CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Office of the City Attorney
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September 8, 2009

FILED
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DAVID H. YAMASAKI
Chief Executive Officer/Clerk,
Superior Court of CA County of Santa Clara
BY D. ALDYCKI

The Honorable Jamie Jacobs-May
Presiding Judge, Superior Court of California
191 North First Street
San Jose, CA 95113

Re: Grand Jury Report

Dear Judge Jacobs-May:

Pursuant to California Penal Code section 933, et seq., please accept the City's response to the June 10, 2009 Santa Clara County Civil Grand Jury Report entitled "Los Lagos Golf Course – San Jose's Financial Sand Trap". The approved City responses and the Grand Jury's Report are enclosed for your review.

Please feel free to contact me if you have any questions. Thank you for your consideration.

Very truly yours,

RICHARD DOYLE
City Attorney

Enclosures

cc: Mayor Chuck Reed
Debra Figone, City Manager
Albert Balagso, Director of PRNS

COUNCIL AGENDA: 09-01-09
ITEM: 5.2

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Albert Balagso

SUBJECT: RESPONSE TO GRAND JURY

DATE: 8-19-09

Approved

Date 9-4-09

COUNCIL DISTRICT: Citywide

RECOMMENDATION

It is recommended the Mayor and City Council accept this response to the 2008-2009 Santa Clara Civil Grand Jury Report, filed on June 10, 2009, and titled "Los Lagos Golf Course - San Jose's Financial Sand Trap."

OUTCOME

Approval of this report satisfies the requirements of Penal Code Section 933.05 (f), which requires the City Council to respond to the Civil Grand Jury report no later than 90 days after the Grand Jury submits its final report to the presiding judge of the Superior Court.

BACKGROUND

The Santa Clara Grand Jury investigated the financing, construction and operation of the City of San José's Los Lagos Golf Course to determine why, despite the City's original intention, the golf course has failed to fully cover its operating costs and debt service payments on the bonds issued to finance course construction, thereby requiring the City to use its General Fund to cover a portion of the debt service payments. In its Final Report, the Grand Jury makes six (6) findings and six (6) recommendations that identify the reasons it believes the unanticipated General Fund subsidy of these costs are required, and steps the City should take to avoid similar, unanticipated burdens on its General Fund in the future.

The sport of golf was extremely popular in the 1990's. Between 1990 and 2000, the number of golfers in the country (those that played more than eight rounds per year) grew from 11.8 million to 14.1 million, according to the National Golf Foundation (NGF). To accommodate the demand, course developers and architects turned out new courses in staggering numbers. In 2000 alone, about 300 new 18-hole courses opened throughout the country and there was a strong desire from San Jose residents, and therefore from the City Council, to construct a new golf course in the City of San Jose. To advance Council's interest, a Golf Facilities Task Force was formed which included three Council members. Their task was to ensure that direction for project development was streamlined and communicated in a timely manner. Ultimately, Los Lagos Golf Course was

completed and opened in April 2002. The course was designed by JMP Golf Design, built by Granite Construction, Inc., and is operated by CourseCo, Inc. dba Los Lagos Golf, LLC, under an Operations and Maintenance Agreement with the City. The Operational Agreement is for a term of fifteen (15) years ending in 2017. CourseCo, Inc. also operates the City's Rancho del Pueblo Golf Course under a separate agreement.

As an organization, the City of San Jose recognized that the golf market changed significantly in the 2000's. In 2006, the City collaborated with CourseCo to conduct an operational and financial review of Los Lagos Golf Course (Attachment F); in 2007, Office of the City Auditor, as part of its annual workplan, conducted a review of Los Lagos Golf Course (Attachment A); and in 2008, the City further contracted with Economics Research Associates in an operational review of the entire municipal golf system (Attachment B). All of these studies confirmed the following:

- The Bay Area public golf market softened considerably between 2002 and 2005.
- Los Lagos' revenue supports its operational expenses, but only a portion of its debt payments.
- The City will likely continue to subsidize the bond payment to a cost of about $600,000 to $800,000 annually.
- CourseCo noted that Los Lagos out performed its competitors notwithstanding the market downturn.

According to the Grand Jury Report, "The Grand Jury decided to inquire into the circumstances of the construction of Los Lagos Golf Course and the implications of the predicted adverse impact to the City's General Fund." The Grand Jury concluded the following:

1) The City relied on outdated financial feasibility studies for the golf course and failed to update the studies at critical stages before key decisions were made.
2) The final project design exceeded the original scope, thereby increasing the project cost.
3) Construction costs for the project as bids were much higher than estimated.

Grand Jury Findings/Recommendations and Staff Responses

The following section includes City of San Jose responses to the findings and recommendations from the Grand Jury:

Grand Jury Finding & Recommendation #1

Finding

The City decided to construct another municipal golf course at a time when six other golf courses were under construction and the surrounding communities already had municipal or public golf access courses. The expected total annual rounds of golf to be played have fallen short of the expectations contained in the original feasibility studies.

Recommendation
Prior to making critical decisions the City Manager must furnish the City Council with current feasibility studies. The information should include a City staff review of all assumptions made in the study for accuracy and conformance to existing City policy and procedures (e.g., living and prevailing wage rates, labor hours, cost-of-borrowing, etc.)

Response
Six Other Golf Courses—The Civil Grand Jury is correct that other golf courses were under construction during the development of Los Lagos. However, according to the ERA report, those courses were not direct competitors to Los Lagos. The Civil Grand Jury does not identify the other golf courses, but they are probably those shown in bold in Table II-1 of the ERA Review. Assuming so, two of the courses (one in Hollister and one in Hayward) are located outside the market area ERA defined for Los Lagos (Santa Clara and San Mateo counties, ERA Review, p II-13), while the other four are considered by ERA as high-end courses with retail green fees at least twice those of Los Lagos. Public access courses in this price range did not exist in the Los Lagos market area as defined by NGF.

Further, the 1997 National Golf Foundation *Market and Financial Analysis for the Proposed Development of the Coyote Creek Golf Course* had defined the primary market for Los Lagos to be located within a 15-mile radius of the course. NGF used two predictive models to estimate the number of golfers and public rounds (private rounds were not included) and driving range facilities demanded in the Los Lagos market. NGF concluded that the estimated demand in 2001 would be 2,137,500 rounds, and that the estimated public rounds supplied from all public access courses in the market, including seven courses then being planned, would be 1,485,000 resulting in an unmet need of 652,500 rounds for the Los Lagos market area. Despite the construction of the seven other golf courses, market analysis showed the estimated demand for the Los Lagos market justified construction.

Current Feasibility Studies—During the study, development and construction of Los Lagos Golf Course, the City Manager did furnish the City Council with current development, financing and operational information. The original feasibility study was completed by NGF in October, 1997 and published in its Market and Financial Analysis and provided to City Council in December 1997. (The course name was changed to Los Lagos before it opened in 2002.) Subsequently, the study and financial data were updated and presented to City Council as follows:

- ✓ October 1998 - by NGF.
- ✓ June 1999 - by NGF.
- ✓ June 30, 1999 – 1999 NGF update was provided to the Golf Facilities Task Force (which included three City Council members) with revised project costs for the golf course master plan.
- ✓ May 30, 2000 staff report approved by the City Council (Attachment C).
- ✓ July, 2000 to reflect the Net Operating Income assumptions used prior to the issuance of the lease revenue bonds (Attachment D).

- ✓ March 13, 2002 - following final negotiations with the course operator for operations and maintenance of the course (Attachment E).

It is important to note that Los Lagos continues to meet its operating expenses and a portion of its debt service obligation. The General Fund subsidy is primarily a result of 1) inability to achieve forecast market growth revenue due to overall decline in golf demand and economic downturn, 2) an underestimate (by 33,000 hours) of the labor that is required to operate Los Lagos and associated prevailing/living wages, and 3) construction bids that exceeded the Engineer's Estimate by $3,387,900, or 31%.

Grand Jury Finding & Recommendation #2

Finding
The cost of labor for operations and maintenance of the golf course was found to have been underestimated by the feasibility studies by about 33,000 labor hours resulting in $570,000 annually. The City Manager failed to provide an explanation whether this was the fault of the original study, failure of verification by City staff, or lack of operational oversight.

Recommendation
The City Manager should investigate the reasons behind the increased labor costs of the project, which has had a significant impact on the structural deficit. The City Manager should change and apply policy to reflect any lessons learned.

Response
The disparities in labor hours and costs were identified and shared with the City Council in May 2006 in the Operational and Financial Report conducted by CourseCo, Inc. (Attachment F). That report found that the original feasibility analysis, conducted in 1999 by NGF Consulting, underestimated the allocation of course operation staffing hours and the annual prevailing/living wage increases.

Staffing Hours & Prevailing Living Wage Increases - In the following areas of the golf operation, the NGF report underestimated the staffing and hours that were eventually required of CourseCo to maintain Los Lagos to the City's standards.

	NGF Estimate Hours/Year	CourseCo Actual Hours/Year	Difference
Maintenance	10,400	23,483	(13,083)
Golf Operations	6,651	18,732	(12,081)
Food & Beverage	5,113	13,135	(8,022)
TOTAL	22,164	55,350	(33,186)

In addition, the 2002 operations projections indicated 4% annual expense inflation while personnel rates alone increased approximately 5.5% annually for prevailing and living wage salaries. It is the combination of the underestimated hours and underestimated prevailing/living wage increases that accounts for the $570,000 disparity.

Grand Jury Finding & Recommendation #3

Finding
At the time the construction bids were opened, an unanticipated 31% increase in construction costs was revealed.

Recommendation
The City Manager should ensure that all departments develop and rigorously follow policies that require:

- *Project studies to be updated to reflect the impact of "scope creep" on cost*
- *Additional approval cycle if cost increases exceed a predetermined percentage of the total*

Response
The 31% increase in construction costs was due specifically to the bidding climate of the time. As explained in the 2000 staff report to Council (Attachment G), the primary reason for this overage was the extremely high level of construction activity at the time and its impact on the bid amounts for the structural elements of the course, including the clubhouse, driving range, cart barn and maintenance yard facilities. Accordingly, the approximate $3.4 million (the amount by which the contract exceeded the engineer's estimate) was due to an unforeseen spike in construction costs, not an expanded scope of the project. The remaining difference of approximately $3.0 million (engineer's estimate of $10.685 million – Conceptual Plan cost of $7.7 million) reflects the original project as developed in final design, the eight added project elements noted in the memorandum (including public art, enhanced golf cart facility, trail paving, etc.), and the cost of inflation between 1997 and 2000 which was included in the engineer's estimate when the project was put out to bid.

The City Manager did ensure all departments developed and rigorously followed standard policies for construction and cost estimation for capital projects. A review of the history of the Los Lagos project and its development is included in Attachment C, pp 8-10. The project was originally presented to the City Council on December 9, 1997 as a conceptual plan with a preliminary cost estimate and was followed up with numerous updates, construction and financial, up until March 2002. Below is a list of updates provided to City Council:

- ✓ December 1997 – *Market and Financial Analysis For The Proposed Development of the Coyote Creek Golf Course* provided to City Council NGF Projected
- ✓ June 30, 1999 – revised course design with added features and updated cost estimates to the Golf Facilities Task Force on June 30, 1999, together with the second update by NGF of its Market and Financial Analysis. In that update, NGF raised its revenue projections significantly, resulting in an approximate 50% increase in projected NOI
- ✓ May 23, 2000 – Council Memorandum regarding Tuers-Capitol Golf Course / Camden Park Refunding
- ✓ May 30, 2000 - City Council presentation regarding the final master plan and cost estimates (Attachment C)
- ✓ June 27, 2000 – Staff report to Council/Financing Authority
- ✓ July 31, 2000 – Revised proforma (Attachment D)

- ✓ August 8, 2000 – Tuers-Capitol Golf Course Construction Award memorandum
- ✓ June 5, 2001 – Council Memorandum seeking additional project funding
- ✓ June 26, 2001 – Council Memorandum requesting Project Consultant Agreement Amendment for continued construction management
- ✓ March 19, 2002 – Proposed Agreement for Operations and Maintenance

Grand Jury Finding & Recommendation #4

Finding
At the time a decision was reached to approve the master plan, the feasibility study was one year old and had not been updated.

Recommendation
Prior to making critical decisions the City Manager must furnish the City Council with current feasibility studies. The information should include a City staff review of all assumptions made in the study for accuracy and conformance to existing City policy and procedures (e.g., living and prevailing wage rates, labor hours, cost-of-borrowing, etc.).

Response
The City Council was furnished with updated feasibility studies after the Master Plan was approved. At the time the City Council approved the Master Plan (May 30, 2000), staff was also working with the City's Financial Advisor to assess the size of the bond issue supportable by golf course Net Operating Income (NOI). The update was completed in June 2000 (published July 31, 2000) and demonstrated that the NOI could support the sizing of the bonds issued in August of that year.

The final projected financial performance of Los Lagos was completed one month prior to the course opening with City Council's approval of the Proposed Agreement for Operations and Maintenance of Los Lagos Golf Course dated March 13, 2002. In 2008-09, the City Council adopted Budget Principle #8 that ensures operations and maintenance impacts to the General Fund over $100,000, regardless of the construction funding source, are considered early in project development and within the context of other budget needs.

Grand Jury Finding & Recommendation #5

Finding
Although there were significant increases of amenities and construction costs, the City Council and City Manager failed to readdress whether or not the golf course would be financially self-sustaining.

Recommendation
The City Manager should ensure that all departments develop and rigorously follow policies that require:

- *Project studies to be updated to reflect the impact of "scope creep" on cost*
- *Additional approval cycle if cost increases exceed a predetermined percentage of the total*

Response
Recommendation #5 is the same as Recommendation #3. The City Manager followed standard policies for construction and cost estimation in the Los Lagos project as evidenced by the May 2000 staff report (Attachment C) pp 8-10.

See Response #1 for details related to the issue of financial self-sustainability.

Grand Jury Finding & Recommendation #6

Finding
The City Council and City Manager have failed to identify any viable solutions to mitigate the ongoing golf course deficit.

Recommendation
The City Manager should provide information to the public as to proposed alternatives or solutions to the golf course deficits at Los Lagos and Rancho del Pueblo.

Response
The City Council and City Manager have recognized that the NOI shortfall is problematic and, through the City's annual budget process, the Council has approved use of the General Fund to mitigate the shortfall. As previously noted, prior to the Grand Jury investigation the City organization recognized that the golf market changed significantly in the 2000's. The City Auditor and the Parks, Recreation and Neighborhood Services (PRNS) Department completed three separate analyses between 2006 and 2008 regarding the financial situation of the City golf course program.

The ERA report also conducted preliminary land value and alternative use options in its report. For the purpose of determining whether alternative uses of the land would be advantageous to the City, the following is a summary of their conclusions.

Land Value
The ERA report estimated the market value of the land at both Rancho del Pueblo and Los Lagos. The report concludes that based on those estimates, individually or collectively, sale profits would not be enough to pay for the outstanding debt service if properties were sold for other recreational uses. Since market assessments change depending upon alternative uses proposed for the land sale, non-recreational uses may garner enough proceeds to clear debt service obligations. Consequently, further analysis should be conducted to fully document the true land values for these properties.

Alternative Uses
The courses could be converted into other recreational uses. If any of the golf course properties were converted to other recreational uses, there would be one-time capital investments and on-going operations and maintenance expenses associated with the new use and a continued debt service obligation. Non-recreational uses or sale would require more extensive studies to determine financial sustainability and to identify other restrictions such as additional environmental impacts, deed restrictions, parkland designation, etc.

financial sustainability and to identify other restrictions such as additional environmental impacts, deed restrictions, parkland designation, etc.

As part of the Mayor's 2009 Budget Messages, the City Manager was directed to review all underperforming City-owned properties and to develop a plan for the golf program that would eliminate the General Fund support and allow the courses to be self sustaining. The General Services Department Asset Management Program will undertake this effort beginning in January 2010.

Related Policy Issues

The Grand Jury report correctly identifies policy issues that arose in the Los Lagos project, some of which have already been resolved and others which have administrative solutions or will be presented to the City Council by the Administration.

- Living/Prevailing Wage - The Ordinance states any contract entered into after October 11, 1988 requires general prevailing wage of per diem wages as defined in the California Labor Code for public works construction projects, direct services related to residential street sweeping, convention center food services, parking lot maintenance services, janitorial or custodial services, and any City maintenance projects. The ordinance impacts Los Lagos and Rancho del Pueblo in the Food & Beverage (F&B) and Maintenance categories. The direct impact has resulted in 5.5% annual personnel increases versus the 4.0% annual expense inflation identified in the 2002 operations projections.

- Cost Estimation Policy - This policy was enacted August 22, 2000, to improve the quality and effectiveness of the City Public Capital Budget Process and accuracy of subsequent projects. This policy allows for improved estimates for capital costs providing City Council and the public with detailed project cost data.

- Operating & Maintenance Funding Certification - The 2008-2009 budget included specific Budget Principles to facilitate fiscally responsible and informed decision making in the development of the City's future budgets. Budget Principle #8 directs that capital improvement projects with annual operating and maintenance costs exceeding $100,000 in the General Fund cannot proceed without City Council certification. Implementation guidelines, approved by Council in December 2008, have been developed to ensure that O&M impacts to the General Fund, regardless of the construction funding source, are considered early in project development and within the context of other budget needs. This will provide Council the necessary contextual information to fully evaluate the impact of capital improvement projects prior to approval.

- Debt Management Policy - This policy was approved by City Council on May 21, 2002, and sets forth certain debt management objectives and establishes overall parameters for issuing and administering the City's debt. The policy's purpose is to ensure long-term borrowing may be used to finance the acquisition or improvement of land, facilities or equipment. Additionally, repayment of debt is guided by the principle that the maturity of the debt issue is

consistent with the economic or useful life of the capital project to be financed. The golf courses exceed this requirement as the usefulness of the acquisition will outlast the maturity of the debt and bring financial benefits to the City for years to come.

- Asset Management Principles - The Mayor and City Council have referred the evaluation of golf cost recovery to the Asset Management Program. The City Manager has been directed to develop a plan for the golf program that would eliminate General Fund support and allow the courses to be self sustaining. Currently, that evaluation is scheduled to commence in January 2010 as noted above.

NEXT STEPS/MOVING FORWARD

- Proceed with the adopted budget direction to review all under performing City-owned properties and develop a plan for the golf program that would eliminate the General Fund support and allow the courses to be self sustaining.

- Annually, the General Manager for Los Lagos and Rancho del Pueblo assesses and streamlines operations to reduce expenses and expand revenue opportunities. The City reviews and approves annual budgets and capital investment proposals and will continue to do so. Currently, the operator is reducing non-essential landscape areas and mandating maintenance staff take 40 hours of unpaid leave in order to reduce expenses.

Since its introduction into the market on April 1, 2002, Los Lagos Golf Course has garnered praise for its quality and affordability as reflected in public response, survey data, awards and recognition. The overall course conditions have remained at an award-winning high standard since opening. Los Lagos customers have rated course conditions at the 93rd percentile while the 2005 national average was at the 70th percentile. The course also ranked well above the national average in overall experience, overall value, condition of greens, and friendliness of staff. Los Lagos has also received national honors in customer service, agronomic quality, and environmental management.

The San Jose Municipal Golf Program (San Jose Municipal, Los Lagos and Rancho del Pueblo Golf Courses) has been a valuable asset to the San Jose community. The San Jose Golf program has averaged 190,000 rounds played over the last seven years and demographics indicate play as 45% seniors, 5% junior, 43% are 30-49 years of age, and 76% are residents.

- Los Lagos averages 65,000 rounds of golf each year, serving a broader number of recreational users from a variety of social-economic backgrounds.
- Los Lagos serves a diverse population of youth, senior, women and disabled participants. The course conducts many community events, including the nationally recognized "Saving Strokes" event designed as an exercise program for surviving stroke victims.
- Los Lagos conducts Junior Camps, serves as an Affiliate facility for the San Jose Chapter of The First Tee Program, and collaborates with six local high schools by offering free golf lessons to their golf teams during their seasons.

- Los Lagos has a partnership with Stonegate Elementary School by providing environmental educational programs along the Coyote Creek, as well as a basic introduction to golf for all of the fourth grade classes (over 120 students annually) and is a Certified Audubon Cooperative Sanctuary.

The Administration wishes to acknowledge the work of the Civil Grand Jury and looks forward to working with City Council on this important issue.

COORDINATION

This memorandum has been coordinated with the Departments of Public Works, Finance, General Services, and the City Manager's Office, including the Budget Office.

CEQA

Not a project.

ALBERT BALAGSO
Director of Parks, Recreation and
Neighborhood Services

For questions, please contact Cindy Rebhan, Park Manager, at 535-3581.

ATTACHMENTS

A. Audit by the City Auditor in 2007
B. Operational Review of City of San Jose Municipal Golf Course System, prepared by Economics Research Associates March 2008
C. Tuers-Capital Golf Course Master Plan May 30, 2000
D. Proforma for Los Lagos prepared by City's Financial Advisor dated July 31, 2000, entitled City of San Jose Tuers-Capitol Golf Course, Total Project Costs $18,134,925; Fixed Rate Debt Issue of $20,680,000
E. Proposed Agreement for Operations and Maintenance of Los Lagos Golf Course March 19, 2002
F. Los Lagos Operational and Financial Report May 2006
G. Tuers-Capitol Golf Course August 8, 2000

Due to volume of attachments and web site capabilities, persons who wish to review the documents may contact the Office of the Civil Grand Jury at 408-882-2721.