
OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: June 23, 2009

IBA Report Number: 09-58

Rules Committee Date: June 24, 2009

Item Number: 2

San Diego New Main Library – Letter of Intent with SDUSD

OVERVIEW

At the meeting of June 24, 2009, the Rules Committee will consider whether to recommend to Council entering into a letter of intent between the City and the San Diego Unified School District (SDUSD) to lease two floors of the proposed main library. This letter of intent aims to solidify the City's plans for the main library and to provide justification to the State to extend the period of authorization for a \$20 million grant that is a critical component of the library financing plan. The current deadline is July 1, 2009, but staff believes an extension is possible if this plan can be affirmed.

The City applied for the State Library Bond Funds in March 2003. The application was lengthy and quite detailed, and provided specific information about the capital project and the City's ability to finance the project costs and its subsequent ongoing operations. The IBA has reviewed the information in the State application and other reports, and has relied on this past data as a baseline for comparison as the Main Library project evolves. Clearly the City's financial situation has changed over this period of time, and an economic downturn continues; it is to be expected that these and other plans would need to be revised to reflect current realities. However, it is important to note those instances where major shifts have occurred since previous approvals have been obtained.

This report discusses the components of the lease with the School District as well as other considerations of the overall library plan. Our intent is to provide additional context and information to ensure a robust inspection and discussion of this proposal.

FISCAL/POLICY DISCUSSION

In the original project proposal, the sixth and seventh floors of the proposed New Main Library were included in the design as future expansion space for library uses, and would not be needed for twenty years. In the interim period, the expansion space was to be leased, and would provide a source of revenue to the City. That plan has since evolved to a lease of the space to the SDUSD for school purposes. However, a long-term lease with a possible option to purchase by SDUSD may preclude the City from ever utilizing the expansion space for the library in the future.

LEASE ANALYSIS

The IBA has analyzed the lease assumptions and cash flows presented by the Real Estate Assets Department. This lease analysis appears to have been an unusual challenge, given that the amount of money was fixed at \$20 million and the variable to construct a fair deal became the lease term. The IBA deconstructed the components of the lease analysis and provides the following comments:

Tenant Improvements

The IBA questions the applicability of crediting the \$3.7 million in assumed tenant improvements to the School District. The City's 2006 Value Engineering eliminated the tenant improvements on those floors, therefore the construction budget for this project is not actually reduced by \$3.7 million due to this proposal. It should be noted that the most recent estimates of lease revenues to an alternative outside tenant eliminated the cost of tenant improvements provided by the City. If the tenant improvements are not counted toward the total value of the lease, the City would be losing \$3.7 million through this proposal.

Parking

The IBA disagrees with the department that parking revenues should be included in the lease analysis. Parking is used and paid annually, so there is no reason to discount this revenue back to Net Present Value (NPV). In addition, in the department's analysis, the School District is getting the benefit of counting parking revenue toward the NPV, while the \$23.7 million upfront payment does not include the NPV of the parking revenue each year. Without counting parking, the NPV is \$24.6 million, and the City may be losing approximately \$900,000, in addition to the \$3.7 million in tenant improvements mentioned above, for a total disparity of \$4.6 million. In other words, the School District is getting \$24.6 million in value from the lease, while paying the City \$20 million for it. Our analysis is provided in the attachment to this report. The IBA recognizes that staff disagrees with this assessment and invites further discussion on this topic. We also discuss some options below to address these concerns.

Favorable Lease Factors

While we suggest that the City is losing the value of \$4.5 million in this proposal, there are a number of factors unique to this lease that would create advantages for the City. Certainly, the provision for tenant improvements is one, as well as the elimination of any tenant improvement allowances over the years. Additionally, this long-term lease provides potential cost avoidance for the City, by precluding the necessity for revised and new tenant improvements more frequently on multiple, shorter-term leases. Also, since this proposal has been made directly between the two parties, the City has avoided a broker commission on the lease, which is estimated at around \$1 million per instance.

Other Notes

This proposal also makes a significant shift from the prior proposals for the library. Previously, the lease revenue from the tenant was to be used to fund and mitigate the costs of operations and maintenance in the new building. In this model, all of the lease revenues are used upfront to construct the building. Thus, the City loses potential future cash flows that would provide additional support for the General Fund. A further discussion of the operating costs of the library is provided below.

The IBA also notes, as a point of information, that we reviewed lease rate scenarios using the same assumptions as used by Jones Lang LaSalle in their analysis for the proposed Civic Center redevelopment. Those assumptions include annual escalations in rent of 2.5% and a discount rate of 5.25%. This analysis did add approximately \$1.5 million to the NPV of the proposal (meaning the School District would be getting an even better deal than described above). However, in discussions with staff, it was noted that long-term leases, such as this proposal, are not generally modeled with annual rent escalations. The discount rate makes a nominal adjustment to the balance and is slightly different due to the timing of the development of the two reports and market adjustments.

Further Negotiations

The IBA suggests a few avenues that may be pursued should the City desire to negotiate the terms of this agreement further. One suggestion is to negotiate additional funds to make up the lost value to the City. While \$20 million is the amount the School District has under Proposition S for this project, we suggest that the School District's tax increment from Centre City may contribute as well. It appears that the tax increment may only be used for facilities within the project area and this proposal would qualify. As shown above, \$4.6 million would be required to make the value to the School District equivalent to the payment to the City. Secondly, the City may wish to modify the term of the lease agreement so as to equalize the value. The IBA estimates that, under the terms as described, a lease period of 29 years would equate to approximately \$20.2 million in value, as opposed to the current proposal for 40 years.

FUTURE COSTS

As the IBA has noted previously in various reports, the 2002 Library Facilities Improvement Program (which includes the New Main Library project) has not been comprehensively updated since it was adopted. Projects have not been reevaluated or reprioritized with an eye towards the City's operating budget capacity. Most projects have been delayed due to lack of capital funding and the focus has shifted to projects relying on grants, developer money or other non-City funding. At the same time, the issue related to operating costs has not been reconsidered in light of the City's ongoing budget challenges.

The original plan called for the issuance of three series of bonds over a four year period to fund the New Main Library and branch library projects. Total borrowings were estimated at \$191.4 million. Annual debt service payments for all three series were estimated at \$13.8 million, for thirty years. As the City was unable to issue bonds to fully implement the plan, and significant funding for the New Main Library now comes from the Redevelopment Agency and additional fundraising, the costs of annual debt service payments will be avoided by the City.

When the plan was developed in 2002, operating costs for all new facilities were fully identified. The Library Ordinance, requiring that a set level of General Funds be dedicated to libraries each year, was put into place that same year to secure a source of funding for these newly identified operating costs, and to ensure funding for annual debt service payments. However, as pressure came to bear on the General Fund, the Library Ordinance has been waived since 2004, to free up funds for other priority areas.

The report to Rules indicates that "when the City sees better economic times and returns to the goals set in the Library Ordinance to fund the Library system at 6% of the General Fund rather than the current 3%, that level of funding would adequately cover the operating costs of the library system." Unfortunately, as we have discussed in prior budget report, the IBA believes that it may be unrealistic to assume the level of funding called for in the Library Ordinance, given the many competing needs within the City's General Fund. Additionally, as no bonds have been issued, funding for debt service requirements is no longer needed, and the 6% funding goal should be reevaluated and made more consistent with current requirements.

The Mayor's Five Year Financial Outlook, last issued in November 2008, did not include costs associated with new facilities planned to open during the five-year period. An update to the Five Year Outlook has been expected, and should address the many priority projects currently contemplated by the City, including the Civic Center Complex, the Convention Center Expansion and the New Main Library. An updated Five Year Outlook would shed light on the City's financial future and help to provide context to these significant decisions.

In preparation of the November Outlook, the Library Department submitted estimates of additional costs related to a FY 2012 opening of the new Main Library reflecting an increase of 16.94 FTEs at an additional cost of \$5.8 million (including non-personnel expenditures.) These costs were not included in the final Outlook. These increases (added to current budget levels) would bring total FTEs to 91.88 and costs to \$13 million for the New Main Library. In the current report to the Rules Committee, the Library Department now projects the need for a total of 81.94 FTEs and annual costs of \$10.5 million. These costs exclude Building Services, Technical Services, Delivery and READ San Diego, in order to make an appropriate comparison with the costs of other central libraries, as shown below. In contrast, the 2003 State application described a staffing plan reflective of 148.00 FTEs and annual operating costs of \$16.1 million.

The San Diego Public Library Foundation has indicated they have secured donations of \$10 million to fund the first five years of operating costs. If increased costs exceed \$2 million annually for the first five-year period, and after the private donations are exhausted, additional cost requirements for operations will fall to the City's General Fund.

Because of the changing plans and cost estimates related to the operations of the New Main Library, the IBA prepared a comparison of the City's current and projected costs with new and expanded city libraries in the cities of Seattle, San Francisco, and Phoenix. This information is summarized in the table below.

Jurisdiction	Size of facility (sq. ft.)	Main Library (FTE)	Sq. Ft. per FTE	Annual Main O&M Cost	Main Library Hours of Operation (per week)	Main Library Door Count	Total Library (FTE)	Total Annual Budget	Main Library Circulation/ Collection Size
Seattle Central Library	363,000	104.00 ⁽¹⁾	3,490	\$10.2M	62	2 million	533.00	\$50.8 M	Circulation : 1.6M of 9.3M total Collection size : 1.1M of 2.3M total (FY 2008)
San Francisco Main Library	376,000	187.00 ⁽²⁾	2,011	\$15.4M	60	2 million	649.00	\$84.6M	Circulation : 2.2M of 8.3M total Collection : 1.3M of 2.5M total (FY 2008)
Phoenix, Burton Barr Central Library ⁽³⁾	280,000	88.90 ⁽⁴⁾	3,150	\$9.2M	52	784,000	348.60	\$35.8M	Circulation: 2.4M of 15.4M total Collection : 705,000 of 2M total (FY 2009 estimates)
San Diego Central Library (Current)	144,000	74.94 ⁽⁵⁾	1,922	\$7.2M	52	563,000	375.00	\$37.0M	Circulation: 635,000 of 7.4M total Collection size: 823,000 of 3.6M total (FY 2008)
Projected San Diego New Main Library	366,000	81.94	4,467	\$10.5M	52	tbd	382.00	\$39.7M	Central collection projected to increase to 1.3M (Source: San Diego Public Library Foundation)

(1) Public service staff only. Excludes City Librarian, Administrative Services, and Technology and Collection Services divisions which are located at the central library.

(2) Public service staff only.

(3) Data reflect 20% FY 2009 mid-year budget reduction

(4) Public service staff only. Administrative staff, IT staff budgeted separately

(5) Public service staff and central NPE only.

Using the data in the comparison, the square foot per FTE was calculated, which shows that San Diego's current staffing at the existing library has the lowest ratio (1,922 sq ft per FTE) of the four cities, growing to the highest ratio (4,467 sq ft per FTE) using the projected staffing at the new, larger facility. This ratio may suggest the relative demand being placed on each full-time equivalent staff person, with a lower ratio being more desirable.

The City's Library Director has indicated that operational and technological advances will assist with efficiency gains that will enable the reduction of staffing requirements (on a per square footage basis) in the larger New Main Library facility.

CONCLUSION

This report discusses key elements of the proposed letter of intent with the San Diego Unified School District for the lease of the sixth and seventh floors of the New Main Library project. This information is intended to provide additional context and areas deserving further review to ensure a robust inspection and discussion of this proposal.

The Rules Committee may want to reevaluate the terms of the lease proposal, including the proposed treatment of credits related to tenant improvements and/or reducing the number of years for the lease term to equalize the value among both parties. In addition, information related to future costs has been provided, including a comparison of operating costs for main libraries in other cities.

[SIGNED]

Penni Takade
Deputy Director

[SIGNED]

Elaine DuVal
Fiscal & Policy Analyst

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst

Attachment: IBA Analysis of Lease Proposal