



Office of the City Auditor

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

**2012-13 ANNUAL
PERFORMANCE AUDIT OF
TEAM SAN JOSE'S
MANAGEMENT OF THE
CITY'S CONVENTION AND
CULTURAL FACILITIES**

**Report 13-09
October 2013**

October 10, 2013

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

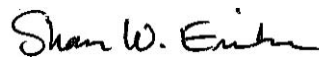
2012-13 Annual Performance Audit of Team San Jose's Management of the City's Convention and Cultural Facilities

Since 2004, the San José McEnery Convention Center and several other facilities have been operated on the City's behalf by Team San Jose, Inc. Under the terms of the Management Agreement between Team San Jose (TSJ) and the City, the City Auditor annually audits TSJ's management of the facilities. Our objective is to determine whether, and how well, TSJ achieved its agreed-upon performance goals and incentive fee targets that are the basis for the City's incentive payments to TSJ.

Team San Jose Achieved a Weighted Incentive Fee Score of 160 Percent. In FY 2012-13, TSJ drew 1.1 million people to events at the Facilities and booked nearly 248,000 future hotel room nights. It met all and, in most cases, far exceeded economic impact and fiscal performance targets, in large part because of efforts to mitigate client concerns about the renovation and expansion of the Convention Center, smaller-than-anticipated construction impacts, and an improving economy. It achieved its customer service goal for the eighth straight year, and surpassed theater performance targets for the first time in three years. TSJ's weighted incentive fee score of nearly 160 percent corresponds to a maximum incentive fee of \$350,000.

We will present this report at the October 17, 2013 meeting of the Public Safety, Finance, and Strategic Support Committee. We would like to thank Team San Jose, the City Manager's Office, the Department of Transportation, the Finance Department, and the City Attorney's Office for their time and cooperation during the audit process. The Administration has reviewed and agrees with the information in this report.

Respectfully submitted,



Sharon W. Erickson
City Auditor

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Introduction

In accordance with the City Auditor's fiscal year (FY) 2013-14 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 and Center and Cultural Facilities Between the City of San José and Team San Jose, Inc.* (Management Agreement) for FY 2012-13.

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, 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. We limited our work to those areas specified in the "Audit Objective, Scope, and Methodology" section of this audit report.

The City Auditor's Office thanks the management and staff of Team San Jose, Inc., the City Manager's Office, the Department of Transportation, the Finance Department, and the City Attorney's Office for their time, information, insight, and cooperation during the audit process.

Background

The San José Convention and Cultural Facilities (the Facilities) consist of the San José McEnery Convention Center, San José Civic, Parkside Hall, South Hall, Center for the Performing Arts, California Theater, and Montgomery Theater. These seven venues offer trade show exhibits, conventions, corporate meetings, social events, consumer shows, and performing arts.

Team San Jose, Inc., a non-profit corporation, was formed in December 2003 in response to the City's request for proposal (RFP) for the management and operations of the convention center, which was formerly managed by the City's Department of Convention, Arts, and Entertainment. TSJ has a 15-member board of directors that includes representatives from local hotels, arts, business, and labor. It also includes a City Council liaison and an ex-officio member from the City Manager's Office. TSJ's management agreement with the City requires the City Auditor's Office to conduct an annual audit of the performance measures in the agreement.

Contract History

The City entered into a Management Agreement with Team San Jose to operate and manage the Facilities for the five-year period from July 1, 2004 through June 30, 2009. On August 13, 2009, the City exercised its option to extend the original term for one additional five-year period through June 30, 2014.

In August 2010, the City issued TSJ a notice of default because TSJ's FY 2009-10 expenditures exceeded its operating budget by more than \$750,000, a violation of the terms of the Management Agreement. This resulted in a number of actions including an expanded performance audit by the City Auditor, and Council later directed the City Manager to begin development of an RFP for management of the convention center and cultural facilities and services provided under the Convention and Visitors Bureau (CVB).

In March 2011, the Council adopted a second amendment to the Management Agreement that reflected recommendations from the City Auditor's FY 2009-10 Annual Performance Audit. As of June 30, 2011, Team San Jose was no longer in default of the Management Agreement, and in December 2011, the Council voted to discontinue work on the Request for Proposal for the management of the Facilities.

In September 2012, the Council adopted a third amendment to the Management Agreement, effective FY 2012-13, to clarify and redefine the methodology for the *gross operating profit* and *return on investment* performance measures.

Finally, in October 2012, the City Council directed the City Manager to negotiate a new five-year agreement with Team San Jose. Negotiations were ongoing as of October 2013.

Convention Center Expansion

The Convention Center recently underwent renovation and expansion. Construction began in Summer 2011, though the most disruptive work began in Summer 2012. The expansion added an additional 125,000 square feet of flexible ballroom and meeting room space, increasing San José's convention center space to 550,000 square feet of usable space. The 125,000 total square feet of new, flexible space includes:

- 25,000 square feet of flexible meeting space
- 35,000 square feet of flexible ballroom space
- Renovation and integration with the prior structure
- The new construction is a new footprint that expanded the square footage with minimal impact to the prior convention center.

In May 2011, TSJ began selling the new expansion space with Convention and Visitors Bureau sales staff. The Convention Center was open during construction and celebrated grand re-opening events in September and October 2013.

Performance and Incentive Fee Measures

The June 2009 addendum to the Management Agreement clarified performance measures and incentive pay. It requires TSJ to submit annual targets for the following performance measures and incentive fee measures, used to determine incentive pay, for City review and joint agreement (under the prior agreement, targets were set during contract negotiations for the entire five-year term of the agreement). Exhibit I shows these measures and their weighting.

Exhibit I: Performance and Incentive Fee Measure Weighting

Performance Measures		Incentive Fee Measures	
Economic Impact	40%	Economic Impact	40%
Hotel Room Nights (10%)		Hotel Room Nights (15%)	
Attendance (10%)		Attendance (10%)	
Estimated Economic Impact (10%)		Estimated Economic Impact (15%)	
Return on Investment (10%)			
Gross Operating Profit	40%	Gross Revenue	40%
Theater Performance	10%	Theater Performance	10%
Performance Days (7%)		Performance Days (7%)	
Occupied Days (3%)		Occupied Days (3%)	
Customer Service Survey Results	10%	Customer Service Survey Results	10%
Total	100%	Total	100%

Source: Second Amendment to Management Agreement between Team San Jose and the City

The second and third amendments to the Management Agreement have clarified and redefined the weightings of and methodologies for calculating measures over time.¹ 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 net profit; hence, the incentive fee measures used to determine TSJ's incentive pay differ slightly from the general performance measures.

Performance-Based Contracting Requires Challenging Incentives

Incentive contracts, such as the City's Management Agreement with Team San Jose, have been common in government for several decades. In 1998 Best Practices for Performance-Based Service Contracting,² the White House Office of Management and Budget described performance-based contracts as follows:

¹ Appendix A describes the methodology for calculating each individual measure in detail.

² Although the Best Practices document was subsequently rescinded, its overall message is echoed in Federal Acquisition Regulation and in the National Institute of Government Purchasing's guidance on performance based contracting.

Performance-based service contracting (PBSC) emphasizes that all aspects of an acquisition be structured around the purpose of the work to be performed as opposed to the manner in which the work is to be performed or broad, imprecise statements of work which preclude an objective assessment of contractor performance. It is designed to ensure that contractors are given freedom to determine how to meet the Government's performance objectives, that appropriate performance quality levels are achieved, and that payment is made only for services that meet these levels.

Concerning incentives, the best practices caution that:

Care must be taken to ensure that the incentive structure reflects both the value to the government of the various performance levels, and a meaningful incentive to the contractor. Performance incentives should be challenging yet reasonably attainable. The goal is to reward contractors for outstanding work, but not penalize them for fully satisfactorily but less than outstanding work.

From FY 2009-10 to 2012-13, the City's setting of "challenging yet reasonably attainable" targets was impacted by external factors.³ During this period, the City generally lowered targets because of economic uncertainty and anticipated disruptions from the convention center's renovation and expansion. In hindsight, the City expected construction would begin sooner than it did and may have overestimated its impact (or underestimated TSJ's ability to mitigate the impacts).

In our opinion, it is critical that targets incent a challenging, yet attainable, level of performance on the part of Team San Jose. With the recent grand re-opening of the Convention Center, the City can establish more challenging targets.

Audit Objective, Scope, and Methodology

The objective of our audit was to determine whether TSJ met its performance and incentive fee measures for FY 2012-13. To do so we:

- Obtained and reviewed relevant documents including: the Management Agreement and its addendum and amendments, Council-adopted performance targets for FY 2009-10 to 2012-13, TSJ's performance reports, the FY 2012-13 final audited financial statement for the Facilities, the convention center debt service schedule, parking garage revenue and expense reports, Budget office reports for the Convention and Cultural Affairs Fund, TSJ's attendance and theater records, the agreed-upon procedures for hotel-room night bookings performed by Petrinovich, Pugh, and Company on TSJ's behalf, and TSJ's customer service surveys for the year;

³ Appendix B charts TSJ's performance and targets since FY 2004-05.

- Interviewed management and staff from TSJ, the City Manager's Office of Economic Development and Budget Office, and the City Attorney's Office about the performance measures and TSJ's accomplishments for the year;
- Tested the accuracy and completeness of TSJ's recording of the number of occupied and performance days for theaters, and attendance at convention and cultural events during the year; and
- Tested the accuracy of TSJ's computation of gross revenue, gross operating profit, and return on investment using the audited financial statements and the Management Agreement's methodologies, and its estimation of economic impact using approved economic models.

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Finding I Team San Jose Achieved a Weighted Incentive Fee Score of 160 Percent

Summary

The Management Agreement requires Team San Jose to report annual performance compared to established targets. In FY 2012-13, TSJ drew 1.1 million people to events at the Facilities and booked nearly 248,000 future hotel nights. In addition to surpassing fiscal targets for gross revenue and gross operating profit, TSJ met all four of its performance measures for economic impact—hotel room nights, event attendance, estimated economic impact, and return on investment. TSJ also met its performance targets for customer satisfaction and its two theater measures, occupied days and performance days. In aggregate, TSJ achieved a weighted incentive fee score of 160 percent, which corresponds to a maximum incentive fee of \$350,000.

Team San Jose Met Its Performance and Incentive Targets in FY 2012-13

In September 2013, the independent accounting firm of Macias, Gini, and O'Connell completed its financial audit of the City's Convention and Cultural Affairs Fund, issuing a clean opinion with no issues found. Based on our review of the audited financial statements, third-party reviews of hotel room night bookings, and Team San Jose's attendance, customer satisfaction, and theater records, we found Team San Jose:

- Met targets for all eight of the performance measures
- Met targets for all seven of the incentive fee measures

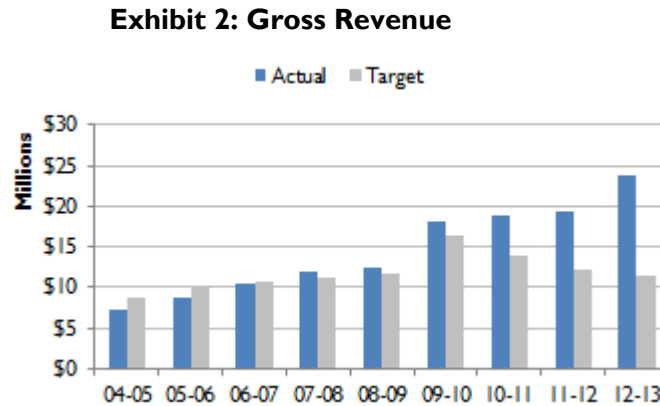
TSJ's performance results against targets are shown below by measure. **Appendix A** describes the methodology for calculating each individual measure in detail. In addition, **Appendix B** summarizes TSJ's performance and targets for performance and incentive fee measures since FY 2004-05.

Team San Jose Met Its Two Targets for Financial Performance in FY 2012-13

In financial terms, FY 2012-13 was a successful year for Team San Jose. As shown in Exhibits 2 and 3, TSJ surpassed both its gross revenue and gross operating profit performance measures.

Gross Revenue (Incentive Fee Measure)

Gross revenue, as shown in Exhibit 2, is the revenue generated from operation of the Facilities.



Source: Auditor analysis of the Management Agreement and its third amendment, audited financial statements for the Convention and Cultural Affairs Fund, and our prior TSJ audits

We confirmed that TSJ vastly exceeded its target of \$11.5 million by generating \$23.8 million in gross revenue. According to TSJ, this was due to an improving economy, efforts to mitigate client concerns about construction at the Convention Center, smaller-than-anticipated construction impacts, and a sales focus on short-term business opportunities.

TSJ's fourth quarter performance report said of expected impacts from the economy and construction:

During the budgeting process, it was anticipated that FY2012-2013 would be more challenging than the prior year. The business forecast was reviewed and approved by CSL, the City of San Jose's third-party industry advisor as part of the benchmarking study analysis.

Contributing factors in forecasting for FY 2012-2013 included:

- Due to construction and renovation, it was anticipated that it would be more difficult to contract events within the year and as a result a 20% - 30% decline in revenue and additional bookings was anticipated.*
- Client apprehension related to construction noise and disruption reflected lower than prior year attendance for repeat clients.*
- As a result of the downturn in the economy, event attendance and services needed were anticipated to be low.*

- As a result of construction related impacts, the forecast included client mitigation resulting in revenue reduction and added expenses.

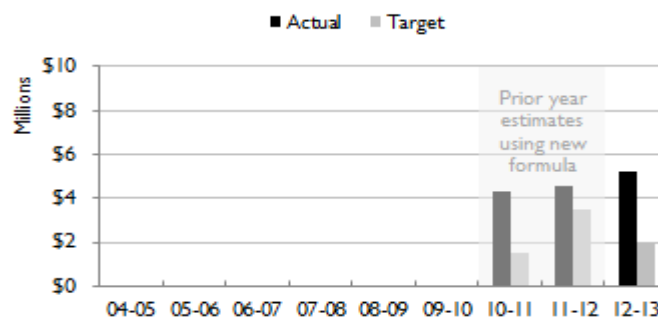
It also should be noted that actual gross revenue was much higher from FY 2009-10 to 2012-13 than in prior years largely, but not entirely, as a result of TSJ bringing food and beverage services in-house. In fact, FY 2012-13 gross revenue of \$23.8 million was \$4.4 million more than FY 2011-12 gross revenue, with the increase almost entirely in food and beverage, and event production labor revenue streams.

Gross Operating Profit (Performance Measure)

The Management Agreement’s definition of gross operating profit is gross revenue (as described above) minus direct and indirect expenses related to the operation of the Facilities. The third amendment to the Management Agreement, effective FY 2012-13, modified the measure to include Transient Occupancy Tax (TOT) allocated to the Convention and Cultural Affairs Fund, Convention Center parking garage revenue and expense, and CVB expense funded by the Convention and Cultural Affairs Fund.

FY 2012-13 was the third consecutive year (and third year overall in its nine year operation of the Facilities) that TSJ met its target for gross operating profit. The gross operating profit of \$5.3 million was \$3.3 million more than the \$2.0 million target. In accordance with the Management Agreement, the calculation does not include the City’s \$15.3 million payment in FY 2012-13 for debt service for the convention center’s original construction or the \$6.5 million payment for debt service for the recent renovation and expansion. Exhibit 3 shows TSJ’s performance to its target in FY 2012-13, along with our estimation of what gross operating profit would have been in FY 2010-11 and 2011-12 had the current calculation then been in place.

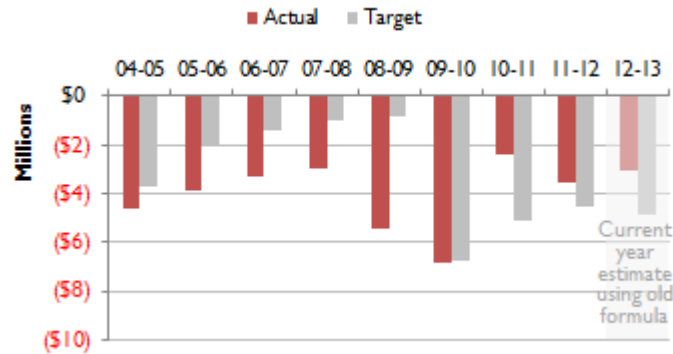
Exhibit 3: Gross Operating Profit – Current Formula



Source: Auditor analysis of the Management Agreement and its amendments, audited financial statements for the Convention and Cultural Affairs Fund, parking garage revenue and expense reports, Budget Office reports for the Convention and Cultural Affairs Fund, and prior TSJ audits

For comparison to prior year performance audits, Exhibit 4 shows TSJ’s gross operating profit, and our estimate for FY 2012-13, calculated in accordance with the prior formula.

Exhibit 4: Gross Operating Profit – Prior Formula



Source: Auditor analysis of the Management Agreement and its amendments, audited financial statements for the Convention and Cultural Affairs Fund, and prior TSJ audits

The audited financial statements for the Convention and Cultural Facilities show an operating loss of \$6.6 million calculated in accordance with Generally Accepted Accounting Principles. Exhibit 5 reconciles the audited financial statements to the Management Agreement’s definitions of gross revenue and gross operating profit.

Exhibit 5: Reconciliation of Revenue and Net Loss According to the Audited Financial Statements and the Management Agreement (FY 2012-13)

	Audited Financial Statements	Adjustments (per Management Agreement)			
		Prior Formula	New Formula		
Operating revenues:					
Building rental	\$4,263,160				
Food and beverage services	11,343,648				
Commission revenue	1,218,294				
Event electrical/utility services	408,738				
Audio/visual services	318,915				
Ticketing services	374,245				
Telecommunications services	37,291				
Equipment rentals	70,408				
Event production labor revenues	5,777,996				
Other revenues	10,523				
Less: City of San José credits for facility usage	(53,540)	\$53,540	a		
Total operating revenues	23,769,678	23,823,218			
NEW Add: TOT allocation to Convention and Cultural Affairs Fund			\$6,569,988	b	
NEW Add: Parking garage revenue			2,795,823	b	
Revenues for gross operating profit calculation			33,189,029		
Operating expenses:					
Administrative and general salaries - TSJ	10,012,122				
Cost of event production labor	5,905,796				
Utilities	2,296,402				
Food and beverage costs	1,965,220				
Overhead - City of San José	238		(238)	b	
Bad debt expense	12,320				
Contracted outside services	1,967,995				
Professional services	535,472				
Operating supplies	558,611				
Depreciation	400,040	(400,040)	a		
Repairs and maintenance	956,960				
Insurance	239,874				
City of San José oversight	1,037,823	(1,037,823)	a		
Ticketing costs	146,059				
Workers' compensation insurance premiums	659,260				
Fire insurance	101,582	(101,582)	a		
Management fee - Team San Jose	744,607	(594,607)	a	(150,000)	b
Equipment rentals	190,760				
Repairs and maintenance - City funded	1,380,931	(1,380,931)	a		
Other expenses	1,276,794				
Total operating expenses	30,388,866	26,873,883			
NEW Add: City use expense			53,540	b	
NEW Add: CVB expenses paid by Convention and Cultural Affairs Fund			51,000	b	
NEW Add: Parking garage expenses			1,103,391	b	
Expenses for gross operating profit calculation			27,931,576		
Gross operating profit/(loss)	\$(6,619,188)	\$(3,050,665)	\$5,257,453	c	

Source: Auditor's analysis of FY 2012-13 audited financial statements for the San Jose convention and cultural facilities, and the Management Agreement between Team San Jose and the City and its amendments, parking garage revenue and expense reports, and Budget Office reports for the Convention and Cultural Affairs Fund

- Notes: (a) Change made to calculate gross revenue and gross operating profit in accordance with the Management Agreement and its amendments (i.e., reverse the revenue deduction for City of San Jose facility usage; and deduct from total expenses depreciation, City oversight, fire insurance, the fixed executive management fee, and City-funded repairs and maintenance)
- (b) Change made to calculate gross operating profit in accordance with the Management Agreement's third amendment (i.e., include the TOT allocation to the Convention and Cultural Affairs Fund, Convention Center parking garage revenues and expenses, and CVB expenses paid by the Convention and Cultural Affairs Fund, and exclude the fixed minimum management fee)
- (c) In September 2013, TSJ reported a gross operating profit of \$4.8 million for FY 2012-13. The \$0.5 million difference between this amount and our calculation was due to the completion of the annual financial audit of the Convention and Cultural Facilities, which adjusted year-end expenses and changed the classification of some costs from operating expenses to capital expenditures.

The audited financial statements for the Convention and Cultural Facilities caution:

In order for the Center to continue its operations, it relies on the City for operating contributions. The operating loss for the year was \$6,619,188, which required operating cash contribution totaling \$6,889,500 from the City. The City uses a portion of TOT from its Transient Occupancy Tax Special Revenue Fund to fund these contributions. Accordingly, any significant changes in the TOT or a decision to change the amount of support could greatly affect the Center's ability to continue as a going concern.

As noted in prior reports, when TSJ performs better than expected (as it did from FY 2010-11 to FY 2012-13), it reduces the chance that reimbursements from the City's General Fund would be required.⁴ Indeed, the City has not made a significant transfer from the General Fund to the Convention and Cultural Affairs Fund since FY 2009-10, though the General Fund advanced a portion the convention center's debt service payment of \$15.3 million in FY 2012-13.⁵ Overall, during FY 2012-13, the Convention and Cultural Affairs Fund ending balance declined by \$1.6 million, from \$8.9 million to \$7.3 million (the ending fund balance was \$2.1 million higher than expected), due in part to expenditures for the Convention Center's furniture, fixtures, and equipment, and for its kitchen renovation.

Additionally, as shown in Exhibits 2 and 3, TSJ's performance on gross revenue and gross operating profit measures surpassed 200 percent of target. This highlights the importance of acknowledging that the closer a target, especially

⁴ The Facilities, under TSJ's management, generate revenues which help fund operations. However, to continue its operations, TSJ relies on operating transfers from the Transient Occupancy Tax Fund, which collects the City's hotel taxes. Currently, approximately 30 percent of TOT collections are transferred to the Convention and Cultural Affairs Fund (Fund 536).

Approximately 30 percent are split between CVB and the Office of Cultural Affairs and the remaining 40 percent of TOT collections go to the City's General Fund. To the extent that TSJ's net operating loss (from the accounting perspective) is less than the TOT revenue transferred into the Convention and Cultural Affairs Fund, remaining TOT funds from the year fall to fund balance.

⁵ According to the Budget Office, the City advanced \$10.3 million of the FY 2012-13 debt service amount from the General Fund, but staff anticipates that the subsidy will be fully reimbursed by the Successor Agency to the Redevelopment Agency in January 2014.

gross operating profit, is to zero, the larger the Weighted Achievement Percentage can be for that measure, which may be worth examining for future agreements.⁶

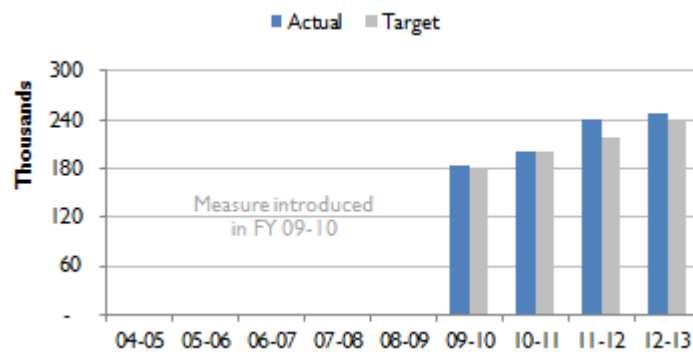
Team San Jose Met Its Four Targets for Economic Impact in FY 2012-13

In the area of economic impact, TSJ met all four of its performance measures—hotel room nights, event attendance, estimated economic impact, and return on investment.

Hotel Room Nights Booked (Performance and Incentive Fee Measure)

Hotel room nights booked, as shown in Exhibit 6, is measured as the total number of future hotel room nights booked by Team San Jose over the course of the fiscal year.

Exhibit 6: Hotel Room Nights Booked



Source: Auditor analysis of the Management Agreement and its amendments, TSJ's hotel room nights production report, third-party reviews of TSJ's hotel room night bookings, and our prior TSJ audits

⁶ For instance, if the City were to set a performance target of only \$0.5 million for gross operating profit during an economic downturn, a profit of \$2.5 million would result in a Weighted Achievement Percentage of 200 percent (500 percent performance relative to the target, multiplied by the 40 percent weighting for the gross operating profit performance measure). Assuming TSJ achieved 100 percent of other performance targets, its performance compared to the low gross operating profit target would skew its overall performance score, which adds together individual Weighted Achievement Percentages for the various performance measures, up to 260 percent.

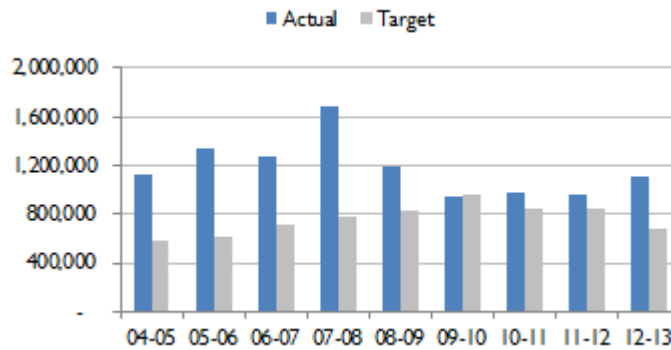
In comparison, if TSJ had still outperformed its gross operating profit by \$2 million, but that target had been \$4 million, the Weighted Performance Percentage would have been 60 percent (150 percent performance relative to the target, multiplied by the 40 percent weighting for the gross operating profit measure) and the overall performance score would have been 120 percent.

TSJ met its hotel room night goal in each of the four years it has reported on the measure. We confirmed that TSJ exceeded the year's goal by five percent (247,711 hotel room nights, compared to a target of 236,806 hotel room nights).⁷

Event Attendance (Performance and Incentive Fee Measure)

Event attendance, as shown in Exhibit 7, is the number of local/social visitors, out of town visitors, and exhibitors who attend events at the convention and cultural facilities.

Exhibit 7: Event Attendance



Source: Auditor analysis of the Management Agreement and its amendments, and TSJ event attendance reports, and our prior TSJ audits

Although attendance is down from a peak in FY 2007-08, TSJ has achieved its targets for attendance in eight of its nine years in charge of the Facilities. For FY 2012-13, it exceeded the goal by 60 percent (1,103,490 compared to a target of 687,857). According to TSJ, several factors contributed to higher than expected attendance and estimated economic impact:

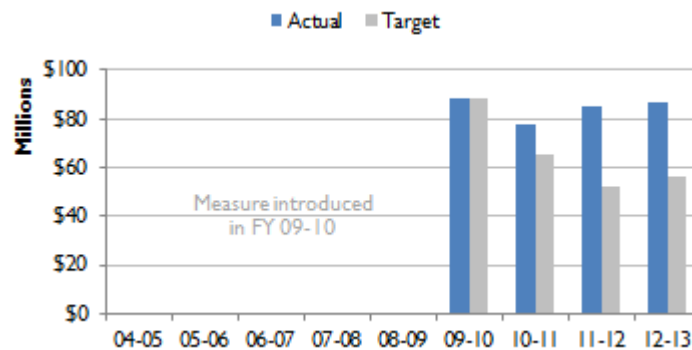
- 1. The construction project disturbed and displaced less business than anticipated due to mitigation efforts on behalf of Team San Jose and the City. It is not uncommon for Centers undergoing renovation / expansion projects to experience some significant attrition during their construction periods.*
- 2. The increased performance of the economy (notably the local corporate segment) led to increases in both the scope of existing events (i.e. more attendees, more exhibitors) and Team San Jose's ability to change our sales strategy to secure more short-term bookings.*

⁷ 35,000 of the future hotel room nights were booked on the last day of FY 2012-13, which is not unusual according to TSJ.

Estimated Economic Impact (Performance and Incentive Fee Measure)

Estimated economic impact, as shown in Exhibit 8, is the average daily spending rate multiplied by event attendance and duration. Average daily spending rates vary depending on event type (i.e., conventions and meetings, spectator sports and demonstrations, and participant sports and competitions) and attendee type (i.e., local/social visitors, out of town visitors, and exhibitors).

Exhibit 8: Estimated Economic Impact



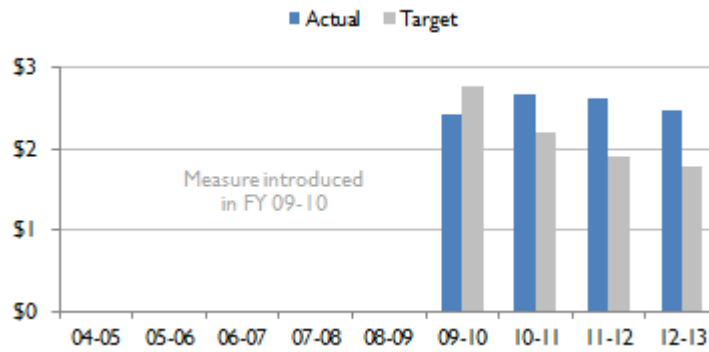
Source: Auditor analysis of the Management Agreement and its amendments, and TSJ event attendance reports, TSJ's estimated economic impact calculations, and our prior TSJ audits

TSJ has met its estimated economic impact targets each of the four years it has reported on the measure. In fact, in FY 2011-12 and FY 2012-13, TSJ outperformed its goals for estimated economic impact. For FY 2012-13, TSJ beat its target by 54 percent (\$87.1 million in estimated economic impact, compared to a target of \$56.5 million).

Return on Investment (Performance Measure)

The Management Agreement's broad definition of return on investment, as shown in Exhibit 9, is the sum of gross revenues from the operation of the Facilities, estimated economic impact, parking garage revenues, and the TOT allocation to the Convention and Cultural Affairs Fund, divided by the sum of expenses paid for the operation of the Facilities, Facilities debt service, parking garage expenses, and other expenses paid by the Convention and Cultural Affairs Fund.

Exhibit 9: Return on Investment



Source: Auditor analysis of the Management Agreement and its third amendment, audited financial statements for the Convention and Cultural Affairs Fund, the convention center debt service schedule, TSJ's estimated economic impact and return on investment calculations, parking garage revenue and expense reports, and our prior TSJ audits

TSJ has achieved its return on investment goal every year except FY 2009-10. From FY 2010-11 to 2012-13, TSJ outperformed its goal for return on investment because it is a formula-driven measure that increases when its inputs, especially estimated economic impact and gross revenue, increase.

For FY 2012-13, TSJ achieved a return on investment of \$2.48, compared to a goal of \$1.79.⁸ It is important to note that this **does not** mean that the Convention and Cultural Affairs Fund received \$2.48 in net profit for every \$1 invested, as would be suggested by the traditional calculation of return on investment (i.e., the traditional definition of return on investment is net profit divided by investment). Instead, the Management Agreement's broad definition of return on investment is driven by estimated economic impact; that is to say, it measures spending in San José's economy as a result of conventions and other events (i.e., at restaurants, at the Airport, for transportation, and in hotels and retail establishments). Spending on hotel rooms generates Transient Occupancy Tax, of which \$6.6 million was transferred to the Convention and Cultural Affairs Fund for activity in FY 2012-13. The TOT transfer roughly equaled the operating loss as shown in Exhibit 5, but as noted earlier, the ending balance in the Convention and Cultural Affairs Fund declined by \$1.6 million during FY 2012-13 from \$8.9 million to \$7.3 million (the ending fund balance was \$2.1 million higher than expected), due in part to expenditures for the Convention Center's furniture, fixtures, and equipment, and for its kitchen renovation.

⁸ TSJ reported an ROI of \$2.43 in its September 2013 year-end report. The \$0.05 difference between this amount and ours was due to our exclusion of certain costs not contemplated when the ROI target was established. Neither the TSJ ROI amount nor our ROI calculation included the \$6.5 million in debt service for the Convention Center expansion paid for by the 4% increase to TOT (approved in June 2009), per the formula agreed to by TSJ and the City Manager's Office. Had we included that debt service in the calculation, the ROI for FY 2012-13 would have been \$2.19.

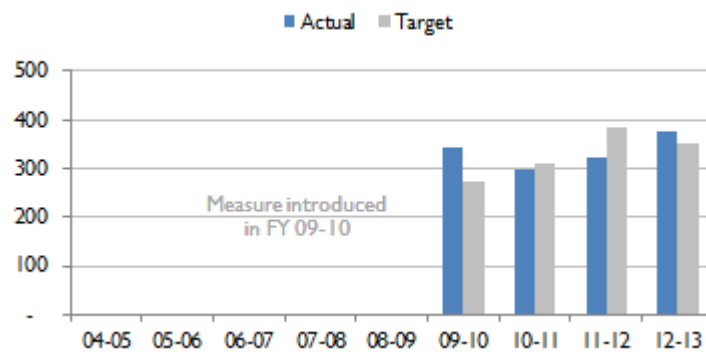
Team San Jose Met Its Two Targets for Theatre Performance in FY 2012-13

Team San Jose achieved theater performance targets for both performance days and occupied days for the first time in three years.

Performance Days (Performance and Incentive Fee Measure)

Performance days, as shown in Exhibit 10, are the number of days on which a performance takes place at the cultural facilities.⁹

Exhibit 10: Performance Days



Source: Auditor analysis of the Management Agreement and its amendments, TSJ's theater records, and our prior TSJ audits

For FY 2012-13, the City's cultural facilities hosted 375 performance days, above the target of 352 performance days. As expected, about 180 of these 375 performance days were contributed by the City's resident art partners, including Symphony Silicon Valley, the Children's Musical Theater of San Jose, Opera San Jose, Lyric Theatre of San Jose, and Ballet San Jose.

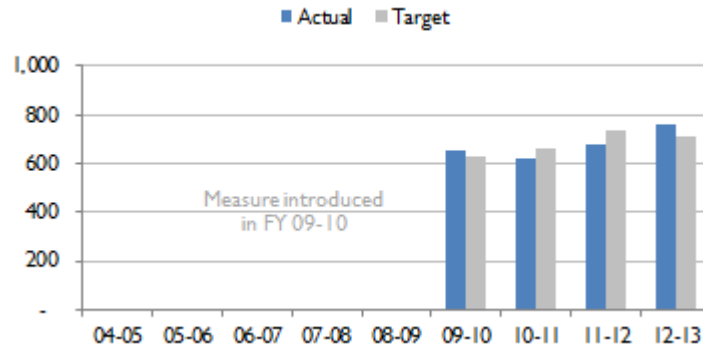
⁹ During the course of fieldwork, we learned that events spanning multiple fiscal years, such as "The Gondoliers" presented by the Lyric Theatre of San Jose, are counted solely in the fiscal year in which the events conclude for theater performance and other performance measures.

Additionally, during the course of the FY 2011-12 performance audit, we learned that one cultural facility can have multiple "performance days" on a single calendar day if the venue hosts unique performances (i.e., if the California Theater hosts a youth symphony performance in the afternoon and a choir performance in the evening, TSJ counts two performance days). Further, performance days may include days on which a cultural facility hosts private showings (i.e., if the California Theater hosts an invitation-only opera performance, the day count as a performance day even though the show was not a public ticketed event). Because the goal of theater performance measures is to track "activation" of cultural facilities (in other words, the number of times these facilities drew people downtown), we did not deduct performance days in the event of private showings or multiple performance days on a calendar day.

Occupied Days (Performance and Incentive Fee Measure)

Occupied days, as shown in Exhibit 11, are the number of days that a theater is utilized under contract and not available for booking for other events.

Exhibit 11: Occupied Days



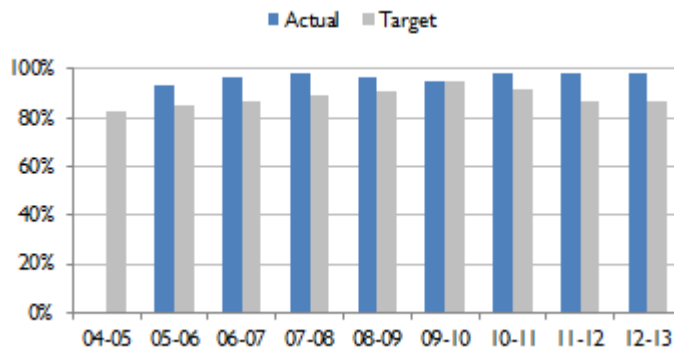
Source: Auditor analysis of the Management Agreement and its amendments, TSJ's theater records, and our prior TSJ audits

TSJ also achieved its occupied days target for FY 2012-13 (763 occupied days, compared to its target of 707).

Team San Jose Met Its Target for Customer Satisfaction in FY 2012-13 (Performance and Incentive Fee Measure)

Customer satisfaction, as shown in Exhibit 12, is the percent of event coordinators who respond to a customer survey with an overall satisfactory rating of the product and services provided. Satisfactory is considered "excellent," "very good," or "good."

Exhibit 12: Customer Satisfaction



Source: Auditor analysis of the Management Agreement and its amendments, TSJ's customer service survey results, and our prior TSJ audits

For customer satisfaction, Team San Jose has met its targets for all but one of the past nine years.¹⁰ In FY 2012-13, a year in which TSJ staff had to mitigate construction impacts on events at the convention center, 98 percent of customers rated their overall satisfaction with the product and services provided as good or better (compared to a target of 87 percent).¹¹

Team San Jose Achieved Weighted Performance and Incentive Fee Scores of 183 and 160 Percent, Respectively, in FY 2012-13

As shown above, Team San Jose met its targets for all eight of the performance measures. In accordance with the Management Agreement, this resulted in a total weighted performance score of 182.9 percent. TSJ also met its targets for all seven of the incentive fee measures, resulting in a total weighted incentive fee score of 159.7 percent. Exhibit 13 summarizes Team San Jose's performance against its goals, and calculates total weighted performance and incentive fee scores.

Exhibit 13: Team San Jose's FY 2012-13 Weighted Performance and Incentive Fee Scores

Measures	Target	Result	% of Goal	Performance		Incentive Fee	
				Weight	%	Weight	%
Economic Impact							
Hotel Room Nights	236,806	247,711	105%	10%	10.5%	15%	15.7%
Event Attendance	687,857	1,103,490	160%	10%	16.0%	10%	16.0%
Estimated Economic Impact	\$56,500,000	\$87,061,604	154%	10%	15.4%	15%	23.1%
Return on Investment	\$1.79	\$2.48	139%	10%	13.9%	n/a	n/a
Gross Revenue and Gross Operating Profit							
Gross Revenue	\$11,500,000	\$23,823,218	207%	n/a	n/a	40%	82.9%
Gross Operating Profit	\$2,000,000	\$5,257,453	263%	40%	105.1%	n/a	n/a
Theater Performance							
Occupied Days	707	763	108%	3%	3.2%	3%	3.2%
Performance Days	352	375	107%	7%	7.5%	7%	7.5%
Customer Service							
Satisfaction Rate	87%	98%	113%	10%	11.3%	10%	11.3%
Weighted Performance/Incentive Fee Score				182.9%		159.7%	

Source: Auditor analysis FY 2009-2014 Management Agreement and its addendum and amendments, FY 2012-13 audited financial statements, event attendance reports, and other Team San Jose records

Note: weighted percentages are the product of the measure weights listed in Exhibit I in the Background, and actual performance as a percentage of the goal. For instance, Event Attendance is given a weighted incentive fee score of 16.0 percent because the result of 1,103,490 was 160 percent of the target of 687,857, and the amended Management Agreement assigns Event Attendance a weight of 10 percent.

¹⁰ Insufficient customer responses were collected in FY 2004-05 to present a meaningful rating.

¹¹ The 102 customer service survey responses included 64 excellent, 27 very good, 9 good, and 2 fair scores.

As shown in Exhibit 5, Team San Jose received \$744,607 in management fees in FY 2012-13 as a base payment. In FY 2012-13, the City also reimbursed through the Convention and Cultural Affairs Fund \$290,000 in expenses (included in Exhibit 5's operating expenses) initially paid by TSJ's corporate account. In addition to these payments, the City makes incentive payments based on TSJ's performance.

The Management Agreement includes incentive fee targets and a corresponding incentive fee structure, along with performance measures. The performance and incentive fee measures provide a quantifiable way of evaluating TSJ's management of the convention and cultural facilities. In the FY 2009-10 performance audit, we recommended that the incentive fee payment structure be revised such that TSJ receives incentive payments only if it achieves a specified threshold. This was accomplished by separating what was previously known as the "incentive fee" into two components, the Fixed Minimum Management Fee and the incentive fee.¹² In our prior analysis, we also found that the incentive fee was not structured to incentivize performance that exceeds expectations. The incentive fee schedule has since been revised and is shown in Exhibit 14.

Exhibit 14: Incentive Fee Payment Schedule

Weighted Incentive Fee Score	Incentive Fee Amount
Less than 100%	No incentive fee
At least 100% but less than 110%	\$200,000
At least 110% but less than 115%	\$300,000
115% or greater	\$350,000

Source: Second Amendment to Management Agreement between Team San Jose and the City

Team San Jose achieved a weighted incentive fee score of 160 percent for FY 2012-13, which corresponds to the maximum incentive fee of \$350,000.

¹² The Fixed Minimum Management Fee is \$150,000. TSJ also received a Fixed Executive Management Fee of \$594,607 to pay for a portion of executive salaries and benefits. Together these fees make up the City's base payment of \$744,607 for Team San Jose's management of the Facilities in FY 2012-13.

Conclusion

In FY 2012-13, Team San Jose met all nine performance targets. It met all and, in most cases, far exceeded its economic impact and fiscal performance targets, in large part because of efforts to mitigate client concerns about the renovation and expansion of the Convention Center, smaller-than-anticipated construction impacts, and an improving economy. It achieved its customer service goal and two theater performance goals. Altogether, TSJ achieved a weighted incentive fee score of 160, which corresponds to a maximum incentive fee of \$350,000.

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APPENDIX A

Methodology for Calculating Performance and Incentive Fee Measures

Measures	Type of Measure	Methodology for Calculation
Gross Revenue and Gross Operating Profit		
Gross Revenue	Incentive only	Those revenues from operation of the Facilities excluding revenue billed by TSJ on behalf of other vendors providing services to clients of the Facilities.
Gross Operating Profit	Performance only	<p>The third amendment to the Management Agreement, effective September 2012, changed the methodology for the gross operating profit calculation to be: Revenues (as described above) plus Transient Occupancy Tax (TOT) revenue allocated to the Convention and Cultural Affairs Fund and net Convention Center parking garage revenue (i.e., the revenue received from parking garage operations less the City's cost to operate the garage) minus direct and indirect expenses related to the operation of the Facilities and CVB funding from the Convention and Cultural Affairs Fund.</p> <p>Per the agreement and its amendments, we did not include the following expenditures in calculating gross operating profit: the fixed executive management fee, fixed minimum management fee, incentive fee, depreciation expense, City contract oversight costs, fire insurance, or City-funded repairs and maintenance.</p>
Economic Impact		
Hotel Room Nights	Performance and Incentive	Measured as the total number of hotel room nights booked by the CVB over the course of the Fiscal Year and the total number of hotel room nights booked that can be directly or indirectly attributed to activities at the Facilities.
Event Attendance	Performance and Incentive	Number of local/social visitors, out of town visitors, and exhibitors who attend events at the convention and cultural facilities.
Estimated Economic Impact	Performance and Incentive	Average daily spending rates multiplied by event attendance and duration. Average daily spending rates vary depending on event type (i.e., conventions and meetings, spectator sports and demonstrations, and participant sports and competitions) and attendee type (i.e., local/social visitors, out of town visitors, and exhibitors). This methodology was mutually agreed upon by the City and TSJ as a means to estimate consumer spending related to events.
Return on Investment	Performance only	<p>The Management Agreement, its addendum, and amendments outline that the measure of the City's return on investment is based on a set formula. In September 2012, City staff and Team San Jose agreed to a slightly amended formula as follows:</p> $\frac{[\text{gross revenues from the operation of the Facilities}] + [\text{estimated economic impact}] + [\text{TOT allocated to the Convention and Cultural Affairs Fund}] + [\text{Convention Center parking garage revenues}]}{[\text{total expenses from sources and uses for the Convention and Cultural Affairs Fund, including CVB funding}] + [\text{Facilities debt service}] + [\text{Convention Center parking garage expenses}]}$

Measures	Type of Measure	Methodology for Calculation
Theater Performance		
Performance Days	Performance and Incentive	<p>All days that the City and the operator mutually agree are both available and suitable for performance of a scheduled performance or event, and on which a performance indeed takes place. Performance days are measured by the extent to which TSJ maintains or increases use of the theaters on performance days.</p> <p>As discussed above, one location may have multiple “performance days” on one calendar day if there are unique performances (i.e., not a matinee and regular performance of the same show). In addition, performance days may include private performance (i.e., performances of a show that is for select patrons and not open to the public).</p>
Occupied Days	Performance and Incentive	Days that a theater is utilized under contract and not available for booking for other events.
Customer Satisfaction		
Satisfaction Rate	Performance and 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.”

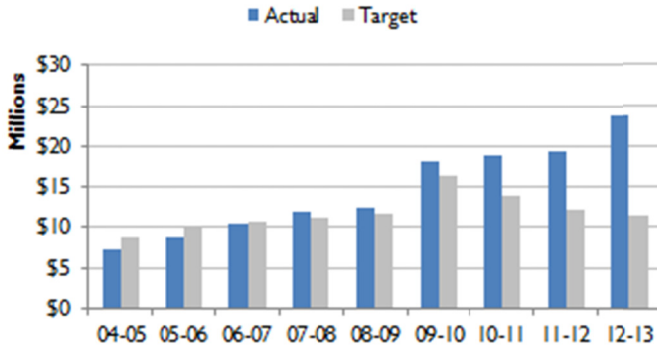
Source: Auditor summary of terms outlined in the Management Agreement, addendum, and amendments, and other issues identified during course of audit work

APPENDIX B

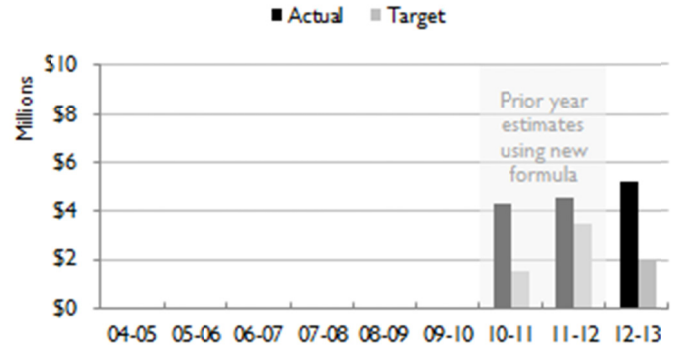
Team San Jose Performance and Targets Since FY 2004-05

Measures Tracked Since FY 2004-05

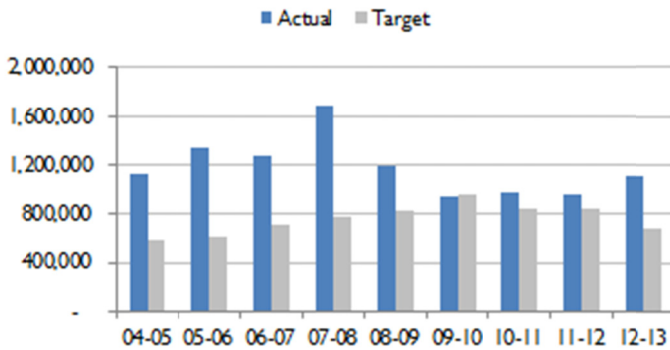
Gross Revenue



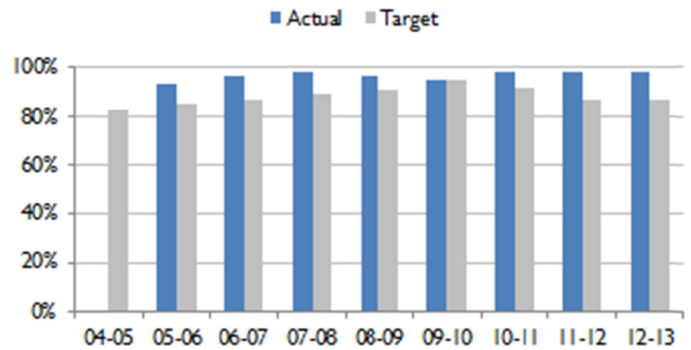
Gross Operating Profit*



Event Attendance

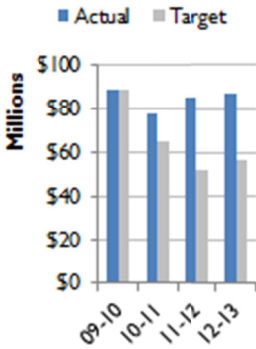


Customer Satisfaction**

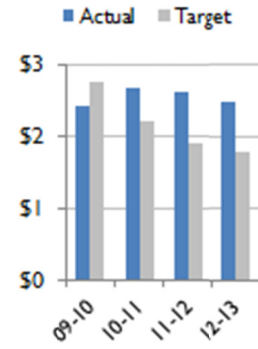


Measures Tracked Since FY 2009-10

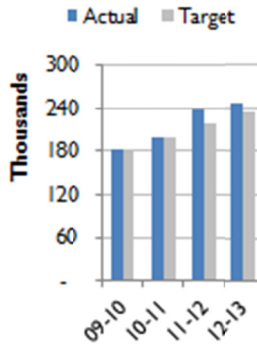
Est. Economic Impact



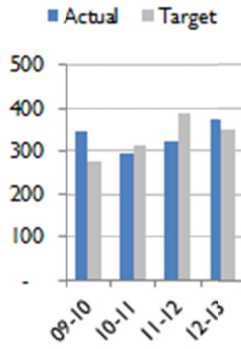
Return on Investment



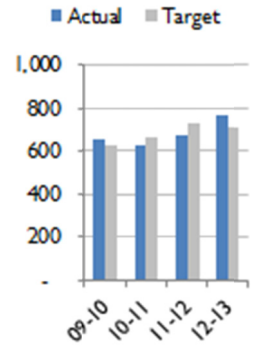
Hotel Room Nights



Performance Days



Occupied Days



Source: Auditor analysis of data from Exhibit 13 and our previous TSJ performance audits

Notes: *The gross operating profit calculation was modified in FY 2012-13. FY 2010-11 and 2011-12 figures are estimates of what TSJ's performance would have been had the FY 2012-13 formula then been in effect. Exhibit 4 estimates the gross operating profit for FY 2012-13 using the prior formula, and charts that value against prior year results.

**Insufficient customer responses were collected in FY 2004-05 to present a meaningful rating.