seattlecenter

M E M O R A N D U M

TO: Councilmember Tim Burgess, Chair,
Government Performance and Finance Committee
Councilmember Nick Licata
Councilmember Sally Clark
Councilmember Mike O'Brien

Councilmember Jean Godden, Chair
Libraries, Utilities & Center Committee
Councilmember Richard Conlin
Councilmember Sally Bagshaw
Councilmember Bruce Harrell

VIA: Beth Goldberg, City Budget Director

FROM: Robert Nellams, Seattle Center Director

DATE: April 13, 2012

RE: Interfund Loan Repayment Plan - Response to Statement of Legislative Intent 32-1-A-1

Summary
The following report is in response to the Seattle Center SLI stating that "It is the intent that Seattle Center, with assistance from CBO, to complete the following in 2012: By March 31, 2012, a detailed repayment plan for Seattle Center's interfund loan. The repayment plan should describe the specific actions Seattle Center expects to undertake in 2012 in order to pay off its loan and qualify the amount of revenue associated with each action."

This report provides a comprehensive review of Center's financial picture, including a review of its accounting practices, funding structure, business risks, current challenges, and an evaluation of various repayment scenarios.

Background
Seattle Municipal Code (SMC 060.030(c)) stipulates that fund balances are not to remain in a negative cash position for more than 90 days. In April of 2011, Seattle Center reached the 90 day point, and in June 2011, the Department turned to the remedy offered by the Municipal Code by requesting that the City Council provide authority for a temporary interfund loan to the Seattle Center Operating Fund (Ordinance No. 123644). The loan was executed for up to $3.0 million and was to be fully repaid by December 31, 2012. The Council also approved a Statement of Legislative Intent (SLI) requiring Seattle Center to make progress reports in March, August, and December of 2012. By the end of 2011, the outstanding balance on the loan was $2.3 million.

Prior to 2011, Seattle Center's Operating Fund has generally functioned within the policy requirements of the SMC, but had, on several occasions in the past decade, required an advance in their General Fund transfer. In recent years, a combination of factors that include an imbalance of revenues and expenditures, and the non-payment of leases by several non-profit tenants that were suffering in the economic downturn, led to the cash balance remaining in a negative position.

The Department has taken steps to address its cash shortfall through a range of measures including payment plans for resident tenants in arrears, lease terminations, and lease renegotiations. However, the cash position is not expected to improve in 2012, and it is unlikely that the Department will be able to fully repay the loan amount by the end of the year. Unless revenues come in higher than projected, or expenditures are reduced, the cash position of Seattle Center's three primary Operating funds (not including the $1.3 million in McCaw Hall reserve funds) at the end of 2012 is projected to be negative $3.3 million. It will therefore be necessary to update the loan ordinance to extend the timeline for repayment, and it is possible that the amount of the loan may need to be adjusted as well. The amount of the loan was calculated with the reserve funds included, but the intention moving forward, and the cash balance referred to in this SLI, contemplates holding McCaw Hall reserves harmless and requiring the three primary operating funds to maintain a positive cash balance with regard to SMC 060.030(c).

Response
This SLI response is divided into two sections.

- The first section provides information regarding Seattle Center's accounting practices, financial structure, risk factors, management strategies, and current challenges. Taken together this information gives an overview of the Department's operating environment and the business context which affects the department's loan repayment options.

- The second section of the response outlines several loan repayment scenarios. Each scenario makes certain business assumptions and identifies possible Departmental service changes and the likelihood of achieving a specific loan repayment amount.

<u>SECTION 1</u>

Accounting Practices
The City's standard accounting method is a "modified accrual approach" which requires that revenue be recorded when billed and expenses be recorded when paid or contracted (encumbered). The difference between revenue and expense is then reported as **net income** – often referred to as "profit." For any given fund, this net income is what is shown in the City's Comprehensive Annual Financial Report (CAFR) as a contribution to (or use of) Fund Balance. Net income reflects operational profits and losses for a given year, and Fund Balance reflects the cumulative effect of net profits over time.

In an ideal world, net income and cash flow would match perfectly. In reality, timing differences between billings and payments, delinquent accounts, disputed billings, contingency deposits, and reimbursement cycles can all produce a difference between the net income and the actual amount of cash received. Simple cash flow issues are not problematic if they are temporary delays in payments, and to address these temporary fluctuations between expenditures and the collection of revenues, the Seattle Municipal Code provides for loans between funds of up to 90 days. Delinquent accounts, or the actual non-payment of booked revenues, on the other hand will lead to a fund having a lower cash balance than the CAFR reports, and can lead to the appearance of a healthy fund balance when in actuality, the fund has a negative cash position. This is what has occurred with Seattle Center. By the end of 2011, approximately $1.2 million of booked revenue from as far back as 2007 had gone uncollected. Primary contributors to the uncollected revenues include The Children's Museum, Intiman Theatre, and the Seattle Children's Theatre. The Department continues its efforts to resolve this problem through renegotiated payment plans and revised lease agreements, including credit towards the public benefits provided by the organizations. As these plans take effect, the cash balance will move closer to the booked revenue amount.

2007 – 2011 Financial Summary

Based on the modified accrual accounting methodology approach typically used by the City, Seattle Center earned a profit (including General Fund Support) and maintained a positive fund balance in both 2007 and 2008. In 2009, the impact of the Sonics departure caused the Department to lose $1.1 million overall. With energies refocused at KeyArena, the Department averaged break-even years in 2010 and 2011 (with the one-time 2011 expenditure of $500,000 for the 50th Year Celebration removed). Despite the resurgence in KeyArena bookings, profits remain below pre-Sonics-departure levels. Lease revenues may also suffer ongoing reductions, as not only do several non-profit leases carry outstanding balances, but renegotiations have in some cases led to reduced annual payments. These factors, along with other components outlined in Attachment A, contribute to a forecast that shows the Department losing an additional $1.2 million in 2012.

Unless revenues come in higher than projected, or expenditures are reduced, the cash position of Seattle Center's Operating funds at the end of 2012 will be negative $3.2 million. These estimates will be discussed further in Section 2.

Funding Structure

Seattle Center's mission is to "delight and inspire the human spirit in each person and bring together our rich and varied community." This mission manifests itself in a wide variety of commercial and public programming offerings aimed at providing cultural arts and entertainment experiences to the Puget Sound region.

Seattle Center's funding model is structured to rely both on income from commercial activities (approximately 63% of total resources), as well as and tax support from the City's General Fund (37% of total resources). There is no legislated percentage split as to how much tax support the Department receives each year nor is there a guaranteed amount of tax support provided for the benefits provided. On a practical level, the Department is required to balance the goals of maximizing commercial income while offering public benefits such as free open spaces, free and affordable cultural programming, funding and in-kind support for major festivals, and below-market lease rates for nonprofit arts, cultural, and educational tenants. While the below-market leases sometimes are designed to recognize the initial capital investment tenants brought to the campus, they also have an ongoing impact on the Center's potential income. The tension created by the uncertainty of funding levels from both commercial and tax sources makes managing Seattle Center's budget challenging, but also creates opportunity and provides flexibility in the City's efforts to achieve policy goals. Ongoing discussion regarding the Center's funding structure may be necessary to most effectively address the Department's financial challenges and to revisit the department's broad identity as an entertainment venue, commercial landlord, arts hub, and community gathering place.

Business Risk
The Center's funding model carries both stabilizing factors and a certain amount of inherent risk. The risk factors are, in part, endemic to a commercial marketplace which relies on consumer preferences. But along with the expected commercial variability, there is risk inherent in nonprofit operations as well. While the Center's role in helping the City to support arts, cultural, and education organizations leverages notable public benefits, it also requires the Department to be flexible in supporting tenants whose business models are dependent on philanthropic and discretionary income. This introduces added business risk to the Department's operations. The Center is cognizant of these risks and employs a number of strategies to manage variability and lessen the City's exposure.
Commercial revenue risk is well understood and results from competition in the marketplace and business cycles. The Department competes for event bookings with a number of venues ranging from large theaters such as the Paramount and the CenturyLink Events Center to other arenas such as the Tacoma Dome and the Everett Events Center. The Center also competes with hotels and convention centers for meeting room event rentals. Even after booking an event into a Seattle Center facility, consumer spending choices affect attendance and, as a result, the Department's ancillary revenues such as parking and concession sales.

Nonprofit organizations bring their own inherent business risk. They are particularly susceptible to fluctuations in the local and national economy. Ticket sales at theaters or admissions to museums typically account for less than 50 percent of their operating revenues. The remaining amounts must come from government grants, corporate giving, sponsorships and individual giving. In the current economic climate, a number of the Center's tenants have struggled financially and some entities are no longer in existence.

Risk Management Strategies
The Department actively pursues strategies which help manage the business risks associated with its operations. These strategies help to limit the City's risk and protect General Fund resources. At the same time, these business choices affect the cash flow of the Department and hence the amounts potentially available for loan repayment in 2012.

- <u>Lease Management Strategies</u> – The Department adopts prudent efforts to reduce or manage leasing risk including negotiating payment plans, revising lease terms and formally terminating lease agreements when appropriate. A number of the Center's nonprofit tenants with delinquent accounts have been adversely impacted by the severe economic downturn in recent years, a situation impacting many nonprofit groups throughout the country. These tenants have worked with the Department to negotiate payment plans to address their delinquent accounts, or where appropriate, other steps have been taken. While these efforts have helped make it possible for these organizations to continue operations, the Center was not able to absorb the financial impact of the accumulated delinquent payments. As a result, in 2012 the Center will write-off $220,000 in delinquent payments from The Children's Museum. Additionally, the lease was restructured to incorporate credit for public benefits provided by the museum. The new lease reduces payments by $100,000 annually, while collecting 50% of the remaining debt ($20,000 annually) over the next 10 years. In another example, the Department recently terminated the long-term lease with Intiman Theatre, entered into a short term lease to support Intiman's efforts to restructure their organization, agreed upon a payment plan for their outstanding debt and started the process of conducting a Request for Proposal process to select a new long term tenant for the Playhouse.
- <u>Diversity of revenue streams</u> – Just as a personal financial advisor suggests a diversified portfolio, it makes good sense for the Department to spread revenue risk by encouraging a

variety of revenue streams. Seattle Center manages over 100 separate revenue sources. This diversity of income sources tends, in the long run, to smooth out marketplace fluctuations. In any given year, under-performing revenues can often be offset by those which exceed targets.

- Maximizing commercial revenues – As mentioned previously, the Department actively markets its facilities to attract and book as many events as feasibly possible. In certain instances, the Director may choose to "co-promote" events as a strategy to increase bookings. Similarly, we look to attract market rate lessees whenever possible to help lock in favorable financial returns from the City's assets. As a rule, the Center acts in an opportunistic manner and attempts to book the maximum number of events within available dates. When commercial clients are unable to meet their obligations appropriate actions are taken. The recent departure of the Fun Forest is an example of the implementation of an exit plan when a commercial lessee was unable to make payments to the City.

- Limiting contract exposure – The Department seeks to minimize expense impacts of tenant operations wherever possible. Over time the Center's leases have shifted responsibility to tenants for all maintenance and operating costs within their lease footprint. This approach helps to align financial responsibility with the operating choices tenants make. In another example, the Center has converted its support for the Folklife Festival from a set number of labor hours to a set dollar value. This "expense cap" has worked well to stabilize the Center's support to the festival and thereby limit the City's financial exposure.

- Workforce Management Strategies – Event related business cycles and workload demands can vary widely based on bookings and attendance levels. The Center relies heavily on intermittent staffing resources to staff for events and facilities. Use of intermittent staffing permits the Center to "flex" staffing levels to meet the fluctuating event levels and avoid ongoing expense for staff when event levels drop off. The Department also actively manages use of overtime hours to minimize unreimbursed expenses.

Financial Management: Challenges, Responses and New Opportunities
Like other business entities, Seattle Center continues to experience financial pressures in a down economy. However, 2012 presents significant and unique opportunities as the Department looks towards its next 50 years. The response to these pressures and opportunities will impact the Department's ability to repay its loan.

Challenges

- General Fund pressures – Most City departments, and the City as a whole, have experienced reductions in their General Fund allocations in recent years. Seattle Center is no exception. These reductions have resulted in cutbacks in staffing levels which adversely impacts maintenance and service levels. Further reductions to expenses for the purpose of generating needed cash risks eroding quality and safety of the Center's grounds and facilities. In 2008, the Department had a staffing level of 278.30 FTEs. Financial pressures have led to the reduction in the last five years of 33.18 FTEs, for a 12% reduction in staffing levels. At a certain point, reductions in maintenance of the campus grounds may compromise the Department's ability to meet revenue targets if the public responds with declining bookings and attendance.

- Contract Requirements – Long-term leases designed to give nonprofit arts tenants a measure of financial stability can constrain the Department's ability to respond to financial challenges. The Department may not be able to easily take advantage of shifts in rental rates or increases in demand. In other cases, City policy has determined that revenue sharing strategies to recognize the value that specific tenants bring to the community are a priority. Support for the Seattle Storm and Seattle University basketball teams are examples of this type of arrangement, in which the Department is obligated for a fixed amount of financial support regardless of financial or other performance measures.

- New Arena Proposals – The KeyArena is now entirely paid for with the retirement of the construction debt. While not on the immediate horizon, any future new arena proposal has the potential to impact KeyArena profitability. A new arena represents another competitor for suites, concerts, and other events, whether in SODO or in other locations in the region. Given the likelihood that this competition will materialize within the next decade at some location, this is a challenge that will need to be addressed.

- Maintenance of Campus Facilities – Continued low levels of facility reinvestment, due to reduced availability of capital funding will eventually have a negative impact on Seattle Center. Facility attractiveness and safety have a direct impact on attracting visitors and commercial clients, and may therefore eventually impact the Department's ability to meet revenue targets.

- Center House Atrium Redevelopment – The Department is in the middle of a modest building renovation and significant upgrade of its food service offerings in the Center House. This project represents incremental progress toward the Century 21 master plan and responds to public outreach feedback desiring better food options and revived gathering space in Center House. Competition for high quality local restaurateurs in this economic environment is especially challenging. Many potential food service businesses have multiple offers from prospective new landlords, and this means the Department may have to sacrifice revenues in the short-term to attract higher quality tenants for the long-term.

- Greater Reliance on Public Benefits – One of the strategies used in negotiating nonprofit leases has been to substitute the provision of public benefits for cash. While this approach leverages appropriate value for the community, it does not put cash into the Center's operating fund.

Response and New Opportunities

- Managing within Available Revenues – The Department actively manages revenue performance and expense trends, and in the past has typically been able to manage within existing resources from a net income perspective. If revenue or expense trends diverge, the Department may institute pre-emptive expense reductions to ensure targets are met. While business levels (more event bookings) may cause expenses to exceed budget, the Department generally has not requested additional General Fund support but rather ensures that there are sufficient commercial revenues to support the higher activity levels. However, the current economic crisis has kept Center's operating funds in a negative cash position since January 2011, and it has made it challenging for the Department to manage expenses to stay within revenues.
- Adapting to Business Conditions – Responding to changed business conditions is an ongoing responsibility for the Department. Addressing changes in KeyArena is an example of the Center's ability to modify operations to deal with financial challenges. In 2008, KeyArena's anchor tenant, the Sonics, relocated. That year, the facility lost $755,000 in net income. In 2009, anticipated as being a transition year, the loss was $1.2 million. By 2010 the Department managed to a break-even fiscal year for the facility. And by 2011, KeyArena turned a profit of $300,000. While it took time to make changes of this magnitude, it was possible to make a significant shift in the market perception of the facility and transition the building to profitability. Despite the operating profit described, the Department has extremely limited funds with which to make any major capital repairs or

improvements in KeyArena. Over time, this lack of funds may detract from the attractiveness of the venue to patrons, event producers, and concert promoters, which will increase pressure on the Department's finances.

- Leveraging New Opportunities – 2012 has been well publicized as the 50th Anniversary of the 1962 Seattle's World's Fair. To celebrate this event, the Department (working with the Seattle Center Foundation, a wide range of organizations, and multiple citizen committees) has planned six months of Seattle Center "Next 50" programs. In addition, in 2012 the campus will host the opening of the Chihuly Garden and Glass exhibit, and the King Tut exhibit at the Pacific Science Center. Overall, approximately 500,000 additional visitors are expected to attend these special events and exhibits. These extra visitors are expected to generate an increase in ancillary revenues (parking, Center House food sales, Monorail) during 2012. Further, the Department is aggressively pursuing new business partnerships and programming opportunities resulting from renewed public interest in Seattle Center as a result of the 50th Anniversary.

- New Arena Proposals – Recent discussions around the proposed SODO arena present an opportunity for the Department. Should that proposal proceed, there will be a renewed focus on the future of KeyArena in particular. This focus will expedite the needed public discussion of options for transforming KeyArena into a long-term financially viable venue that complements other regional venues and serves the needs of the community. The investor group proposing to develop the new arena has offered to add their knowledge and insight into the mix, and to work as partners in fleshing out options. The Department would seek to initiate a vigorous public discussion to further identify potential approaches about how best to make changes, and ultimately help guide City officials to a decision.

SECTION 2

Repayment Options

Ordinance 123644 requires repayment of the loan in full by December 31, 2012. At this point in the year, financial predictions are less than certain. This is particularly the case in 2012 when the many special Next 50 activities may produce a spike in attendance and thereby incremental revenues. The Department has outlined four scenarios related to the strategies for repayment of the loan which rely, in part, on incremental revenues accruing over the summer. Those scenarios assume in 2012: A) baseline, B) a break-even scenario C) a partial loan repayment of $500,000, and D) full loan repayment of the loan.

Attachment A provides detailed estimates of the repayment calculations for all the scenarios discussed below.

Scenario A – *Baseline.*

This scenario creates a baseline to be used in anticipating likely year-end balances. It represents the most realistic estimate of the expenses and revenues likely to occur in 2012. Because the budget is established up to two years in advance, it is common to anticipate a number of adjustments not reflected in the adopted budget. In addition to these known adjustments, the baseline scenario assumes that all other revenues and expenses and the associated cash come in as budgeted. The baseline scenario would result in a 2012 end-of-year cash deficit of roughly $3.3 million. Specific variances included in the baseline are:

Revenue Adjustments:

- ($100,000) – Skatepark sponsorship foregone due to lack of sponsor interest
- ($300,000) – Lease revenue foregone related to delayed Northwest Crafts lease schedule, proration of Chihuly lease, Intiman lease termination, and estimated rent credit for EMP.
- ($220,000) – Children's Museum write-off approved by Council but not anticipated in the adopted budget.
- ($250,000) – Parking revenue trends below budget. The 2012 Adopted Budget assumed a $300,000 parking revenue increase above 2011 actuals. This $250,000 adjustment means that parking revenue is now assumed to increase by $50,000 above 2011 actuals (before 2012 special exhibits are factored in).
- ($200,000) – Center House vendor rents delayed to incentivize new lessees.
- ($120,000) – CIP revenue below budget. The Center's revenue estimates for CIP reimbursement to its Operating Fund were based on an optimistic forecast of CRF allocations.
- ($128,000) – 1% General Fund reduction requested to help fund citywide savings
- $100,000 – KeyArena profit due to business upswing
- $325,000 – Generate additional levels of ancillary revenues from special events during 2012 (conservative scenario).

Expense Adjustments

- ($200,000) – Invest additional revenue proceeds to augment services during 50th Anniversary celebrations. Increased security, routine cleaning and event related costs due to increased attendance.
- ($240,000) – The Center will pay a management fee to Levy Restaurants to assist with food court transition activities.
- $128,000 – Expense savings to offset 1% reduction in General Fund support.

The known variances provide a net total deficit of approximately $1.2 million in adjustments to create the baseline scenario for 2012 and a 2012 year-end estimated loan amount of $3.3 million.

Scenario B – *Break-even Scenario.*

This scenario seeks to have the Department break-even in 2012. For this to occur, the Department would need to achieve the following financial results to make up the $1.2 million loss in the Baseline Scenario:

Revenue Targets

- $400,000 – Generate an additional $400,000 in ancillary revenues from special events during 2012 on top of the conservative Baseline forecast of $325,000 (total of $725,000 - aggressive range)
- $100,000 – Generate an additional $100,000 in KeyArena profit (total of $200,000) over anticipated levels

Expense Targets

- ($700,000) – Eliminate an additional $700,000 (beyond the Baseline reduction of $128,000), in programming and services to achieve additional expense savings. Specific options are dependent on target amounts but may include reductions to public programming, overhead staffing, maintenance of facilities and grounds, and/or security patrolling of the campus.

Expense reductions of the magnitude required for this scenario would have a noticeable impact on service levels and public perceptions. In order to achieve these savings amounts, the Department would need to begin the reductions mid-year. Under this break-even scenario, the Department would owe approximately $2.1 million at the end of 2012.

Scenario C – *Partial Loan Repayment of $500,000 in 2012.*

This scenario seeks to pay down $500,000 of the cash shortfall. To do this, the Department would have to achieve a total of $1.7 million in net savings beyond the Baseline Scenario.

<u>Revenue Targets</u>

- $675,000 – Generate an additional $675,000 on top of the conservative Baseline forecast of $325,000 in revenues from special events during 2012 (total of $1.0 million – very aggressive range)
- $200,000 – Generate an additional $200,000 in KeyArena profit (total of $300,000) over anticipated levels

<u>Expense Targets</u>

- ($825,000) – Eliminate an additional $825,000 (beyond the Baseline reduction of $128,000), in programming and services to achieve additional expense savings. Specific options are dependent on target amounts but may include reductions to public programming, overhead staffing, maintenance of facilities and grounds, and/or security patrolling of the campus.

Expense reductions of the magnitude required for this scenario would have a noticeable impact on service levels and public perceptions. In order to achieve these savings amounts, the Department would need to begin the reductions mid-year. Under this scenario, the Department would owe approximately $1.6 million at the end of 2012.

Scenario D – *Full Loan Repayment in 2012.*

This scenario assumes the Department will achieve full loan repayment by the end of 2012, as required by Ordinance 123644. This scenario requires the Department to achieve a total of $3.3 million in net savings from the Baseline Scenario. To generate sufficient cash to repay the loan, the Department would have to achieve the following financial results:

<u>Revenue Targets</u>

- $675,000 – Generate an additional $675,000 on top of the conservative Baseline forecast of $325,000 in revenues from special events during 2012 (total of $1.0 million - aggressive range)
- $200,000 – Generate an additional $200,000 in KeyArena profit (total of $300,000) over anticipated levels

<u>Expense Targets</u>

- ($2.6 million) – Eliminate an additional $2.6 million (beyond the Baseline reduction of $128,000), in programming and services to achieve additional expense savings. This level of reductions may include the elimination of all public programming, and include significant FTE reductions, in addition to reductions in overhead staffing, maintenance of facilities and grounds, and/or security patrolling of the campus.

Expense reductions of this magnitude would require the Department to make fundamental changes in their structure and core lines of business. It is unlikely that the Department will be able to meet this scenario and fully pay back the loan in 2012. As in the other scenarios, to achieve these savings, the Department would need to begin the reductions mid-year.

Next Steps

Seattle Center clearly understands the need to repay any interfund loan amounts. The Department will closely manage both its revenues and expenses and its cash receipts to maximize surplus cash to the largest extent possible. The Council's Statement of Legislative Intent requires that the Center report back to Council in August, 2012. By that time, with the 50th Anniversary celebration into its fifth month and the busy summer visitor season well underway, Center will have better trend data on its progress and will be able to provide a more detailed update and a long-term plan for addressing payment of the loan. An update to the loan ordinance extending the repayment date will be submitted with the 2013-2014 Proposed Budget. If adjustments are necessary to the loan amount as well, they will be submitted at this time.

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