6. Management of the Port's Real Estate

- **The Port's revenues come largely from rents for Port real estate, including rents from its industrial and commercial properties, percentage of sales rents from restaurant and retail properties, parking, and filming and special event revenues. In FY 2002-2003, the Port's real estate revenues were $39.5 million, which is 72.5 percent of the Port's total FY 2002-2003 revenues of $54.5 million.**

- **The Port has not consistently negotiated and monitored its leases to ensure maximum revenues. Although the Port Commission generally establishes minimum rental rates for Port properties and uses, the Port Commission has not established minimum rental rates for all Port properties and uses. For example, the Port Commission has not established minimum rental rates for most types of storage space, although the Port has 135 property agreements for use of Port property for storage. This results in tenants paying different rental rates for comparable properties and uses. Additionally, the Port fails to consistently increase rental rates to meet the Port Commission's minimum rental rates for month-to-month leases and leases that are expired and held over. In a review of all month-to-month and expired leases in the Port's October of 2003 rent roll, the Budget Analyst found that 38 out of 226, or 16.8 percent, of the tenants with month-to-month or expired leases were paying less than the Port Commission's minimum rental rates, or if the Port Commission had not established rental rates for the property or use, were paying less than comparable leases, resulting in an estimated loss of $143,000 annually in rent revenues. Further, based on a review of ten new leases implemented in 2003, the Budget Analyst found two new leases with rental rates that were less than the Port Commission's minimum rental rates, resulting in $11,000 in lost rent revenues annually.**

- **The Port does not consistently enforce lease provisions, resulting in unnecessary financial risk to the Port. In the review of ten new leases implemented in 2003, the Budget Analyst found that the Port did not check the tenant's credit rating in three leases nor require proof of insurance in one lease. The Port also entered into a lease with one tenant with a "high risk" credit rating. The tenant paid rent for the first month of the lease, but failed to pay the security deposit or the second month's rent.**

- **The Port does not aggressively pursue tenants who do not comply with lease provisions. During a review of four Port facilities, the Budget Analyst found one tenant occupying additional Port space not included in its lease with the Port, without Port permission and without paying additional rent. Another tenant has not paid the full amount of the security deposit although they have occupied the property since July of 2003.**

- **The Port has continued to work with tenants or has re-negotiated leases for tenants who have failed to meet the terms of the original lease or comply with Port policy in leases. In leases with Big C Traders, Pacific Cement, and a restaurant development on Pier 80, the Port has delayed in resolving tenant issues or re-negotiated agreements because the tenant's proposed use of the property has met Port or community objectives. However, the tenants failed to comply with lease provisions, undermining the Port's objectives for the proposed use of the property. The Port Commission approved a new five-year lease with Big C Traders and wrote off $840,000 in bad debt, after the tenant failed to meet the terms and conditions of their original lease. Under the original lease, Big C Traders was to develop up to 50,000 square feet of office space on Piers 19 to 23 for maritime vendors, but was unable to finance construction of the office space and pay full monthly rent. During negotiation of the new five-year lease with Big C Traders, Big C Traders failed to provide audited financial statements to the Port, verifying Big C Traders' financial capacity to pay rent to the Port under the terms of the new lease.**

- **Although Pacific Cement has not complied with various lease and environmental requirements, the Port Commission has approved two amendments to the Pacific Cement lease, extending the timelines for complying with lease requirements, including complying with the Southern Waterfront Supplemental Improvement Report mitigation measures and obtaining required permits. Further, Pacific Cement was fined by the Department of Public Health on March 30, 2004, in an amount not yet determined, regarding Pacific Cement's hazardous materials spills and related issues.**

- **For the past 18 months, the Port has not resolved problems with a Pier 80 tenant who has entered into a lease to develop a restaurant site but has not obtained the necessary financing to do so. The tenant was the sole respondent to a Request for Proposal to develop the site, and when the Port staff presented the Pier 80 restaurant lease to the Port Commission for approval in October of 2002, the staff reported that the tenant, who also leases Port office space, was in good standing, although the tenant was in arrears for April and June of 2002 rent.**

The Port's Real Estate Revenues

The Port's revenues come largely from commercial real estate rents, which make up more than three-quarters of the Port's total revenues. In FY 2002-2003, according to the Port's audited financial statement, the Port received $39.5 million in real property rents and parking meter collections, of which $32.0 million were commercial rents. The Port's property rents come from its industrial and commercial properties, including percentage of sales rents from restaurant and retail properties and parking. The Port receives other miscellaneous revenues, such as filming and special events and other miscellaneous revenues, as shown in Table 6.1.

Table 6.1

The Port's Real Estate Revenues FY 2000-2001 through FY 2002-2003

	FY 2000-2001	FY 2001-2002	FY 2002-2003	Increase/ (decrease) FY 2000-2001 to FY 2001-2002	Percent Increase/ (decrease)
Commercial rents					
Commercial/ industrial	$19,680,836	$21,698,235	$21,096,206	$1,415,370	7%
Percentage rent	12,309,321	10,767,748	10,941,098	(1,368,223)	(11%)
Subtotal, commercial rents	31,990,157	32,465,983	32,037,304	47,147	0. 1%
Parking rents and fines					
Parking meters	1,103,365	983,105	1,006,311	(97,054)	(9%)
Parking stalls	143,723	148,235	132,894	(10,829)	(8%)
Parking rents	5,742,250	5,048,162	5,126,993	(615,257)	(11%)
Parking fines [1]	1,200,000	1,200,000	1,200,000	0	0%
Subtotal, parking	8,189,338	7,379,502	7,466,198	(723,140)	(9%)
Total, commercial and parking	**$40,179,495**	**$39,845,485**	**$39,503,502**	**($675,993)**	**(1.7%)**
Filming and special events					
Filming	67,522	31,946	29,560	(37,962)	(56%)
Special events	65,350	79,946	143,861	78,511	120%
Subtotal, filming and special events	132,872	111,892	173,421	40,549	31%
Miscellaneous real estate	44,980	201,814	145,896	100,916	224%
Total, real estate revenues	**$40,357,347**	**$41,159,191**	**$39,822,819**	**(534,528)**	**(1%)**

Source: San Francisco Port, based on the Port's audited financial statements

[1] The Port receives parking fine revenues based on an agreement with the Department of Parking and Traffic.

The Port's total real estate revenues, including commercial, percentage, parking, filming and special events, and miscellaneous revenues, declined by one percent between FY 2000-2001 and FY 2002-2003, resulting largely from reductions in restaurant and retail percentage rents and parking revenues. According to the Port, much of the real estate revenue reductions occurred after September 11, 2001, when tourism dropped, and the Port received reduced percentage rents from retail and restaurant tenants.

Sources of Real Estate Revenues

The Port's real estate revenues come from monthly rents for commercial and industrial properties, percentage rents of restaurant and retail sales, parking revenues for parking meters, stalls, lots and fines, and other miscellaneous revenues. The Port derives the majority of its revenues from commercial and industrial property agreements, including restaurant and retail leases, which provide for monthly minimum rents and percentage rents of sales. The Port also has property agreements for fish processing and fishing-related facilities, as well as property agreements associated with cargo, harbor and marine, cruise ship and ferry landings, and ship repair activities, as shown in Table 6.2.

Table 6.2

Percentage of Monthly Revenues by Type of Property Agreement [1]
Summary of October 2003 Real Estate Rents

Type of Property Agreement	Total Monthly Base and Percentage Rent October 2003	Percentage of Monthly Property Agreement Revenues
Commercial and Industrial	$1,866,854	40%
Restaurant and Retail	1,039,353	22%
Parking	791,289	17%
Cargo	336,803	7%
Cruise Ships and Ferry Landings	279,466	6%
Harbor and Marine	179,273	4%
Fish Facilities	109,358	2%
Ship Repair	70,833	2%
Total	**$4,673,230**	**100%**

Source: San Francisco Port Monthly Rent Roll and Monthly Sales and Rent Report
[1] Monthly rents include base rent and percentage rent.

The Port's commercial and industrial property agreements include agreements for office space, storage, industrial use, artist studio space, and other miscellaneous uses. Most of the Port's property agreements for industrial activities are for properties located on the Southern Waterfront, and industrial uses include batching plants for cement and other aggregates, and recycling. The cargo, harbor and marine services, and cruise ship and ferry landing agreements are for property agreements associated with maritime uses.

The Port's Real Estate Division

The Port's Real Estate Division is responsible for the leasing and property management of the Port's real estate. According to the Real Estate Divisions FY 2003-2004 business plan, the Real Estate Division's goals include:

- Achieving maximum revenue from leasing activities;

- Achieving and maintaining maximum net operating income through efficient asset management;
- Providing professional service to Port tenants;
- Reviewing the Southern Waterfront land use plan for leasing activities; and
- Promoting interdivisional team approach for projects.

The Real Estate Division is managed by the Deputy Director, who reports to the Executive Director of the Port. The Real Estate Division has two Assistant Deputy Directors, of whom one manages the Northern Waterfront real estate portfolio and one manages the Southern Waterfront portfolio. Each Assistant Deputy Director supervises a Senior Property Manager and Property Manager. In addition, the Northern Waterfront portfolio has an Asset Manager who is responsible for complex and large scale lease negotiations.

The Real Estate Division has a Senior Marketing and Leasing Manager, who supervises two Leasing Managers. The Senior Marketing and Leasing Manager and his staff are responsible for the overall tracking and strategic planning for Port properties. The Marketing and Leasing staff are responsible for identifying, tracking and marketing vacant Port property, and negotiating new and renewal leases.

All Port Real Estate staff are responsible for the business details of the property leases. Property Managers often negotiate renewal of leases for properties under their management and the Assistant Deputy Directors participate in high level negotiations for properties within their portfolios. The Senior Property Managers and Property Managers are responsible for the day-to-day operations of their properties, including building maintenance, lease administration, property oversight, and tenant relations.

The Real Estate Division is supported by administrative staff who are responsible for real estate financial projections, maintaining the real estate information system (PROPworks), including maintaining the rent roll in the information system, and other administrative functions.

The Port's Strategies for Increasing Property Revenues

In the FY 2002-2003 budget, the Port's performance measures for the Real Estate Division included a 2 percent increase in commercial and industrial fixed-rent revenues and in percentage rent revenues, compared to FY 2000-2001. As noted in Table 6.1, fixed-rent commercial and industrial revenues increased by 7 percent during that period, offset by an 11 percent reduction in percentage rent revenues, resulting in a net increase of 0.1 percent. The Port's performance measures for FY 2003-2004 also include 2 percent increases in fixed-rent and percentage rent revenues compared to FY 2000-2001.

In the FY 2003-2004 budget, the Port's strategies for increasing property revenues include, among others:

- Identifying below market rate leases and adjusting these leases to the Port Commission's approved rate parameters;
- Maintaining a Port-wide leasing plan for all vacant properties;
- Evaluating leasing opportunities in accordance with the Waterfront Plan and regulatory policies.

Identifying and Adjusting Below Market Rents

The Budget Analyst reviewed the October 2003 real estate information system rent roll, which summarizes all the Port's property agreements, including type of space, use of property, and rental rates, to identify rental rates for tenants with expired or month-to-month leases that were below the Port Commission's minimum rental rates or rental rates established in comparable leases.

<u>The Port Commission's Minimum Rental Rates</u>

Rental Rates for Commercial and Maritime Industrial Properties

The Port Commission sets the minimum rental rates for Port leases and property agreements, and most recently adopted minimum rental rates in June of 2002. At that time, the Port Commission approved reducing rental rates for office properties, reflecting the downturn in the San Francisco office market. The Port Commission also implemented a new rate for office storage, which did not exist previously, and set new rates for industrial and warehouse uses.

The Port Commission last adopted rental rates for maritime industrial uses, including warehouse, maritime office, and open land use, in 1999. These rates were based on a survey of California ports, conducted by an outside consultant. Because these rental rates are five years old and at least one of the ports surveyed, the Port of Oakland, adjusted its maritime rates on January 1, 2004, the Port should conduct another survey to determine if the Port's rental rates for maritime industrial uses meet market standards.

Competitive Bidding for Retail and Restaurant Leases and Rents

Under Port policy, the Port submits retail properties and the associated percentage rent provisions to competitive bid. Port policy does identify criteria for instances when the Port negotiates a retail lease with one party rather than utilizing the bid process. Under this policy the Port may negotiate directly with an existing Port tenant, rather than competitively bidding the leasing opportunity, if the tenant:

- Is in good standing;
- Committed to making a significant investment in the property; and

- Has a good business plan, and has a good record on affirmative action and non-discrimination.

Also, according to the Port's policy, the tenancy must be in the best economic interest of the Port.

The Port Commission's Rental Rates for all Expired and Month-to-Month Leases

The Port's Senior Leasing Manager is responsible for reviewing month-to-month leases and expired holdover leases to determine if the rental rates are significantly below market rates, and for notifying tenants in writing of proposed rent increases. According to the Senior Leasing Manager, although the Port does not have a formal policy to negotiate term leases for tenants with expired holdover and month-to-month leases, the Port's practice is to negotiate renewal term leases for tenants with below market rents. The Port may elect to continue expired holdover leases on a month-to-month basis if the Port plans a construction or development project for the location. The Port Commission sets minimum rental rates, and Real Estate Division staff are authorized to renew leases without Port Commission approval if rental rates exceed the Port Commission's minimum rates.

<u>Rent Adjustments in Month-to-Month and Expired Leases.</u>

Nearly 17 percent of tenants with expired or month-to-month leases, or 38 out of a total of 226, were paying rent that is below the Port Commission's minimum rental rates or below comparable leases. In a review of expired holdover and month-to-month leases, the Budget Analyst found that the Port does not consistently increase rents for tenants occupying Port property, for which the leases are held over after the expiration date or are month-to-month. Nor has the Port Commission adopted rental rates for all uses of these Port properties.

Full Service and Net Office Rental Rates

The Port is the lessor for approximately 347,000 square feet of office space, with estimated annual rents of $5.5 million.[1] The Port has existing leases in which the rents are based on the Port paying the costs of utilities, janitorial and other services, called "full service" leases. Under the Real Estate Division's current practice, new office leases are often "net" leases, in which the tenant pays for utilities, janitorial, security and other costs.

On average, the Port's existing office rents for full service leases, in which the Port pays the costs of utilities, janitorial, and other services are comparable to San Francisco Office rents generally, according to market analyses conducted by two different commercial real estate consultants.[2]

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[1] Based on October 2003 real estate rent roll.

[2] Average San Francisco Port rents for the Northern Waterfront and South Beach were equal to or slightly greater than average rents reported by BT Commercial Real Estate for the 2nd quarter of 2003 and by the CAC Group for September 2003.

The Port Commission rental rates for office space provide minimum rates for full service and net office space in the Roundhouse Plaza and the Agriculture Building. For other office properties, the Port Commission rental rates provide minimum rates for net office space only. In a review of expired holdover and month-to-month office leases, the Budget Analyst found several discrepancies with Port policy and the Port Commission's leasing parameters.

- Nine tenants occupied full service or net office space at Piers 50 and 80, although the Port Commission has not adopted office rental rates for these locations.

- Two office tenants paid significantly less the Port Commission's minimum rental rates, resulting in lost rental revenues to the Port of $27,902 annually.

Storage Rental Rates

The Port Commission has not adopted minimum rental rates for storage space, other than office storage space, although the Port has 135 property agreements for use of Port property for storage. Because the Port Commission has not established minimum rental rates for storage, the Port does not consistently increase rents for tenants with expired or month-to-month leases who use Port property for storage.

Many tenants with expired or month-to-month leases who lease Port property for storage or office use pay less than comparable leases for the location, property type, and use. In these instances, the Port has not adopted minimum rental rates for the use or location. As noted in Table 6.3, the Port loses approximately $109,825 annually in rental revenues for storage for tenants who have expired or month-to-month leases and are paying rental rates that are less than comparable leases.

Table 6.3

Month-to-Month and Expired Leases with Rental Rates Below the Port Commission's Minimum Rental Rates or Below Comparable Lease Rental Rates for Location, Space Type and Use

	Rental Rates Below Port Commission Minimum Rental Rates		Rental Rates Below Comparable Lease Rates for Location, Space Type, and Use		Total	
	Number of Leases	Total Annual Rental Revenue Loss	Number of Leases	Total Annual Rental Revenue Loss	Number of Leases	Total Annual Rental Revenue Loss
Storage Use on Open Land			1	$82,696	1	$82,696
Storage Use in Shed Space			8	16,892	8	16,892
Fishing Gear Storage	23	5,483			23	5,483
Office Use	2	27,902	4	10,238	6	22,541
Total	**24**	**$33,385**	**13**	**$109,825**	**38**	**$143,210**

Source: San Francisco Port's October 2003 real estate rent roll

Leasing Procedures and Rent Provisions in New Leases

To identify the Port's leasing and property management processes, the Budget Analyst conducted a case review of four Port facilities: Seawall Lot 303 on Fisherman's Wharf; the Pier 35 Bulkhead on the Northeast Waterfront, Pier 50 in South Beach, and Pier 92 on the Southern Waterfront. In addition, the Budget Analyst reviewed ten new leases, which were implemented in calendar year 2003 or early 2004.

The Real Estate Division's procedures for new leases require review by the Senior Leasing Manager, the Assistant Deputy Director, and the Division Director. These leases should be reviewed for compliance with Port Commission policy and Real Estate Division procedures. In a review of ten new leases, which were implemented in calendar year 2003, the Budget Analyst found that the Real Estate Division generally followed its internal lease review procedures for these ten leases.

However, the Real Estate Division did not consistently comply with the Port Commission's lease parameters in negotiating these ten leases. Two of the ten leases had rental rates that were less than the Port Commission's parameters, but were not presented to the Port Commission for approval, in violation of Port Commission policy. The Port has lost approximately $11,000 annually in rental revenues for these two leases.

- In one new lease, the rental rate of $0.09 per square foot for Southern Waterfront open pier space was less than the Port Commission's rate of $0.12 per square foot, resulting in lost rent revenues annually of $8,161.

- The rent per square foot per month for one new office lease, located at Pier 50, was $1.37, or $0.08 less per square foot than the Port Commission's parameter of $1.45, resulting in lost rent revenues annually of $3,037.

Managing Port Property Vacancies

The Real Estate Division's Property Managers are responsible for identifying vacant properties in their portfolios and the Real Estate Division's Leasing Department is responsible for maintaining the weekly vacancy report and tracking property vacancies. In November of 2002, the Real Estate Division conducted an internal audit of the Port's Rent Roll and found that, although the Rent Roll is generally accurate, the vacancy report is not. According to the audit, the vacancy report had not been maintained and did not list all vacant properties. According to the Senior Leasing Manager, the Real Estate Division is now maintaining a current and accurate vacancy report.

The Real Estate Division needs to continue to improve the process of maintaining a current and accurate vacancy report. For example, the Budget Analyst, during site visits of four Port facilities on March 11, 2004, found one vacant space in Pier 50's Shed B, which was not included in the March 3, 2004 or March 23, 2004 vacancy reports.

The Port's Management of Properties

The Real Estate Division has divided the Port's properties into two portfolios: the Northern Waterfront, which includes properties from Fisherman's Wharf to the Ferry Building, and the Southern Waterfront, which includes properties south of the Ferry Building to Pier 96 adjacent to Hunter's Point. Each portfolio is managed by an Assistant Deputy Director, who supervises a staff of Senior Property Managers and Property Managers. According to the Real Estate Division Director, the Assistant Deputy Directors prepare weekly status reports for the Division Director, identifying major property issues within the portfolio, and meet regularly with the Division Director to make strategic decisions about the management of properties.

Generally, Property Managers are responsible for the day-to-day operation of Port properties, including:

- Marketing Port properties to prospective tenants;

- Negotiating and implementing property leases, including maintaining the associated documentation;

- Administering leases and ensuring compliance with lease provisions, including collection of rents; and

- Inspecting Port properties regularly to determine maintenance and repair needs and to ensure tenant's conformance with the terms of the property agreements.

Lease Negotiation and Implementation

The Real Estate Division's Leasing Department is generally responsible for negotiating new property leases and lease amendments or renewals, with review by the Port's legal staff, the portfolio's Assistant Deputy Director, and the Division Director. Leasing Managers who negotiate new or renewal leases are responsible for preparing the associated lease documentation, such as the Lease Abstract and Basic Lease Information, and providing the information to the administrative staff to input into the information system. Property Managers receive information about new leases through the Real Estate Division's Leasing Status Report, which is updated weekly. Property Managers assume responsibility for the lease and tenant once the tenant occupies the premises.

<u>Verification of Tenant's Credit and Insurance Status</u>

As part of the implementation of new leases, the Real Estate Division administrative staff perform a credit check and verify insurance coverage. Leasing Managers and Property Managers are responsible for ensuring that the credit check is completed, the tenant has an adequate credit status, and that insurance coverage is available.

The Port does not consistently check tenants' credit status or insurance coverage. The Budget Analyst found, in the review of ten new leases and case study of four Port properties, that the Real Estate Division did not prepare credit profiles for three new tenants. The Real Estate Division also implemented a lease for open land, shed, and office space for one tenant, although the tenant had a "high risk" credit rating. The tenant paid rent for the first month of the lease, but failed to pay the security deposit or the rent for the second month.

Also, the Real Estate Division did not require evidence of general liability and garage keeper's insurance for another tenant included in the Budget Analyst's review of ten new leases. Interviews with Real Estate Division staff suggest that the Port does not always require tenants to comply with exact lease provisions regarding insurance. For example, tenants do not consistently obtain insurance for the required dollar amount. The Budget Analyst identified one tenant who provided only $50,000 fire damage coverage, although the lease required $250,000 fire damage coverage.

<u>Tenant's Initial Date of Occupancy</u>

Port property leases may contain a provision for "Right of Early Entry", allowing the tenant to occupy the premises prior to the rent commencement date to paint, install carpeting, or make other improvements. Under Port Commission policy, the tenant may occupy the premises for up to one month for construction purposes prior to the commencement of rent. The Budget Analyst review of ten leases shows that the Port does not specify dates when agreeing to the Right of Early Entry. During the review of the four Port facilities, the Budget Analyst found one tenant, who occupied the premises in

January of 2004, but did not begin paying rent until April 1, 2004, a period of more than two months. The Budget Analyst also found that in two lease addenda, in which the Port agreed to the Right of Early Entry, neither the tenant nor Port staff initialed the addenda.

<u>Preparing Lease Abstract and Basic Lease Term Documents</u>

During the course of the case review, the Budget Analyst found that the Real Estate Division staff do not consistently complete the Lease Abstracts and Basic Lease Term documents. The Basic Lease Term document is reviewed and signed by the Senior Leasing Manager and Assistant Deputy Director to ensure that leasing process is consistent with Port policy. Failure to complete the Basic Lease Term document undermines this process. Administrative staff use the Lease Abstract documents to enter lease information into the property management information system, PROPworks. Incomplete lease abstract documents result in incomplete PROPworks information.

Property Management and Tenant Relations

The Real Estate Division has not consistently documented property management performance, although the Division Director and senior managers have expressed their intention to improve documentation.

<u>Facility Profiles</u>

Within the past year, the Real Estate Division has implemented "facility profiles", which document property information for the Port's properties, including tenant and lease information, assessments of the facility's physical condition, tenant disputes, and other property information. According to the Division Director, compiling property information provides the Port with necessary information for the Port's strategic planning. Many of the Port's facilities require major repairs and upgrades, and assessment of the facility's structural condition, as well as information about the facility's tenants and leases, are supposed to be included in the facility profiles. Over the past year, the Real Estate Division has prepared some, but not all, facility profiles. Facility profiles had not been completed for two of the four facilities included in the Budget Analyst case review.

<u>Property Inspections and Real Estate Surveys</u>

The Division Director has established a goal for Property Managers to inspect their properties quarterly and complete a "real estate survey", although currently, Property Managers are expected to inspect properties and complete the real estate survey at least two times per year and on the termination of the lease. The real estate survey consists of the Property Manager's physical inspection of the interior and exterior condition of the property, including the roof, the apron surrounding the building, fire sprinklers and extinguishers, and presence of hazardous materials. The Division Director, Assistant Deputy Director and Senior Property Manager review and sign the survey.

The Property Managers do not consistently complete the real estate survey for existing tenants and upon termination of the tenant's lease. The Budget Analyst did not find consistent documentation of facility inspections and real estate surveys during the case review of four Port properties or upon review of 12 terminated property agreements.

Further, the Real Estate Division has not established policies for coordinating and communicating real estate property inspection and survey information with the Port's Director of Environmental Health and Safety and the Chief Harbor Engineer. In interviews, neither the Director of Environmental Health and Safety nor the Chief Harbor Engineer had seen the real estate survey.

The Port should develop a written policy on routine property inspections and completion of real estate surveys. The written policy should include:

(a) The frequency of inspections:

(b) Procedures for ensuring that inspections are completed on termination of the tenant;

(c) Procedures to inform tenants of the facility condition: and

(d) A mechanism to ensure that the Real Estate Division, the Maritime Division, and the Division of Engineering and Maintenance are coordinating property inspections and sharing information. For example, the Port should consider a policy to require participation of the Engineering Department in inspections of terminating agreements for all properties greater than 5,000 square feet.

<u>Property Managers' Site Visits</u>

According to Real Estate Division staff, the Real Estate Division is preparing a protocol to document Property Managers' site visits. Currently, the Real Estate Division has no formal mechanism to document site visits, although Property Managers are evaluated on their knowledge of their properties and tenants, including their site visits, during their annual performance review.

Property managers' practices to visit their properties are inconsistent, with some Property Managers making more frequent and routine site visits than other Property Managers. The Budget Analyst's survey of Port tenants, conducted as part of the case review, indicates that some tenants have regular contact with Property Managers while others had infrequent or no contact.

Budget Analyst interviews with Port staff demonstrated a lack of clear policies and procedures for the respective responsibilities of Wharfingers and Property Managers for Port properties. One tenant survey responded that the tenant worked exclusively with the Wharfinger and although the tenant believed that a Real Estate Property Manager was responsible for the facility, the tenant did not know who was the Property Manager.

<u>Enforcing Compliance with Lease Provisions</u>

The Port does not consistently enforce tenant compliance with lease provisions. The Budget Analyst found two examples of the Port's failure to assertively enforce lease provisions during the case review of four Port properties.

- One tenant has been occupying space, in addition to the tenant's leased space, without Port permission or paying additional rent for the space. Although the Property Manager has referred this incident to the City Attorney for follow-up, the Property Manager has not pursued the issue. According to the Property Manager, the tenant has occupied the additional space for more than one year.

- One tenant has not paid the full amount of the security deposit, specified in the lease, although the tenant has occupied the space since July of 2003. The tenant has disputed that the Port has failed to provide necessary information to the bank to prepare the credit letter for the security deposit. The Port has not provided evidence of actively pursuing this issue.

The Port's Management of Tenant Problems

The Port has not always intervened aggressively when tenants have posed problems, and in some instances has failed to protect the Port's interests. The Port not only loses revenues when problems with tenants are not resolved quickly, but also incurs City Attorney and Port staff costs for extended intervention and negotiation with problematic tenants.

The Port's Policy Objectives Measured Against the Port's Costs for Tenant Problems

The Port has delayed in resolving tenant issues or has re-negotiated agreements with several problem tenants because the tenant's proposed use of the property has met Port or community objectives. However, in the leases discussed below, the Port has negotiated new leases or maintained leases with tenants that failed to comply with Port regulations or meet the terms of the leases. Although the tenant's property use may meet Port objectives, these objectives are undermined by the tenant's failure to comply with the lease terms.

<u>Pacific Cement Lease</u>

Although Pacific Cement has not complied with various lease and environmental requirements, the Port Commission has approved two amendments to the Pacific Cement lease, extending the lease timelines for complying with various requirements. The Port has entered into leases with several different tenants for cement batching facilities on Pier 92 and the adjacent seawall lot. The cement batching facilities, which are part of the Port's plan to develop maritime industrial uses on Port lands, must comply with the applicable environmental mitigation measures identified in the Southern Waterfront

Supplemental Environmental Improvement Report. According to Port staff, Pacific Cement, one of the cement batching plant tenants, has been a non-compliant tenant.

The Port Commission adopted a 25-year lease with Pacific Cement in June of 2001 to operate a cement batching plant on Seawall Lot 352. Pacific Cement has long been a non-compliant tenant. The Port Commission approved an amendment to the lease in November of 2002 and January of 2004, allowing Pacific Cement to extend the timelines to meet the lease requirements, including complying with required Southern Waterfront Supplemental Improvement Report mitigation measures and obtaining required permits.

Additionally, Pacific Cement has a sublease with the Municipal Railway (Muni), which holds a lease-in-perpetuity for Port property. Under this sublease Pacific Cement has failed to comply with various regulatory and permitting requirements and has encroached upon Port property adjacent to Muni's leased site. Pacific Cement has been cited by the Department of Public Health for hazardous materials spills, and in violation of Port policy, has moved uncharacterized soil and debris onto Port property. Both Muni and the Port notified Pacific Cement in the summer of 2003 of their possible violation of the uncharacterized soil and debris ban and other environmental hazards. The Department of Public Health cited Pacific Cement for the violation, and conducted a preliminary hearing on March 30, 2004, regarding Pacific Cement's hazardous materials spills and related issues. The Department of Public Health issued a fine to Pacific Cement, in an amount not yet determined, and will enter into a stipulated agreement with Pacific Cement.

Big C Traders

The Port Commission adopted a new lease with Big C Traders in January of 2004, after Big C Traders defaulted under the terms of the original lease. Big C Traders operates Foreign Trade Zone #3 under the terms of an operating agreement approved by the Port Commission for the period from March 1, 2000 through February 28, 2030. Big C Traders also entered into a lease with the Port in 2000 to develop up to 50,000 square feet of office space for Free Trade Zone vendors at Piers 19 to 23. The Port entered into a 50-year lease for development of the pier, which included rent credits up to $420,000 for the design, construction and installation of the office space. According to the lease, the tenant was to repay the Port with interest the entire amount of rent credits if construction of the office space was not completed by December 31, 2002.

Under the lease for Piers 19 to 23, Big C Traders was to pay rent of $18,480 monthly, which increased to $45,454 per month on March 1, 2001, due to the expected completion and subleasing of the Free Trade Zone vendor office space. Although the Port issued $413,960 in rent credits to Big C Traders, the tenant was unable to construct the 50,000 square foot office space and did not pay the increased rent amount beginning on March 1, 2001. The tenant did continue to pay the lower rent amount of $18,480 monthly. As of December, 2003, Big C Traders owed the Port $782,709 in unpaid rent. The combined value of the rent credits and unpaid rent was approximately $1.2 million.

The Port Commission adopted a new five-year lease agreement with Big C Traders in January of 2004, which would forgive most of the monies owed to the Port and rescind development of the office space.

- Under the new five-year lease, Big C Traders would pay $351,360 to the Port in two installments, with $845,309 in rent credits and past due rent remaining unpaid.
- The Port would receive all architectural, planning, and other documents and plans related to development of the 50,000 square feet of office space, enabling the Port to seek other developers for the project.
- Big C Traders would be responsible for all maintenance for Piers 19 to 23, including the piers' substructure and fendering systems.
- Big C Traders would pay $46,300 monthly in rent to the Port.

The Port has claimed that the restructured lease will continue rent payments to the Port and allow the Port to develop the office space through another developer, if the Port elects to do so. However, the Port has written off $845,309 in rent credits and past due rent as part of the restructured lease.

When the Port negotiated with Big C Traders to restructure the lease, the Port requested audited financial statements from Big C Traders, which were never provided. Therefore, the Port staff has recommended, and the Port Commission has adopted, a revised lease with Big C Traders, after Big C Traders defaulted on the original lease, without obtaining necessary financial data.

The Port did not submit the original 50-year lease to the Board of Supervisors, stating that the lease was part of the Free Trade Zone and therefore a maritime lease not subject to Board of Supervisors review. Under the 1996 Charter, only non-maritime leases are subject to Board of Supervisors approval.

Pier 80 Restaurant Lease

For the past 18 months, the Port has not resolved problems with a Pier 80 tenant, who has entered into a lease to develop a restaurant site but has not obtained the necessary financing to do so. The Port had issued a Request for Proposal (RFP) for the Pier 80 restaurant site and entered into a lease with the sole RFP respondent, although the Port's Finance Department raised questions about the tenant's financial capacity.

When Port staff presented the Pier 80 restaurant lease to the Port Commission for approval in October of 2002, the staff report stated that the tenant, who also leased Port office space, was in good standing, although, the tenant was in arrears for April and June, 2002 rent. The restaurant lease contained provisions to protect the Port's interests, including requiring a guarantor for performance of all tenant lease obligations. The tenant provided his own assets as a guarantee, but has been unable to complete construction of the necessary tenant improvements to operate the restaurant.

Port staff report that they have continued to work with the tenant, despite the tenant's inability to perform under the terms of the lease, because the proposed Pier 80 restaurant project meets the Port's and community's objectives for developing the Southern Waterfront. The Port has not assessed opportunities for the Port to lease the space to another tenant. Also, the Port has not received rent from the tenant since the lease approval in October of 2002, nor terminated the lease for failure to comply with the lease provisions.

Implementing Performance Bond Requirements

The Port has not consistently required performance bonds or guarantors for tenants who will be constructing costly tenant improvements, resulting in costs to the Port for tenants who fail to construct the tenant improvements.

For example, the Port did not include performance bond requirements in the lease with Information Network Radio for the construction of a radio station at Roundhouse Plaza. The Roundhouse Plaza space had previously been used for office space but Information Network Radio proposed to install a radio station at an estimated cost of $2.1 million. The tenant proposed financing the radio station installation through equity and venture capital financing. According to the Port, Real Estate and Finance Department staff reviewed the tenant's financial capacity to fund the proposed tenant improvements prior to implementation of the lease, including reviewing the tenant's credit status through Dun and Bradstreet, a credit agency.

The lease between the Port and Information Network Radio did not contain provisions, requiring proof of financing for the project, proof of performance bond to secure the completion of the proposed construction, or a guarantor to ensure the performance of all the tenant's lease obligations.

The tenant began construction of the tenant improvements, which included restructuring the existing office space to meet the needs of the radio station, but was unable to obtain the necessary financing to construct the tenant improvements and defaulted under the terms of the lease. The tenant failed to make all payments due to the contractors for construction of the tenant improvements and to the Port for rent and the security deposit. The Port wrote off as bad debt approximately $334,000 in unpaid rent and the security deposit. In addition to the bad debt write-off, the Port has incurred an unknown cost for the uncompleted tenant improvements. Because the tenant was constructing radio station space, the uncompleted improvements were not usable for other tenants as office space. Any subsequent leases for the space will have to account for the costs to new tenants to convert the space to another use, resulting in reduced rent revenues to the Port.

According to the Port, performance bonds do not ensure timely completion of the construction project with no expense to the Port if a dispute arises between the tenant and the contractor. Requiring a guarantor with the financial capacity to complete the project provides additional protection to the Port, should disputes arise regarding the performance bonds. However, as noted above, the Port authorized the Pier 80 restaurant tenant to act as guarantor of the restaurant construction project without sufficient financial capacity to complete the project. The Port needs to ensure that the guarantor has the financial capacity to complete the project.

Monitoring Tenant's Environmental Activities

The Port does not have a written protocol to coordinate the Real Estate Division's leasing activities with the Environmental Health and Safety Department. Currently, Real Estate Division staff refer new leases to the Environmental Health and Safety Department if they identify a potential environmental issue in the lease. Many Port leases include industrial or other activities with an environmental impact. The Port needs to establish a formal protocol that triggers environmental review of a new lease by the Environmental Health and Safety Department if a tenant meets specific environmental thresholds.

According to the Environmental Health and Safety Department, the Port inspects Port facilities in response to an incident or a request, but does not have a protocol for conducting routine environmental inspections. The Real Estate Division's real estate survey is the main mechanism for Property Managers to inspect the environmental condition of properties, but the Port has not enforced use of these surveys. The Real Estate Division needs to work with the Environmental Health and Safety Department, as well as the Engineering and Maintenance Division, to ensure completion and coordination of inspections.

Conclusion

The Port needs to strengthen its management of properties and enforce its leases. The Port either does not have identified procedures or does not consistently follow its procedures for identifying vacant properties, conducting on-site real estate surveys, and routinely conducting site visits. The Port has implemented documentation for leases and facility profiles to enable the Port to better assess and manage the status of Port properties, but does not ensure that the documentation is completed.

The Port Commission has implemented minimum rental rates for some but not all property locations and uses. The Real Estate Division does not consistently negotiate new leases or adjust expired leases to meet these standards or to meet rental rates in leases with comparable locations, space types, and uses. The Port loses approximately $143,210 annually for expired leases and month-to-month leases that are below the rental rates set by the Port Commission or below comparable lease rental rates.

The Port also loses revenue by not aggressively enforcing the terms and conditions of its leases. The Port has written off $845,000 in rent credits and past-due rent for the Big C Traders lease and another $334,000 for past-due rent for the Information Network Radio lease. The Port did not require a performance bond for the Information Network Radio lease, resulting in the Port assuming the costs for the unfinished tenant improvements. The Port did not require Big C Traders to repay $413,000 in rent credits, as required by the lease, but instead negotiated a new lease agreement with Big C Traders, forgiving much of the rent credits and past-due rent.

The Port incurs direct costs for City Attorney and staff time engaged in working with problematic and non-compliant tenants. The Port has continued to work with Pacific Cement, including implementing lease amendments when Pacific Cement failed to meet the original lease requirements, although Pacific Cement has been a non-compliant tenant. The Port has continued to work with a Pier 80 tenant for 18 months, although the tenant has not met the terms of the lease. The Port needs to assess its costs for enforcing leases and negotiating settlement agreements with tenants who do not or cannot comply with lease terms. Although the Port's policies may be to promote development and certain uses on Port property, maintaining relationships with non-performing tenants uses significant Port resources without achieving Port objectives, such as developing office space for Free Trade Zone vendors or promoting restaurant and other development on the Southern Waterfront.

Recommendation

The Port Commission should:

6.1 Adopt rental rates for:

(a) Full service and net office leases for Pier 50 and Pier 80 office space; and

(b) Storage use for all Port land, shed and open pier space.

6.2 Instruct the Port Director to provide to the Port Commission an analysis of the Port's costs and revenues for lease amendments and re-negotiated leases, in which the tenant has not met the criteria of the original lease. The analysis should include:

(a) City Attorney, Port staff, and other direct Port costs to enforce the lease and negotiate amendments or re-negotiated leases;

(b) Actual rents and other payments to the Port made by the tenant under the terms of the lease, including the amounts of any rent credits;

(c) Rents and other payments due to the Port and not paid, including applicable service charges;

(d) Estimated opportunity costs to the Port of not obtaining an alternative tenant for the property.

6.3 Develop minimum financial criteria, including standards for tenant credit ratings and provision of audited financial statements and other financial documents, for all Port tenants and explicitly state in the Port Commission resolution, which approves the property agreement, as to whether all of the Port's financial criteria have been satisfied.

The Director of the Port should:

6.4 Enforce the Port Commission's minimum rental rates for all new, expired, and month-to-month leases, and present to the Port Commission quarterly a list of all new, expired, and month-to-month leases which do not meet the Port Commission's minimum rental rates and the reasons for not meeting the minimum rental rates.

6.5 Develop, implement, and enforce a protocol, establishing lease criteria for financial guarantees and insurance coverage which are specific to the lease use, including criteria to require:

(a) performance bonds for hazardous materials management and construction of tenant improvements,

(b) guarantor with financial capacity to ensure completion of construction of tenant improvements,

(c) proof of financing for construction of tenant improvements, and

(d) specific types and amount of insurance coverage.

The Real Estate Division Director should:

6.6 Survey West Coast ports to determine the market rates for maritime industrial uses, and present new rate parameters to the Port Commission for adoption.

6.7 Prepare a written policy, defining Property Managers' responsibilities and procedures for identifying and reporting vacant space to the Leasing Department.

6.8 Consistently enforce lease provisions, including negotiating settlement agreements or terminating leases for non-performing tenants in a timely manner.

6.9 Enforce existing Real Estate Division policies to check the credit and insurance status of new tenants.

6.10 Require all leases with provisions regarding "Right of Early Entry" to contain specific dates for entry and rent commencement and to be signed by both parties; and enforce Port Commission policy to allow tenants to occupy Port property for no more than one month prior to rent commencement.

6.11 Require all lease addenda for the "Right of Entry" specify dates of entry, not to exceed 30 days prior to rent commencement, and enforce requirements for tenants and Property Managers to sign the addenda.

6.12 Enforce existing Real Estate Division policies regarding completion of the Lease Abstract and Basic Lease Terms documents.

6.13 Clarify Real Estate Division policy in writing regarding the implementation and use of facility profiles and direct the Real Estate Division Director to work with Property Managers regarding facility profile implementation.

6.14 Develop a written policy on routine property inspections and completion of real estate surveys, including:

(a) the frequency of inspections,

(b) procedures for ensuring that inspections are completed on termination of the tenant,

(c) procedures to inform tenants of facility conditions, and

(d) mechanisms to ensure that the Real Estate Division, the Maritime Division, the Division of Engineering and Maintenance, and the Environmental Health and Safety Department are coordinating property inspections and sharing information.

6.15 Develop a formal protocol, establishing a threshold for new leases that require review by the Environmental Health and Safety Department.

6.16 Prepare a protocol for the frequency and documentation of Property Managers' site visits.

Costs and Benefits

The Port would increase its annual rent revenue by at least $120,000 by adjusting all expired leases, which have been held over, and all month-to-month leases to meet the Port Commission's leasing parameters or to meet the rental rates of Port leases that are comparable in use, space type and location. The Port could also increase rent revenues by enforcing lease provisions, and entering into stipulated settlements or terminating leases in a more timely fashion.

The Port could reduce City Attorney and staff expenses if the Port did not negotiate new leases or terminated leases with non-compliant tenants. A ten percent reduction in City Attorney expenses would save the Port approximately $223,000 annually.