TORONTO STAFF REPORT

June 10, 2003

To: Administration Committee

From: Commissioner of Corporate Services and Chief Financial Officer and Treasurer

Subject: Union Station Request for Proposals- Financial Comparison
Negotiations with Union Pearson Group
(Ward 28 - Toronto Centre-Rosedale)

Purpose:

This report responds to motions from the January 29, 2003 special meeting of the Administration Committee requesting City staff to provide a financial comparison of the master agreement terms negotiated with Union Pearson Group ("UPG") to the original proposals offered by UPG and LP Heritage + Union Station Consortium ("LPH") and a hypothetical "public sector comparator" and to advise to what extent the City is encumbered or specific rights assigned to the proponent with respect to reciprocal rights regarding the upper area of Union Station.

Financial Implications and Impact Statement:

There are no financial implications arising out of this report.

Recommendations:

That this report be received for information purposes.

Background:

After the completion of the City's purchase of Union Station in August, 2000, City Council directed the Commissioner of Corporate Services to issue an international Request for Expressions of Interest (REOI) to determine the extent of private-sector interest in restoring, developing and operating Union Station. That directive was in accordance with the approach outlined in the business case for purchasing the station provided to Council at its Feb. 1, 2 & 3, 2000 meeting.

City Council subsequently adopted the staff recommendations to pre-qualify three of the respondents to the REOI for a subsequent Request for Proposal (RFP) process. Two of the pre-qualified proponents, UPG and LPH, submitted proposals to the City as part of the RFP process.

In July, 2002, City Council adopted a staff recommendation selecting UPG as the preferred proponent. City Council then directed staff to negotiate the appropriate legal agreements with UPG and report back to the Administration Committee.

At its special meeting held January 29, 2003, the Administration Committee considered a staff report regarding the negotiated terms of the Master Agreement with UPG. The Committee adopted, among other things, motions directing the Commissioner of Corporate Services to:

(a) negotiate further with Union Pearson Group with the intent of removing the second 50 year term of the lease or otherwise reducing the length of the lease or redefining the triggering mechanisms that afford greater control to the City;

(b) produce the lease and any agreements related to future density rights over Union Station lands to Council for consideration, through the Administration Committee;

(c) review further the design issues raised by the deputants appearing at the January 29, 2003, Special Meeting of the Administration Committee, particularly pedestrian flow, east, west, north and south connections, the GO concourses and the location of retail and report on potential improvements; and

(d) provide a public report to the Special Meeting of the Administration Committee to be arranged at the call of Chair of the Committee:

    (i) comparing the financial arrangements negotiated with Union Pearson Group with the original financial proposals of Union Pearson Group and LP Heritage + Union Station Consortium and with a "public sector comparator"; and

    (ii) on what extent the City is encumbered or specific rights assigned to the proponent of reciprocal rights regarding the upper area of Union Station; and

(e) report on the submissions and concerns raised by the deputants appearing at the Special Meeting of the Administration Committee held on January 29, 2003, specifically the issues raised by Mr. Art MacIlwain, President, Urquhart, Mr. John Sewell, Save Union Station Committee; Mr. Wayne Olson, Architect, OAA MRAIC, the Toronto Railway Historical Society, and the Toronto Preservation Board.

Comments

This report responds to items (a) and (d) above. A separate report examines the design issues and deputant concerns related to the RFP and specifically the UPG proposal.

At its meeting held February 4, 5, & 6, 2003, City Council requested the Commissioner of Corporate Services to seek the consent of the two proponents to the release of their financial proposals. UPG wrote to City Council on February 3, 2003 stating "We are expecting you to ensure that the question of disclosure of sensitive financial and business information is handled in a way that respects the process established by the City and the legitimate interests of all concerned." LPH wrote to City Council on February 21, 2003 to "endorse the view that at this critical point in the process full disclosure of all aspects of both Proponents' plans would be in the public interest". In response to the City Council motion, City staff wrote to UPG to request their consent. UPG submitted a further response dated March 18, 2003, a copy of which is attached as Appendix 'A', reiterating their serious concerns.

This report must be considered in the context of the RFP process which is still underway. Any material change(s) to that process could lead to significant legal and financial implications which should be carefully considered as part of this comparison.

(a) Lease Negotiations

The Master Agreement which is before the Administration Committee contemplates a lease term, which, with renewals, could extend to 100 years. The Administration Committee recommended that City staff negotiate with Union Pearson Group with the intent of removing the second 50 year term of the lease or otherwise reducing the length of the lease or redefining the triggering mechanisms that afford greater control to the City. Because this recommendation had not been referred to Council, City staff have merely had very preliminary discussions with UPG. UPG has responded positively but with the reminder that this additional lease term does have a value to UPG which must be recognized.

(b) Financial Comparison

<u>Original Offers</u>

The original financial offers submitted by UPG and LPH were reviewed by a Business Plan Review Team established specifically for this purpose. This team consisted of staff from the Corporate Services and Finance Departments along with outside legal counsel and the consultants hired to manage the RFP process. In June 2002, the Administration Committee considered the following summary of the financial aspects of the two proposals prepared by the Business Plan Review Team.

Table 1 – Summary of Financial Offers

	LP Heritage +	**Union Pearson**
Term: Base **Alternate Approach**	35 yrs. + 15 50 yrs. + 49 yrs.* (*reduced from 200 years)	50 yrs. + 50 yrs.
NPV of City Income over 1st 50 Years: **Base Proposal** **Alternate Approach**	 $25.6 million $35.4 million	 $37.5 million
Sensitivity of City Income to Retail Rent Achievement	Low	High
Sensitivity of City Income to Development Delays	Medium	Low short term but increases with long-term delays
Capital Investment (includes City requirements)	$83 million	$95 million
Financial/Legal Strength of Proponent	Low	Medium

Each of the offers had been submitted with financial pro-formas based on very different assumptions about the retail rental performance within the station. Part of the original financial comparison involved the standardization of the offers so that they were based on relatively similar assumptions.

Based on advice received from retail development consultants, both proposals were standardized to a common retail rental rate. At this rental rate, the estimated 50-year cash flows to the City from the LPH Alternate Proposal and the UPG Base Proposal resulted in relatively similar overall net present values of approximately $35-37 million based on a discount rate of 7%.

The achievement of the estimated cash flows to the City is subject to various forms of risk under either proposal. One form of financial risk is that the projected retail rental rates may not be realized. The City’s income under the UPG offer is more sensitive to this risk than under the LPH offer as a greater portion of the overall return to the City is in the form of participation rent and adjusted minimum guaranteed rent, which are geared to the station’s actual income performance.

A second form of financial risk is that development delays may result in delayed or reduced compensation to the City. LPH's development schedule is particularly sensitive to delays in GO's construction schedule as the LPH proposal includes the creation of a significant retail area within the GO concourses. Any delay in the retail development within these concourses would be reflected in a slower-than-projected increase in the minimum guaranteed rent, which is directly tied to the area open for service.

Conversely, UP's proposed compensation to the City will not be sensitive to GO's schedule as UP is not proposing significant retail development in the GO concourses. However, development delays as a result of other factors may result in a delay in the stabilization date at which UP's participation rent and adjusted minimum guaranteed rent begin to be paid to the City.

Negotiated Lease Terms

Aside from the removal of air rights, the Master Agreement financial terms negotiated with UPG do not differ in any material way from those presented in the original UPG offer. However, the negotiated terms did result in a refinement of the mechanism for the initial upward adjustment of the base rent to reflect actual project performance. These provisions now allow for a partial initiation of these payments as each phase of the project is completed rather than at full project completion, reducing the risk to the City.

The negotiated terms also reflect updated knowledge about the condition of the station. As part of a more detailed architectural review and design exercise, both the scope of work to be undertaken at the station and the costs of some of the budgeted items by UPG have increased from their proposal as a result of heritage issues. City staff have reviewed the list of additional work and concur with UPG that this work, with an estimated cost of $1.8 million, is in addition to that detailed in the RFP documents. If these additional items cannot be funded from the funds to be provided by the Federal government, the agreement commits the City to altering the scope of work at the station or delaying a portion of such work to address the difference.

Finally, the agreement commits the City to make up any material (ie. by more than 10%) variance from the net revenue amount presented in the station's pro-forma 2001 income statement. This statement, which was included in RFP documents, was prepared after the City had only been in possession of Union Station for part of 2000 and represented the best information that was available at that time. Due to a number of extraordinary items that occurred, the fact that TTR uses a cash-based accounting system, and because some expenses, such as property taxes, were still applied to both the station and the rail corridor, it has been determined that this statement may not be indicative of the current financial performance of the station.

Public Sector Comparator

Ever since Council's direction to initiate the REOI, staff have engaged the private sector in the process for renovating and operating Union Station. Staff's approach towards structuring the REOI and RFP process has been guided by the following principal objectives, as identified by Council:

- Minimizing the City's financial investment in the station
- Maximizing the value of this asset
- Enlisting the expertise of the private sector

The first of these objectives has been driven by Union Station's unique funding situation in comparison to other major, recent transportation hub projects. As shown in Table 2 below, most similar projects of this scale have received very significant portions of their overall funding from senior-level governments. The City has only received a conditional commitment of $25 million from the Federal government for improvements at the station that have yet to be determined. It has been assumed that none of this funding will be available for the work envisioned in the RFP.

Consequently, as a result of the City's funding constraints, the REOI and RFP documents directed proponents to submit offers to provide all of the financial investment necessary for the station's deferred maintenance, core heritage renovation and retail fit-out. None of the projects outlined in Table 2 depend entirely on private sector investment for their capital funding.

As private-sector proponents would require a long-term lease to recoup such a major investment, the RFP defined a base lease term of thirty-five years with one 15-year extension. This lease term could, potentially, be lengthened further if a proponent proposed additional capital expenditures for the development of existing or new areas below the station's concourse level.

An analysis of similar projects indicated that a large equity investment by a private sector proponent, coupled with a long-term leasehold interest, would result in strong incentives for the most efficient development and management of this asset. It would also minimize the City's staffing requirements to oversee the station's development and operation.

This approach is not the only one that could have been followed. A wide variety of approaches can result from different levels of public and private sector input to this type of project. Yet it is difficult to quantitatively compare potential alternative approaches with the offers received from UPG and LPH. The proponents have made firm offers to the City based on a detailed estimation of the potential costs and revenues. Moreover, the proponents' offers incorporate carefully considered allowances for the potential variability in the costs and revenues based on their experience gained in carrying out similar projects.

Table 2 – Examples of Other Recent Transportation Hub Renovation/Expansion Projects

Project	Non-Transportation Uses	Construction Cost ($US millions)	Financing	Private Sector Input
Boston South Station	• office • retail	100	• Federal govt. financed base building • Developer financed retail fit-out	• Private developer selected through RFP process to develop, operate and manage retail area • Developer received 30-year lease with two potential 10-year renewals
Grand Central Terminal, New York	• retail	220	• State and Local Revenue Bonds	• Construction, project management & initial leasing awarded to privately-held company through bid process • Ongoing management of station handled by separate firm on 3-year contract
JFK Airport Terminal 4, New York	• retail	1,300	• Primarily Port Authority bonds with small equity investment by developer	• Private consortium awarded contract for design, construction, and operation • Consortium received 25-year post-construction lease
Pearson Airport, Toronto	• retail	3,300	• Federal funding	• Project manager hired on fee basis
Pittsburgh Airport	• retail	783	• Federal, State and Local funding	• Private partnership chosen to manage the design, construction and operation of the retail development under 15-year master concessions agreement
Union Station, Washington, DC	• office • retail	175	• 75% of funding from Fed. Govt. and Amtrak • 25% private equity	• Private firm responsible for construction, operation and management of station under 99-year sublease
Union Station, Los Angeles	• office • retail	319	• Federal, State, Local & transit authority funding	• Private developer under fixed fee contract for design, construction, operation, and management of station

A similarly rigorous analysis has not been carried out for potential alternative approaches. Even if such an analysis were carried out, it would only represent an estimate rather than a firm commitment. An estimate by City staff would incorporate considerable uncertainty as the City has limited experience in carrying out similar projects.

Certain aspects of the proposed project are familiar to staff as a result of projects such as the restoration of Old City Hall and the construction of the National Trade Center. However, there is little quantitative data on the potential difference in costs for these projects had alternative models been followed. In addition, the Union Station project is unique in that it combines the sensitive, large-scale restoration of a deteriorated structure with the need to attract and satisfy a wide range of transportation-related and retail tenants.

Certain specific facets of an alternative approach, such as cost of capital, can be estimated in a quantitative fashion. However, others, such as the impact of varying levels of incentives on the performance of the station's operators, cannot. Therefore, the following is primarily a qualitative discussion of the pros and cons of alternative approaches that incorporate a greater degree of public sector input.

Development Phase

As shown in Table 2, capital financing is one of the areas in which there have been a wide variety of approaches towards mixing public and private inputs.

In some cases, such as the recent Grand Central Terminal revitalization in New York City and the current Pearson Airport upgrades, governments, either directly or through public sector agencies, have provided all of the necessary financial capital for the project. In other cases, the private-sector entities involved in the project have provided significant portions of the project equity. In the Boston South Station Project, financing responsibilities were apportioned according to the physical areas of responsibility so that government financed the base building upgrades while the private sector financed all of the retail fit-out. However, none of the projects on this table has been financed entirely by private equity as is currently proposed for the Union Station project.

There can be advantages to the use of public sector funds in financing the necessary capital improvements for these projects. Governments can usually benefit from a lower cost of funds than a private sector proponent can. When lending to a private firm, financial institutions will demand an interest rate that includes a premium to cover credit risk. A special-purpose private-sector entity created specifically to carry out this type of project may not have any significant assets (other than those directly related to the project such as a leasehold interest) to provide a lender as collateral. In addition, a private-sector proponent will likely only receive a loan for 60-70% of the project cost. The remainder of the project cost will have to be raised through equity investments, which will demand a much higher return to reflect their higher risk.

It is difficult, however, to precisely quantify the difference in overall costs that may result from the greater use of public sector funds. The actual interest rate that a lending institution will charge a private-sector borrower will depend on prevailing economic conditions, the financial strength of the project and the creditworthiness of the borrower.

Under the public sector approach, the City could maintain greater control over portions of the renovation and construction work. As discussed above, the public sector financed and managed the base building work in Boston South Station and Pittsburgh airport projects, while the private sector financed and managed the retail fit-out. In this way, the public sector directly managed the facets of the work with the greatest public interest.

Table 3 – Pros and Cons of Greater Public Sector Involvement		
	Pros	**Cons**
Development Phase	• City has lower cost of funds • Greater control over construction and renovation work	• City exposed to development risk • City may not manage construction as efficiently as private-sector entity with equity investment in station and long-term lease • Greater City staff requirement for supervision of consultants and contractors • Negative impact on overall City debt levels • Private developer may be better able to select retail/hotel fit-out that maximizes long-term revenues
Operational Phase	• Greater ability to replace unsatisfactory management • Greater flexibility to implement changes to station • City shielded from corporate income taxes	• Greater financial risk as there will be no guaranteed minimum rent to the City • Property managers hired on short-term contract will not have same incentives for long-term performance as private operator with long-term lease

However, as a result of dividing the areas of responsibility in the Boston South Station project, difficulties arose in determining responsibility for problems and defects. The cost of the project may have also increased due to the multiple learning curves of the various entities involved.

If the City provided some of the financing to the Union Station project, it would also be taking on greater exposure to the project's development risk. Although this could be mitigated to some extent through the terms of fixed-price contracts, the City would still be exposed to the risk of delays and requirements for additional work resulting from unforeseen conditions. These conditions may be particularly likely to surface in the large-scale renovation of a high-profile heritage structure such as Union Station.

In addition, these risks may be significantly increased by the City's potentially weaker ability to manage the project. The renovation of the station, together with its preparation for more effective retail use, will have to be carried out in a timely manner, under a strict budget, without unduly impacting daily station operations. City staff are likely not as experienced as private developers in the management and coordination of the large number of consultants and contractors that will be involved in a project of this scope. They may also not have access to equally rapid decision-making and approval processes when problems are encountered and changes are required. As a result, total project costs may be significantly greater. The Grand Central Terminal project, entirely financed by the public sector, had an original budget of $175 million and a final cost in excess of $220 million.

As discussed above, a private-sector proponent, with its own equity investment in the station, will have strong incentives to carefully manage the construction so that it is completed on time and on budget. Developers are more experienced than City staff in the disciplined supervision and coordination of consulting engineers, architects and contractors. A developer with a long-term lease is also more likely to ensure that the retail and/or hotel fit-out will meet the needs of prospective tenants.

Operational Phase

The level of public input in the operational phase of these types of projects has often been closely tied to the public involvement in the development phase. Where the public sector has maintained significant control in the development phase, the public sector has usually also maintained greater long-term operational control. In publicly-funded projects such as Grand Central Terminal and Los Angeles Union Station, governments have retained fee-based property managers on contract rather than giving over control of the facility through long-term sub-leases. This is also the approach currently being used by the City at the National Trade Center where O&Y/SMG manages this facility under contract.

Deputants to the January 29, 2003 Administration Committee have suggested that one of the principal benefits to this approach is that it will preserve greater control and flexibility for the City if any major changes to the station are required. It should be emphasized that control is not necessarily a function of the funding source for the project. It is possible to exercise control contractually or through regulatory powers.

Deputants also emphasized the City's need to maintain flexibility in making any major transportation improvements to the station. However, it appears that any potential transportation improvements will mostly impact the GO envelope at the station that would not be under UPG's control according to the Master Agreement. Unlike LPH's proposal, the UPG proposal did not include any retail development within the GO concourses where changes to rail alignments, platforms and stairs would have their greatest impact.

Any potential improvement in flexibility from increased City control would be offset by the City's exposure to additional risk. With the station under City control, there would be no guaranteed base rent for the City. Therefore, there would be no limitation to the City's financial downside. At Grand Central Terminal, the use of property managers on short-term contract has been found to hinder effective and continuous operation of the station. Although these types of contracts usually include some form of incentive payments for the manager, these payments are calculated based on each year's performance and do not provide incentives to maximize the long-term financial health of the station.

The City's own long-term funding for the maintenance and capital upgrading of the station may also be affected by changes in short-term funding priorities. While the initial capital investment in upgrades will result in a major reconstruction of the station, regular and continual funding will be necessary to maintain and refresh the station.

Nevertheless, the City can accept lower financial returns from the station than a private operator as it is shielded from corporate income taxes. A private-sector entity must achieve sufficient returns from the station to generate a reasonable profit after accounting for corporate income taxes. This is offset to some extent by the City's need to compensate a private property management company, which must incorporate sufficient revenues in its fees to cover taxes and an adequate profit.

(c) Upper Area Rights

The Administration Committee has before it the form of "Master Agreement" which has been negotiated between the UPG and City staff. Schedule H to the Master Agreement is the comprehensive outline of the principal terms to be contained in the long-term lease (the "Station Lease") of Union Station from the City to UPG (the "Station Lease Terms"). Both the Master Agreement and the Station Lease Terms address the City's right to build-out improvements in the air space above the existing Union Station building and above the rail corridor south of the building (the "Upper Area").

The Master Agreement and the Station Lease Terms provide that:

- the Upper Area will not be leased to UPG, but rather will be retained by the City, unencumbered by the Station Lease;
- following an initial period that is long enough to allow UPG to carry out its restoration work to Union Station, the City may proceed to create and build-out additional density in the Upper Area in such manner and with such parties as it may, in its complete discretion, determine; and
- UPG has no rights to build-out additional density in the Upper Area.

The Station Lease Terms identify more specifically the types of provisions that will need to be incorporated more comprehensively into the Station Lease in order to ensure that the City's right to build out improvements in the Upper Area is effective. The terms in question would cover:

- easements for access, subject to reasonable objective requirements;
- easements for support, subject to reasonable objective requirements and provided lessee's consent would be required with respect to any material impediment, restriction or interruption of the lessee's activities;
- lessee's approval of the scheduling of the work, not to be unreasonably withheld;
- lessee's (and sublessees) costs of disruption (i.e. actual direct costs of accommodating the build-out and lost revenues, if any, during disruption) to be covered by the party undertaking the build-out;
- lessor to indemnify the lessee against any third party claims arising from the build-out of the Upper Area unless caused by the lessee or persons for whom it is responsible;
- co-operation of the parties in respect of joint initiatives;
- restrictions against barring access;

- cross indemnities;
- insurance arrangements;
- arrangements for equitable allocation of shared costs; and
- binding dispute resolution procedures.

In addition, having regard to the fact that GO Transit owns the "envelope" that contains the train shed behind the Union Station building (from track level to 27 feet above track level) there is a Reciprocal Rights Agreement already in place with GO Transit, which also confirms the City's build-out rights above the rail corridor. It too provides for easements for access, support and repair and the other detail level terms as set out above.

The Station Lease Terms have been modelled on other projects where there is a need to effectively allow for integrated construction and operation of separate building components in one overall project. The terms address the issues which may arise. However, the Station Lease itself is yet to be settled. To the extent that it is determined that additional rights or protections are required to ensure that the City has a clear unencumbered right to develop the Upper Area and to confirm that UPG has not been given any rights to build out the Upper Area, staff can be instructed to address them further in settling the Station Lease. It must be recognized, however, that the restoration and operation of Union Station itself should not be materially impeded and the rights of UPG and its subtenants to certain basic protections would need to be preserved. It is suggested that the key to ensuring that any protections to be given to UPG do not in fact prevent any ultimate build-out of the Upper Area is to incorporate objective criteria to determine that the protections have been satisfied and to provide for a binding dispute resolution framework in case the parties cannot agree.

Conclusions

Various levels of public sector input can be blended with input from the private sector in carrying out the renovation and operation of major transportation hub facilities such as Union Station. While a wide variety of public/private partnerships are feasible, it is difficult to quantitatively compare their potential financial value to the City's Union Station project. The restoration and operation of complex transportation facilities containing very significant commercial activities is not part of the City's regular, core activities. Consequently, it is difficult to develop a realistic estimate of an alternative approach incorporating a greater level of public sector involvement. Such an estimate will not be comparable to the firm offers submitted by the two proponents.

The Master Agreement negotiated with UPG incorporates terms that are consistent with the terms originally offered by UPG as part of the City's RFP process. This process was, in turn, consistent with Council's stated goals of maximizing the value of this asset while minimizing the commitment of City funds and staff. City Council should be aware that a material change in the process at this point in time could attract legal consequences with significant financial implications.

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Appendix ‘A’ – Letter from Union Pearson Group