The City of Quesnel

FINAL DRAFT

New City Hall Financial Sustainability Plan A Discussion Paper

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1.0 EXECUTIVE SUMMARY

The initial purpose of this report is to assist Council in identifying financing options and an acquisition strategy relative to the New City Hall (i.e., John Ernst Building). The report then goes on to examine the performance of the building from an investment perspective and identifies options that would help the City reduce the extent to which it must support the building from general taxation.

The Report is divided into three main parts. Part I describes the lease financing arrangement with On-Line, including the challenges that the City faces as it looks towards formalizing a long-term interest in the property. Part II looks at the economic performance of the building from an investment perspective, while Part III focuses on a discussion of options available to reduce the direct cost to the City.

The review resulted in the following key conclusions:

1. The City has an obligation to pay for the building after the expiration of the existing lease agreements with On-Line. The option of "walking away" from the building after these leases expire is unrealistic. Steps should be taken to formalize the City's long term financial obligation and seek the assent of the electors to restructure the financial arrangement.

2. The City's lease with Gold's Gym does not incorporate many of the characteristics that are typically used for income-producing properties. The base rent charge is substantially lower than what the Appraisal Report identified as an estimate of market value. Furthermore, the City is responsible for all expenses associated with operating the building.

3. The decision of the Cariboo Regional District not to relocate the library to the fifth floor is further affecting the financial viability of the project and placing added strain on the City's operating budget.

4. Although the building is underperforming from a purely real estate investment perspective, selling the building in whole or in part is not seen as a realistic option.

5. Many of the operating expenses associated with the building are fixed rather than variable. Therefore, opportunities for reducing these costs are limited.

6. There is no real option to increase income from the space leased by Gold's Gym until July 2007. If Gold's Gym does not exercise its option to renew the lease in January 2005, then this opportunity will be lost altogether. Council should consider this possibility and make contingency plans, including adaptive reuse options for the lower levels of the building.

7. The City will need to consider what it envisages as a suitable use on the fifth floor, in both the short and longer terms. Care needs to be taken to avoid undertaking costly tenant improvements if only minimal returns are anticipated.

8. All things being equal, opportunities exist to save money by converting the existing lease financing to conventional debt financing. Further savings can be achieved by making an initial contribution from reserve funds to pay down the total amount of the loan. To date, no balloon or down payment has been applied against the lease principal. Rather, the City has maintained the lease with only minimal monthly payments.

Based on the analysis and conclusions, several recommendations are included for Council's consideration.

2.0 PURPOSE AND OBJECTIVES

The scope of this report is concerned broadly with the long-term financing of the New City Hall (John Ernst Building) and the adjoining lands. In preparing this report, staff was asked to address the following objectives:

1. To develop a financial acquisition plan for the land and buildings;
2. To quantify the extent to which the City is required to support financially this real estate investment through general purpose taxation; and
3. To identify options designed to reduce the level of ongoing financial support required from general taxation.

3.0 METHODOLOGY

To accomplish these objectives, staff reviewed several documents relating to the New City Hall project. Documents reviewed included:

- North Country Appraisals (1985) Ltd.
  Appraisal of Place St. Laurent
  March 14, 2001
- Arthur Andersen Consulting
  Financial and Economic Review of Place St. Laurent Project
  April 2001
- City of Quesnel
  Report to Council on New City Hall Building Sustainability Plan
  April 24, 2002
- City of Quesnel
  Report to Council on Final Expenditures and Consolidated Lease
  October 29, 2002
- Order of the Hon. Justice Fraser of the B.C. Supreme Court
  in the matter of *Campbell et al v. City of Quesnel*
  June 12, 2001

- Lease Agreement between
  City of Quesnel and On-Line Leasing & Finance Corporation
  December 21, 1999

- Letter of Understanding between
  City of Quesnel and Municipal Finance Authority
  December 17, 1999

- Access Engineering/RBB Architect Partnership
  Master Plan and Addenda to Master Plan
  October 25, 2000 and November 21, 2000

- R.E. Rasmussen, Chartered Accountant
  Report on the Special Audit
  October 17, 2000

- City of Quesnel
  Report to Council on the Place St. Laurent Purchase Option
  January 17, 2001

- Kroll Lindquist Avey
  Place St. Laurent Inquiry
  February 19, 2001

- Sub Lease Agreement between
  City of Quesnel and Riverside Services Ltd.
  July 2001

- Lease Agreement between
  City of Quesnel and On-Line Leasing & Finance Corporation
  January 8, 2003

- City of Quesnel
  General Ledger Detail
  City Hall Leasing and Operating Accounts
  2000, 2001, 2002

- Correspondence between
  City of Quesnel and Cariboo Regional District
  2000, 2001, 2002

4.0 INTRODUCTION AND BACKGROUND

In December 1999, the City of Quesnel proceeded with the acquisition of Place St. Laurent and the adjoining four lots. Place St. Laurent is a five-story building, complete with a full basement, located in the downtown commercial core of Quesnel. The building was constructed in the early 1980's at an estimated cost of $8 million.

The two lower floors and basement are finished commercial space, which contains a fitness centre, a large swimming pool, and a lounge. The third, fourth, and fifth floors of the building were never finished by the original owner and builder and remained as unfinished office space at the time the building was acquired.

The acquisition of Place St. Laurent was intended to be an important civic development initiative by encouraging economic revitalization within the main business district of the City. The conceptual plan was to expand the existing City Hall and library and relocate them into the facility after renovations were completed. The concept also called for leasing the basement and first two levels of the building to an individual or company that would be interested in operating it as a fitness/leisure facility.

When Council decided to acquire the land and improvements for $4.7 million, the City elected to finance the acquisition through a lease to purchase arrangement with On-line Finance and Leasing Corporation (On-Line), rather than through an outright purchase. The costs to improve and renovate the facility were also financed through lease financing.

It was anticipated that the income stream generated from the fitness centre and library would reduce the amount that the City would need to pay to support the project from general taxation.

It was originally estimated that the cost to renovate the building and develop the site would be $800,000 to $900,000. Renovations and improvements to the building commenced in early 2000.

In October 2000, the Project Engineering consultant was instructed to prepare a formal *Master Plan* for the project. Contrary to the initial cost projections, the estimated cost to complete the required renovations had climbed to $2.7 million, including the $400,000 that the City has already spent on general improvements to the building. This figure was subsequently increased to $3.4 million in the *Addenda to the Master Plan*.

Despite the higher costs, Council's direction was to proceed with the renovations. From January 2000 through May 2002, the City managed the renovation of the buildings, with financing arranged through interim leases with On-Line. Total renovation costs amounted to $3,472,018. The City's total investment in the project amounts to $8,261,118. In the following sections of the report, we will:

1. Examine the various options available to the City of Quesnel in terms of acquiring the land and buildings outright;

2. Review the proposed lease terms that were discussed between City of Quesnel, Gold's Gym, and the Cariboo Regional District (CRD) in respect of their interest as potential tenants in the facility;

3. Evaluate the current performance of the building as a real estate investment and quantify the extent to which the City is required to support the building through general taxation; and

4. Look at ways by which the City can reduce its ongoing level of tax support.

5.0 FINANCIAL ACQUISITION PLAN

This section of the Report discusses the City's existing lease financing arrangement with On-Line and its corresponding financial obligation to the Municipal Finance Authority. The legislative prohibition against incurring a liability beyond a period of five years is also discussed. An understanding of this provision is important because it helps dictate the range of options available to the Council as it considers the most appropriate acquisition strategy for the building.

5.1 Current Situation

In late December 1999, the City entered into an agreement with On-Line under which On-Line agreed to purchase certain lands and buildings for the purpose of leasing them to the City. After the purchase was completed, the City and On-Line then entered into two separate lease agreements, one for the buildings and one for the lands. The City and On-Line agreed that certain improvements were needed for the purposes of making the building functional as a City Hall and also suitable for sub-leases to the Cariboo Regional District Library and Gold's Gym. The City and On-Line agreed that On-Line would pay for the improvements and that once all improvements were completed, a consolidated lease agreement would be entered into between the parties.

The consolidated lease incorporates the original lease financing of the building (i.e., not including land lease) of $4,047,100 with the cost of leasehold improvements, which totaled $3,472,018. The consolidated lease and final expenditures were presented to and approved by City Council on November 4th, 2002. The effective date of the final consolidated building lease is January 8, 2002. Some have suggested that by consolidating the original lease into a new lease we were violating the *Local Government Act*. It is worth noting that the original land lease is a separate lease and was unaffected by the consolidation of the original building lease financing and subsequent leasehold improvement costs. What we have however, are two leases with On-Line that have different expiry dates, both of which however are limited to a five-year term.

Exhibit 5-1 Summary of Lease Balances and Terms

	Date Entered	Expires On	Original Amount
Adjoining Land Lease	Dec. 1999	Dec. 2004	742,700
NCH Land & Bldg. (consol.)	Nov. 2002	Oct. 2007	7,519,118
			8,261,818

There is some uncertainty as to what the City is legally entitled to do and what obligations it may have when the current five-year leases agreements expire. The key issues that need to be addressed include:

- Does the City have an obligation to purchase the asset at the conclusion of the five year lease with On-Line?
- Does the City have the authority to negotiate a new lease based on the residual value?
- Can the City borrow money and pay out the leases in a lump sum amount?
- Can the City enter into a long-term (an additional 15 years) lease agreement?

5.2 Liability beyond Five Years

The uncertainty surrounding what the City is legally entitled to do stems from the provision of the *Local Government Act* which prohibits a local government from incurring a liability for a term of more than five years, or with an option to renew that could exceed five years, without the assent of the electors. Because the City acquired the property through lease purchase financing, there was no requirement to first seek the assent of the electors.

In June 2001, a Petition was filed in the B. C. Supreme Court challenging the agreements entered into between the City and On-Line. The Petitioners claimed, among other things, that the City acted unlawfully because the City was not permitted to incur a liability for a term of more than five-years without the approval of the electors of Quesnel. The B. C. Supreme Court ruled in June 2001 that the City had not acted unlawfully. The City's argument in the litigation was that insofar as the agreements between the City and On-Line were concerned, they constituted an operating lease such that the City had only a five year obligation to make lease payments and thereafter, the option to purchase the asset. The lease agreement with On-Line did not provide for a renewal of the lease or obligation on the part of any party to extend the contractual obligation beyond five years, which was the specific issue in that litigation.

5.3 City Obligation beyond Five Years

The argument advanced by the City and the subsequent Court ruling naturally raises the question as to what obligation, if any, the City has to purchase the lands at the end of the lease period. Put another way, could the City simply walk away from the building and any further financial obligation? The City does have legal and financial obligations in respect of the lands at the expiration of the current leases. The City's obligation, however, is not to On-Line, but rather to the Municipal Finance Authority. On December 7, 1999, the City and the Municipal Finance Authority (MFA) entered into a Letter of Understanding. Pursuant to that agreement, the City agreed with the MFA that it would either purchase the asset at the conclusion of the five year lease with On-Line or negotiate a new lease based on the residual value.

I suspect some will question the City's agreement with MFA. Having said that, I think it safe to say that if the City breached its agreement with MFA, the City would be faced with significant legal costs and potential damages.

If the City has a binding agreement with MFA to either purchase the property or enter into a new lease for the residual value, the question that begs to be asked is whether this can be done without obtaining the assent of the electors beforehand. The City can negotiate a new lease agreement for the residual value of the property, provided, of course, that the new lease does not incur a liability that would exceed five years. On the other hand, if the City chose to renew or extend the existing lease agreements, provincial legislation would require Council to obtain the assent of the electors. Although Council may have legal authority to enter into a new five year lease without obtaining elector assent, City Council would likely be criticized for violating the intent of the legislation because the City does – for all intents and purposes -- have a financial commitment that will exceed five years.

In view of the foregoing, there are various choices that need to be made before the end of the first five-year agreements. These options are outlined below.

5.4 Options for Consideration

Option 1 - Restructure financing by borrowing the entire amount necessary to pay out the existing two leases with On-Line.

In this scenario, the City would need to borrow approximately $8 million to pay out the land and consolidated leases with On-Line. In order to convert the lease financing into debt financing, the City would need to introduce a Loan Authorization bylaw. Before a loan authorization bylaw can be adopted, the City would need to obtain the assent of electors by providing them with a counter petition opportunity or a referendum.[1]

[1] I say that the assent of the electors would be required, but this may not be the case if some of the regulations that are being proposed come into effect with the *Community Charter.* Of particular relevance is the proposed increase to a municipality's limits on total liabilities (i.e., the notion of assent free borrowing room). The effect of the proposed new regulation governing assent free borrowing, as I understand it, may allow the municipality to borrow the money, without obtaining the assent of the electors or without providing for a counter-petition opportunity.

In the case of a counter-petition opportunity under the *Local Government Act*, if less than 5% of the electors petition against the bylaw then Council may proceed with the proposed bylaw. If more than 5% of the elector's petition against the bylaw, then council would have the option of seeking electors' assent through a referendum. Current legislation provides a threshold of 5% of the electors to petition against a bylaw. In Quesnel, this implies that it would take approximately 292 electors to effectively block Council from proceeding, without necessitating the need for a referendum.

It is being proposed in the new *Community Charter* that the counter-petition threshold percentage will be increased to 10% of electors. The new legislation will be in effect on January 1, 2004. The proposed change to the counter-petition threshold percentage is an important consideration. In view of the controversy that has surrounded this project from its inception, it is conceivable that at least 292 electors will petition against any initiative to either enter into a long term lease-to-purchase arrangement or to contract long term debt financing to purchase the property outright.

By increasing the percentage threshold to 10% of electors, a greater onus will be placed on those opposing the project to demonstrate the extent of their opposition. It is still conceivable that 10% will petition against the project, and if this happens, then Council would have the option of holding a referendum. It should be noted that the counter petition process is a much less onerous and costly process than seeking the assent of the electors through a referendum.

Option 1(a) - Restructure financing by using a combination of reserve funds and borrowed money to pay out the existing leases with On-Line.

This scenario is a variation of Option 1, except that rather than borrowing the entire amount required to pay out the leases, the City would pay down a portion of the total loan amount up front from general reserve funds. The reason for making a lump sum payment at the outset is to reduce the City's level of indebtedness. This, in turn, will reduce the City's annual cash flow requirement for debt servicing purposes. As under Option 1, the City would need to obtain the assent of the electors before a loan authorization could be adopted. A more detailed discussion of this option is included in Section 8.2.2 of this Report.

Option 2 - Enter into long-term lease-to-purchase arrangement (15 to 20 years)

As noted previously, if the City wished to enter into a new lease agreement for a period of more than five years or for a period which by exercising rights of renewal or extension could exceed five years, then Council must provide a counter-petition opportunity in relation to that proposed liability. This also holds true – as noted under both Options 1 and 1(a) -- if Council wanted to capitalize the purchase of the asset through long-term borrowing. The lease financing option is compared with the purchase option in Section 8.2 of this report.

Option 3 - *Seek elector approval to borrow money to purchase building outright but continue with existing leasing arrangement given the favourable interest rate obtained through the leasing program.*

This option is a combination of Options 1 and 2. Under this scenario, the City would seek the assent of the electors to one of the following or both:

A. Restructure the existing lease financing by borrowing money to purchase the building outright.

B. Continue with existing lease financing arrangement but allow the City to extend the agreements for a period of more than five years.

The rationale of this option is that it would give the City the flexibility to benefit from the more favourable interest rate achieved through the leasing program. At the same time, it would eliminate once and for all the uncertainty surrounding the issue of whether the City can incur a liability for a term of more than five years. The below market interest rate achieved through the lease financing arrangement offers some value to the City, but as we will see later on in this report that value is not that great. Additionally, it needs to be recognized that the lease financing interest rate is a floating rate and there is an element of risk that rates may rise over time. In the event of an unexpected rise in interest rates, this option would give the City the ability to restructure the lease financing with more conventional debt financing. A more detailed discussion of interest rate value and risk is included in Section 8.2.2 of this report.

Option 4 – Simply enter into new leases at the end of the five-year leases

As noted previously, the City is not prohibited from entering into a new lease for the residual value at the end of the five-year lease period. Recent court decisions have confirmed that a municipality cannot incur a liability for a period of more than five years or for a period, which by virtue of a renewal lease would exceed five years. However, as the Court ruled in *Campbell et al v. City of Quesnel*,

> *"The lease agreement…is for a period of five years. It contains no provisions for renewal and thus does not confer or purport to confer*

> *any legal rights for a period in excess of five years…. The lease agreement itself sets out the obligations and the opportunities of the City of Quesnel, and those take place according to the document, within the specified period of five years."*

There is some limited risk associated with this option -- particularly in light of the more recent B.C. Court of Appeal decision in the *Robson v. Maple Ridge* case – if the new leases were seen by the Court as part of the original transaction. In that case, the Court ruled in July 2001 that the District should have asked for the assent of the electors before proceeding with their Downtown Core Redevelopment Project. The Court ruled that the District did not have the authority to enter into the project agreements. The facts in the *Maple Ridge* case were however different from those in the Quesnel case.

Aside from the legal issue, there is also some political risk associated with this option; in that, some residents would likely view this approach as yet another example of the City circumventing – if not the letter of the law, at least the intent of the legislation.

Interestingly, however, if a court were to rule that the City acted unlawfully, the City would still have legal and financial obligations to the MFA. Conceivably, if the City attempted to breach its agreement with MFA to either purchase the asset or negotiate a new lease based on the residual value, the MFA would sue the City for specific performance of the agreement. If a Court ruled in favour of the MFA and issued an order pursuant to s. 335.1(c) and 335.1(d) of the *Local Government Act*, the City would be required to borrow money to pay for its financial obligations and this could be done without the assent of the electors.

Although this not the preferred option, it might still be considered as our fallback position in the event that the other options are not acceptable to either Council or the electors of the City.

5.5 Recommendations

5.5.1 THAT Council, after considering the lease vs. buy analysis in Section 8.2, approve-in-principle Option No. 1(a) as the preferred course of action.

5.5.2 THAT Council awaits the enactment of the Community Charter before seeking the assent of electors by providing a counter-petition opportunity.

6.0 BACKGROUND TO LEASE NEGOTIATIONS

As noted previously in this report, when the City acquired the property, it had a clear idea of the expected tenant mix for the building and the space tenants were expected to occupy. In this section, we discuss the history surrounding the discussions and negotiations that took place with Gold's Gym and the Regional District relative to their respective tenancies. This is not intended to be an exhaustive chronology of events. Instead, it is intended to help highlight the extent to which the outcome of these negotiations is impacting the current performance of the building from an investment point of view.

6.1 Gold's Gym Sub-Lease

Several informal discussions had taken place with a local fitness operator before the City acquired the property. However, it was not until after the building was purchased that anything was done to formalize some type of lease arrangement.

In April 2000, a Request for Proposals was issued by the City of Quesnel for a fitness company to sub-lease the basement and first two floors of the building. Only one proposal was received from the firm Riverside Services Ltd. (d.b.a. Gold's Gym). After submitting their proposal, Gold's Gym took possession of the premises on September 11, 2000, even though a formal sub-lease agreement had not been entered into between the parties. The arrangement proposed by Gold's' Gym included the following provisions:

- Flat lease of $60,000, GST included, with the City to receive a percentage of the profit to be generated. Rent was to commence on October 1, 2000.
- Utilities up to $12,000 annually.
- Maintenance and janitorial to $12,000 annually.
- The City is to deliver the pool facility in working order and the City shall pay for leasehold improvements, with the total amount being repaid over a period of time.

As the City watched its project costs increase dramatically during the Fall of 2000, concerns were raised that rental payments of $5,000 per month and a $12,000 cap on operating expenses were insufficient and came no where near representing fair market value. Furthermore, there was no provision in the terms of the proposal for the payment of property taxes.

During the fall of 2000 and into the spring of 2001, several attempts were made to formalize a sub-lease agreement with Gold's Gym. The owner of Gold's Gym was not receptive to the idea of renegotiating the financial terms of his current arrangement. He had submitted a proposal to the City, which outlined the financial obligations of the parties, and he understood that the City had accepted these terms when he was granted occupancy of the building in September 2000.

The City found itself in a difficult situation and in a rather weak bargaining position. In the *Inquiry Report*, Ron Parks summarized the City's position in the following way:

> *…We note that the City paid for all the renovations to Place St. Laurent, including for floors 1,2, and 5. We believe this approach exposes the City to certain business risks that may have been mitigated had the City entered into a formal agreement with its potential tenants prior to commencing the project.*
>
> *As of the date of our report, the City does not have signed long term leases negotiated with its tenants. However, the City has already paid in excess of $200,000 for renovations to the space occupied by Gold's Gym and it's committed to completing the renovations for the proposed library on the fifth floor. The major risk to the City of Quesnel is that it may not be able to sign long term leases with its potential tenants that justify the expenditures for leasehold improvements, or pass those costs directly to its tenants. We believe this ultimately weakens the City's position in its continuing negotiations with the potential tenants.*

Despite the weakened position in which the City found itself, repeated attempts were made to negotiate a formal lease arrangement with Gold's Gym. Eventually, a formal sub-lease agreement was agreed to and approved by Council at a Special In Camera meeting on January 8th, 2001. The main features of the sub-lease agreement are as follows:

- Basic minimum rent of $100,000 per annum, plus GST, commencing July 1, 2001. The sub-lease also includes a percentage rent provision, whereby the tenant is required to pay additional rents to the City if 8% of the tenant's gross receipts are greater than the basic rent.

- The term of the sub-lease is three years, six months and 24 days. The commencement date is July 1, 2001 and the end date is January 24, 2005.

- The tenant shall be responsible for payment of all property taxes levied on the premises.

- Except for property taxes, the rent shall be gross and inclusive of all operating costs relating to the building, including utilities, mechanical systems, structural repairs to pool and hot tubs, exterior lighting, and parking lot maintenance.

- The tenant shall be responsible for all operating costs that are separate to his premises.

- The tenant shall reimburse the City for tenant improvements made to the premises in the amount of $120,000 payable at a rate of $1,000 per month for 120 months to commence retroactively October 1, 2000. In the event the City terminates the term or any renewal, the tenant shall be relieved of any remaining obligation. In the event the tenant does not renew and otherwise terminates the agreement, the balance of tenant improvements will become due and payable forthwith.

- The tenant shall have two options to renew the sub-lease for a maximum of two additional terms of five years.

- The basic rent for a renewal term shall be the same basic rent for the first 18 months of the renewal term and thereafter shall be the fair market value for the premises.

6.2 Regional Library Framework Deal

Before acquiring Place St. Laurent, preliminary discussions had also taken place with the Cariboo Regional District about the possibility of the regional library becoming a tenant in the building and eventually a part owner. The original concept was for the library to be located on the third floor as this would give library patrons easy and direct access to the facility from the third floor ground entry on the north side of the building. However, due to the structural limitations of the third floor in terms of floor loading and difficulty to upgrade the structural supports because the lower floor was already finished space, it was decided to locate the library on the fifth floor, while the City Hall space requirements would be located on the third and fourth floors.

To be sure, the Cariboo Regional District had always preferred the third floor location; however, the CRD Board approved-in-principle the location of the library on the fifth floor of Place St. Laurent. This was confirmed by the CRD in a letter to the City of Quesnel, dated June 21, 2000. Based on this confirmation and other assurances from the CRD, the City proceeded with significant consulting and construction work to accommodate the library on the fifth floor.

The Phase II Structural Steel Contract proceeded in October 2000 and was tailored around the library occupying the fifth floor. Specific work in the contract for the library included adding joists to the fifth floor system and installing an additional set of stairs from the fourth floor lobby to the fifth floor.

It is the City's position that these costs, which amounted to $112,605, were incurred on the basis of representations and assurances provided to the City by the Regional District and its officials over an extended period of time. It was understood, at least by the City, that the City that the Regional District would enter into the sub-lease for library purposes in accordance with the terms and conditions that had been negotiated over that same period of time.

In December 2000 through January 2001, the City and the CRD finalized negotiations surrounding a sub-lease agreement, as well as an option to purchase a portion of the building and a co-ownership agreement to deal with issues of joint ownership. The business nature of the transaction was as follows:

- The City will grant to the Regional District a sub-lease for five years from December 21, 1999 through until December 20, 2004.

- The Regional District will pay the City the annual rent of $100,000 in four $25,000 proportionate quarterly installments. The notional "back-rent" from December 21, 1999 through until December 20, 2000 (being $100,000) is to be paid within thirty days after the City has awarded the contract for leasehold improvements.

- The City will be responsible for constructing the leasehold improvements to a budgeted amount of $595,000.

- The City will receive in return for those leasehold improvements, the existing library property and a further $220,000 on December 20, 2004 – as well the Regional District will pay to the City $14,000 per year in each year, as the City's carrying costs on that $220,000.

- With respect to the risk of cost variation on completion of leasehold improvements, if the costs come in at less that $595,000, there will be a reduction in the amount payable by the Regional District to the City (the $220,000 amount) on December 20, 2004 and the City will be responsible for cost overruns of a maximum of $75,000, beyond which the Regional District would bear the risk.

- The Regional District will pay the City $20,000 per year in four $5,000 installments as its contribution towards maintenance, repair, and utility costs. In the event the agreement is replaced by a new agreement, the "rent" payments will continue, there will be no further payments for leasehold improvements and utility costs will be resolved by way of an agreement based on actual expenditures and percentage use.

- The Regional District will have the right once the City acquires title to these lands to acquire an undivided 20% interest as a tenant in common, or alternatively, exclusive ownership of its portion of the building through either an airspace or strata subdivision; and

- In the event the City for some reason does not acquire title to the lands and transfer a 20% interest or agree to a new lease, the rent and amounts paid directly and indirectly towards tenant improvements paid by the Regional District are to be refunded, less an amount defined as "market rent", which may be established by arbitration.

In December 2000, the Regional District Board offered its support in principle for the above-described terms and directed staff to finalize the terms and conditions in a formal legal document for final consideration and approval. Quesnel City Council approved the terms and conditions on January 8th, 2001, and on January 15, 2001, the CRD issued a press release, announcing its intention to locate the Quesnel library on the fifth floor of Place St. Laurent.

In March 2001 the CRD came to the realization that the space available on the fifth floor was only 8,700 sq. feet, rather than the 10,000 sq. feet that they had understood the case to be. Accordingly, the CRD proposed to expand the fifth floor roof structure over the existing balcony area, thereby increasing the available square footage to close to 10,000 sq. feet. City Council approved in principle the proposed changes to the roof line, provided that these modifications could be accommodated with the budget framework that had been negotiated with the CRD – namely, $470,000 in renovation costs plus an additional $125,000 allowance to resolve the roofing issue. The estimates for the library including the re-roofing amounted to $974,650.

As an alternative to the costly expansion of the fifth floor roofline to encompass the balcony area, the City offered to the CRD in May 2001 the use of 1,300 sq. feet of surplus floor space located on the fourth floor. The CRD subsequently retained a consultant, Bernard Perreten Architecture Inc. to identify all options available to expand the roofline over the balcony on the fifth floor.

In August 2001, the CRD issued their report entitled *Financial Impact – Quesnel Branch Library*. The report indicated that the least costly option would be the original plan to relocate the library on the fifth floor, without modifying the roofline. The most expensive option was the full expansion of the fifth floor roofline over the balcony area. The CRD chose the latter, more expensive option.

The City ultimately had to decline the CRD's preferred option on the basis that the Regional District was only willing to pay 20% of the cost of expanding the building envelope to enclose the fifth floor balconies. Moreover, Bernard Perreten's cost estimate to extend the roofline and enclose the balconies was unrealistically low. According to the City's Project Manager, the cost estimate supplied by the CRD's consultant represented approximately 35% to 40% of the City's cost estimate. The CRD was only willing to pay for 20% of their cost estimate, not 20% of the City's estimate or the actual cost.

In August 2001, Quesnel City Council met with the then Chair of the Regional District Board, along with the then Chair of the Library Board. The purpose of the meeting was to discuss the various options available and the potential for the library to be relocated onto the fifth floor as had been originally anticipated. After the various options and corresponding cost scenarios were considered by City Council and the CRD Board, the CRD issued a press release on October 1st, 2001, which stated that "After several years of negotiations with the City of Quesnel, no agreement was concluded on the leasing of the 5th floor of the Place St. Laurent complex."

7.0 EXTENT OF TAX SUPPORT

This section of the report deals with the current economic performance of the building. From a real estate investor's viewpoint, the economic feasibility and profitability of a project is based on whether the market value of the site after development will exceed the acquisition cost of the land, plus improvement costs. It may not be entirely appropriate to look at the New City Hall as a purely income-producing real estate investment. When the City decided to acquire the property, its decision was not based solely on the expected future performance of the property. Instead, its decision was based on other, perhaps less quantifiable objectives, such as downtown revitalization and economic renewal. It was noted in the *Appraisal Report* that

> *As in any rehabilitative project, development costs can often outstrip the estimated market evaluation of the property when conducted on the basis of pure economics*

However, one of the main factors influencing the City's decisions to acquire the property in the first place was its potential to generate income. More specifically, it was suggested that the income generated from the property would be sufficient enough to minimize the extent to which the City would need to support the investment through general taxation. Although there is no evidence that a proforma cash flow analysis was carried out before the building was acquired, it has been suggested that the net cost to the City would be in the range of $500,000 per year. Because the actual rate of return is substantially less that what was originally expected, the net cost to the City is substantially higher than $500,000 per year, and, this, in turn, is placing tremendous strain on the City's operating budget.

It was originally anticipated that the income stream generated from the fitness facility, as well as from the library, would reduce the amount that City would need to pay to support the investment. Before acquiring the building, however, only informal discussions had occurred with potential tenants. No negotiations had taken place as to what potential tenants would be willing to pay for renovations, rents, utilities, taxes, and other operating expenses. Because these issues were not addressed in advance, the City really had no idea how well the project would perform as an investment or what potential existed to generate income.

Exhibit 7-1 Summary of City Costs based on FY 2003 Budget Figures

OPERATING COSTS		
Insurance	$	5,169.00
Wages	$	32,560.00
Natural Gas	$	101,125.00
Hydro Rebate	$	(23,811.00)
Hydro	$	92,000.00
Maintenance & Supplies	$	50,800.00
Grounds	$	2,000.00
Security	$	-
Total Operating Costs	**$**	**259,843.00**
OPERATING COSTS SPECIFIC TO CITY		
Cleaning/Janitorial	$	39,270.00
Insurance-contents	$	1,261.00
		40,531.00
PROPERTY TAX LEVY		
Property Taxes	$	85,374.00
Property Tax Recovery - Gold's Gym	$	(49,148.00)
Net Property Taxes Payable	**$**	**36,226.00**
Total Operating Costs and Net Property Taxes Payable	**$**	**336,600.00**
INCOME		
Gross Rental Income	$	100,000.00
Other Income (Percentage Rent)	$	-
Effective Gross Income	**$**	**100,000.00**
LEASE PAYMENTS		
Land Lease	$	59,814.00
Building & Renovation Lease	$	553,578.00
Tenant Improvement Recoveries - Gold's Gym	$	(12,000.00)
Tenant Improvement Recoveries - Library	$	-
Total Lease Payment (Net of Recoveries)	**$**	**601,392.00**
Less: Lease Income Gold's Gym	**$**	**(100,000.00)**
Net Lease Payment	**$**	**501,392.00**
TOTAL NET LEASE PAYMENTS, NET TAXES AND OPERATING COSTS = LEVEL OF CITY TAX SUPPORT	**$**	**837,992.00**

7.1 Income Potential

The City Hall building has the potential to generate income by renting space to users. The income potential of a particular building depends on its ability to attract tenants to lease the space they need. In the remaining part of this section, we discuss some of the factors affecting the property's income potential and ultimately the extent to which the City must support the investment from general taxation[2].

7.1.1 Market Rents

The term market rent refers to the price that must be paid by a potential tenant to use a particular type of space under current market conditions. The rent depends on many factors, including real estate outlook, market demand for commercial property, and the supply of similar competitive space.

In the *Appraisal of Place St. Laurent*, the Appraiser, Mr. Harvey Erickson, noted the following with respect to rental rates:

> *Market surveys indicate rental rates of between $10 to $12 per square foot of office space that is largely inferior to the subject proposal. There is some limited evidence to show rental rates for institutional properties in the range of $14 to $16 per square foot.*
>
> *It is concluded that the custom designed nature of the works on the third, fourth, and fifth floors warrant an imposed rental rate of $16 psf with all tenant leaseholds completed by the City of Quesnel. A lesser rate of $8 psf is estimated for the Gold's Gym areas and $6 psf for the common areas of the building.*

With respect to expenses, the Appraisal report went on to state:

> *Based on the surveys conducted, we have included that rent for space in this property would be negotiated on a "net" rent basis, whereby the tenant would also pay a proportionate share of operating expenses through additional rent.*

The Appraisal Report estimated market rents and operating expenses as follows:

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[2] Much of the following discussion is based on material contained in the following two publications: (1) *Real Estate Financing in a Canadian Context*, Real Estate Division, Faculty of Commerce, University of British Columbia, 1998 and (2) William Brueggeman and Jeffrey Fisher, *Real Estate Finance & Investments*, 10t^{h} ed., (Irwin/McGraw-Hill, 1997).

Exhibit 7-2 Estimates of Market Rents and Operating Expenses

	Net Rate	Operating	Gross Rate
Basement Floor	$7.23	$5.87	$13.10 psf
Main Floor	$7.82	$5.87	$13.69 psf
Second Floor	$7.59	$5.87	$13.46 psf
Third Floor Offices	$16.00	$7.22	$23.22 psf
Fourth Floor Offices	$16.00	$7.22	$23.22 psf
Fifth Floor	$16.00	$7.22	$23.22 psf

The Report concluded that the combination of these estimated rates indicate an estimated net potential income of $701,602, inclusive of $326,784 in rent payments made by the City. This estimate converts to an overall rental rate of $11.63 per square foot. On the expense side, the report estimated a total expense of $401,400, which translates into an overall-operating rate of $6.65 per square foot.

The following table illustrates what the City is actually receiving in rental and operating expenses on a square footage basis. The rate that the City is paying has been calculated by simply adding the City's lease payments and overall operating costs to be paid by the City and then subtracting all income received.

Exhibit 7-3 Summary of Gross Rental Rates

	Actual Rate	Operating	Gross Rate
Gold's Gym	$3.68	$1.81	$5.49 psf
City Hall	$26.61	$14.16	$40.77 psf
Vacant Office	$0.00	$0.00	$0.00 psf
Fifth Floor	$0.00	$0.00	$0.00 psf

The estimate of market value prepared by the Appraiser indicated an average gross rate for the lower three levels of $13.42 psf, whereas the actual gross rate translates to $5.49 psf. For the space occupied by City Hall, the Appraiser's Report identified a gross rate of $23.22 psf, whereas the City is actually paying a gross rate of $40.77 psf. This rate excludes City Hall specific costs of $40,531.

7.2.2 Vacancy

In evaluating any income-producing property, it must be recognized that all space in a building may not be leased at a particular time. To project income for a property, it is necessary to project how much of the space will be occupied during the anticipated holding period. There should always be some allowance for vacant space.

The original concept for the facility provided no allowance for vacant space. The City Hall has relocated on to the third and fourth floors and is established as a long-term tenant. As noted earlier, the City was unsuccessful in securing the regional library as a long-term tenant and this is certainly affecting our initial gross income estimate. Furthermore, although the lower levels are currently sub leased to Gold's Gym, the Appraisal report noted that this space is vulnerable to vacancy and has estimated that a rate of 20% be utilized on the potential income estimated for the health spa.

Obviously, the fact that the facility has been operating at less that full occupancy is having a profound impact on our gross income estimates. The longer it takes for the fifth floor space to be rented, the less income the City will receive and, in turn, the more the City will need to pay from its general operating budget to support its investment. Because a vacancy implies a loss of rents and affects cash flow, it will also have an impact on the investment value of the property. The longer it will take for the remaining space to be rented, the more the City will need to pay to cover its costs.

7.2.3 Expenses

There are basically two different categories of expenses associated with income properties: variable and fixed.

Variable expenses are expenses that fluctuate with the level of occupancy. Utility expenses usually depend on how many tenants are in the building and are usually categorized as variable. However, there may be some minimum amount paid for utilities (heat and light) even if the building is vacant. We see this to a large extent with the new City Hall facility, where the fifth floor sits vacant but the City is paying to heat this space.

Fixed expenses do not fluctuate with the level of occupancy. Property taxes are determined by the assessed value of the property. Because this tax will not change with the level of occupancy, it is a fixed expense. Other expenses categorized as fixed expenses include insurance, maintenance, and repairs.

Clearly, the operating expenses for the New City Hall facility are a significant cost factor to the City. Standard practice in commercial real estate is to download these costs to the tenant as additional rent through recovery covenants. Except for the requirement to pay property taxes, this was not done with the Gold's Gym lease. In effect, the Gold's Gym lease is what is commonly referred to as a "gross lease", whereby the tenant pays a basic rent charge and the lessor, which in our case is the City, is responsible for payment of all operating expenses.

The following table compares the estimated operating expenses, including property taxes, per square foot based on FY 2003 budget figures with what the tenants are paying in respect of operating expenses.

Exhibit 7-4 Comparison of Operating Costs based on Floor Allocation vs. Actual

	Prorata Share	Actual	Difference
Gold's Gym	$6.27	$1.81	-$4.46 psf
City Hall	$6.06	$14.16	+$8.19 psf
Vacancy Office	$5.87	$0.00	-$5.87 psf
Fifth Floor	$7.22	$0.00	-$7.22 psf

7.2.4 Leases

Income properties are typically leased to tenants for a specified period of time. The lease assigns rights, duties, and responsibilities between the lessor (owner) and the lessee (tenant) that affect each party for the duration of the lease. The lease agreement defines the legal and financial characteristics of the agreement between the parties. The lease also determines how much risk will be borne by the lessor vs. the lessee and the amount that the tenant expects to pay for the rights associated with the use of space over the term of the lease.

The initial rent that must be paid under the lease contract is usually a specified dollar amount which is referred to as the "base rent". Some leases include "step-up" provisions that specify that the rent will increase periodically by predetermined amounts over the term of the lease. Another way for providing for increases in rents is to adjust the rent according to a specified index. The Consumer Price Index (CPI) is commonly used for this purpose. The lease with Gold's Gym includes no "step-up" provision until after 6.5 years at which time there is a provision for the rent to move to market rates.

In lieu of a step-up provision, the Gold's Gym lease includes a provision for rents to be partially based on a tenant's sales volume. This is referred to as "percentage rent". In the case of Gold's Gym, a minimum rent of $100,000 per annum must be paid regardless of the tenant's sales level. Then, if the tenant sales volume exceeds a specified amount, rent is calculated as a percentage of sales. The amount that total rent exceeds the minimum rent is referred to as "overage rent". The City has not received any overage rent payments from Gold's Gym based on their sales performance over the past two years.

7.2.5 Responsibility for Expenses

A lease should clearly identify which party has the responsibility for paying for building operating expenses such as property taxes, insurance, utilities, and maintenance. Two extreme lease types place all or none of this responsibility with the tenant. If the lessor pays for all operating expenses, the lease is referred to as a “gross lease”. In this case, the owner bears the risk of all unexpected changes in operating expenses. Alternatively, if the tenant pays all operating expenses, the lease is referred to as a “net lease”. Historically, the term “triple net lease” was used to refer to a lease that required the tenant to pay for property taxes, insurance, and maintenance in addition to rent. In this case, the tenant bears the entire risk of unexpected changes in operating expenses. The lease with Gold’s Gym might be referred to as a “single net” lease; in that, the City is responsible for all operating costs, except for the payment of taxes which is the responsibility of the tenant.

7.3 Summary

From the above discussion, we realize that there are a number of factors that determine the income potential of a property, as well as the degree of risk that is borne by the owner and tenant over the term of the lease. The following is a summary of the key factors affecting the City’s net operating income associated with operating the New City Hall building. The term net operating income is the term used to represent the net income generated by a particular property from rental of occupied space less operating expenses[3].

1. The actual rental rate of $3.68 psf paid by Gold’s Gym is substantially less that what the Appraisal Report had identified as the estimated net rent for this facility.

2. No vacancy allowance was provided for when initial income projections were calculated. The fact the fifth floor remains unoccupied is resulting in less rental income, as well as higher operating expenses for the City of Quesnel.

3. The operating costs for the building, including property taxes but excluding City Hall specific expenses, are in excess of $340,000 per annum. Except for the requirement that Gold’s Gym pays for property taxes, the City is responsible for all other operating expenses.

[3] The term net operating income, as defined, does not include the costs associated with debt service.

4. There is no provision for the periodic adjustment of rental rates. As a result, the City must bear the risk of increases in inflation. As inflation increases, the real value of the lease payments diminishes.

5. The use of a minimum and percentage rent provision in combination was, as I understand it, to allow the City to share in the success of the tenant while limiting downside risk. Of course, one can expect that the City would have to accept less minimum rent in exchange for participating in an increase in the tenant's sales activity. It would seem that the minimum rent charge was established at much too low a level.

8.0 REDUCING COSTS TO THE CITY

It is clear, based on the estimates illustrated in Exhibit 7-1 that the level of tax support required to sustain the building is significantly higher that what was originally anticipated. In the following analysis, it is assumed that the only realistic option for the City at this time is to retain the building, either by continuing to lease the building or by purchasing the building outright. This assumption is based on the following considerations:

- The agreement that the City has with the Municipal Finance Authority precludes the City from simply walking away from the property and its corresponding financial obligations at the end of the existing lease terms with On-Line.
- Given that the City has invested in excess of $8.2 million in the property, the option of disposing of the property without incurring a substantial loss is unlikely because the value of the building will depend to a large extent on the property's income potential over its economic life.
- The specialized nature of the building, coupled with the general state of the local commercial real estate market will likely prevent the City from realizing a market value that would come close to the $8.2 million already invested in the project.
- The remaining life expectancy of the building is considered to be in excess of 60 years. This useful life expectancy is almost double that of a pure investment property.

In view of the foregoing considerations, there is really only one rather straightforward option available to the City to reduce the ongoing level of tax support and that is to increase the investment performance of the building. This can be achieved in one of the following ways – notably, (1) by increasing the net operating income of the property, and/or (2) by realizing savings through a restructuring of the existing financing.

8.1 Improving Investment Performance

Based on FY 2003 budget estimates, the City will need to pay $837,992 to support the building. Perhaps some members of Council can justify this level of tax support in order to achieve the revitalization objectives that it originally wanted to achieve. Others may feel that this is an excessive premium to pay and is resulting in the City not being able to do other things that it would otherwise like to do.

To lessen the amount of tax support required, the City will need to improve the performance of the property as an investment vehicle by increasing net operating income. To achieve this, the City will need to examine its base rent charges, shift greater responsibility for payment of operating expenses onto tenants, increase occupancy by securing a tenant for the fifth floor, and be prepared to look at adaptive re-use options. A discussion of the various options for the City to consider is outlined below.

8.1.1 Base Rent

Apart from the City's occupancy of the third and fourth floors of the building, the City has only one paying tenant. As noted earlier in this report, the base rent charge paid by Gold's Gym is substantially lower than what the Appraisal Report identified as fair market rent. Moreover, the base rent charge is inclusive of all operating costs, except for property taxes, and this is simply adding to the City's cost burden.

Increasing the base rent charge for the space occupied by Gold's Gym would be the logical starting point if our aim were to increase net operating income. However, the City's options are very limited, at least in the short-term. Gold's Gym has a sub-lease agreement with the City, which clearly sets out the base rental charge. The current sub-lease will expire on January 24, 2006. The sub-lease also contains an option to renew for another five years. During the first 18 months of the renewal period, the tenant is required to pay the same basic rent as is currently being paid. After that initial 18-month period, the tenant is then required to pay fair market rent for the premises.

A cautionary note is in store at this point. It is conceivable that the existing tenant may elect not to exercise the option to renew, knowing full well that after 18 months into the renewal period, he will be faced with what may well be a substantial rent increase. Although the lease provides that he repay the outstanding balance of tenant improvement costs if he chooses not to renew, this may still be a better business decision when compared to the requirement to pay fair market value for the premises.

We do not know what the business' sales volume is or whether it would be sufficient to pay fair market rent and still maintain a reasonable profit margin for the operator. We do know, however, that the City has received no overage rent payments in the past two years, and, therefore, it can be determined that 8% of his gross sales has been less than $100,000.[4]

The owner will be faced with a business decision when it comes time to exercise his option to renew the sub-lease for a further five years. If the tenant elects not to exercise the sub-lease option and vacates the premises, the City itself will then be faced with its own business decision – namely, what to do with the vacant space, which represents roughly 45% of the entire building. The City will need to decide whether to try and attract a new tenant for the purpose of operating a leisure fitness centre or should it look at converting the space to suit an entirely new use. Whether the space on the lower floors of the building is a candidate for adaptive reuse is discussed later in this section.

8.1.2 Download Greater Responsibility for Payment of Operating Costs

The prorata share of operating costs for the Gold's Gym space amounts to $6.51 psf or $177,075. This figure is based on the 2003 budget estimates and includes property taxes. The City has budgeted to receive $49,148 or $1.81 psf from Gold's Gym as their prorata share of property taxes. The difference between these amounts is $127,927 and will need to be absorbed by the City as an operating expense. It is interesting to note that Gold Gym's minimum rent payment is less than what the City is paying to cover Gold Gym's prorata share of operating expenses.

There are limited opportunities to achieve savings by cutting operating expenses because most of the expenses associated with operating the building are fixed costs. One example of cost cutting on the expense side was the City's decision to participate in the Power Smart Program in an effort to reduce electricity costs. Under the program, the City, in partnership with B.C. Hydro, replaced the electrical fixtures on the lower three levels of the building with more energy efficient fixtures. The cost of the retrofit program was $39,685, with the City funding $15,874 from its 2003 operating budget and the remaining $23,811 to be received from B.C. Hydro in the form of a grant. It is anticipated that the savings in electricity costs will amount to $10,300 per year, which represents a pay back period of 1.5 years for the City to recoup its investment.

Despite these savings, they are not of a sufficient magnitude to appreciably reduce the level of ongoing tax support required by the City. Realistically, this can only be achieved by increasing rental income, shifting greater responsibility for payment of operating expenses on to tenants or both.

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[4] We have relied on a certified statement from the company's auditor to verify whether the percentage rent provision will override the minimum rent charge.

8.1.3 Renting Unoccupied Floor Space

At the present time, there is 8,700 square feet of vacant unfinished space on the fifth floor, as well as an additional 1,300 square feet of vacant unfinished space on the fourth floor.

The City has asked the Regional District to revisit their decision to relocate the library to the fifth floor on several occasions. The CRD's position is that they require 10,000 square feet, while only 8,700 square feet is available on the fifth floor, and, therefore, this location does not satisfy their requirements. The City has had a difficult time accepting the CRD's position on the available space issue, particularly in view of the negotiations that took place as described earlier in this report. The City believes that there is sufficient space on the fifth floor to allow for a modern and attractive library facility for the foreseeable future. The City was also willing to make available the 1,300 sq. feet on the fourth floor for office purpose, if deemed necessary.

In part based on the CRD's unwillingness to revisit the library issue, the City has initiated a statutory service review of the regional library function and its participation therein. One of the options the City will be considering during the course of the review will be the feasibility of establishing its own municipal library and locating it on the fifth floor. It may also be necessary to utilize the 1,300 square feet of unfinished floor space on the fourth floor for administrative use if offices cannot be comfortably accommodated on the fifth floor.

The Quesnel and Community Economic Development Corporation has approached the City to lease the 1,300 square feet of vacant space on the fourth floor. Although City Council initially gave favourable consideration to this request, it was later decided to defer this decision until such time as the library matter was resolved. The City did not want to spend any more money to renovate this space, only to find that either the CRD had a change of heart or, in the alternative, that the City decides to establish its own library and determines that this space is required.

8.1.4 Adaptive Reuse Options

The term "adaptive reuse" refers to converting an existing building or portion thereof to suit the needs of a new tenant or a new use altogether. Conventional wisdom holds that reuse makes the most sense when the new use is close to the original one. In some cases, however, the most successful adaptive reuse projects are the most radical ones.

The primary reason for considering adaptive reuse options is money. An unmarketable or underperforming property may have little value in its current condition. Having said that, we also have to keep in mind the concept of "highest and best use". In the Appraisal Report, the term was defined as follows:

> *…The principle of highest and best use is defined as that use which is most likely to produce the greatest net return over a given period of time.*

On the issue of highest and best use, the Report concluded that

> *… The proposed use conversion represents an optimum use of the property development and that the highest and best use will be achieved through the intended civic utility of the property… Value appears to be more associated with practical utility as opposed to investment scope.*

On the issue of alternative uses (i.e., adaptive reuse), the Report concluded that:

> *Even if the health spa only stays as a tenant in the building for a short-term period of say 5 to 10 years, the existence of this extensive superstructure area provides for some long term expansion capabilities of the building for other associated or complimentary uses… This space could be used for development such as a civic centre, arts gallery, playhouse/auditorium, courthouse, medical centre, and provincial or federal government offices, among other more specialized uses.*

As noted previously, it is a distinct possibility that Gold's Gym will not exercise its lease renewal option in January 2005. At that time, the City will need to decide whether it wishes to continue leasing the space as a fitness/leisure centre, and, if so, is it prepared to do so at any cost? If a proponent comes forward and is prepared to lease the space for fair market value, then the City should accept the proposal. If this does not happen, then the City will need to determine what opportunities exist to convert this space to another use and what the costs will be to carry out such a conversion.

If, as concluded in the Appraisal Report, the optimum use of the property were as a civic property, then one of the leading candidates to occupy the space – at least in my view – would be a library facility. The perceived space limitations associated with the fifth floor would be overcome. Additionally, the location is desirable and the ease of access from street level would be advantageous and preferable to the fifth floor. It is indeterminate at this time what the cost would be to convert this space and this would have to be looked at carefully before making such a decision. Aside from the direct conversion costs, it is anticipated that the utility costs for the lower levels would be substantially less if the pool were to be decommissioned. The City's Facility Manager has estimated annual savings of $ 42,000 for the pool alone.

A library facility, whether it is a municipal library or a branch of the regional system, would not require the 27,190 square feet of available space on the lower three levels. The surplus space could be rented and provide for additional lease income for the City. Obviously, the lounge area could be leased quite readily, with few improvements to the premises. There may also be some opportunities to lease space on the mezzanine level, but this would likely require a reconfiguration of the existing layout, which may be costly. Again, the costs associated with these types of renovations would need to be measured against the income generating potential of the space.

An obvious implication if the above scenario were to unfold is that the fifth floor would either remain vacant or become vacant in the event a library were to locate there in the interim. In the larger scheme of things, I believe it is more important to ensure the lower levels of the building are occupied. In my view, the fifth floor, which represents only 15% of the building area, is a secondary concern. If civic use is indeed the optimum use, the City could then focus its energies on attracting a suitable tenant or tenants for the fifth floor space.

8.2 Lease-to-Own versus Outright Purchase Analysis

The focus of the proceeding discussion was on improving the investment performance (i.e., net operating income) of the property. Clearly, improving this performance will have the greatest impact on reducing the cost to the City. On the other hand, the City could also save money by simply restructuring the existing lease-to-own financing and purchasing the asset outright. The following analysis identifies the relative benefits, costs, and risks associated with the existing lease financing as opposed to more conventional debt financing.

8.2.1 Property Tax Implications

Municipally owned properties are exempt from local government taxation. In our case, the property is not owned by the City but is owned by On-Line, a private company. The land and buildings are therefore not exempt from local taxation. The City has the authority under the *Local Government Act* to grant a permissive exemption from the municipal portion of property taxes, but it does not have the authority to exempt the property from taxes levied by other jurisdictions – namely, school taxes, regional hospital and district taxes, BC Assessment Authority, and Municipal Finance Authority.

The 2003 tax notice for the New City Hall, which is issued in the name of On-Line, amounts to $85,374. Of this total, $49,148 is apportioned to Gold's Gym, thereby leaving the City with a tax bill of $36,226. If the City owned the building, it would be exempt from all forms of local taxation, which in the current year would result in savings of $36,226. Under the *B.C. Assessment Authority Act*, if a municipally owned building is occupied in whole or in part by a business or commercial entity, the portion of the building that is used for commercial or non-governmental purposes is subject to local taxation and a tax notice is issued accordingly. In short, the City would save some money if it owned the building outright, while any commercial leasehold interests would still be required to pay local taxes. The amount that they would pay is based on the assessed value of the space that they occupy within the building.

An option that the City did investigate is whether it would be eligible for tax exempt status if the City were to pay off the land lease when it expires in December 2005. This is apparently what the CRD did with their new office/library complex in Williams Lake. Although the CRD continues to make payments on the lease financing that was obtained from On-Line for the renovations to the building, we understand that the property was granted tax exempt status by virtue of the fact that the land lease was paid out and title to the land was now vested in the name of the CRD and not On-Line. Unfortunately, it would seem that the provincial government has since changed its regulations so that a local government property would not be tax exempt unless title to both the land and improvements is vested in the name of the local government entity.

8.2.2 Interest Rates, Amortization Period and Total Indebtedness

A key objective of this report is to identify opportunities for reducing the extent to which the City must support the building from its general operating budget. Increasing net operating income will have the greatest potential of lessening these costs, but, as explained in the previous section of this report, the opportunities to increase net operating income are somewhat limited, at least in the short term.

By turning our attention to the other side of the ledger, it would appear that some real opportunities exist to save money and relieve the strain on the City's operating budget by simply restructuring the financing of the project. The following discussion focuses on (1) the inter-relationship between interest rates and the term of the loan, (2) the effect of extending the amortization period and (3) the effect of lowering the total loan amount.

Interest Rate

Under the current lease financing arrangement with On-Line, the City is paying a lower interest rate than if it were to finance the purchase of the building through long term debt. The City pays an interest rate of prime less one- percent. At the present time, the prime business-lending rate is 5%; therefore, the City is paying

4%.[5] By comparison, the interest rate charge to borrow money from the Municipal Finance Authority for a 10, 15, 20, or 25 year period is 4.9%, 5.6%, 5.6% and 5.6% respectively.

The cost of 10-year money, for example, is 4.9%, while the cost to borrow 15, 20, or 25-year money increases by more than ½ of a percentage point to 5.6%. The question that needs to be asked is whether an additional 0.7% is an excessive premium for longer, fixed rate stability.

The below market interest rate that the City obtains through the lease financing arrangement has some value to the City. The amount that the City is currently paying on its lease financing results in lower annual payments of approximately $45,403 when compared to a rate of 5.6%, amortized over 25 years. However, once you add the City's share of third party property taxes and the G.S.T charged on the lease payments, the debt financing option is actually less expensive that the leasing option.

Moreover, because the prime rate is a floating rate there is an element of risk that interest rates will rise, thereby increasing the amount of the lease payments. By borrowing money at a higher interest rate, the City would be able to obtain a stable, fixed rate and guard itself from an unexpected rise in interest rates. In considering the various interest rate options, the City will need to consider what rates are expected to do in the short, medium, and longer terms. According to the Municipal Finance Authority, it is anticipated that short-term interest rates will increase in the next 24 months to at least 4.9%. If, as predicted, interest rates increase over this period, the City may end up paying a higher rate than the rate that is currently available for 10-year money.

Extending the Amortization Period

If Council were to chose -- for reasons of rate stability -- to lock in the 4.9% rate for a 10-year term, it would not be necessary to utilize the same amortization period. In fact, staff is recommending that we amortize the debt over 25 years, but opt for a fixed rate for the first 10 years. This option is referred to as a partially amortized loan. On such loans, the balance owing at the end of the contract term (i.e., 10 years) will be used as the basis for a payout or for refinancing at then the prevailing interest rates. As the duration of the amortization period is increased, the rate of principal repayment is retarded, and, therefore, the outstanding debt at any point in time will be larger. On the other hand, extending the amortization period will allow the City to reduce its annual debt servicing requirements.

[5] This City's current payments have been calculated based on an interest rate charge of 3.5%, even though the current rate that we are being charged is 4%. In order to account for the fluctuating rate, On-Line will adjust the final lease payment to recover any interest owing.

Exhibit 8-1 below summarizes the annual cash flow requirements to service our existing lease financing arrangement with what the City would need to pay if it were to restructure the financing through long-term debt. A number of debt financing scenarios, using different interest rates and amortization periods, are included for comparison purposes. Unless otherwise noted, all scenarios have been calculated using an original loan amount of $8,261,818. A detailed comparison of the cost of owning versus leasing is included in Schedule IV to this report.

Exhibit 8-1 Summary of Annual Cash Flow Requirements

Financing Structure	Fee Simple Option	Lease Option
Status Quo – 4.0% interest rate using an amortization period of 25 years. Also includes City's portion of property taxes.		$644,075
MFA Debt Financing – 5.6% interest rate, amortized over 25 years.	$635,767	
MFA Debt Financing – 4.9% interest rate amortized over 10 years.	$1,184,806	
MFA Debt Financing – 4.9% interest rate amortized over 10 years, with a $2.0 million lump sum payment to reduce loan amount.	$906,706	
MFA Debt Financing – 4.9% interest rate for 10 years, but using an amortization period of 25 years.	$577,934	
MFA Debt Financing – 4.9% interest for 10 years, using an amortization period of 25 years, and making a lump sum payment of $2.0 million up front to reduce loan amount.	$438,029	

Pay Down Total Loan Amount

To further lessen the annual debt payments, staff is suggesting an option, which calls for an initial lump sum payment of $2.0 million against the outstanding balance. Not only will this have the effect of reducing the amount of interest payable over the term of the loan; it will also – as noted above – provide relief to the general operating budget by lessening our annual debt servicing costs. Annual savings of approximately $206,000 could be realized by choosing this option. It should be recognized that there is an opportunity cost associated with the use of these reserve funds. In the detailed cost breakdown contained in Schedule IV, staff has included an opportunity cost of $600,000, which reflects the potential earnings of this money if it were not used for this purpose. Even after we factor in this notional cost of $600,000, the City's interest savings are substantial.

In considering the various options to minimize the burden on the City's future cash flow and annual budgets, the concept of paying down the principal balance by utilizing reserve funds is deemed a viable option by staff. The 2002 Audited Financial Statements disclose a total of $8.7 million of combined reserves and prior years' fund surpluses. It would be feasible to allocate $2.0 million of these funds towards the reduction of the City Hall debt. If Council were to approve the use of these funds for this purpose, care must be taken to ensure that we do not lose sight of our reserve policy objectives/guidelines. One suggestion is that a corresponding plan be developed, which would be designed to provide for the orderly replenishment of these reserve funds.

8.3 Summary

The level of City funding that is required to sustain the New City Hall project is substantially higher than what was originally anticipated. It is not clear to what extent this is the result of lower than anticipated income or the result of substantially higher development and operating costs. To reduce the level of tax support, the options available to the City include:

1. Increasing net operating income by examining base rent charges, shifting greater responsibility for payment of operating costs on to tenants, and increasing level of occupancy by finding a suitable, long-term tenant for the fifth floor; and

2. Converting the existing lease financing to debt financing. Depending on the structure of the debt, the City could realize savings of up to $66,000 per year compared to what we are currently paying. If Council agreed to pay down the total loan amount up front, the savings would increase to over $206,000 per year.

There is no real opportunity to increase income from the space leased by Gold's Gym until July 2007. If Gold's Gym does not exercise its option to renew the lease in January 2005, then this opportunity will be lost altogether. Council should consider this possibility and make contingency plans, including adaptive reuse options for the lower levels of the building.

Finally, Council should consider what it envisages as a suitable use on the fifth floor, in both the short and longer terms. Care needs to be taken to avoid undertaking costly tenant improvements if only minimal returns are anticipated.

8.4 Recommendations

8.4.1 THAT Council agrees that the only realistic option is to retain the building and adjoining lands as a civic asset, rather than selling the building in whole or in part.

8.4.2 THAT Council determines – given the economic performance of the building as an investment -- whether it will consider adaptive reuse options for the lower three floors of the building, as well as for the fifth floor.

8.4.3 THAT, if Council wishes to explore adaptive reuse options, it should endeavour to determine at the earliest possible time whether the owner of Gold's Gym intends to exercise the renewal option.

8.4.4 THAT Council identifies what it envisages as being the "highest and best use" of the building in the long term.

8.4.5 THAT the City -- as part of the statutory service review of the regional library function – revisit short-term and longer-term spaces usage and co-ownership options with the CRD.

8.4.6 THAT Council considers the various financing options available to the City and select Option "I" as the preferred option (i.e., 4.9% over 10 years, 25-year amortization period, and $2.0 million contribution from reserves to pay down principal).

8.4.7 THAT Council direct staff to prepare the required bylaw(s) in order for the City to convert the existing lease financing to long term debt financing.

8.4.8 THAT Council direct staff to take steps to sell the old City Hall building.

8.4.9 THAT Council agree-in-principle to apply the sale proceeds from the old City Hall building against the proposed $2.0 million lump sum payment.

9.0 CONCLUSION

The objective of this Report was to address the following three issues:

1. To develop a financial acquisition plan for the land and buildings;

2. To quantify the extent to which the City is required to support financially this real estate investment through general purpose taxation; and

3. To identify options designed to reduce the level of ongoing financial support required from general taxation.

Based on our review and keeping these objectives in mind, the following conclusions are submitted for Council's considerations:

1. The City's lease with Gold's Gym does not incorporate many of the characteristics that are typically used for income-producing properties. The base rent charge is substantially lower than what the Appraisal Report identified as an estimate of market value. Furthermore, the City is responsible for all expenses associated with operating the building.

2. The decision of the Cariboo Regional District not to relocate the library to the fifth floor is adversely affecting the viability of the project as an income-producing investment.

3. The building is underperforming from a purely real estate investment perspective. Notwithstanding, selling the building in whole or in part is not a realistic option for the following reasons:

    - Based on the income potential of the property, it is unlikely the City would recapture its investment of more than $8.2 million. The specialized nature of the building and the soft commercial real estate market generally will also reduce the estimate of market value to a level well below what the City has invested to date.

    - The remaining life expectancy of the building is considered to be in excess of 60 years.

4. Most of the operating expenses associated with the building are fixed rather than variable. Therefore, opportunities for reducing these costs are limited.

5. There is no real option to increase income from the space leased by Gold's Gym until July 2007. If Gold's Gym does not exercise its option to renew the lease in January 2005, then this opportunity will be lost altogether. Council should consider this possibility and make contingency plans, including adaptive reuse options for the lower levels of the building.

6. The City will need to consider what it envisages as a suitable use on the fifth floor, in both the short and longer terms. Care needs to be taken to avoid undertaking costly tenant improvements if only minimal returns are anticipated.

7. All things being equal, opportunities exist to save money by converting the existing lease financing to conventional debt financing. Further savings can be achieved by making an initial contribution from reserve funds to pay down the total amount of the loan,

10.0 RECOMMENDATIONS

The following is a summary of the recommendations that have been made throughout the report. The pages are noted where the recommendations appear in the text.

Financial Acquisition Plan

5.3.1 THAT Council approves Option No. 1(a) as the preferred course of action. (Page 12)

5.3.2 THAT Council waits until after the Community Charter comes into effect on January 1, 2004 before seeking the assent of electors by providing a counter-petition opportunity. (Page 12)

Reducing Costs to the City

8.4.1 THAT Council agrees that the only realistic option is to retain the building and adjoining lands as a civic asset, rather than selling the building in whole or in part. (Page 36)

8.4.2 THAT Council determines – given the economic performance of the building as an investment -- whether it will consider adaptive reuse options for the lower three floors of the building, as well as for the fifth floor. (Page 37)

8.4.3 THAT, if Council wishes to explore adaptive reuse options, it should endeavour to determine at the earliest possible time whether the owner of Gold's Gym intends to exercise the renewal option. (Page 37)

8.4.4 THAT Council identifies what it envisages as being the "highest and best use" of the building in the long term. (Page 37)

8.4.5 THAT the City -- as part of the statutory service review of the regional library function – revisit short-term and longer-term space usage and co-ownership options with the CRD. (Page 37)

8.4.6 THAT Council considers the various financing options available to the City and select Option "I" as the preferred option (i.e., 4.9% over 10 years, 25-year amortization period, and $2.0 million contribution from reserves to pay down principal). (Page 37)

8.4.7 *THAT Council direct staff to prepare the required bylaw(s) in order for the City to convert the existing lease financing to long term debt financing. (Page 37)*

8.4.8 *THAT Council direct staff to take steps to sell the old City Hall building. (Page 37)*

8.4.9 *THAT Council agree-in-principle to apply the sale proceeds from the old City Hall building against the proposed $2.0 million lump sum payment. (Page 37)*

SCHEDULE I

SUMMARY OF CURRENT LEASE BALANCES

	NCH Land & Buildings	Adjoining Lots	TOTAL
Purchase Price	4,047,100.00	742,700.00	4,789,800.00
Renovation Costs	3,472,018.00		3,472,018.00
Consolidated Total	7,519,118.00	742,700.00	8,261,818.00

	Adjoining Lots Lease
Monthly Lease PMT 1-59	4,984.50
Monthly Lease PMT 60	4,984.71
Total Payments	60
Begin	Jan-00
End	Dec-05
Expired as of May 31, 03	41
Outstanding Payments	19
Residual	654,200.00

	Building & Renovation Costs Lease
Monthly Lease PMT 1-2	45,339.95
Monthly Lease PMT 3-59	44,212.61
Monthly Lease PMT 60	44,212.90
Total Payments	60
Begin	Nov-02
End	Oct-07
Expired as of May 31, 03	7
Outstanding Payments	53
Residual	5,798,958.54

SCHEDULE II

Summary of Lease Information - New City Hall

Tenant	Sq. Foot incl. common area	Pro rata Area	Current Rental	Current Rent per Sq. Foot	Prorata Share of Operating Costs for 2003	Prorata Operating Costs per Sq. Ft.	Operating Costs to be Paid in FY 2003 (Excl. Taxes)	Taxes for FY 2003	Actual Share of Operating per Sq. Foot Incl. Taxes	**Total Rental & Operating Costs**
Gold's Gym	27,190	45.10%	$ (100,000.00)	$ (3.68)	$ 127,927.95	$ 4.70	$ -	$ (49,148.51)	$ (1.81)	**$ (149,148.51)**
City Hall	22,598	37.48%	$ 601,392.00	$ 26.61	$ 106,341.88	$ 4.71	$ 283,654.00	$ 85,374.68	$ 14.16	**$ 970,420.68**
City Hall -Specific	n/a	n/a	n/a	n/a	n/a	n/a	$ 40,531.00			**$ 40,531.00**
Vacant Office	1,254	2.08%	$ -	$ -	$ 5,900.01	$ 4.70	$ -	$ -	$ -	**$ -**
Fifth Floor	9,247	15.34%	$ -	$ -	$ 43,484.16	$ 4.70	$ -	$ -	$ -	**$ -**
	60,288	100.00%	$ 501,392.00		$ 283,654.00		$ 324,185.00	$ 36,226.17		**$ 861,803.17**
BC Hydro Powersmart Grant Recovery										$ (23,811.00)
City Support from General Taxation										**$ 837,992.17**

SCHEDULE III

OPERATING EXPENSE CATEGORIES AND FLOOR SPACE ALLOCATIONS

OPERATING COSTS	37.49% City Hall Offices	15.33% Fifth Floor	2.08% Vacant Office	45.10% Gold's Gym	Parking	100% FY 2003 Budget
Insurance	$ 1,937.86	$ 792.41	$ 107.52	$ 2,331.21	$ -	$ 5,169.00
Wages	$ 12,206.74	$ 4,991.45	$ 677.25	$ 14,684.56	$ -	$ 32,560.00
Natural Gas	$ 37,911.76	$ 15,502.46	$ 2,103.40	$ 45,607.38	$ -	$ 101,125.00
Hydro	$ 34,490.80	$ 14,103.60	$ 1,913.60	$ 41,492.00	$ -	$ 92,000.00
Maintenance & Supplies	$ 19,044.92	$ 7,787.64	$ 1,056.64	$ 22,910.80	$ -	$ 50,800.00
Grounds	$ 749.80	$ 306.60	$ 41.60	$ 902.00	$ -	$ 2,000.00
Sub Total	$ 106,341.88	$ 43,484.16	$ 5,900.01	$ 127,927.95		$ 283,654.00
OPERATING COSTS SPECIFIC TO CITY						
	City Hall Offices					
Cleaning/Janitorial Wages & Supplies	$ 39,270.00					$ 39,270.00
Insurance - Contents	$ 1,261.00					$ 1,261.00
Property Taxes-2003 Property Tax Notice	$ 36,226.00			$ 49,148.00		$ 85,374.00
TOTAL	$ 183,098.88	$ 43,484.16	$ 5,900.01	$ 177,075.95		$ 409,559.00
OPERATING RECOVERIES						
	City Hall Offices	Fifth Floor	Vacant Office	Gold's Gym	Parking	FY 2003
Insurance						
Water, Sewer, & Garbage						
BC Hydro - Power Smart Grant	$ (8,924.36)	$ (3,652.61)	$ (495.27)	$ (10,738.76)		$ (23,811.00)
Hydro						
Maintenance/Minor Repairs						
Grounds						
Property Taxes				$ (49,148.00)		$ (49,148.00)
TOTAL OPERATING RECOVERIES	$ (8,924.36)	$ (3,652.61)	$ (495.27)	$ (59,886.76)		$ (72,959.00)
NET OPERATING COST TO CITY BEFORE LEASE PAYMENTS & TENANT IMPROVEMENT RECOVERY						$ 336,600.00
City Financing Charges (Lease Payments)						$ 613,392.00
Less: Lease Payment				$ 100,000.00		
Less: Tenant Improvement				$ 12,000.00		
				$ 112,000.00		$ (112,000.00)
						$ 501,392.00
CITY SUPPORT FROM GENERAL TAXATION						$ 837,992.00

SCHEDULE IV