CITY FAILS TO HOLD TEAM SAN JOSE ACCOUNTABLE

Summary

Team San Jose (TSJ) is a private, nonprofit corporation that was created in December 2003 to bid for the management and operation of the San Jose Convention Center and five other cultural facilities in San Jose. It won a five-year contract with the City of San Jose (City) and began operations on July 1, 2004. The terms of the contract require the San Jose City Auditor (Auditor) to evaluate TSJ's performance annually based on four criteria specified in the contract. The audit for Fiscal Year (FY) 2004-2005, published in October 2006, stated that TSJ did not meet two of its four performance measures and did not gather enough information to assess a third; the fourth performance measure was set so artificially low that it was easily achieved. The agreement allows the City to cancel the contract if TSJ fails to meet three of its four performance measures, but the City has not cancelled the contract and TSJ continues to lose money at more than double the rate stipulated in its contract.

The 2006-2007 Santa Clara County Civil Grand Jury investigated this issue because the TSJ audit report exposed serious concerns about how City contracts are awarded and managed. The Grand Jury found that the contracting process that selected TSJ to manage the San Jose Convention Center and Cultural Facilities (SJCC/CF) was flawed. The request for proposals (RFP) for companies to manage these facilities did not provide enough information to produce accurate financial estimates, and criteria for evaluating the proposals to select the most qualified operator were applied inconsistently. During contract negotiations with TSJ, performance measures were established to ensure that TSJ was effectively marketing and managing the contracted facilities, and that it was fulfilling its financial obligations to the City. The Grand Jury found that the City has ignored substantial failings by TSJ to fulfill its contractual obligations. While the City agreed to provide nearly $2 million per year subsidy to TSJ by accepting an expected loss of $9.8 million over the five-year contract term, current losses to date have required a subsidy from taxpayers of nearly $4 million per year.

In regard to management and operations of the SJCC/CF, the Grand Jury recommends that the San Jose City Council direct the City Manager to:

- Not renew the contract with TSJ when it expires in June 2009;
- Begin working immediately with the Procurement Department and the Auditor to prepare a new RFP that better reflects the directives of the City Council and that includes necessary and sufficient information to select the most qualified responder;

- Validate financial assertions by responders that have economic consequences to the City. Follow new City procurement policy that requires validation of financial projections by the appropriate financial department within the City;

- Ensure that all responders meet all qualification requirements established in the RFP and that all selection criteria are applied equally to all responders;

- Establish more challenging performance measures that accurately reflect the intent and terms of the contract;

- Enforce contractual agreements to protect taxpayers from supporting failed operations.

Background

In June 2003, the City Council directed the City Manager's Office to prepare an RFP to find a new operator for the SJCC/CF. Until that time, these facilities were managed by the City Arts and Entertainment Department (CAE). The City was facing declining revenue, declining visitor attendance, and increasing cost for running these facilities over the previous three years, and it was looking for ways to improve efficiencies and reduce costs.

The RFP was issued in December 2003 and yielded four responses, one from CAE, one from the newly formed TSJ, and two from companies with national and international facility management experience. TSJ is a private, nonprofit corporation formed in December 2003 specifically to respond to the City's RFP. The weighted criteria used in the selection process to evaluate the proposals included 35 percent for marketing plan, 35 percent for financial proforma, 20 percent for qualification and experience, and 10 percent for transition plan. In accounting, a "proforma" is a presentation of financial figures based on previous business operations for estimate purposes. TSJ's marketing plan and proforma were key to its being awarded a five year contract to operate and manage these facilities from July 1, 2004, through June 30, 2009.

The contract is governed by a Management Agreement that defines performance measures to ensure that TSJ is complying with its obligations to the City. These performance measures set targets for gross revenue, net operating loss, economic impact, and customer satisfaction. The Management Agreement also requires annual financial and performance audits as oversight of the operations. In October 2006, the Auditor issued its first performance audit for FY 2004-2005. Of the four performance measure targets, the gross revenue target and net operating loss target were not met, and TSJ had not collected sufficient data to determine whether the customer satisfaction target was met; the economic impact target was met, but the Auditor was critical that the target was set too low.

After reviewing the report, the Grand Jury was interested in how TSJ has been performing since the end of the first year of operation. Additionally, the Grand Jury reviewed the RFP, the proposal from TSJ, the Management Agreement, and financial and operations reports from the last eighteen months. The Grand Jury also interviewed officials from the City and from TSJ. This investigation exposed serious deficiencies in the selection process and the management of this contract.

Discussion

The Grand Jury is concerned about three areas of the TSJ contract: (1) the RFP and operator selection process is flawed; (2) the Management Agreement between the City and TSJ specifies performance measure targets, which govern oversight of the contract, that are ineffective; (3) the City has failed to hold TSJ accountable for not achieving agreed performance targets.

The Selection Process

Several factors indicate that TSJ was given an unfair advantage in the selection of the most qualified responder.

First, the information provided in the RFP was not sufficient to produce an accurate financial estimate by the responders of the cost of operations. In their proposal, TSJ prepared a proforma that projected a net loss of $4.3 million over the five-year term of the contract, based on the information provided in the RFP. However, during the course of the Management Agreement negotiations, the proforma projection for net loss was increased to $9.8 million. In the recommendation to the City Council, the City Manager attributed this increase "…to decreased revenue projections, as well as additional expenditures to fully cover City civil service staff salaries and benefits, increased utility costs and other non-personal costs." TSJ was granted the right to enter exclusive negotiations for this contract based in large part on its significantly lower projected cost to the City over the term of the contract. Global Spectrum was ranked second in the evaluation process and projected a five-year loss of $9.7 million. Information provided by the City during the negotiation process allowed TSJ to more than double its projected loss so that its financial projections were then equivalent to the Global Spectrum. None of the other responders was allowed to provide a revised proposal based on this new information.

Secondly, the stated objective of selecting a new operator was to decrease cost of operations and increase the occupancy and revenue-producing capabilities of the facilities. CAE was the previous operator and was a City department comprised entirely of City employees. CAE was only responsible for facility operations, not for producing revenue through marketing its facilities. The San Jose Convention and Visitors Bureau (CVB) is a nonprofit organization that contracts with the City to provide marketing and advertising to book conventions and other events at the SJCC/CF. Typically, public facility management companies include both marketing and management functions in their contracts. When preparing the RFP, the City decided to make it more comparable to similar contracts in the industry by including both functions. TSJ made an arrangement with CVB to provide the marketing operations in their proposal, but did not include CVB's costs in their financial projections. All of the other responders included marketing costs in their estimates.

In FY 2003-2004, the year before TSJ assumed control of SJCC/CF, CVB received a subsidy of $4.7 million. Currently, in FY 2006-2007, the City is providing $5.2 million in subsidies to CVB. The *Convention and Visitors Bureau Second Amended and Restated Agreement*, dated May 31, 2005, stated that "…the Council amended and restated the earlier Agreement to have it reflect the changes in the management and operation of the Convention and Cultural Facilities by Team San Jose, Inc." and yet the CVB subsidy continues to increase while marketing is purportedly an integral part of the TSJ agreement. In response to the City Manager's Office regarding TSJ's failure to include marketing costs in its proposal, TSJ wrote:

> Team San Jose purposely elected not to designate discrete dollar amounts for the sales and marketing efforts of the Convention Center and Cultural facilities because, in actual fact, the lion's share of the Convention & Visitors Bureau budget and a substantial portion of Team San Jose's overall proposed budget is tightly focused and inextricably woven into the enhanced positioning and selling of these facilities.

Later in the memorandum, TSJ estimates that 75 percent of the CVB subsidy is for marketing the SJCC/CF. Had another company been awarded the contract, it would have been responsible for marketing the SJCC/CF and the CVB subsidy would have been reduced by as much as $3.5 million dollars annually. The City accepted this explanation and ignored CVB expenses that relate to SJCC/CF marketing when comparing the TSJ financial projections to the other responders.

Finally, 20 percent of the evaluation criteria in the selection process was "qualification and experience" of the responder in managing event centers. TSJ was formed in December 2003 specifically to respond to this RFP and thus had no experience as a corporation in this business. By comparison, Global Spectrum, the second ranked responder, had operated since 1994 and was managing 36 public facilities across the United States at the time of the proposal.

The Management Agreement

The key elements of the Management Agreement are the performance measures, including gross revenue, net loss, economic impact, and customer satisfaction. Well-defined performance measures are essential to effectively manage a contract. The Grand Jury is concerned about the quality of the targets negotiated in the Management Agreement.

The gross revenue and net loss targets were established from TSJ's financial projections. The Auditor found that neither of these targets was met; revenues were less than required, and net loss was more than allowed by the Management Agreement. The City agreed to financial goals established during the negotiation process. The five-year gross revenue target averaged $10.4 million per year, and the five-year net loss target averaged just under $2 million per year. Both targets compare favorably with the previous operator, CAE, which averaged $6.9 million in gross revenue and $6.1 million per year in net loss over the previous four fiscal years. While TSJ has increased revenue and decreased losses compared to CAE, it has not met the targets contracted with the City. TSJ's first year revenue was only $8.7 million, and its net loss was over $3.7 million. It should be emphasized that the subsidy to CVB for marketing costs has not been included in TSJ's net operating loss for the purpose of evaluating their true cost to the City.

The other two performance measures in the agreement were economic impact and customer satisfaction. Economic impact represents additional income to the City from tax revenue from visitors' spending on hotel rooms, meals, and shopping. In the Management Agreement, this is measured by counting attendees at SJCC/CF events. For FY 2004-2005, TSJ reported more than 996,000 visitors to its events, exceeding its target of 577,000 visitors. The Auditor declared this target is "set too low", at an average of 703,000 visitors per year, since the previous four year average of CAE was more than 1 million visitors per year. Customer satisfaction is measured by summarizing questionnaires voluntarily submitted by event planners. The questionnaires poll various topics of quality, timeliness, effectiveness, and performance of services provided. The Auditor found that data collection was too irregular and sparse to determine whether this target was met. In the first year, only 10 percent of event planners completed the questionnaire.

The results of performance measures demonstrate that TSJ was not fulfilling its contractual obligations to the City. The Management Agreement requires TSJ to meet at least three of the four performance measure targets each year, and to achieve a specified minimum percent of each target measure. At the end of its first year of operation, TSJ had failed to meet its obligations.

Recent Performance

To complete its evaluation, the Grand Jury examined TSJ's performance since the Auditor's FY 2004-2005 report. Neither gross revenue nor net loss targets have ever been met. The following chart compares the financial estimates agreed to in the Management Agreement to actual gross revenue and actual net loss for the first two years, and to projected gross revenue and net loss for the last three years of the contract. In this chart, "net loss" reflects expenses after management fees but before City oversight expenses.

(dollars in $000)	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**
	Management Agreement Targets				
total revenue	$8,698	$9,943	$10,600	$11,303	$11,739
net profit (loss)	($3,745)	($1,996)	($1,432)	($975)	($836)
	Actuals		**Projected**		
total revenue	$7,159	$8,794	$9,792	$10,000	$10,500
net profit (loss)	($4,629)	($3,953)	($3,594)	($4,000)	($3,950)
	Actuals vs Agreement		**Projected vs Agreement**		
total revenue	82%	88%	92%	88%	89%
net profit (loss)	124%	198%	251%	410%	472%

In March 2007, TSJ presented its budget report to the City. The presentation included statistics about improving visitor attendance, revenue, and expenses as well as budgets for the remaining two years of the contract. Based on actual revenue and expense figures for the first two years and on TSJ's estimates for the last three years of the contract, TSJ will fail to meet these two performance measures in every year of the contract. Revenue will remain near 90 percent of their contractual agreement. Net loss will remain constant at approximately $4 million per year, rising from 25 percent over budget in the first year to almost 500 percent over budget in the last year. TSJ contends that its revenues and visitor attendance is increasing every year, yet the bottom line to the taxpayer is that it will cost $4 million per year for TSJ to continue to fail. Increasing revenues have had no impact on net loss, indicating expenses that are out of control.

City officials referenced a study by Strategic Advisory Group LLC in June 2003 that indicated salaries and benefits were primarily responsible for the high cost of SJCC/CF operations. In comparing San Jose to ten comparable cities, San Jose had the highest cost of operations at $58.90 per square foot compared to an average cost of $33.50 per square foot. Salary and benefit costs alone for San Jose were $33.30 per square foot, more than double those costs for the other cities and equal to the total cost of operations for the other cities. However, TSJ was aware of these costs during negotiations with the City and voluntarily committed to retain existing CAE staff in their operations plan. Since these costs were included in their financial projections, they do not explain why TSJ has so significantly exceeded its estimates.

TSJ had no experience in facility management and, as a result, its proforma was overly optimistic compared to an experienced vendor in both revenue and net loss. The proforma for Global Spectrum, the second ranked responder in the RFP process, projected $45.3 million in revenue and a loss of $9.7 million over five years. TSJ's original proforma projected $52.7 million in revenue and a loss of $4.3 million over five years. At the end of the negotiations with the City, TSJ projected a loss of $9.8 million, the same as Global Spectrum. TSJ's April 2007 financial statements now project total five year revenue of $45.8 million, the same projection as Global Spectrum, but projected net loss has grown from $9.8 million to $20.1 million.

City officials told the Grand Jury that they are encouraged that higher than expected losses from TSJ are somewhat offset by increased revenue from the Transient Occupancy Tax (TOT), a 10% tax paid to the City on hotel room rental charges. In FY 2003-2004, the last year that CAE managed SJCC/CF, TOT revenue was $8.5 million and has increased to a projected $11.3 million for FY 2006-2007. However, not all of the $11.3 million is generated from TSJ events at SJCC/CF. TSJ hopes to book 251,251 hotel room-nights in conjunction with their events for FY 2006-2007. At an average room rate of $125 per night at convention center hotels, this would represent $3.1 million total TOT revenue from TSJ bookings. Assuming the same percentage of hotel bookings, FY 2003-2004 TOT revenue from event visitors would have been $2.4 million. The approximately $700,000 annual increase in TOT revenue from the time TSJ took over control from CAE does not begin to offset the $2 million in excess subsidies paid to TSJ each year by the City.

It bears repeating that CVB marketing costs are not reflected in these figures. Even though TSJ is responsible for marketing SJCC/CF, in addition to the annual $4 million subsidy to TSJ, CVB receives an additional $3.9 million subsidy from the City annually for that work. As stated earlier, TSJ estimated that 75 percent of the CVB subsidy is needed for SJCC/CF marketing, as shown in the following chart.

Fiscal Year	CVB Subsidy ($000)	75% of CVB Subsidy ($000)
2002-03	$4,996	$3,747
2003-04	$4,661	$3,496
2004-05	$4,423	$3,317
2005-06	$4,807	$3,605
2006-07	$5,197	$3,898

Conclusion

The City failed its responsibility in selecting TSJ as the best qualified operator for SJCC/CF. The RFP was poorly written and the selection criteria were applied inequitably. TSJ was selected in large part on the strength of its financial estimates, but it was allowed to more than double its estimated loss with information provided only to it during the negotiation process; in fact, its estimated losses would have been even higher had they been required to include the CVB marketing costs. Likewise, its marketing plan represented another significant factor in selecting TSJ, even though CVB continues responsibility for marketing the facilities as a separate entity from TSJ and continues to be subsidized by the City for its work. Finally, 20 percent of the scoring in the selection process was based on experience in the industry, even though TSJ was a new company that had never managed an event facility.

The City has also failed to enforce the TSJ contract at the expense of taxpayers. It is disconcerting that the City constructed a Management Agreement with specific performance requirements, and then fails to enforce the contract when requirements are not met. The Management Agreement states that TSJ must produce a certain level of revenue and must not exceed a certain level of loss or the contract may be cancelled. TSJ agrees that it has failed on both counts and that the subsidy it requires is double what the City agreed to pay. There has been no consequence to TSJ for its failure to perform, since the City continues to pay the extra subsidy and TSJ retains its contract.

The Grand Jury recommends that when the contract period ends in June 2009, the City should not renew the contract with TSJ. The City should issue a new RFP for this contract to identify a new operator that can achieve the original objectives of City Council, namely, decreasing costs of operation and increasing the occupancy and revenue producing capabilities of the facilities. According to the new policy adopted by the Procurement Department and approved by the City Council, any service contract valued at more than $250,000 must have Procurement Department involvement with help from the Auditor as needed. The City should take advantage of such professional expertise in preparing the new RFP to ensure that terms and conditions of service, and performance measures in the Management Agreement are understood and examined before seeking proposals.

Findings

The following findings were reviewed with the subject agency:

F1: TSJ has failed to meet its contractual obligations to the City.

F2: The RFP did not include significant information that was necessary for responders to prepare accurate financial proposals.

F3: TSJ, while intending to reduce operating loss, placed undue restrictions on itself regarding salaries and benefits by retaining specific City employees who had been working for CAE. These restrictions have had a negative impact on its ability to control expenses.

F4: In selecting the operator, proposals were not evaluated equally for all responders.

- During negotiations, it was found that TSJ's projected net loss was inaccurate by more than 100 percent.
- Even though marketing was an explicit component of the RFP, marketing costs were left out of the TSJ proposal, thereby allowing it to present a more attractive proforma than other responders.
- TSJ was deemed the most qualified of those competing for the contract even though it had no previous experience operating or managing any event facility.

F5: The measures used to evaluate TSJ's contractual performance are inadequate and ineffective.

F6: Rather than cancel the contract as allowed under the terms of the Management Agreement, the City has chosen to support TSJ at more than double the anticipated subsidy at taxpayers' expense.

Recommendations

The 2006-2007 Civil Grand Jury recommends that the San Jose City Council direct the City Manager to take the following actions:

R1: Not renew the contract with TSJ when the contract period expires in June 2009.

R2: Begin working immediately with the Procurement Department and the Auditor, in accordance with the new City procurement policy, to prepare a new RFP that better reflects the directives of the City Council and that includes necessary and sufficient information to select the most qualified responder.

R3: Validate financial assertions by responders that have economic consequences to the City. Follow new City procurement policy that requires validation of financial projections by the appropriate financial department within the City.

R4: Ensure that all responders meet all qualification requirements established in the RFP and that all selection criteria are applied equally to all responders.

R5: Establish performance measures that accurately reflect the intent and terms of the contract.

R6: Enforce contractual agreements to protect taxpayers from supporting failed operations.

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April 6, 2007	Official, City of San Jose Mayor’s Office.

PASSED and **ADOPTED** by the Santa Clara County Civil Grand Jury on this 19th day of June 2007.

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