdale Princess for calendar year 2011.

Beginning on July 1, 2011, the fourth amendment changed the rent calculation from 2% of gross sales to a fixed annual amount of $1.5 million, plus an additional percentage of gross sales should the Princess reach a specified threshold. In addition, the Princess is required to pay the City 50% of gross sales received from wireless communication facility property rentals. However, the Princess continued making monthly rent payments based on 2% of gross sales through the end of 2011 and into 2012. The resulting rent underpayment is summarized in Table 2.

Table 2. Calculated Rent Compared to Rent Received, Calendar Year 2011

Month	Calculated Rent Due [1]	Actual Rent Paid	Difference
January	$128,459	$124,839	($3,620)
February	149,040	149,040	0
March	188,050	188,102	52
April	157,490	157,816	326
May	135,149	135,149	0
June	69,617	69,617	0
July	125,049	55,437	(69,612)
August	125,049	56,048	(69,001)
September	125,049	87,804	(37,245)
October	133,218	137,178	3,960
November	125,000	123,414	(1,586)
December	125,049	80,816	(44,233)
Monthly Payments	**$1,586,219**	**$1,365,260**	**($220,959)**
Additional Payment [2]	0	86,369	86,369
Total Payments	**$1,586,219**	**$1,451,629**	**($134,590)**

[1] These rent amounts are calculated based on the lease terms in effect for each month.

[2] The City received this additional payment in April 2012.

SOURCE: Auditor analysis of the ground lease agreement and related amendments, accounts receivable records and Contract Administrator files.

In January 2012, while the fourth amendment was being negotiated, the Princess provided a proposed rent calculation that calculated the annualized rent due under terms of the original agreement, called "Period One Rent Calculation Method," and the annualized amount due under the fourth amendment, called "Period Two Rent Calculation Method." These amounts are summarized in Table 3. The Princess proposed using 50% of each amount to calculate the total amount due for calendar year 2011.

In February 2012, the Public Works Division's Real Estate staff prepared two rent calculations for calendar year 2011. One calculation was based on the Princess' proposed methodology. The second calculated the first six months of 2011 at 2% of revenues using the Period One Rent Calculation Method and the second six months of 2011 using fixed amounts and additional payments as defined in the Period Two Rent Calculation Method. The Real Estate staff then provided these options to the Community & Economic Development Division staff involved in negotiating the fourth amendment.

Table 3. Proposed Rent Calculation Method Used, Calendar Year 2011

Rent Calculation Method	Annual Calculation	Proposed 2011 Rent: 50% of Each Annual Calculation
Period One	$1,365,262	$682,631
Period Two	1,535,149	767,574
Total		**$1,450,205**

SOURCE: Auditor analysis of Contract Administrator files.

According to e-mail communications at the time, former Community & Economic Development Division staff agreed to the Princess' proposed rent calculation. Subsequently, the Princess paid the additional $86,000. As a result, the City did not receive about $134,000 in rent revenue that would have been collected under the terms of the fourth amendment. Although these communications occurred prior to the fourth amendment approval, the decision to accept the Princess' proposed calculation for the 2011 rent was not disclosed in the Council action report for City Council approval.

Subsequently in early 2012, the Real Estate section of the Public Works Division began assisting with contract administration for this lease agreement.

Recommendation:

The Public Works Division Director should ensure that any rent calculations not made in accordance with the Council-approved agreement are presented to the City Council for approval.

2. Contract administration and oversight of the lease agreement can be improved.

A Contract Administrator has not formally been designated to monitor the agreement. Also, the staff primarily fulfilling Contract Administrator duties can more closely monitor monthly rent payments and better ensure segregation of duties is maintained. Further, the staff did not obtain complete documentation to demonstrate compliance with the terms of the agreement.

A. At this time, the Public Works Division's Real Estate section carries out most Contract Administrator duties. From 2009 until 2012, a Parks & Recreation Manager served as Contract Administrator. In March 2012, Community & Economic Development staff recommended to Council approval of the fourth amendment. However, at the time of our review, it was not clear that full responsibility for contract administration had been formally designated. Administrative Regulation (AR) 215 *Contract Administration* requires that each City contract is assigned a Contract Administrator responsible for monitoring all aspects of the written contract. Lack of a specific assignment for contract administration can increase the risk that key terms, conditions and specifications of the agreement will not be monitored and enforced.

B. The staff carrying out contract administration duties has not ensured rent payments comply with the agreement terms or identified when additional rent payments are required. Additionally, the staff has not ensured rent payments were timely.

   1. Although verifying that monthly rent payments were received, the staff did not determine that the monthly rent payments complied with terms of the agreement. As a result, the Princess continued to submit rent payments during 2012 based on prior rent calculation terms. More than a year passed before the error was identified and remedied.

      Additionally, the standard accounts receivable billing documents do not remind the Princess to provide gross sales, as required by the terms of the agreement, that could be used by the Contract Administrator to verify the accuracy of rent payments.

   2. Over the past four years, approximately 75% of the Princess rent payments were paid later than the required date, the 20th of the following month. Payments averaged 5 days late, and ranged from 1 to 10 days late. Further, only one of the last four annual payments for the BOR property use was received by the contractual due date. AR 215 *Contract Administration* states that the Contract Administrator should ensure that payments are submitted to the City on a timely basis.

C. The Real Estate staff does not always maintain appropriate segregation of duties for accounts receivable. In two instances upon determining the Princess owed additional amounts, the Real Estate staff requested rent payments to be mailed directly to their office rather than to the City's Remittance Processing unit. Proper segregation of duties provides that incompatible duties of custody of assets, authorization of the related transactions, and recording or reporting those transactions, be separated to provide adequate checks and balances. Segregation of duties was especially important since these rent amounts were in addition to the regularly anticipated receipts.

D. Two compliance requirements were not well documented. AR 215 *Contract Administration* requires the Contract Administrator to monitor performance of the contractors to the terms of the agreement.

1. The ground lease provides that the "Lessee shall deliver to Lessor an annual accounting with respect to the status of the sinking fund showing all deposits therein and all expenditures therefrom." While Real Estate staff requested sinking fund documentation and received copies of the sinking fund reconciliations for calendar years 2013 and 2014, the reconciliations do not provide a detailed accounting of the deposit and expenditure transactions. Further, no sinking fund accounting documentation was received or requested by staff for calendar years 2011 and 2012.
2. The staff performing contract administration duties did not maintain complete insurance certificates as required. While most of the insurance requirements had been met, coverage for workers' compensation and employer's liability insurance was not included in the Certificates of Insurance maintained. In May 2015, at our request, the Real Estate staff requested and the Princess provided certification of the required workers' compensation and employer's liability insurance.

Recommendations:

A. The Public Works Division Director should ensure management formally designates a contract administrator for this ground lease agreement and associated amendments. Additionally, management should develop a succession plan to ensure continuity of contract administration for long-term lease agreements.

The Contract Administrator should:

B. Monitor monthly rent payments to:
   1. Ensure the rent payments comply with the agreement terms. Further, the Contract Administrator should review sufficient gross sales documentation to ensure the monthly rent payments are calculated as required by the terms of the agreement.
   2. Ensure the rent payments are timely received as specified in the lease agreement and subsequent amendments.

C. Instruct the Princess to mail all payments to Remittance Processing to maintain appropriate segregation of duties.

D. Monitor the performance of the Princess to the terms of the agreement, including:
   1. Requiring the annual sinking fund accounting with documentation of sinking fund deposits and expenditures.
   2. Ensuring the insurance certificates are complete and include all types of required coverage.

MANAGEMENT ACTION PLAN

1. **City staff did not collect about $134,000 in rent due from the Fairmont Scottsdale Princess for calendar year 2011.**

   Recommendation:

   The Public Works Division Director should ensure that any rent calculations not made in accordance with the Council-approved agreement are presented to the City Council for approval.

MANAGEMENT RESPONSE: Agree

PROPOSED RESOLUTION: Contract Administrators for lease agreements will notify the Public Works Division Director of any rent calculations not made in accordance with Council-approved agreement. Such variation will be presented to City Council for approval.

RESPONSIBLE PARTY: Dan Worth, Public Works Division Director

COMPLETED BY: 06/02/2015

2. **Contract administration and oversight of the lease agreement can be improved.**

   Recommendations:

   A. The Public Works Division Director should ensure management formally designates a contract administrator for this ground lease agreement and associated amendments. Additionally, management should develop a succession plan to ensure continuity of contract administration for long-term lease agreements.

   The Contract Administrator should:

   A. Monitor monthly rent payments to:

      1. Ensure the rent payments comply with the agreement terms. Further, the Contract Administrator should review sufficient gross sales documentation to ensure the monthly rent payments are calculated as required by the terms of the agreement.

      2. Ensure the rent payments are timely received as specified in the lease agreement and subsequent amendments.

   B. Instruct the Princess to mail all payments to Remittance Processing to maintain appropriate segregation of duties.

   C. Monitor the performance of the Princess to the terms of the agreement, including:

      1. Requiring the annual sinking fund accounting with documentation of sinking fund deposits and expenditures.

      2. Ensuring the insurance certificates are complete and include all types of required coverage.

MANAGEMENT RESPONSE: Agree

PROPOSED RESOLUTION: A Contract Administrator has been designated. Should an existing Contract Administrator for long-term lease agreements be reassigned to other duties or resign from employment with the city, the Senior Real Estate Manager will immediately designate a new Contract Administrator and the lease database will be updated to reflect that change. Contract Administrator will monitor and maintain records for all lease performance responsibilities.

RESPONSIBLE PARTY: Martha West, Senior Real Estate Manager

COMPLETED BY: 06/02/2015

City Auditor's Office
7447 E. Indian School Rd., Suite 205
Scottsdale, Arizona 85251

OFFICE (480) 312-7756
INTEGRITY LINE (480) 312-8348

www.ScottsdaleAZ.gov/departments/City_Auditor

The City Auditor's Office conducts audits to promote operational efficiency, effectiveness, accountability, and integrity.