

**Real Estate Services Division – Restore Focus on
Union Station Leasing**

Date: June 13, 2017
To: Audit Committee
From: Auditor General
Wards: All

REASON FOR CONFIDENTIAL INFORMATION

This report involves the security of property belonging to the City or one of its agencies or corporations.

SUMMARY

This report presents the results of the Auditor General's audit of leasing at Union Station.

The Real Estate Services Division oversees leasing at the Station. Union Station has generated approximately \$59.4 million in leasing revenue over the last five years. The operating costs over this same period were \$62.4 million.

Overall, we found that lease administration functions have not been performed for the past number of years and immediate action is needed to resolve past issues. Of particular importance is the need for management to finalize, record, and collect in a timely manner, the estimated \$9.4 million in rents and recoveries owed by Station occupants for prior periods. The details of the outstanding rents and recoveries to be collected are provided in Confidential Attachment 1 of this report. We estimate that the delayed collection of these funds has resulted in the City losing the opportunity to earn a return on capital of \$740,000.

Once the focus on Union Station leasing has been restored, attention should quickly be turned towards ensuring future success of leasing in the revitalized Station. Currently, 4,000 out of an anticipated 165,000 square feet of commercial space under the Head Lease is already operating. During this initial phase of commercial operations, management should implement a strong framework to proactively and effectively monitor commercial operations under the Head Lease.

The effective implementation of the 21 recommendations contained in this report will remediate the collection of the City's annual leasing revenue streams and restore contract compliance. In addition, the development of effective controls will lay the foundation for the City to both contain costs and monitor future commercial revenue streams. Collectively, these measures will contribute to Union Station's long-term financial sustainability.

RECOMMENDATIONS

The Auditor General recommends that:

1. City Council request the Chief Corporate Officer to:

a. determine the City's measurements at Union Station (as at January 1, 2010) and assess the impact of significant changes to the following measurements for each year after 2010:

1. rentable area (occupied and vacant)
2. common areas and facilities
3. common use equipment
4. areas used for municipal purposes
5. areas under construction

b. ensure that current measurements are maintained and used for annual settlement purposes.

2. City Council request the Chief Corporate Officer, in consultation with the City Solicitor, to determine the appropriate action to take to settle the accounts related to the retail operations at Union Station for the period from 2010 to 2015.

3. City Council request the Chief Corporate Officer to:

a. review the VIA Rail settlement calculations for the years 2012 through 2015 to ensure accurate measurement data and operating costs are applied in compliance with their respective contracts.

b. ensure amounts owing by VIA Rail, for settlement of additional rent for the years 2012 through 2015, are recorded and collected on a timely basis.

4. City Council request the Chief Corporate Officer to:

a. review the current Metrolinx settlement calculations to ensure accurate measurement data and operating costs are applied in compliance with their respective contracts.

b. calculate and recover amounts owing related to Metrolinx occupancy of the West Wing and Centre Block office space from September 7, 2012 to June 30, 2013.

c. ensure amounts owing by Metrolinx, for settlement of additional rent for the period from July 1, 2013 to December 31, 2015 are recorded and collected on a timely basis.

5. City Council request the Chief Corporate Officer to:

a. complete the 2016 settlements of additional rent for all occupants at Union Station and ensure the amounts owing are recorded and collected on a timely basis.

b. ensure future settlements of additional rent are completed with each occupant at Union Station on an annual basis and in accordance with their respective agreements.

6. City Council request the Chief Corporate Officer to annually review and update lease data for each occupant at Union Station in the City's financial information system.

7. City Council request the Chief Corporate Officer in consultation with the Director, Accounting Services Division, to develop and implement a process to periodically review the accuracy and completeness of Union Station leasing receivables and revenues recorded in the City's financial information system.

8. City Council request the Chief Corporate Officer to ensure the estimated Union Station operating costs are calculated annually and each occupant is notified of their required monthly installment payment towards rents and recoveries.

9. City Council request the Chief Corporate Officer to report to City Council on the plans for the East Wing of Union Station. Such plans should include a complete financial analysis of the capital funding requirements and potential profits, costs, and opportunity costs of the available options (i.e. City purposes, retail, office, or strata sale) for the space.

10. City Council request the Chief Corporate Officer, in consultation with the Corporate Finance and Financial Planning Divisions, to validate assumptions underlying the existing financial forecasts for Union Station and report back to City Council with an up-to-date forecast of expected revenues and expenses.

11. City Council request the Chief Corporate Officer, in consultation with the Financial Planning Division, to develop and implement a comprehensive financial model to annually evaluate the financial performance of the commercial operations in Union Station.

12. City Council request the Chief Corporate Officer to develop and implement a cost allocation model that clearly defines how annual operating costs associated with different areas of Union Station will be allocated to and recovered from the Station's occupants.

13. City Council request the Chief Corporate Officer to determine the proportionate share of property taxes payable by each occupant at Union Station relative to the annual property tax bill.
14. City Council request the Chief Corporate Officer, in consultation with the Director, Accounting Services Division, to obtain a financial statement audit of the Leasing Manager's financial records for Union Station's commercial operations from 2010 to 2015.
15. City Council request the Chief Corporate Officer to develop formal policies and procedures to perform periodic reviews of budgets and actual expenditures provided by the Head Lessee. Reviews and explanations for variances should be documented and retained.
16. City Council request the Chief Corporate Officer to:
 - a. obtain audited financial statements of commercial operations to accompany the annual statement of profit distribution which is contractually due within 120 days after the end of each lease year.
 - b. determine whether there is a need for a periodic, independent contract compliance review to ensure that commercial revenues, expenditures, and profit calculations comply with the defined terms in the Head Lease Agreement.
17. City Council request the Chief Corporate Officer to implement processes to oversee the commercial enhancement works at Union Station for the purposes of ensuring that construction costs are minimized and the City only contributes up to its contractually agreed share of these enhancements.
18. City Council request the Chief Corporate Officer to review the City's rights under the Head Lease Agreement to enter into rental agreements with the Head Lessee for use of office space in Union Station and take the necessary actions to generate leasing revenue and recover operating costs.
19. City Council request the Chief Corporate Officer, in consultation with the City Solicitor, to determine the City's contractual right to retain any property tax refunds for Union Station and, if necessary, ensure refunds are distributed to the correct occupants.
20. City Council request the Chief Corporate Officer to clarify and summarize the terms in the Head Lease Agreement that are significantly material or subject to interpretation so that quick reference summaries are readily available for City staff assigned to manage leasing at Union Station.
21. City Council request the Chief Corporate Officer to centrally retain records related to Union Station leases.
22. City Council authorize the public release of Confidential Attachment 1 following the settlement of all Union Station occupant accounts up to and including 2016.

FINANCIAL IMPACT

The financial impact of audit findings and recommendations are as follows:

Description	Revenue or (Cost)
Finalize settlements and collect outstanding rents and recoveries	\$9.4 million
Avoid opportunity cost of delayed collection of outstanding rents and recoveries	(\$740,000)
Limit costs absorbed by the City as a result of the contracted cap on operating cost recoveries for commercial space	(\$1.5 to \$2.5 million)
Allocate and distribute property tax refunds, where appropriate	(\$5.8 million)
Avoid opportunity cost of vacant East Wing upon Union Station Revitalization Project (USRP) completion	cannot be quantified at this time
Monitor commercial operations for optimal financial results	cannot be quantified at this time
Charge rent annually for space used by the Head Lessee	\$54,000 to \$122,000

DECISION HISTORY

This review stemmed from the Audit of City Cleaning Services which was initiated during 2015. The Auditor General's reports on the Audit of City Cleaning Services issued in June 2016 can be found at:

<http://www.toronto.ca/legdocs/mmis/2016/au/bgrd/backgroundfile-94477.pdf>

<http://www.toronto.ca/legdocs/mmis/2016/au/bgrd/backgroundfile-94618.pdf>

During the course of that audit, it was brought to our attention that Union Station operating costs were not being recovered from occupants. An audit of cost recoveries from Union Station tenants was added to the Auditor General's Audit Work Plan.

<http://www.toronto.ca/legdocs/mmis/2017/au/bgrd/backgroundfile-101843.pdf>

COMMENTS

Union Station is the country's busiest multi-modal transportation hub. The Station is currently in the midst of an \$800 million revitalization with a vision of becoming a destination for dining, retail, special events and culture.

The Real Estate Services Division oversees leasing at Union Station. Union Station's leasing function has generated average annual revenues of \$11.9 million over the past five years. The average annual operating costs have been \$12.5 million. Revenue streams are expected to be sufficient to repay City debt and fund future Station operating and capital costs. Financial controls are needed to ensure the Station is financially sustainable in both the short and long-term.

In 2009, the City entered into two separate agreements with a private sector company:

- A Leasing Management Agreement governing the management of existing retail tenants prior to Union Station Revitalization Project construction commencing in the 33,000 square feet of existing retail space in the Station for the period from 2010 through 2015.
- A Head Lease of the commercial premises, together with the exclusive right to undertake commercial uses, in the Station. This includes leasing retail space, advertising, commercial signage and commercial special events. Initial retail leasing commenced in 2015.

Our audit report emphasizes the need to restore the focus on Union Station leasing.

Immediate action is needed to resolve past issues

This report identifies lease administration functions which were not performed for the past number of years. Consequently, an estimated \$9.4 million in rents and recoveries related to prior periods have not been finalized, recorded or collected. We estimate that the delayed collection of these funds has resulted in the City losing the opportunity to earn a return on capital of \$740,000.

The issues identified in this report should be addressed immediately to restore revenue streams and to eliminate the opportunity cost of delayed collection. Accounting records and financial information systems should also be brought to an accurate and up-to-date state.

Strong oversight is the foundation for future success

Once the focus on Union Station leasing has been restored, attention should quickly be turned towards ensuring future success of leasing in the revitalized Station.

The Head Lessee is currently operating 4,000 square feet of retail in Metrolinx-owned space. Upon completion of the Union Station Revitalization Project in 2018, the Head Lessee is anticipated to lease approximately 165,000 gross square feet of commercial space.

A strong control framework must be developed and implemented to oversee commercial operations. This foundation must be in place before the commercial operations under the Head Lease become fully operational.

Implementation of the 21 audit recommendations will bring the City's financial records up-to-date, and remediate the annual calculation and collection of rents and operating cost recoveries. In addition, they will help lay the foundation for the City to monitor future commercial revenue streams. This is needed to ensure adequate funding is available to repay debt, cover Station operating costs as well as provide for capital improvements in the short and long-term.

Our audit findings may not be isolated to leasing at Union Station and may be relevant to the entire leasing portfolio managed by the Real Estate Services Division, as well as other City divisions, agencies and corporations which oversee leasing activities independently of Real Estate Services.

The Auditor General has issued a separate letter to management detailing other less significant issues that came to our attention during the audit.

CONTACT

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SIGNATURE

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Auditor General

ATTACHMENTS

Attachment 1: Real Estate Services Division – Restore Focus on Union Station Leasing

Confidential Attachment 1: Real Estate Services Division – Restore Focus on Union Station Leasing (Confidential Information)