

# **AUDITOR GENERAL'S REPORT**

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

**June 13, 2017**

---

**Beverly Romeo-Beehler, CPA, CMA, B.B.A., JD, ICD.D, CFF**  
**Auditor General**



---

# TABLE OF CONTENTS

---

**EXECUTIVE SUMMARY ..... 1**

**BACKGROUND..... 8**

**AUDIT RESULTS..... 11**

**A. ACCURATELY CALCULATE AND ANNUALLY RECOVER COSTS..... 11**

    A.1. Finalize Annual Settlements for Additional Rent or Operating Costs ..... 12

    A.2. Record All Receivables in the City's Financial Information System..... 14

    A.3. Ensure Calculations to Settle Additional Rent are Accurate..... 15

    A.4. Annually Calculate and Communicate Estimated Operating Cost Installments..... 16

**B. ENSURE ROBUST FINANCIAL ANALYSIS INFORMS STRATEGIC DECISIONS ..... 19**

    B.1. Strategic Decision Needed to Maximize Value from Vacant Space ..... 19

    B.2. Update Union Station's Financial Forecast ..... 20

    B.3. Develop an Operating Cost Allocation Model for Union Station ..... 21

**C. IMPROVE OVERSIGHT OF COMMERCIAL OPERATIONS ..... 24**

    C.1. Obtain Independent Assurance of Financial Results for Past Retail Operations..... 24

    C.2. Implement Monitoring to Achieve Optimal Financial Results..... 26

**D. ADDITIONAL OPPORTUNITIES FOR IMPROVEMENTS ..... 30**

    D.1. Allocate Property Taxes and Refunds Appropriately to Occupants..... 30

    D.2. Consistent Understanding of Head Lease Agreement Terms is Critical..... 32

    D.3. Centralize Record Retention of Lease Information..... 33

**CONCLUSION ..... 34**

**AUDIT OBJECTIVES, SCOPE AND METHODOLOGY..... 35**

**EXHIBIT 1: Diagrams of the Anticipated Use of Space and Occupants at Union Station..... 38**

**APPENDIX 1: Management’s Response to the Auditor General’s Report Entitled: “Real Estate Services Division – Restore Focus on Union Station Leasing” ..... 41**

---

## EXECUTIVE SUMMARY

---

**Union Station is a key City asset**

Union Station is one of Canada's key gateways to Toronto. With a total planned capital investment of \$800 million, the Station is currently in the midst of a major revitalization. Despite the ongoing construction at the Station since 2010, it has continued to operate as the country's busiest multi-modal transportation hub. The vision is for the Station to become a destination for dining, retail, special events and culture.

**Station occupants include retail, office, and transit operators**

The Real Estate Services Division oversees leasing at Union Station. The Station's occupants include retail, office, and transit operators.

**Agreements governing commercial operations**

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

1. 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.
2. A Head Lease of the commercial premises, together with the exclusive right to undertake commercial uses, in the revitalized Station. This includes leasing retail space, advertising, commercial signage and commercial special events. Initial retail leasing commenced in late 2015.

Diagrams of the anticipated use of space and occupants at Union Station are included in Exhibit 1 of this report.

**Audit Objective**

The objective of this audit was to review the leases at Union Station to ensure leasing revenues and operating costs were settled between the City and each occupant, in accordance with each respective occupancy agreement.

**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 and collected. The issues identified in this report should be addressed immediately to restore revenues, accounting records, and information systems 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 (USRP) 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.

Table 1 highlights key audit findings contained in this report and their financial impact.

**Table 1: Financial Impact of Audit Findings**

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

**Address the past**

**(1) Act Immediately to Remediate Lease Administration**

**Annual estimates and settlements of rents and recoveries were not completed**

We noted that annual estimates and actual settlements of rents and recoveries were not performed. The City is contractually required to annually calculate and notify each occupant of their proportionate share of operating costs.

**The City may need to collect an estimated \$9.4 million in additional leasing revenue for prior periods**

At least four years have elapsed since the City's last settlement with anchor occupants at Union Station. In total, an estimated \$9.4 million of leasing revenue has not been recorded in the City's financial information system and 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.

**Current and past settlement calculations cannot be validated**

We could not validate certain assumptions applied to settlements underway. For example, 2010 measurements were used in calculations of operating cost recoveries for the 2012 to 2015 settlement periods because the City did not track the ongoing changes related to the occupied areas in the Station. Given the magnitude of potential outstanding balances, there is a need for City staff to perform further work to ensure that:

1. agreement terms are appropriately interpreted and applied
2. costs included in the settlement comply with agreements
3. calculations are based on accurate measurements

**Staff do not know whether amounts are owed to or due from former retail tenants**

City staff also could not demonstrate that annual estimates or settlements were completed for all of the former retail tenants between 2010 and 2015. At the time of our review, the City did not know whether there were any amounts owed to or due from these retail tenants.

**Immediate action is needed to correct and collect outstanding settlement amounts**

The City needs to take immediate action to review the accuracy of current settlement calculations, record the appropriate receivable, and collect outstanding amounts owing for prior periods up to the end of 2016.

## **(2) Perform Robust Financial Analysis to Inform Strategic Decisions**

**No strategic decision on the use of East Wing vacant space**

As the Union Station Revitalization Project nears its end, the City needs to make a strategic decision on the use of the approximately 100,000 square feet of vacant space in the Station's East Wing. More than two years have passed without a decision on the intended use of the space. The financial implications of the available options for the space, be it for City purposes or commercial use, must be evaluated. A strategic decision on the use of the space should be considered in view of the vision for the Station, the City's ongoing office modernization program, and the City wide real estate transformation.

**Opportunity to generate rent revenue in the East Wing should not be unduly delayed**

Should the City designate the space for commercial purposes, then plans will need to be developed immediately to ensure that the space is fully occupied upon USRP completion. Otherwise, there will be an opportunity cost if this space remains vacant when the Station's revitalization is complete. Time is required to plan, design, and prepare the space. In addition, management indicated that a significant investment is required to bring the space up to a leasable state. Funding sources for any required work must be identified.

**Update financial model to confirm leasing revenue streams are sufficient to repay City debt and fund future Station operating and capital costs**

The Station's retail revenue forecast presented to City Council in 2016 needs to be updated. The forecast did not include sponsorship revenues or percentage rents where the City would be entitled to a percentage of a tenant's revenue or profit. Further, certain assumptions included in this model need to reflect current market conditions and timelines for USRP completion. An updated, comprehensive financial model is needed to continuously monitor projected financial returns. This is needed to ensure that actual revenues are sufficient to cover City debt, and fund operating cost recovery shortfalls and future capital costs of the Station.

**Implement a cost allocation model to support cost recovery**

The financial framework for leasing at Union Station must address both forecasted revenues and operating costs. A clearly defined cost allocation model needs to be developed and implemented to ensure each occupant is allocated their proportionate share of facility operating costs in accordance with agreements. This model must address how operating costs for occupied areas as well as common areas of the Station will be allocated amongst Station occupants.

**City to absorb annual operating costs ranging between \$1.5 - \$2.5 million**

The extent to which the City will absorb operating costs is directly impacted by cost recovery limitations in agreements. For example, as a result of a cap on the operating costs the City can recover from commercial operations, we estimate the City could absorb costs in the range of \$1.5 to \$2.5 million annually. Over five years, the shortfall in operating cost recoveries would be between \$7.5 and \$12.5 million.

**Revenue streams will offset operating cost shortfalls**

Management advised that it was one of the underlying premises of the Head Lease negotiations that the parties would try not to pass the abnormally high costs that come with operating a transportation hub on to commercial tenants. Management asserted that, otherwise, the retail space would be uncompetitive in the marketplace. Therefore, the City decided to absorb a portion of the operating costs on the premise that the shortfall would be offset by the anticipated revenue streams.

To ensure optimal financial returns from Union Station operations, the City must model, monitor and minimize costs that cannot be allocated and must be absorbed.

**Establish a strong foundation of oversight**

### **(3) Implement Effective Oversight to Optimize Value from Commercial Operations**

**Obtain independent assurance of financial results for past retail operations**

Between 2010 and 2015, the Leasing Manager was responsible for retail lease administration in the Station. Retail operations during this period generated a total of \$26 million in gross revenue. Audited financial statements for retail operations were not obtained from the Leasing Manager. We were unable to verify the accuracy and completeness of the total gross retail revenues reported as earned or the \$22.3 million in distributions back to the City.

**Opportunity to develop oversight measures to maximize value from future commercial operations**

In 2015, the City began to turn over commercial space under the Head Lease. The anticipated 165,000 gross square feet of commercial space is being turned over to the Head Lessee in phases. The City's Head Lease Agreement for commercial operations at Union Station could span over 75 years. The most recent model forecasted the present value of retail revenue to the City to be \$168 million over the next 30 years. Given the magnitude and duration of the Agreement, it is important for the City to implement effective measures to oversee the Head Lease during the current start-up period.

Our audit noted that the oversight of commercial operations at Union Station can be improved. The City's contractual rights in the Head Lease need to be effectively exercised to ensure adequate monitoring of costs and revenues. The effective implementation of our audit recommendations is one step towards ensuring optimal financial results from the commercial operations at Union Station.

**Other administrative improvements**

This report also identified other administrative areas where improvements will contribute to the effectiveness and efficiency of leasing operations including:

- appropriately allocating property tax refunds to occupants
- summarizing Head Lease Agreement terms that are subject to interpretation
- centralizing record retention of lease information

**Conclusion**

**Ongoing audit work**

Our findings and conclusions are based on available information at the time our audit was completed<sup>1</sup>. Work on certain matters arising from this audit is ongoing and may be reported upon separately in the future.

---

<sup>1</sup> Refer to the Audit Objective, Scope, and Methodology section at the end of this report



**Recommendations to restore the focus on Union Station Leasing**

This report contains 21 recommendations. In our view, the implementation of these recommendations 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 the financial sustainability of Union Station.

**Relevance of audit findings to City divisions, agencies, and corporations**

In addition, the findings included in this report may not be isolated to Union Station. They may also be relevant to other leases managed by the Real Estate Services Division as well as other City divisions, agencies and corporations which oversee leases 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.

We express our appreciation for the co-operation and assistance we received from management and staff in the:

- Office of the Chief Corporate Officer
- Real Estate Services Division
- Legal Services Division
- Facilities Management Division
- Environment & Energy Division

---

## BACKGROUND

---

**Vision for Union Station included significantly increased retail space**

Union Station is a multi-tenant and multi-purpose facility currently undergoing major long-term construction.

The vision of the Union Station Revitalization Project (USRP) is to expand, restore, and transform Union Station. The three main objectives to be achieved are to:

1. promote Union Station as a multi-modal transportation hub first and foremost
2. preserve it as a heritage building
3. revitalize Union Station as a destination in order to ensure its ongoing financial stability.

<http://www.toronto.ca/legdocs/2006/agendas/council/cc060725/pof6rpt/cl011.pdf>

Over \$800 million will have been invested by the time the revitalization of Union Station is complete.

**Private sector firm responsible for commercial operations**

The revitalization approach adopted by City Council in 2007 was for City staff to manage the heritage, state of good repair, and transportation improvements to the Station. Approval was given for the Station's commercial operations to be run by a private sector firm under a head lease agreement.

**Commercial revenue at Union Station to cover capital costs and offset operating costs**

The commercial revenue generated from the head lease was expected to provide a positive return on investment, offsetting capital costs and reducing the City's costs of operating the Station.

<http://www.toronto.ca/legdocs/mmis/2007/ex/bgrd/backgroundfile-8803.pdf>

**Real Estate Services managed all leasing at Union Station prior to the USRP**

At the time, the City's Real Estate Services Division was responsible for managing all leasing activities at Union Station. The main occupants in the Station were:

- Metrolinx
- VIA Rail
- Bank of Nova Scotia
- Various commercial tenants

**Agreements governing commercial operations**

In 2009, the City awarded a private sector firm a Head Lease of the commercial premises, together with certain rights to carry out commercial uses in the Station. The City and the selected company entered into two separate agreements:

1. Leasing Management Agreement governing the management of the existing retail tenants in the 33,000 square feet of existing space in the Station prior to USRP construction. The Leasing Manager was paid a fixed fee for property management services until the last tenant vacated the retail space in September 2015.
2. Head Lease Agreement granting a head lease for 150,000 square feet of designated commercial space in the revitalized Station. A subsequent amendment increased the anticipated commercial space to 165,000 square feet. This Agreement grants exclusive right to undertake commercial uses including retail leasing, advertising, commercial signage, and commercial special events. The Head Lessee is an independent contractor and is not an agent of the City.

**Commercial profits are shared according to ownership**

The Head Lease Agreement and subsequent amendments stipulate how expenses and profits from commercial operations are shared. Profit sharing depends on the ownership of the space. Table 2 illustrates the sharing of profits amongst the parties that currently have a stake in commercial operations at Union Station:

**Table 2: Commercial Profit Allocations**

<b>Distribution of Profits from Commercial Operations In:</b>	<b>City Share</b>	<b>Head Lessee Share</b>	<b>Metrolinx Share</b>	<b>Total</b>
City-owned space	<b>50%</b>	<b>50%</b>	-	<b>100%</b>
Metrolinx-owned space	<b>30%</b>	<b>40%</b>	<b>30%</b>	<b>100%</b>

**\$168 million in retail revenue (present value) expected over the next 30 years**

The 30-year present value of retail revenues to the City, as reported to City Council, was forecasted in 2013 to be approximately \$168 million. This forecast did not include projected revenue from tenant percentage rent or sponsorship revenue.

<http://www.toronto.ca/legdocs/mmis/2016/cc/bgrd/backgroundfile-87892.pdf>

**Commercial space will be turned over to the Head Lessee in phases**

Commercial space is being turned over to the Head Lessee in phases. The Head Lessee is currently managing 4,000 square feet of retail in Metrolinx-owned space. Retailers in this space are currently up and running. Approximately 9,100 square feet of City-owned commercial space has been turned over to the Head Lessee to be readied for future tenants. Upon completion of the USRP, the Head Lessee is anticipated to lease approximately 165,000 gross square feet of commercial space. The Real Estate Services Division will continue to manage all other leasing and occupancy within the Station. Diagrams of the anticipated use of space and occupants are included in Exhibit 1 of this report.

---

## AUDIT RESULTS

---

This section of the report contains the findings from our audit work followed by specific recommendations.

### A. ACCURATELY CALCULATE AND ANNUALLY RECOVER COSTS

**The City as landlord incurs operating costs**

As primary owner and landlord of Union Station, the City incurs operating costs on behalf of tenants and occupants. For example, expenses are incurred for security, utilities, ongoing building maintenance, attending to any repairs, cleaning services, and waste removal. Areas in the Station that benefit all tenants, such as washrooms and the loading dock, are deemed "common areas and facilities". Tenants in Union Station may also share "common use equipment", such as mechanical, plumbing, heating and air conditioning systems, for some integrated services.

**Industry standard to recover "common area maintenance costs" as additional rent**

These common area maintenance costs are recovered from tenants or occupants as part of "additional rent" or operating costs. These costs are generally allocated to tenants in proportion to their share of the rentable area of the Station, except for utilities which may be metered.

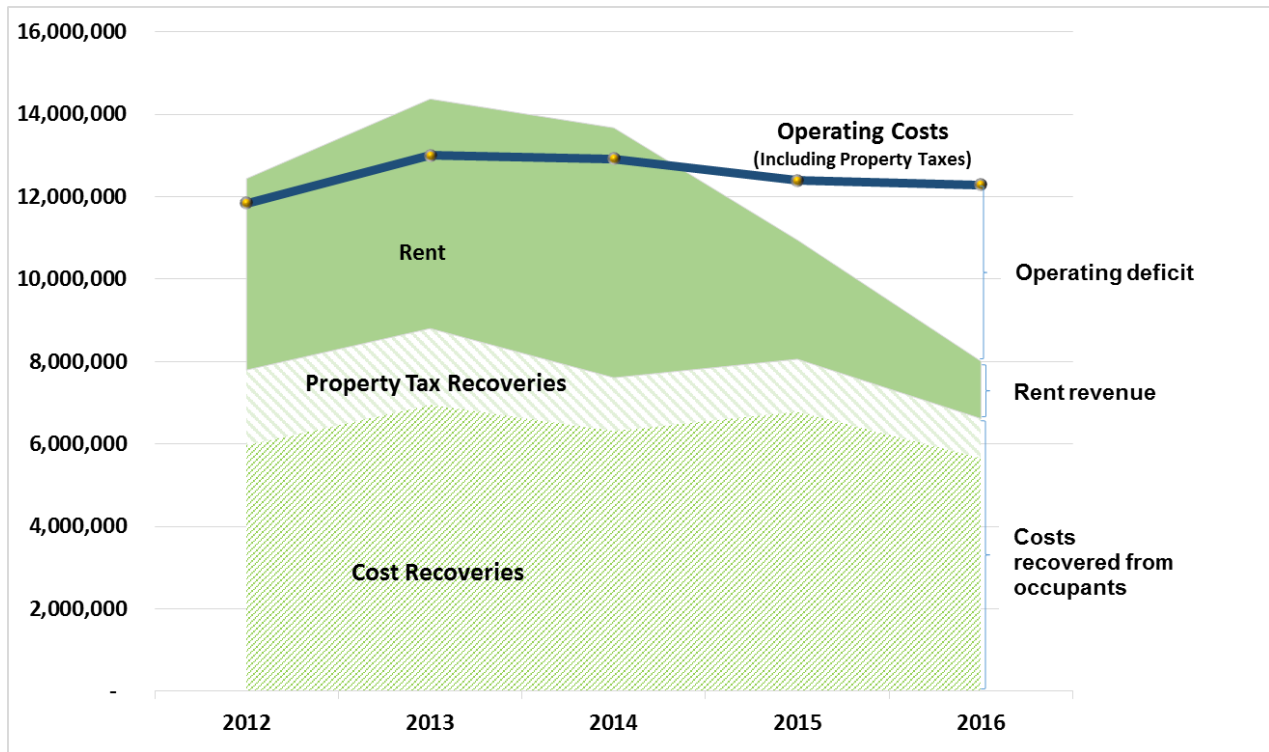
**Occupancy agreements require annual settlement of rents and recoveries**

Occupancy agreements require advance installment payments for rents and estimated recoveries. At the end of each year, the City is required to provide each occupant a statement of the actual operating costs incurred over the year. If the total actual costs vary from the total advance payments, the difference must be paid or settled between the parties. This process is referred to as the annual settlement.

**\$59.4 million in leasing revenue and \$62.4 million in operating costs over the last five years**

Over the last five years (2012 to 2016), average annual operating costs, as recorded in the City's financial information system for Union Station, was \$12.5 million. During this same period, average recorded revenues from leasing activities was \$11.9 million. The annual revenues and costs incurred to operate the Station over the past five years are shown in Figure 1.

**Figure 1: Union Station Revenues and Costs**



**Construction has contributed to higher than normal Station operating costs**

Operating costs specifically related to the Union Station Revitalization Project (USRP) were not separately identified and tracked in the City's financial information system. Therefore, the total Station operating costs for the period presented in Figure 1 are higher because of the USRP construction. Figure 1 also reflects lower rent revenues and operating deficits arising after the closure of existing retail areas during the revitalization. This was expected and included in the financial models presented to Council, as well as the annual budgets for Union Station.

**A.1. Finalize Annual Settlements for Additional Rent or Operating Costs**

**Issues were brought to our attention during the Audit of City Cleaning Services**

During the Auditor General's Audit of City Cleaning Services that was initiated during 2015, it was brought to our attention that Station operating costs were not being recovered from occupants. Our audit findings confirmed that the City was recovering some but not all operating costs from the Station's occupants.

**Annual settlements not performed in accordance with contracts**

Although the City has collected installment payments for rent, additional rent and operating costs, our audit found that the City did not perform annual settlements with each of its occupants as contractually required.

**\$9.4 million in estimated operating cost recoveries is outstanding**

Based on settlements underway, the City may be in a position to collect an estimated \$9.4 million in leasing revenues as detailed 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.

**City did not complete annual settlements with former retail tenants**

City staff could not demonstrate that annual settlements were done and served to former retail tenants between 2010 and 2015. Although these tenants paid advance installments during their lease terms, at the time of our audit, the City did not know whether there were any remaining amounts owing to or due from these retail tenants. These tenants vacated the Station by September 2015.

**City is owed unrecovered operating costs from VIA Rail for 2012 through 2015**

Five years have elapsed since the City's last settlement with VIA Rail. In November 2016, the City calculated and communicated to VIA Rail its intention to settle up on the amount due for the period between January 1, 2012 and December 31, 2015. According to the contract, the outstanding amount should have been paid within 60 days of the notice from the City. As of May 2017, no payment has been received and the matter is unresolved.

**City's last settlement with Metrolinx did not include operating costs for certain areas**

Nearly four years have passed since the City's last settlement with Metrolinx. The last settlement with Metrolinx covered the period from July 2006 to June 2013. This last settlement did not include the recovery of any operating costs related to the West Wing and the Centre Block office space.

**Metrolinx occupancy costs for 2013 to 2015 need to be finalized and collected**

At the time of our audit, City staff were working on the settlement with Metrolinx for the period covering July 1, 2013 to December 31, 2015.

**All 2016 settlements still need to be performed**

We noted that agreements require the City to settle up within 180 days of each fiscal period end. Therefore, the City should complete its 2016 settlement calculations without delay and serve notice to settle for this period. The estimated settlement is detailed in Confidential Attachment 1 of this report. The settlement of all outstanding amounts for rents and operating cost recoveries need to be finalized, recorded, and collected.

## **A.2. Record All Receivables in the City's Financial Information System**

**Leasing module data is not current or complete**

Revenue and receivables data recorded in the leasing module of the City's financial information system is not current or complete. For example, there are credit balances in two Union Station receivables accounts indicating that the City owes money to those parties. However management is of the opinion that these parties actually owe money to the City.

**Large outstanding account differences are not resolved in a timely manner**

Our review also found that annual updates to installments are not made and reflected in the occupants' accounts. As a result, the system-generated receivable that is posted monthly is not current and does not represent all amounts owed to the City. Staff must manually review occupant account details to understand why payments do not match the data in the system. Despite the ongoing review, large outstanding account differences are not resolved on a timely basis.

**\$9.4 million of estimated leasing receivables is unrecorded**

Most importantly, Union Station receivables for expected settlements are not being recorded in the City's financial information system. As at December 31, 2016, based on settlements currently being prepared, unrecorded receivables from Union Station occupants are estimated to be \$9.4 million as detailed in Confidential Attachment 1 of this report.

**Accurate receivables data is important for effective collection of revenues and for budgeting purposes**

Accurate occupant account data in the leasing module is critical for maintaining the integrity of financial information. This information is used for budget purposes as well as to effectively and efficiently collect leasing revenue.



### **A.3. Ensure Calculations to Settle Additional Rent are Accurate**

**Certain assumptions applied to the settlements underway should be revisited**

We could not confirm the validity of certain assumptions applied to the settlements underway. In the initial settlement calculations provided for our review, we noted that:

1. Settlements used rates set out in a schedule to an agreement rather than actual operating costs. The Legal Services Division should be consulted to ensure complex agreement terms are appropriately interpreted and applied.
2. Settlements included a cost allocation for certain building services even though these services and related costs were performed and paid for directly by occupants. These costs should be removed from the settlement to comply with occupancy agreements.
3. Current Union Station area measurements were not used for each settlement year. Real Estate Services have not tracked changes to occupied areas in Union Station since 2010. Calculations should be based on accurate measurements.

**Further work is required to ensure settlement calculations are accurate**

On June 9, 2017, after the completion of our audit, City staff revised the settlements underway. Based on the current calculations, the City may be in a position to collect an estimated \$9.4 million in leasing revenues as detailed in Confidential Attachment 1 of this report. The above noted items have not been fully addressed. Given the magnitude of the outstanding balances, there continues to be a need for further work by City staff before finalizing the settlements.

#### **A.4. Annually Calculate and Communicate Estimated Operating Cost Installments**

**City does not notify occupants at Union Station of their estimated operating cost recoveries**

The occupancy agreements require the City to annually notify each occupant of the estimate for additional rent or operating cost recoveries for the following year. These estimates are to be reasonable and, to the extent possible, based on actual expenses incurred in the previous year. The agreements require this notification to be sent before the start of each lease year such that appropriate installments can be made by each occupant. Despite these clauses in the agreements, City staff could not demonstrate that Union Station occupants were notified of their estimated annual operating cost installments.

**Estimates of operating cost recoveries were not updated after significant changes at the Station**

Moreover, there is no evidence that the City updated its operating cost estimates and the respective installment payments to reflect the significant changes that occurred within the Station as a result of the USRP. For example,

- Since 2013, Metrolinx has remitted the same amount for additional rent on a monthly basis despite significant changes such as occupancy of the West Wing, the opening of the York Concourse, and the closure of the Bay Concourse.
- Common area maintenance costs for a sample of retail tenants were not adjusted despite significant changes to both occupancy and rentable area during the period 2010 to 2015.

**Estimates of rents and recoveries must be updated**

It is important that estimates of additional rent and operating cost recoveries be updated at least annually and when there are significant changes. This ensures that each occupant's monthly installments provide sufficient funds to cover their share of the City's in-year operating costs.

**Efforts need to be made to finalize and collect outstanding amounts**

The effective administration of Union Station leases in accordance with contractual terms is necessary to maintain annual revenue streams and to ensure the City is able to collect what it is entitled to under the agreements. Any faulty assumptions or delays in finalizing matters weakens the City's position in collecting any outstanding amounts.

**Recommendations:**

- 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.**

## **B. ENSURE ROBUST FINANCIAL ANALYSIS INFORMS STRATEGIC DECISIONS**

### **B.1. Strategic Decision Needed to Maximize Value from Vacant Space**

**Vacant East Wing space is not leasable in its current state**

The revitalization plans for Union Station only included the first floor of the East Wing. The former East Wing anchor tenant vacated the remaining space in August 2016 upon expiry of their lease. Currently the second floor is occupied by the City and its contractors. The third and fourth floors are vacant. Due to ongoing construction, management advised that the vacant space is not leasable in its current state. A diagram of Union Station from the East Wing perspective is included in Exhibit 1 of this report.

**No plan exists for the approximately 100,000 square feet of rentable area in the East Wing**

The City currently has no definitive plan of action for the use of the East Wing space, which accounts for 18 per cent of the rentable area of the revitalized Station. The City has had more than two years to decide on the use of this space.

To avoid opportunity costs, the ideal scenario is for the East Wing to be fully occupied when the Union Station Revitalization Project (USRP) is completed in 2018.

**Management is considering using the space for City purposes**

We were advised that management is considering using the East Wing for City purposes. Should the City instead designate the space for retail purposes, then plans will need to be developed immediately to ensure that the space is fully occupied upon USRP completion. Time is required to plan, design, and prepare the space. In addition, management indicated that a significant investment is required to bring the space up to a leasable state. Funding sources for any required work must be identified.

If the City decides not to use the space for its own purposes, there are contractual requirements for the order in which the space is offered to other parties. Formal notice must be given to the Head Lessee about the availability of the space.

**Financial implications of each option should be considered**

The Head Lessee has six months to respond and may decline the offer. In this case, the City must then present the space to Metrolinx. Each option takes time and presents different financial implications for the City. The financial implications for the different uses of the East Wing space, be it for City purposes or commercial use, must be evaluated to make a strategic decision that maximizes value for the City. Any strategic decision on the use of this space should be considered in view of the vision for the Station, the City's ongoing office modernization program, and the City wide real estate transformation.

**Recommendation:**

- 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 for the space, such as City purposes, retail, office, or strata sale.**

**B.2. Update Union Station's Financial Forecast**

**Commercial operations forecasted to generate \$168 million (present value) in retail revenues over 30 years**

A report to City Council in 2016, estimated the present value of retail revenue over 30 years to be \$168 million to the City. These estimates were based on a 2013 financial model and assumed a 2016 completion date for the Union Station Revitalization Project (USRP). The forecast presented to City Council did not include sponsorship revenues or percentage rents where the City would be entitled to a percentage of a tenant's revenue or profit.

**Forecast does not reflect current market rates**

The 2013 financial forecast prepared by the City's external consultants included an additional \$31.2 million (present value) in relation to the East Wing. The financial model assumed the East Wing space would be rented at \$19 per square foot. Currently, average market rates for office rent range from \$30 to \$68 per square foot in downtown Toronto. Forecasts of potential operating profits and any related capital outlays should be updated based on the strategic decision for the use of this space.

**Financial forecasts need to be updated**

The financial forecast model and underlying assumptions should be updated to reflect current conditions and to provide a complete understanding of potential revenue streams and operating costs for Union Station. This is important when evaluating the Station's overall financial performance as well as the performance of commercial operations.

**Financial performance should be evaluated against targets**

Financial targets should be established and aligned with the City's strategic policy directions for the Station. A formal evaluation process to monitor the financial performance of the commercial operations in the Station is needed as an effective management tool.

**Recommendations:**

- 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.**

**B.3. Develop an Operating Cost Allocation Model for Union Station**

**Rent revenue offsets operating costs not recovered**

The City uses basic rent revenue to offset any shortfall in the recovery of operating costs at Union Station. Between 2012 to 2016, the City recovered between 54 to 68 per cent of total annual Station operating costs. This was illustrated previously in Figure 1.

**Guidance needed on how to allocate operating costs**

A cost allocation model or methodology for determining each occupant's fair share of Station operating costs in accordance with their agreement and the extent of operating costs the City is willing to absorb does not exist. Given the complexity of USRP construction, the continually changing use of space at the Station, and evolving costs, determining each occupant's proportionate share of operating costs is quite complex. Consequently, there is a risk that costs may be incorrectly or disproportionately passed on to occupants. The City is also specifically at risk for absorbing any shortfalls in operating cost recoveries related to commercial operations.

Operating Cost Recoveries for Commercial Space are Capped

**Head Lease includes a cap on operating costs the City can recover**

The Head Lease Agreement limits the operating costs the City can recover from commercial operations. Under the Head Lease, the City can recover a maximum of \$20<sup>2</sup> per square foot of Station operating costs.

**No documentation retained to justify contracted rate cap**

Management advised that an external consultant completed market benchmarking analysis to support the reasonability of the limit established in the Agreement. However, staff have not retained any documentation related to this analysis. In 2009, retailers in Union Station were paying the City between \$22 and \$70 per square foot for common area maintenance costs. Furthermore, the City's financial forecast model assumed the 2009 operating cost recovery rate for commercial leasing would be \$34 per square foot.

---

<sup>2</sup> This rate per square foot, set in 2009, is to be adjusted for the Consumer Price Index (CPI) in effect at the time when operating expenses become payable. The 2016 CPI adjusted operating cost recovery rate is \$22.95.



**City willing to absorb annual operating costs of \$1.5 - \$2.5 million**

The City will absorb any actual operating costs exceeding \$20 per square foot. Using actual and forecasted costs, and assuming 90 per cent of the anticipated 165,000 gross square feet of commercial space will be rentable, we estimate that the City may absorb Station operating costs in the range of \$1.5 to \$2.5 million annually. Over five years, the City could absorb \$7.5 to \$12.5 million in operating costs because of the ceiling imposed in the Head Lease Agreement. If the actual commercial area under the Head Lease increases, (for example, if the East Wing is used for retail purposes), the extent of costs the City absorbs may also increase.

**City never intended to fully recover Union Station operating costs from commercial tenants**

Management advised that it was a basic premise underlying negotiations with the Head Lessee that the City would not seek to fully recover all operating costs from the Station's commercial occupants. More specifically, management suggested that it would be unreasonable to pass on the abnormally high costs of operating a major transportation hub, with large common areas like the Great Hall, onto commercial tenants. Management asserted that, otherwise, the retail space would be uncompetitive in the marketplace.

**Commercial revenue will cover debt payments and shortfall in cost recoveries**

Management advised that revenues from commercial operations will be sufficient to offset any shortfall in operating cost recoveries and to pay off the debt incurred to revitalize the Station.

**A financial model should set out how costs are proportionally allocated and recovered**

A clearly defined model will ensure Station operating costs are appropriately allocated to occupants in accordance with agreements and will identify funding sources for operating costs that are not recoverable.

A cost recovery model should be developed to set out how operating costs for the following areas are to be allocated and recovered:

- commercial areas managed by the Head Lessee
- areas occupied by other government agencies
- areas occupied by City operations and security staff
- vacant areas of the Station
- common areas and facilities in the Station

**An understanding of the Station's cost drivers is necessary**

In doing so, City staff need to develop a comprehensive understanding of cost drivers in the Station such as occupancy rates, volume of pedestrian traffic, and other variables that impact operating costs.

**Model should set out how property taxes are allocated**

The cost recovery model should also set out how property taxes are to be allocated and recovered for each of the previously noted areas.

**Recommendations:**

- 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.**

**C. IMPROVE OVERSIGHT OF COMMERCIAL OPERATIONS**

**C.1. Obtain Independent Assurance of Financial Results for Past Retail Operations**

**The Leasing Manager was not required to provide annual audited financial statements**

The retail operations in the old Station generated a total of \$26 million in gross revenue between 2010 and 2015, with \$22.3 million in distributions back to the City. The Leasing Manager administered the retail tenant leases and prepared financial statements to reflect the results of the retail operations. The Agreement between the City and the Leasing Manager did not require that audited financial statements be provided. The City had a contractual right to request independent audits but never exercised this right over the six years.

**No documented evidence of financial statement reviews by City staff**

There was no documented evidence that City staff reviewed financial statements prepared by the Leasing Manager. Staff should have performed a thorough review of the accuracy and completeness of the financial results, especially for the distributions to the City. During our audit, we were unable to verify the accuracy and completeness of the total gross retail revenues reported as earned or the \$22.3 million distributed back to the City due to the absence of supporting documentation related to the Leasing Manager's financial statements.

**Unanswered questions pertaining to the financial statements**

We noted that the 2010 distributions to the City was significantly lower than any other fiscal year. This variation could not be explained by staff. In addition, staff could not address questions pertaining to:

- variances in cash and net income balances in each year from 2010 through 2015
- completeness and accuracy of tenant percentage rents from 2010 to 2015
- a commission paid to the Leasing Manager in 2010

An effective means of addressing these questions would be to obtain an independent audit of the Leasing Manager's financial statements.

**Recommendation:**

- 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.**

## **C.2. Implement Monitoring to Achieve Optimal Financial Results**

**Head Lessee has authority to make strategic and operating decisions related to the commercial premises**

The Head Lessee is responsible for operating the commercial premises at Union Station in a manner designed to maximize revenue and in accordance with prudent shopping centre practices. Within the parameters set out in the Agreement, the Head Lessee has authority to make decisions necessary to:

- lease space for commercial uses
- undertake commercial special events in designated areas
- construct and operate all commercial signage and other forms of commercial advertising.

**Commercial space is being turned over in phases**

Commercial space is being turned over to the Head Lessee in phases. The Head Lessee is currently operating 4,000 square feet of retail in Metrolinx-owned space. Approximately 9,100 square feet of City-owned commercial space has also been turned over to the Head Lessee to be readied for future tenants. Diagrams of the anticipated retail space are included in Exhibit 1 of this report.

**Effective monitoring protects City interests and maximizes profit**

Given that the initial stages of commercial operations under the Head Lease are just starting up, we encourage staff to proactively use the rights in the Agreement to monitor the results from commercial operations at Union Station. For example, the Head Lessee is required to submit an annual budget to the City. It is through diligent review of the budget and the respective actual results, that the City can monitor and assess the reasonability of expenses and revenues.

**Management is becoming more involved in reviewing financial results**

The Head Lessee began submitting quarterly financial results for City review in the second quarter of 2016. The Head Lessee also began providing multi-year budgets and forecasts in 2017. Management advised that review processes are currently being established and frequent meetings are held with the Head Lessee to review financial results.

**Audited financial statements were provided recently**

Audited financial statements should accompany the annual statement of profit distribution which is due within 120 days after the end of each lease year. In May 2017, the Head Lessee provided audited financial statements for the years ended December 31, 2015 and December 31, 2016. The external auditor's opinion stated that the financial statements presented fairly, in all material respects, the financial position and the results of the operations and its cash flows for the years 2015 and 2016 in accordance with the Head Lease Agreement. Management is currently reviewing these audited financial statements.

**City should specify any additional audit procedures required to verify contract compliance**

Going forward, the City should determine whether any additional specified audit procedures should be performed by an external auditor to evaluate whether commercial revenues, expenditures, and profit calculations comply with the defined terms in the Head Lease Agreement.

**Effective monitoring must be put in place before space is turned over to the Head Lessee**

An estimated 152,000 square feet of commercial space still remains to be turned over to the Head Lessee. In order to minimize costs and maximize net operating income distributions to the City, it is critical that City staff continue to become more engaged in monitoring Head Lease operations including effective review of budgets and actual financial results.

The following are three examples identified during our audit which illustrate the need for a proactive approach to monitoring commercial operations in order to ensure optimal future profits.

(1) Enhancements to Commercial Areas

**City constructs base building and Head Lessee prepares for commercial tenants**

Under the Head Lease Agreement, the City is responsible for construction of the base building structure and the Head Lessee is responsible for finishing the commercial areas so that tenants can operate. The Head Lessee is responsible for sourcing any service providers or contractors needed to construct or complete commercial enhancements to the base building structure.

**City's portion of enhancement costs is capped at \$14.8 million**

Commercial enhancements may include changes to the lighting, audio-visual equipment, furniture, amenities and other improvements. The estimated cost for the commercial enhancements under the Head Lease is \$32 million with a \$5 million contingency. Costs will be split between the Head Lessee (60%) and the City (40%). The City's portion of these enhancement costs is capped at \$14.8 million.

**Monitoring process is needed to ensure enhancement costs are appropriate**

Management meets regularly with the Head Lessee. The commercial enhancements budget is discussed at these meetings. Monitoring controls should be implemented to ensure that construction costs are minimized and the City only contributes up to its contractually agreed share of these enhancements.

## (2) Purchasing Goods and Services

**Head Lessee can procure and award contracts for goods and services as it sees fit**

The Head Lessee can award contracts for the goods and services it needs to manage the commercial operations within Union Station. The Head Lease Agreement does not specify how these goods and services must be procured. The Head Lessee is not required to demonstrate that goods and services were competitively procured. City staff were not involved in the Head Lessee's procurement of the contracts we reviewed.

**City staff acknowledged that certain contracted costs may be too high**

Although the Head Lessee is incentivized to maximize profits, this in itself may be insufficient to ensure that procurement decisions represent best value for the City. In certain cases, the Head Lessee is authorized to award contracts for which the City bears 100 per cent of the reasonable cost. Better oversight of the procurement and award of these contracts and related costs may be warranted. Management is aware of certain contracted costs that appear excessive.

(3) Opportunity for Basic Rent Revenue

**City absorbs full cost for Head Lessee's use of East Wing office space**

Currently, the Head Lessee and its associated parties are not paying any rent for their use of approximately 3,600 square feet of office space in the East Wing. Management advised that the Head Lessee needs to be located at the Station to carry out their responsibilities for commercial enhancement work and for its personnel to familiarize themselves with Union Station operations. As a result, management was willing to absorb a portion of the costs to prepare the space for the Head Lessee's use, the actual ongoing operating costs and the opportunity cost of foregone rent related to this space.

**A rental agreement should be executed if the Head Lessee is a long-term occupant in Union Station**

Going forward, if the Head Lessee plans on being a long-term occupant at Union Station, a formal rental agreement should be executed so that the City does not continue to bear the full occupancy costs of the Head Lessee and any associated parties.

**City has the right to charge rent to the Head Lessee**

Under the Head Lease Agreement, the City has the right to charge the Head Lessee office rent. In accordance with the agreement, Head Lessee occupancy costs are then shared equally between the parties. Based on office rent ranging from \$30 to \$68 per square foot in downtown Toronto and the current size of the space occupied by the Head Lessee, the City could earn rent revenue ranging from \$54,000 to \$122,000 annually. Over five years, the City could receive \$270,000 to \$612,000 from this space.

**Recommendations:**

- 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.**

## **D. ADDITIONAL OPPORTUNITIES FOR IMPROVEMENTS**

### **D.1. Allocate Property Taxes and Refunds Appropriately to Occupants**

**City pays the property tax bill for Union Station and collects each occupant's share**

Given the multi-tenant and multi-purpose use of Union Station, the City has a responsibility to maintain appropriate records on the allocated share of property taxes to each occupant. In addition, when refunds for previously paid amounts are issued to the City, there is an obligation to determine if funds need to be returned to any of the occupants.



**Money may be owed to occupants for past property tax refunds**

Between 2011 and 2016, the City received \$6.9 million in property tax refunds related to prior periods from 2001 to 2015. Staff issued refunds in the amount of \$1.1 million to a former occupant. Staff could not provide evidence to support whether the remaining \$5.8 million in refunds were distributed back to the respective occupants or that they could be rightfully retained by the City.

**Union Station's market value is currently under review by MPAC**

The Municipal Property Assessment Corporation (MPAC) is reviewing Union Station's assessed value for property tax purposes. MPAC is ensuring that the City's assessment includes the correct lands and roll numbers. MPAC is also ensuring that all appropriate parties are separately assessed.

**York Concourse is still included in Union Station property tax bill**

MPAC confirmed the assessment status of parts of the Station sold to Metrolinx. The West Wing has been separately assessed and is no longer on the City's Union Station property tax bill. The York Concourse has not yet been separately assessed and billed. Once Metrolinx is directly billed, a refund may be due to the City. The financial impact of this change is currently unknown.

**Refunds need to be distributed to occupants**

Management advised that they continue to work with and provide relevant facility information to MPAC and other authoritative bodies to ensure property taxes are appropriately assessed and reductions are applied as legislatively permitted. Any changes to assessed value that impact the tax bill and result in a refund need to be appropriately accounted for and redistributed to occupants where necessary.

**Recommendation:**

- 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.**

## D.2. Consistent Understanding of Head Lease Agreement Terms is Critical

**City and Head Lessee staff continue to interpret the clauses in the Agreement**

City staff regularly meet with the Head Lessee and the City's Legal Services Division to interpret the complicated terms and clauses in the Agreement. For example, the Agreement contains complicated clauses on permissible and excluded revenues and expenses for each stakeholder (Head Lessee, City, or Metrolinx). These clauses form the basis of how profit is to be derived and shared among the parties. The parties must come to a common understanding of any terms in the Agreement that may be subject to different interpretations. A thorough knowledge of the Agreement is critical to ensuring the accuracy and completeness of the City's future commercial profits. Any incorrect interpretations of clauses may compromise the profit to be shared.

**Staffing changes impact continuity in managing leasing at Union Station**

Due to staffing changes, there has been a lack of continuity in managing the leasing function at Union Station. Each staffing change creates a risk for new interpretations when the intent of complex terms has not been archived.

**A summary of key terms of the Head Lease was not available**

Given the complexity of the terms in the Head Lease Agreement and subsequent amendments, a summary of key terms is beneficial to support staff in day-to-day operations and to ensure consistent interpretation and application of clauses that could be subject to different interpretations. This summary could serve as a quick reference baseline for understanding key sections of the Agreement. However, staff should not use any summary of terms to the exclusion of the entire agreement.

### **Recommendation:**

- 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.**

### **D.3. Centralize Record Retention of Lease Information**

#### **No complete list of leases in effect at Union Station**

At the beginning of our review, we requested a complete list of all leases at Union Station. This information was not maintained by the Real Estate Services Division. Towards the end of our review, a request was made to the City's external legal counsel to compile a list of material agreements for Union Station.

To effectively administer leases at Union Station, staff require access to the following information:

- A record of leases which have ended with date and reason for ending
- List of active leases with summaries of key lease terms such as measurement of leased area, rental term, rent and additional rent amounts
- A copy of each active lease under the Head Lessee
- A list of leases that are in negotiation and the principal negotiators

#### **Adequate record retention is required**

In the absence of such records, staff do not have a reasonable understanding of what they are managing and the associated obligations. Given the complexity of the real estate transactions involving Union Station, adequate record retention is needed to support the continuity of leasing operations. This mitigates the risk of losing corporate intelligence when there are staffing changes.

#### **2006 Auditor General's report identified the need for a complete list of leases**

Inadequate record keeping is a recurrent audit issue for Real Estate Services. The absence of a complete inventory of leases was reported in the Auditor General's 2006 report entitled, "Review of the Administration of Leases on City Owned Property."

<http://www.toronto.ca/legdocs/2006/agendas/committees/au/au060920/it001.pdf>

**2017 Auditor General's report also highlighted the absence of a complete lease inventory**

More recently, the Auditor General, in her 2017 report entitled "Audit of Water Billing and Collections – Phase II: Water Billing and Water Meter Management Controls Require Strengthening", identified that the Real Estate Services Division could not provide a list of City-wide leases. The absence of a complete lease inventory made it difficult to identify City-owned properties leased or licensed to third parties who were not billed for water consumption.

<http://www.toronto.ca/legdocs/mmis/2017/au/bgrd/backgroundfile-102139.pdf>

**Recommendation:**

- 21. City Council request the Chief Corporate Officer to centrally retain records related to Union Station leases.**

---

## **CONCLUSION**

---

This report contains 21 recommendations. In our view, the implementation of these recommendations will remediate the collection of the City's annual leasing revenue streams and restore contract compliance at Union Station. In addition, the development of effective controls will lay the foundation for the City to monitor future revenue streams and to ensure financial targets for commercial operations at Union Station are achieved. Collectively, these measures will contribute to Union Station's financial sustainability.

In addition, the findings included in this report may not be isolated to Union Station. Our findings may also be relevant to other leases managed by the Real Estate Services Division as well as other City divisions, agencies and corporations which oversee leases independently of Real Estate Services.

---

# AUDIT OBJECTIVES, SCOPE AND METHODOLOGY

---

**The need for an audit was identified during the Audit of City Cleaning Services**

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 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>

**Audit objective**

The objective of this audit was to review the leases at Union Station to ensure operating revenues and costs were settled between the City and each occupant in accordance with each respective lease agreement.

**A review of agreements with anchor occupants**

The audit included a review of the Head Lease, as well as, lease agreements between the City and each of the following anchor occupants:

- Metrolinx
- VIA Rail
- Bank of Nova Scotia

The audit was performed with a view to ensuring the City was attending to its landlord responsibilities and contractual obligations related to annual settlements.

**Audit methodology**

Our methodology included a review of the following:

- expenditures incurred for the operation, maintenance, repair, administration and supervision of Union Station
- calculation of proportionate share of Union Station operating costs allocated to each occupant
- leasing revenue collected by the City from each occupant
- year-end settlement of funds collected from each occupant relative to the lease requirements for a given fiscal period
- agreements between the City and its Leasing Manager and Head Lessee.

In addition, we interviewed City staff, reviewed staff reports or records, analyzed data provided by management, and conducted tours of Union Station.

**Audit scope**

The scope of this audit originally included the years 2014 and 2015 or the relevant fiscal period of the last settlement with each occupant. Over the course of our review, we extended the scope period to include additional years.

**Limitations to our audit**

It is important to note that we could not conduct this audit as planned. As a result of significant staffing changes in the Real Estate Services Division, management could not always locate information we requested. At the completion of our audit, there were questions that staff could not address or provide documentation to support, as well as, other matters that require follow up. Therefore, our findings and conclusions are based on available information at the time the audit was completed.

**Outstanding matters**

In addition, work on certain matters arising from this audit is ongoing and may be reported upon separately in the future.

**Compliance with generally accepted government auditing standards**

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

**EXHIBIT 1: Diagrams of the Anticipated Use of Space and Occupants at Union Station**

**Diagram 1 - Union Station Profile from East Wing Perspective**

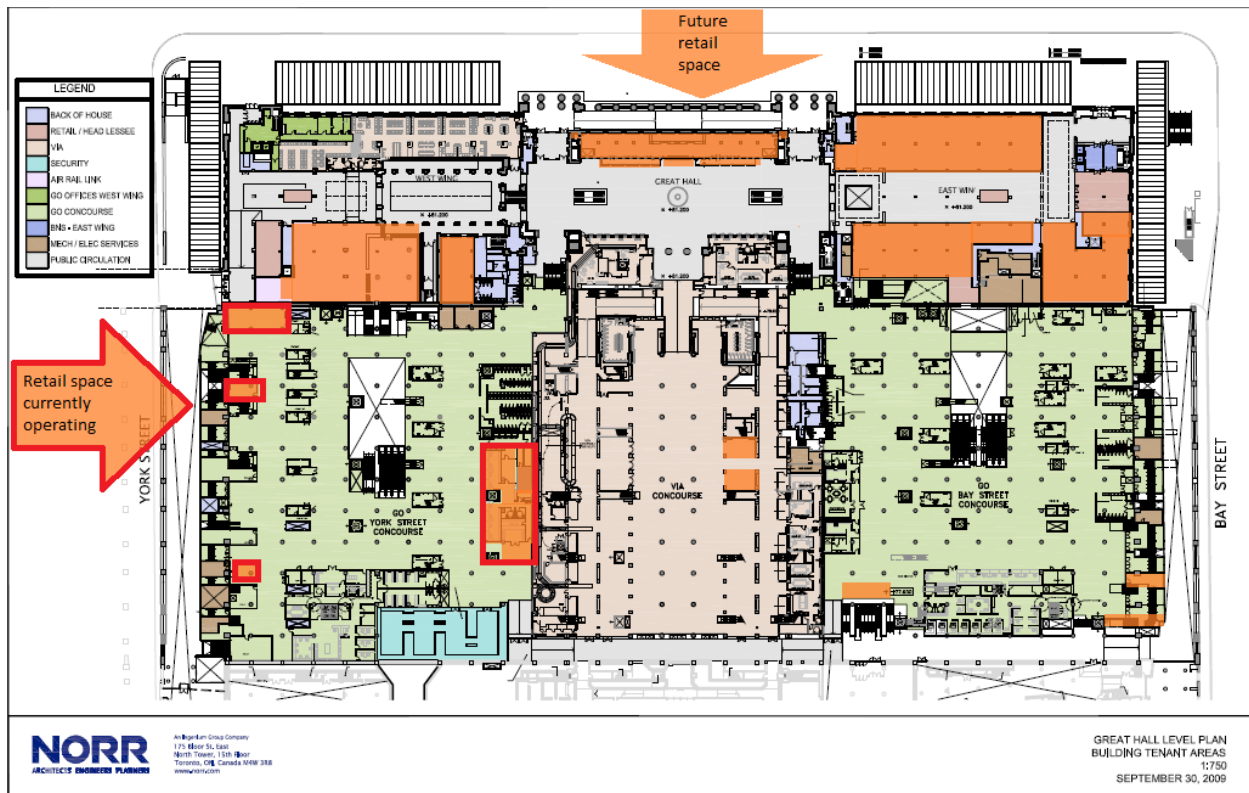


Union Station



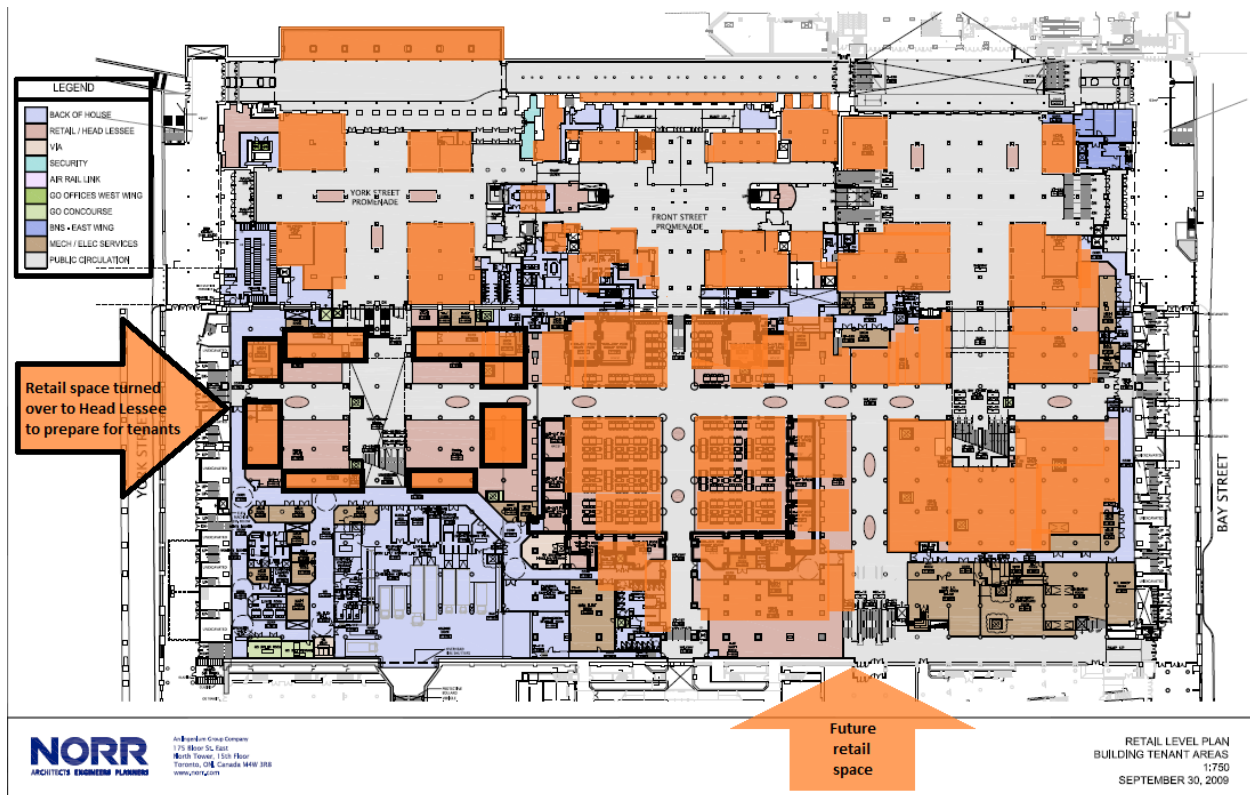


Diagram 2 - Union Station Great Hall Level



Note: Orange highlighted areas were added by the Auditor General's Office to drawings prepared in 2009 to show the general location of existing and future retail areas

Diagram 3 - Union Station Retail Level



Note: Orange highlighted areas were added by the Auditor General's Office to drawings prepared in 2009 to show the general location of existing and future retail areas

## **APPENDIX 1: Management’s Response to the Auditor General’s Report Entitled: “Real Estate Services Division – Restore Focus on Union Station Leasing”**

---

**Recommendation 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.

**Management Response:**  **Agree**    **Disagree**

**Comments/Action Plan/Time Frame:**

Real Estate staff will ensure any significant changes in space usage and measurements during the Union Station Revitalization project from January 2010 to present day will be included in relevant settlements with tenants, and will include any revenue impacts.

This task is ongoing.

Post revitalization plans have been finalized and measurements and space usage has been agreed to by all stakeholders at the Station and will be used to inform annual settlements with tenants.

---

**Recommendation 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.

**Management Response:**  **Agree**    **Disagree**

**Comments/Action Plan/Time Frame:**

Real Estate staff will work with Legal and ensure necessary steps to settle accounts will be taken within the parameters of the agreements with each tenant for the identified period. Management is aware of the need to address this and existing resources will be reassigned in 2017 to address this issue.

---

**Recommendation 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.

**Management Response:**  **Agree**    **Disagree**

**Comments/Action Plan/Time Frame:**

Reconciliation of the VIA settlement had begun in October 2015. City staff have been engaged with VIA Rail on this and will ensure accurate measurements and operating cost details are included in any future settlement. Given the continually shifting construction requirements and space utilization, using 2010 measurements was a reasonable approach, however significant changes in space in the Station will be considered and included in the settlement calculations. Staff have submitted a proposed reconciliation of VIA's account and are awaiting a response from VIA on this.

It is expected that this settlement will be completed prior to the end of 2017.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

City staff are actively working on a settlement calculation that incorporates changes in space usage and measurements. Given the continually shifting construction requirements and space utilization, using 2010 measurements was a reasonable approach, however significant changes in space in the Station will be considered and included in the settlement calculations. Staff are working with Metrolinx on numerous issues in the Station and meet monthly. The settlement is one of the issues that is discussed and Metrolinx is aware that this settlement needs to occur.

It is expected that this settlement will be completed prior to the end of 2017, pending agreement of all parties.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

Staff will prioritize all past year settlements before undertaking 2016 settlements with consideration to order of magnitude. Staff are actively engaged with tenants to compile necessary information to accurately settle outstanding accounts.

Staff are developing processes to ensure annual settlements are reconciled in a timely manner going forward, within available resources. If additional resources are required to ensure timely settlement of accounts they will be included in future year budget processes with accompanying business cases to support these requests.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

City staff will ensure accurate lease data for the direct tenants of the City, including the Head Lessee, VIA, Infrastructure Ontario, Metrolinx and any future direct tenants.

Once settlements are reached and agreements are finalized within these tenants, up to date information will be maintained in the City's financial system, and will be updated on an as needed basis.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

CCOO staff are currently undergoing a review of the leasing administration functions to review the processes followed, tools used, and clearly outlining roles and responsibilities across the CCOO staff and Accounting Services staff. Currently there is a monthly reviewing of outstanding receivables, which includes confirmation on the accuracy of customer accounts and ultimately revenues recorded. Through these meetings, and through the review of leasing administration functions, identification or notification of any outstanding receivables known, but not recorded in the City's system will be documented for action.

The leasing administration functions review is expected to be completed by the end of 2017.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

Once the building operation are stabilized and construction is complete, the City will ensure that annual reconciliations are undertaken, within the parameters of the various existing agreements.

City staff will determine a reasonable amount for operating costs due by each tenant during the construction period. It is not reasonable to assume all operating costs could be recovered while the building is undergoing a major renovation as tenants cannot be expected to cover any additional operating costs that could be attributed to the ongoing construction.

Estimated operating costs and notices of monthly installments will be provided to tenants based on the terms within existing agreements on an annual basis.

---

**Recommendation 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 for the space, such as City purposes, retail, office, or strata sale.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

The existing space within the East Wing requires significant investment to bring the space to base building standards. In addition to this, the Head Lessee is currently developing a business plan on potential uses for the space, should the City decide not to use the space for City office purposes.

City Staff will report on the plans for the future use of the East Wing by Q2 of 2018.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

City Staff will commence work on updating the existing financial model. Assumptions within the existing model will be updated based on actual information related to both revenues and expenses. This information will become more accurate as construction is completed and as leases are finalized. Staff plan on reporting back to Council with this update in Q2 of 2018, aligned with the status updated provided on the Union Station Revitalization project.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

Union Station financials are reviewed and revised through the annual budgeting process. In additional monthly forecasts are updated and actuals versus planned amounts are reviewed.

Given the increase in commercial operations at the Station expected over the next few years, staff will enhance and formalize these processes, and will utilize the budgets that are provided by the Head Lessee to estimate annual performance and periodically review against this. The operating model that is developed will also feed into this overall financial model. Staff will ensure this model is in place by the time of completion of the revitalization project, expected for Q2 of 2018.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

This will need to be undertaken with regard to the various agreements and their respective provisions for operating costs. A model will be implemented at the conclusion of construction as a go forward approach, along the same timelines of the overall financial model for the Station.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

The will be incorporated into the annual settlements for all tenants at the Station, as well as within the cost allocation model and the overall financial model for the Station. Furthermore, immediate allocations will be completed for those that are part of settlements that are expected to be completed in 2017. Adjustments may be required, from time to time, based on events that trigger changes in the overall property tax bill (i.e. the selling of the future Bay Concourse) and City staff will work with MPAC to ensure the impacts of these events are recognized as soon as possible.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

City staff will engage with the leasing manager to review financial statements from 2010 to 2015. Staff will ensure distributions were determined based on terms of the agreement.

City staff plan on engaging an external audit firm to commence the audit in 2017. Completion of this will be dependent on cooperation and participation of the Leasing Manager. Staff will consult with Legal to ensure the City is afforded all rights within the agreement in relation to financial settlements, and take action where necessary.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

Staff have reviewed budget and actual expenditures with the Head Lessee for active retail operations since Q2 of 2016. Processes are currently being formalized internally, as well as with the Head Lessee based on the terms and conditions within the agreement, and will be documented. This will be in place by the end of 2017.

---

**Recommendation 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.

**Management Response:**  **Agree**    **Disagree**

**Comments/Action Plan/Time Frame:**

City holds right to compel audit by an independent third party auditor under the Head Lease Agreement. Furthermore, the Head Lessee has already provided audited statements to the City for all active operations up to the end of 2016. These were prepared based on the terms and conditions within the agreement. The City will coordinate with the Head Lessee to ensure one set of audited statements are completed by an independent, 3rd party audit firm, to the satisfactory of both parties. This will be done in compliance with the defined terms of the Head Lease agreement on an annual basis. Once the Station operations are normalized, the City will evaluate whether a specified procedures audit is needed to ensure compliance with defined terms of the Head Lease agreement.

---

**Recommendation 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.

**Management Response:**  **Agree**    **Disagree**

**Comments/Action Plan/Time Frame:**

Staff meet on a bi-weekly basis with the Head Lessee on progress and to address any issues, inclusive of commercial enhancement work. The agreement on the commercial enhancement work requires the Head Lessee to get City sign off on plans and specifications and also limits the City's risk due to the upset limit of its contribution to the construction costs.

Staff roles and responsibilities have been clarified. Real Estate staff are being provided with cost reports related to the commercial enhancement works on a periodic basis. This will continue going forward.

---

**Recommendation 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.

**Management Response:**  **Agree**    **Disagree**

**Comments/Action Plan/Time Frame:**

The Head Lessee project management and construction team are currently occupying a small portion of office space in the East Wing. This space is currently being used for City operations and construction site offices for the various construction projects active within the station. Site offices are the responsibility of the owner to provide. Once construction is complete and the Head Lessee assumes spaces for the operation of the Station, the City will be in a position to, and will charge rent for occupied spaces, as per the Head Lease agreement.

---



**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

This action will be carried out in conjunction with the actions identified in recommendation 15. Property tax refunds occur only periodically, and when they do Real Estate staff will consult with Legal and defer to agreements to ensure the treatment of these refunds are allocated properly.

---

**Recommendation 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.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame**

City staff have raised issues regarding the potential risks of preparing quick reference summaries, most notably of which is referring to a summary to make a decision that requires consideration of multiple aspects of the agreement, or simply becoming familiar with only the quick summaries and not understanding the agreements in totality.

However, staff will prepare summaries of key aspects of these agreements, including interpretations of key terms and clauses, to assist staff while they become familiar with the agreements in whole. In addition, discussions have already commenced with City Legal staff to consolidate the multiple amendments of the Head Lease agreement into one document for easier reference. This will be completed after the latest amendments are finalized. Quick reference summaries will be prepared and will be available once the commercial operations are fully active. In the meantime existing staff will continue to become familiar and seek clarification on all aspects of the agreements.

---

**Recommendation 21:** City Council request the Chief Corporate Officer to centrally retain records related to Union Station leases.

**Management Response:**  Agree  Disagree

**Comments/Action Plan/Time Frame:**

SAP is currently the central repository for lease related information. The City will leverage its existing SAP system to continue building its existing database of agreements, resulting in a more complete database. There currently are standard operating procedures related to record retention for direct tenants for which City staff administer agreements directly.

Staff prioritize current and active agreements at Union Station to ensure the information is maintained. This is an ongoing action. This task will also be incorporated into the leasing administration review and will be a key process with roles and responsibilities assigned.