State of Washington
Joint Legislative Audit and Review Committee (JLARC)

University of Washington

Metro Tract Report: 2003 Update

Report 03-7

August 6, 2003

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The Joint Legislative Audit and Review Committee (JLARC) carries out oversight, review, and evaluation of state-funded programs and activities on behalf of the Legislature and the citizens of Washington State. This joint, bipartisan committee consists of eight senators and eight representatives, equally divided between the two major political parties. Its statutory authority is established in RCW 44.28.

JLARC staff, under the direction of the Committee and the Legislative Auditor, conduct performance audits, program evaluations, sunset reviews, and other policy and fiscal studies. These studies assess the efficiency and effectiveness of agency operations, impacts and outcomes of state programs, and levels of compliance with legislative direction and intent. The Committee makes recommendations to improve state government performance and to correct problems it identifies. The Committee also follows up on these recommendations to determine how they have been implemented. JLARC has, in recent years, received national recognition for a number of its major studies.

UNIVERSITY OF WASHINGTON METRO TRACT REPORT: 2003 UPDATE

REPORT 03-7

REPORT DIGEST

AUGUST 6, 2003

STATE OF WASHINGTON

JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE

STUDY TEAM

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LEGISLATIVE AUDITOR

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Background

The State of Washington owns the Metropolitan Tract, a parcel of office and hotel properties, occupying approximately 11 acres, in downtown Seattle. The University of Washington (UW) has developed and managed the Tract, which generates income for the University in excess of funds needed for operations and maintenance. 1999 legislation (RCW 28B.20.382) facilitated the Legislature's role in appropriating this Tract income for debt service and construction of other capital projects at the UW. That legislation also directs the UW to report to the Joint Legislative Audit and Review Committee (JLARC), every two years, on its management of the Tract. The UW's 2003 report follows, responding to questions raised from JLARC's Executive Committee (Appendix 1). The next UW report will be due in the 2005 Legislative Session.

Overview

JLARC's previous reviews noted that the Metropolitan Tract generates significantly less income to the University, relative to the Tract's asset value, than does the neighboring Union Square property for the State Investment Board. A major reason is because of the terms of the lease between the UW and UNICO Properties, Inc., the firm that manages much of the Tract for the UW. This lease was initiated in the 1950s, renewed in the late 1970s, and will expire in 2014. JLARC continues to recommend that this current lease arrangement **not** be renewed when it expires in 2014.

Focus of 2003 Report

The attached UW report responds to JLARC's request to address nine topics of concern. Following are JLARC staff comments on that report:

- **Funds Available from Metro Tract for other UW Capital Projects.** For the past several biennia, the Tract has generated approximately $8 million per year in earnings, over and above operating and capital costs, for the UW Building Account. UW anticipates this pattern will continue in 2003-05. The UW's report also indicates that approximate one-half of the Metro Tract earnings in 2003-05 will go toward paying the bonded portion of construction costs of the new Law School. The UW did not estimate the income likely to be transferred to the UW Building Account beyond 2003-05.

  The UW's 10-year Tract financial plan suggests that sufficient future income may not be generated to continue annual transfers of $8 million to the UW Building Account in the 2005-07 biennium. A combination of lower revenue (attributable to the current economic slump) and higher capital costs (attributable to aging buildings) leads to this diminished income picture. This financial plan anticipates improving cash flow beyond 2005-07, with optimistic assumptions for revenue growth.

- **Tract Value and Earnings.** UW estimates that its interest in the Metropolitan Tract is currently worth $192 million. The Tract generated $18 million in income in FY 2002, with an estimated return on investment of 9.4 percent, higher than a national index of commercial real estate investments. The 2003 UW report indicates that the value of the Metropolitan Tract properties **declined** by 11.3 percent in calendar year 2002 (previously declining by 11.9 percent in 2001). This decline in value has considerably exceeded that of a commonly used index of commercial real estate valuation.

  The estimated 9.4 percent return on investment may be somewhat overstated. The calculated return is based on the estimated value of the Tract, which in turn reflects the projected net income to be generated by the Tract, discounted to present value by 10.25 percent. That discount rate assumption appears somewhat high. The effect of such a discount rate lowers the current value of an asset and, thus, increases the estimated return on that asset. Additionally, the UW's projections of both future operating and capital expenditures also seemed high, further reducing future net income and lowering the current valuation of the Tract.

- **Operations and Maintenance Expenditures.** The Legislature has been concerned about on-going maintenance and preservation efforts and expenditures for state facilities. Under the lease arrangements, UNICO is responsible for operations and maintenance costs, while UW is responsible for capital costs. UNICO and the University provided data on operating repair and maintenance expenditures per square foot from 1995 through 2002. These figures are within range of a benchmark—that of the Building Owners and Managers Association (BOMA) of Seattle.

  The UW report also mentions on-going physical inspections of the properties to note those maintenance, modernizing and capital development efforts that require addressing. For those capital cost areas that fall under the University's responsibility, the University proposes these to its Board of Regents. UW's financial plan anticipates making capital expenditures averaging $5 per square foot per year through FY 2014.

- **Future Plans.** The University notes that it will not renew the lease in its current form at its expiration in 2014. However, using a third-party manager/developer is one option under continuing consideration. In the meantime, other development or redevelopment scenarios and opportunities are always under review.

This report on the University of Washington's management of the Metro Tract illustrates the patterns of financial returns from this public asset. Legislative concern that a portion of the earnings should go to debt service on that portion of the Law School's costs funded through bonds is demonstrated in this report. The University has also discussed in general terms alternative management scenarios in the post-2014 period. More details can be explored in future biennial reports.

UNIVERSITY OF WASHINGTON

REAL ESTATE OFFICE

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JLARC

February 28, 2003

Mr. Tom Sykes, Legislative Auditor
Joint Legislative Audit & Review Committee
506 – 16th Avenue SE
Olympia, WA 98501-2323

Re: 2003 Report on the Metropolitan Tract

Dear Mr. Sykes:

On behalf of the Board of Regents of the University of Washington, I am pleased to provide the enclosed 2003 Report on the Metropolitan Tract pursuant to your request of January 8, 2003 and RCW 28B.20.382. The report is organized according to the questions posed in Attachment 1 to your letter.

We look forward to the opportunity to discuss this report with the committee. Please feel free to contact me with any questions or comments you may have.

Sincerely,

Jeanette L. Henderson
Director of Real Estate

enclosure
cc: Weldon E. Ihrig, Executive Vice President

418 Skinner Building 1326 Fifth Avenue Seattle, Washington 98101-2604 (206) 685-1700 FAX: (206) 685-1547

2003 REPORT
ON THE
METROPOLITAN TRACT
SUBMITTED BY THE UNIVERSITY OF WASHINGTON

INTRODUCTION

This biennial report is provided pursuant to RCW 28B.20.382(2) as a summary of the financial performance of the Metropolitan Tract.

The Metropolitan Tract, located in downtown Seattle, is comprised of approximately 11 acres of developed property including office space, retail space, parking and a luxury hotel. This land was the original site of the University of Washington from 1861 until 1895 when the University moved to its present location on Lake Washington. Since the early 1900's, the Metropolitan Tract has been leased by the University to entities responsible for developing and operating the property. The majority of the Metropolitan Tract is leased to Unico Properties, Inc. and consists of office, retail and parking facilities. This lease began in 1953 and will expire in 2014. The Olympic Hotel property is leased to Urban/Four Seasons and operated as the Four Seasons Olympic Hotel. This lease expires in 2040. In addition, the University directly controls approximately 345,000 square feet of office space under the Unico lease referred to as the Rainier Tower Sublease. At the expiration of the ground leases, the University will realize the full value of both the cash flows associated with the third party subtenants of Metropolitan Tract as well as the underlying asset value of the improvements.

The University's objective is to enhance the financial performance of the Metropolitan Tract through proactive asset management of the Unico Lease, the Four Seasons Olympic Hotel Lease and the Rainier Tower Sublease, and to identify, define, evaluate and implement strategies to further improve the long term value and related cash flow of the University's interest in the Metropolitan Tract. In June 2000, the University hired Trammell Crow Company and Heitman Capital Management to jointly provide third-party asset management services for the Metropolitan, for increased oversight of the lessees and comprehensive efforts on strategic initiatives. The University's Real Estate Office provides institutional administrative representation through contract and audit oversight, preparation of financial statements, and accounting (accounts receivable and accounts payable) for the Metropolitan Tract. Direction and control of the Metropolitan Tract is under the authority of the Board of Regents of the University through its Capital Assets Committee.

The specific questions posed by the Joint Legislative Audit Review Committee are recited in this report, with answers following each question.

1. *Provide financial statements for the Metropolitan Tract for the last biennium (1999-01), and the first fiscal year of the current biennium (FY 2002). In addition to income statements and balance sheets, this information should include:*

   a) *The amount of deposits into the UW bond retirement account;*
   b) *The amounts in the facilities bond retirement account that are in excess of the debt service needs and have been transferred to the UW Building Account;*
   c) *A detailed itemization of any operating expenses of the University that are paid for from Metropolitan Tract income;*
   d) *Specific capital projects funded by Metropolitan Tract funds transferred to the UW Building Account; and*
   e) *Year-to-date financial data for the current fiscal year (FY 2003).*

Copies of two Metropolitan Tract financial audits which include financial statements for fiscal years 1999-2000, 2000-01, and 2001-02 are enclosed. Also enclosed is the Metropolitan Tract balance sheet and income statement for the period ending December 31, 2002. For fiscal year ended June 30, 2002, operating expenses for the Metropolitan Tract totaled $3,038,000 consisting of Metropolitan Tract insurance costs, professional services such as third party asset management, audit fees, and legal fees, and Real Estate Office expenses. No other operating costs of the University are paid from Metropolitan Tract income.

During the 1999-2001 biennium, the University allocated funds transferred from the Metropolitan Tract to specific capital projects as follows:

Program Renewal	$3,000,000
Classroom Improvements	$9,000,000
Building Renewal	$1,600,000
Safety	$1,000,000
Utilities - Emergency Power System	$335,000
Building Communications Infrastructure	$1,065,000
TOTAL 1999-2001	$16,000,000

Pursuant to legislation enacted in 1999, the Metropolitan Tract funds are commingled with other revenue sources in the UW Building Account, and after allocation to debt related uses, the remainder is appropriated from the UW Building Account for campus capital projects.

During the 2001-2003 biennium, net proceeds totaling $16 million will be transferred from the Metropolitan Tract to the commingled Facilities Bond Retirement Account. A portion of these funds has been used for Law School debt. The $6 million remaining after allocation to debt related uses were transferred to the UW Building Account and have been appropriated for the following:

Program Renewal	3,500,000
Building Renewal	2,500,000
TOTAL – 2001-2003	$6,000,000

In the coming biennium, we anticipate that debt service reserve requirements (per RCW 28B.20.725) will consume a significant amount of resources as displayed on page 10 of the University's 2003-2005 Capital Budget Request. The total amount projected to be available for appropriation in 2003-2005 from all sources within the UW Building Account is $18 million as outlined below.

PROJECTED UW BUILDING ACCOUNT
(2003-2005 Biennium)
(in millions $)

SOURCES	
Metropolitan Tract	$16.0
Building Fee (% of tuition)	$17.0
Timber Revenue	$ 1.5
Miscellaneous	$ 0.5
Total Sources	$35.0
USES	
Law School Debt	($8.0)
Existing Debt	($3.0)
Existing Debt Reserve	($4.0)
Miscellaneous Expenses	($2.0)
Total Uses	($17.0)
SOURCES LESS USES	$18.0

2. Provide information and update to the 10-year Return On Investment (ROI) figures provided in the previous reports, including the comparison with the index maintained by the National Council of Real Estate Fiduciaries (NCREIF). This should include a breakdown between income ROI and appreciation ROI. Include the amount of income and appreciation each year, as well as the overall property value each year. Provide the above for both the major leaseholds.

The current value of the University's interest in the Metropolitan Tract is made up of the cash flow associated with three separate and distinct leasehold interests and the residual value of the property at the time these leases expire. The leases are as follows:

1) Unico Properties, Inc. ("Unico") has a ground lease which covers six office and retail buildings totaling approximately 1.4 million square feet of office space, 200,000 square feet of retail space and access to over 1,400 parking stalls. This ground lease commenced in 1953 and will expire in October 2014, at which time the "fee simple" interest in these real estate assets will revert to the University;

2) Urban Four Seasons Hotel Venture Limited Partnership ("Four Seasons") leases the Olympic Hotel property, a 450-room luxury hotel operated by the Four Seasons, along with a parking garage of 610 stalls. This architecturally significant building underwent a total renovation beginning in 1980 before reopening in 1982. The Four Seasons lease commenced in 1980 and expires in 2040; and

3) The University directly controls approximately 345,000 square feet of office space in Rainier Tower pursuant to a sublease with Unico. This sublease was the result of the University's acquisition of the leasehold of the original Rainier Bank Headquarters from Seafirst Bank in 1995 ("Rainier Tower Sublease"). This space is leased to third party subtenants. The Rainier Tower Sublease expires in 2017, three years after the expiration of the Unico lease.

To calculate the value of the University's interest in these three leaseholds, it is necessary to analyze each separately. For the ground lease with Unico, a discounted cash flow valuation methodology is used. Under this methodology, the estimated annual future cash flows that will be paid to the University under the ground lease plus the estimated residual value of the property upon reversion to the University at the end of the ground lease are discounted back to the present using an annual discount rate of 10.25%. This valuation methodology results in a present value of the University's current lessor interest and future reversion rights of approximately $135 million. Falling from its peak in 2000, the Seattle office market has suffered over the last two years from an anemic economy, lack of regional job growth, and absence of the historical drivers of office space absorption. Consequently, the value of Metropolitan Tract as of the end of 2002 has decreased from the reported value in 2000 commensurate with the decline in office rents and the increase in market vacancy.

The value of the University's interest in the ground lease with the Four Seasons for the Olympic Hotel has been estimated using a direct capitalization valuation methodology due to the relative stability of the cash flows and the long-term nature of this lease (38 years remaining). Under this methodology, the ground rent paid by the Four Seasons to the University of approximately $3.1 million is capitalized at 8.00% to arrive at a value of $38.75 million, compared to the estimated $41.25 million value at the end of 2001. Actual 2002 ground rent earned by the University in 2002 was $3.1 million compared to $3.3 million in 2001 and $3.7 million in 2000. This ground lease revenue decrease is a direct result of the precipitous decline in the hospitality industry predicated by the general economic malaise as well as the aftermath of 9/11.

The value of the University's interest in the Rainier Tower Sublease space is calculated using a discounted cash flow valuation methodology. Under this methodology, the future estimated cash flows that will be paid to the University under its sublease arrangements with the third-party tenants (using market assumptions to calculate the cash flows beyond the current sublease terms) are discounted back to the present using an annual discount rate of 10.25%. The discounted cash flow analysis runs through 2014 (when the University gains control of the Unico managed properties), at which time the space is incorporated into the previously discussed Unico residual value analysis. Therefore, the value of the Rainier Tower Sublease is estimated to be $17.8 million. The value of this Sublease will move downward each year as the Unico ground lease expiration in 2014 approaches, and it will be impacted less by market conditions, since much of the projected sublease revenue is based on long term lease contracts.

A summary of values is as follows:

Valuation Summary as of 12/31/02
(in millions $)

Component	*UW Ground* Lessor Value*
Unico	$135.20
Four Seasons	$38.75
Rainier Tower Sublease	$17.80
Total	$191.75

* The above values are based on estimates obtained by the University in consultation with its real estate advisors. These valuations are not based upon third-party appraisals.

The total value of the Metropolitan Tract decreased by approximately $24.5 million from the 2001 levels due primarily to the weakening of the office market sector. A reduction in user demand resulting from a soft economy and the pullback in the high technology sector has left most major markets in the nation with substantial vacancies. These vacancies, in connection the dismal future job outlook and a general lack of confidence in the business sector, has resulted in reduced office rental rates and values. Values in the office sector have fallen significantly from the lofty levels of 2000.

Return on Investment

Returns on real estate are often separated into two distinct categories: Income Return and Appreciation Return. Income Return is generally defined as the annual net cash flows generated from property operations divided by the current market value of the property. Appreciation Return is defined as the annual change in value of the property from one period to another resulting from changes in the market, net of capital expenditures and divided by the initial market value.

Because Income and Appreciation Return results are often used in measuring the performance of various types of real estate assets, these computations for the Metropolitan Tract ground leases are included herein. It is important to recognize that these results are most relevant for comparative purposes when analyzing current and anticipated trends for the Metropolitan Tract. With that said, these measurement tools are less applicable, and can often be misleading, when used for comparison with returns of other classes of real estate. Due to the disparity in how the returns are actually calculated and the fundamental differences in various classes of commercial real estate, the current yield and annual appreciation results can vary substantially. To highlight this point, it is critical to look at the key elements that drive the value of the Metropolitan Tract. Since a disproportionately high percentage of the value of the Metropolitan Tract holdings comes from the residual value of the underlying improvements (which revert to the University in 2014) and a lower percentage comes from the current cash flow return derived from the ongoing ground lease payments, it is generally expected that most of the future return will come from asset appreciation.

Comparison with NCREIF

Although the NCREIF return index is often used by institutional investors as a standard benchmark in evaluating the performance of fee simple real estate investments, it is important to note that, due to certain key differences in the methodology used in calculating this index, the overall returns reflected in the NCREIF index are not comparable to the returns reported by the University on the Metropolitan Tract. For example, the Income Return Index reported by NCREIF is based on modified GAAP basis income, which annualizes rental streams over the life of the long-term lease contracts, while Metropolitan Tract returns are reported based on actual cash receipts. This key difference results in the NCREIF Income Return being overstated relative to the Metropolitan Tract Income Return. Other key differences result from the manner in which Appreciation Returns are calculated. The methodology under which the NCREIF Appreciation Return Index is calculated results in understatement of asset depreciation in times of falling values. This understatement of real estate asset depreciation is clearly demonstrated in the 2000 to 2002 time period. During this period, office assets across the nation declined in value by anywhere from 20% to 40%, depending on the market, due to the distressed office market conditions. Over this same timeframe the NCREIF Appreciation Return index only reflected a loss in value of 1.3% to 1.6% per year.

While it is questionable whether NCREIF is an appropriate benchmark for ground lease investments such as the Metropolitan Tract, with these considerations as the context for review, a comparison of the estimated rates of return on investment with NCREIF is as follows:

* *2002 NCREIF Returns are for the twelve months ended 9/30/02.*

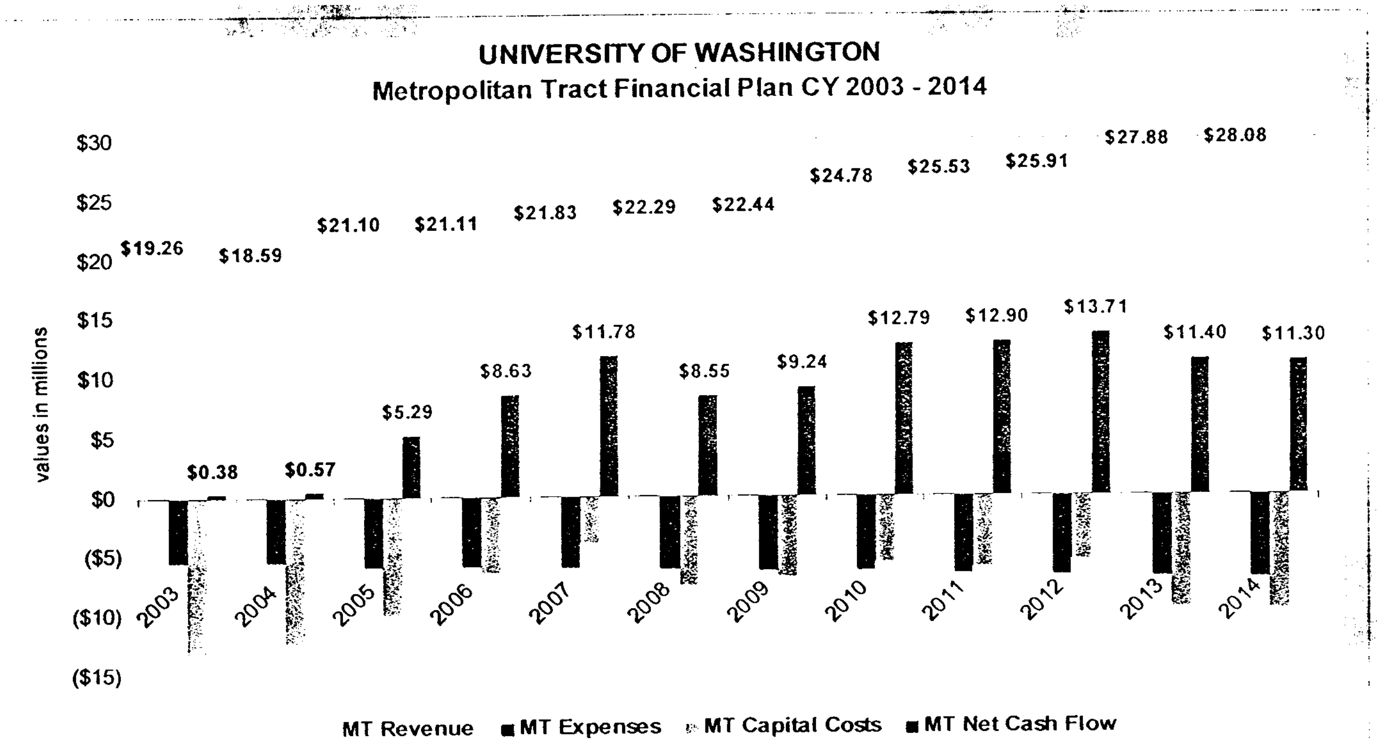
METROPOLITAN TRACT

Data on Financial Returns to UW - Fiscal Years 1991 thru 2002
($ in 000's)

	Metropolitan Tract Value and Return Summary									
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002*
UW Value	138,866	145,554	152,556	162,415	179,604	198,763	211,743	244,100	216,250	191,750
UW Revenue less Op. Expenses	10,942	10,897	11,020	9,931	14,440	13,404	13,169	15,038	15,284	17,983
Capital Reinvestment	(4,897)	(2,202)	6,554	(2,515)	(4,077)	(3,419)	(5,217)	(7,300)	(6,600)	(12,300)
Transfers to Campus	3,354	4,000	9,000	9,000	5,950	8,000	8,000	8,000	8,000	8,000
Return on Investment										
UW Income Return	8.00%	7.79%	7.97%	7.36%	8.70%	7.93%	7.77%	6.20%	7.07%	9.38%
UW Appreciation Return	-0.45%	3.15%	3.33%	5.56%	8.52%	9.14%	5.88%	15.30%	-11.92%	-11.33%
NCREIF Income Return*	8.21%	8.75%	9.13%	8.88%	9.08%	8.77%	8.28%	8.46%	8.68%	8.42%
NCREIF Appreciation Return*	-6.43%	-2.22%	-1.49%	1.34%	4.54%	7.01%	1.86%	3.01%	-1.31%	-1.58%

3. Provide a copy of the FY 2003-2013 financial plan for the Metropolitan Tract that illustrates anticipated revenues and expenditures, as well as the major assumptions driving anticipated revenues and expenditures. This financial plan should include anticipated expenditures for both operating and capital purposes, and the anticipated fund balance for each fiscal year.

The following graph illustrates the anticipated revenues and expenses for the Metropolitan Tract for calendar years 2003 through 2014, the expiration year of the Unico lease term. The financial projections below are estimates only and are based on current contractual rents and on assumptions on future market conditions as applied to the lease up of vacant space and at the expiration of current leases as well as anticipated capital needs. The accuracy of the model is highly dependent upon the accuracy of these assumptions.



The major assumptions driving the financial projections for the Metropolitan Tract are as follows:

- Average Annual Market Rental Rate Inflation
- Annual Contractual Rental Rate Increases
- Vacancy Rates and Projections
- Downtime Before New Leases Commence
- Renewal Probability Factors
- Tenant Improvement Expenditures for Leases

As of 12/31/02, the Metropolitan Tract fund balance was $23.6 million. The following table illustrates the uses of this capital for 2003.

2003 Fund Activity	Amount in Millions
Fund Balance as of 12/31/02	$23.628
Estimated Net Cash Flow	$ .381
Capital Improvements in Process	($7.951)
Subtotal	$16.058
Transfer to Campus CY 2003	($ 8.000)
Ending Balance*	$ 8.058

**The Ending Balance is a reserve toward campus funding in 2004.*

4. *Provide a copy of any policies or criteria used to determine the minimum and maximum fund balance needed for the Metropolitan Tract.*

Five percent of annual gross rentals are reserved in the New Building Fund, a component of the Metropolitan Tract fund balance, as required by the Unico lease. Additional cash reserves are maintained to support expected capital expenditures and tenant improvements as part of the rolling five-year capital improvement plan described in Question 8.

5. *Provide the amount of operating and maintenance expenditures by Unico each year for the last 10 years allocated among:*
   a. *Operations*
   b. *Maintenance*
   c. *Utilities*

As discussed in the 2001 Report, the lease with Unico does not give the University the explicit right to audit Unico's books related to operating costs. However, Unico is required to achieve certain annual Repair and Maintenance thresholds for investment on the Metropolitan Tract. As a follow up to a meeting between Unico's CEO, Dale Sperling, and Tom Sykes in December, 2002, Unico provided the following summary with regard to these expenditures. Unico declined to provide any information on operating expenditures due to its proprietary nature and that, in their opinion, this information has no bearing on the University's current economic interest in the Metropolitan Tract.

The University will ensure that any future lease arrangements with Unico or any another party will include the requirement for full disclosure of all financial information related to the Metropolitan Tract.

Metropolitan Tract
Unico Repair and Maintenance Spending
1995 - 2002

	1995	1996	1997	1998	1999	2000	2001	2002
R&M Spending	$2,365,599	$2,039,553	$1,968,905	$1,570,306	$1,895,293	$2,219,407	$2,419,498	$2,790,500
Square Footage	*1,350,318*	*1,459,373*	*1,459,373*	*1,459,373*	*1,490,625*	*1,521,876*	*1,594,155*	*1,601,579*
Unico $/SF	$1.75	$1.40	$1.35	$1.08	$1.27	$1.46	$1.52	$1.74
BOMA* $/SF	$1.25	$1.19	$1.54	$1.35	$1.34	$1.55	$1.58	NA

* Building Owners and Managers Association, Seattle Chapter

6. *Describe UW's plans for managing the Metropolitan Tract following the expiration of the Unico lease in 2014.*

Given that the Unico lease will not be renewed in its current form, there are three primary alternatives with respect to future management of the Metropolitan Tract:

- Ground Lease. The University could enter into a new ground lease with a third-party manager/developer (may or may not be Unico) on terms that would be significantly different from the terms of the existing ground lease with Unico.

- Contract Management. The University could hire third-party asset managers and property managers to manage the assets, or manage the assets directly.

- Hybrid Structure. The University could manage some of the buildings and enter into ground lease arrangements for others.

The terms of the existing ground lease with Unico reflect a business arrangement that was designed to compensate it for taking on the management responsibilities and the risks associated with the initial development of the Metropolitan Tract with various office and retail projects. Because the Metropolitan Tract is now a mature asset with limited additional development sites, the business arrangement going forward (whatever alternative is chosen) will need to reflect current circumstances and risk criteria then established by the University.

Generally, a ground lease minimizes risk and provides some level of guaranteed return. A management structure, on the other hand, would likely generate the highest rate of return, but at the highest risk level. The advantages and disadvantages of each alternative will be fully considered before a decision is made.

7. *Provide an update to your 2001 report of any plans under consideration for the private sector to finance building improvements to the Metropolitan Tract properties, rather than continue to have the University finance such improvements.*

As noted in the 2001 report, improvements to the Unico-managed buildings on the Metropolitan Tract are financed by the University as stipulated by the lease with Unico. The 2001 report also described a potential transaction for a Hyatt Hotel on the northwest corner of Rainier Square block. The transaction involved the University entering into a long-term ground lease directly with the hotel operator that would then take on all the development and operational responsibility to build and manage the hotel. Hyatt ultimately elected to acquire an interest in the Elliott Hotel that had just been completed rather than build a new hotel from the ground up. However, the Hyatt deal structure is certainly an example of how the private sector could be used to finance improvements on the Metropolitan Tract.

Unico is currently evaluating several development or redevelopment scenarios for the Metropolitan Tract. Concepts under consideration include office, retail and residential projects. It is possible that some of these potential developments could utilize private capital. However, the projects are too preliminary at this point in time to identify exactly what type of financing and capital structure would be used.

8. *As the expiration of Unico's lease approaches, describe how UW will ensure that the properties are being adequately maintained.*

Pursuant to the Unico lease and under the supervision of the University's real estate advisors, Unico prepares a rolling five-year capital improvement plan and corresponding budgets on an annual basis. The University's advisors then perform a physical inspection of the properties as well as a cost/benefit review of Unico's proposed capital improvement plan to determine which items should be undertaken during the budget cycle. The cost/benefit analysis assesses a number of factors such as whether the improvements will extend the useful life of the assets, address essential life/safety standards, maximize the probability of increasing rents in a property, or in the case of a declining market, those improvements that will support tenant retention and stabilize rents. A budget recommendation is then submitted for consideration, first to the Metropolitan Tract Committee, then to the Capital Assets Committee of the Board of Regents. Implementation of the capital expenditures plan is then monitored through physical inspections, review of architectural and engineering plans and thorough examination of billing records.

As a result of this capital improvement planning process, since 2000 approximately $38 million dollars have been invested in seismic repairs and improvements, elevator replacements, building security, mechanical systems improvements, fire prevention, life/safety improvements, upgrades to comply with the Americans with Disabilities Act, and exterior restoration.

By taking a pro-active approach with respect to the physical condition of the buildings, the University ensures that they are properly maintained and remain competitive not only through the remaining term of the ground lease, but also after they revert to the University in 2014 unencumbered by the Unico lease.

9. *Provide information on how the UW assesses the condition of the Metropolitan Tract properties, including information on actual conditions and how these conditions have changed over time.*

The Metropolitan Tract properties can be assessed from a physical, financial and development perspective.

As discussed in the previous Question #8, the University has implemented a structured capital improvement process for the Unico portion of the Metropolitan Tract to see that the physical condition of the buildings are maintained at an acceptable level. This process has afforded the University stronger influence in the overall direction including leasing activity, which ultimately determines the revenue generated and is the main driver for the University's financial returns from these buildings. Direction is given to lease rollover timing, tenant credit strength and tenant improvement investment so that the buildings are well leased and are in good physical condition at the expiration of the Unico lease. Development opportunities to enhance the value of the Metropolitan Tract are being explored as described in Question #7.

Under the Four Seasons Olympic Hotel lease, the tenant is solely responsible for the planning, payment and implementation of physical improvements to the property. The lease requires that the tenant re-invest a certain percentage of gross revenue in capital projects each year and, although the lease does not provide for the University to have input on capital projects, there are operating standards that must be met which govern capital re-investment. (It should be noted that the Nisqually Earthquake caused a considerable amount of cosmetic damage to the hotel, and nearly $7 million of interior improvements have been completed as a result, significantly improving the appearance of the hotel.) The University's auditors perform a compliance audit each year to see that the terms of the lease are being met. Due to the nature of this lease whereby financial and operating risk is not assumed by the University, there are fewer opportunities to influence the management or financial performance of the hotel. The site is fully developed and the historical significance of the building does not lend itself to additional development.

Metropolitan Tract
Statement of Assets, Liabilities, and Net Assets
December 31, 2002

ASSETS:	
Funds held by the University of Washington	23,628,733
Cash held in trust	651,878
Tenant improvements receivable	880,414
Prepaid rent and other receivables from Rainier Tower	380,306
Other receivables	13,363,135
Deferred costs	1,752,885
	40,657,351
Property	155,251,899
Less accumulated depreciation and amortization	(74,854,122)
	80,397,777
Total assets	121,055,128
LIABILITIES:	
Deferred income	366,279
Deposits payable	56,585
Accounts payable and other liabilities	1,221,814
Total liabilities	1,644,678
NET ASSETS:	
Invested in capital assets	80,397,777
Restricted	6,155,642
Unrestricted	32,857,031
Total net assets	119,410,451
TOTAL LIABILITIES AND NET ASSETS	121,055,128

Metropolitan Tract
Statement of Revenues and Expenses and Changes in Net Assets
December 31, 2002

OPERATING REVENUES:	
Gross rental income	17,077,542
Less rent abatements	(1,600,000)
Rainier Tower sublease income, net of related expenses	1,152,101
Total operating revenues	16,629,643
OPERATING EXPENSES:	
Leasehold excise taxes	121,282
Operating expenses	928,655
Total operating expenses	1,049,937
OPERATING INCOME BEFORE DEPRECIATION	15,579,706
DEPRECIATION AND AMORTIZATION	2,135,251
OPERATING INCOME	13,444,455
NONOPERATING REVENUES AND (EXPENSES)	
Interest income	54,693
Total nonoperating revenues	54,693
TRANSFER TO UNIVERSITY OF WASHINGTON	(4,000,000)
CHANGE IN NET ASSETS	9,499,148
TOTAL NET ASSETS:	
Beginning of year	109,911,304
End of year	119,410,451

APPENDIX 1

State of Washington
Joint Legislative Audit and Review Committee (JLARC)

E-mail: neff_ba@leg.wa.gov
Web site: http://jlarc.leg.wa.gov

LEGISLATIVE AUDITOR
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Phil Rockefeller

January 8, 2003

Weldon Ihrig
Executive Vice President
University of Washington
306 Gerberding Hall
PO Box 351235
Seattle, Washington 98195-1235

Dear Mr. Ihrig:

This letter is in regard to the University's reporting requirements as directed in RCW 28B.20.382, relating to the Metropolitan Tract. As you recall, this law requires the University to provide a detailed report of all leases and transactions pertaining to the Metropolitan Tract to the Joint Legislative Audit and Review Committee (JLARC) each odd-numbered year.

In order to facilitate JLARC's review of this information, we request that the University's 2003 report include the information requested in Attachment 1. This information will help us provide the legislative oversight envisioned in the aforementioned statute. We look forward to receiving an updated report on the University's management of this public trust, and ask that the 2003 report be delivered to JLARC by February 28, 2003.

Please direct any questions or communications to Tom Sykes, Legislative Auditor. Thank you in advance for your efforts.

Sincerely yours,

Val Ogden
Representative Val Ogden, Chair

Senator Jim Horn, Vice Chair

Representative Gary Alexander, Secretary

Georgia Gardner
Senator Georgia Gardner, Asst. Secretary

Attachment

Attachment 1
2003 Metropolitan Tract Questions

1. Provide financial statements for the Metropolitan Tract for the last biennium (1999-01), and the first fiscal year of the current biennium (FY 2002). In addition to income statements and balance sheets, this information should include:
    a. The amount of deposits into the UW bond retirement account.
    b. The amounts in the facilities bond retirement account that are in excess of debt services needs and have been transferred to the UW Building Account.
    c. A detailed itemization of any operating expenses of the University that are paid for from Metropolitan Tract income.
    d. Specific capital projects funded by Metropolitan Tract funds transferred to the UW Building Account.
    e. Year-to-date financial data for the current fiscal year (FY 2003).

2. Provide an update to the 10-year Return On Investment (ROI) figures provided in previous reports, including the comparison with the index maintained by the National Council of Real Estate Fiduciaries (NCREIF). This should include a breakdown between income ROI and appreciation ROI. Include the amount of income and appreciation each year, as well as the overall property value each year. Provide the above for both the major leaseholds.

3. Provide a copy of the FY 2003-2013 financial plan for the Metropolitan Tract which illustrates anticipated revenues and expenditures, as well as the major assumptions driving anticipated revenues and expenditures. This financial plan should include anticipated expenditures for both operating and capital purposes, and the anticipated fund balance for each fiscal year.

4. Provide a copy of any policies or criteria used to determine the minimum and maximum fund balance needed for the Metropolitan Tract.

5. Provide the amount of operating and maintenance expenditures by UNICO each year for the last 10 years allocated among:
    a. Operations
    b. Maintenance
    c. Utilities

6. Describe UW's plans for managing the Metropolitan Tract following the expiration of the UNICO lease in 2014.

7. Provide an update to your 2001 report of any plans under consideration for the private sector to finance building improvements to the Metropolitan Tract properties, rather than continue to have the University finance such improvements.

8. As expiration of UNICO's lease approaches, describe how UW will ensure that the properties are being adequately maintained.

9. Provide information on how UW assesses the condition of Metropolitan Tract properties, including information on actual conditions and how these conditions have changed over time.