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CITY OF LONG BEACH

DEPARTMENT OF FINANCIAL MANAGEMENT

333 West Ocean Boulevard, 6th Floor • Long Beach, CA 90802

November 12, 2002

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HONORABLE MAYOR AND CITY COUNCIL
City of Long Beach
California

SUBJECT: Amendment to Agreement Between City of Long Beach and Queen's Seaport Development, Inc., for the Operation and Development of the Queen Mary and Adjacent Properties (District 2)

DISCUSSION

Queen's Seaport Development, Inc. (QSDI) is the master lessee of the City's Queen Mary ship and adjacent property. On April 2, 2002, the City Council approved the issuance of Commercial Development Revenue Bonds on behalf of QSDI for capital improvements and to refinance QSDI's debt. Due to unstable market conditions beyond City and QSDI control, favorable financing was not attainable and the bonds were not issued. However, QSDI recently obtained financing from a private lender that does not involve the City.

The City and Carnival Corporation (Carnival) are also moving forward with issuing approximately \$32 million of tariff-backed revenue bonds to pay for construction of Carnival's dock and related passenger ticketing and boarding improvements. These tariff revenue bonds were approved by the City Council on July 9, 2002, along with necessary subleases. These bonds will be non-recourse to the City, and in addition to the tariff revenue, are backed by a Carnival corporate guarantee. Carnival's construction is progressing and they expect to begin operating out of Long Beach in March or April of 2003.

As a result of the financial review and due diligence performed in preparation for the bond financings, several lease-related issues were identified and determined to be in need of further clarification. The proposed lease amendments address QSDI's financial reporting responsibilities, City access to QSDI books and records, clarification of rent due the City from QSDI's sublease to Carnival, City approval of QSDI management succession, City approval of capital improvement projects and related rent credits, and the extension of certain sublease rent passed through to the City.

Financial Reports

QSDI pays a fixed rent to the City of \$25,000 each month and, in addition, pays a percentage rent annually based on gross receipts as shown in its audited financial statements. These rents accrue to the City's Tidelands Operating Fund. QSDI is required to submit audited financial statements to the City within 90 days of its fiscal year end. In

order to better track and project rental revenue, QSDI will be required to submit unaudited financial reports to the City 30 days after the end of each quarter, in addition to the annual audited financial statements. The reports will include detail and be in a format as determined by the City.

QSDI is currently required to make its records available to the City for review. However, this requirement is currently limited to those records that are relevant to the master lease. This restriction is ambiguous and subject to interpretation. The City will now have access to all books and records, regardless of perceived relevance to the master lease.

Carnival-Related Rent

The master lease, in addressing rent due the City, does not adequately consider the manner in which certain rents are received by QSDI from Carnival. The Carnival sublease utilizes a per passenger fee from Carnival as rent, among other rents due. The current lease is ambiguous and may be interpreted to require QSDI to pay rent to the City based on Carnival's overall gross revenue, which amount would far exceed QSDI's actual revenue from the Carnival sublease. The proposed lease amendment clarifies that rent due the City related to the portion of the Carnival sublease involving the per passenger fee will be calculated using the revenue QSDI receives from Carnival.

Succession

QSDI is currently required to use its best efforts to have Joseph Prevratil serve as Chief Executive Officer/President of operations of the Queen Mary and adjacent property through December 31, 2003. In addition to existing rights to approve certain transfers and assignments of the master lease, the proposed lease amendment provides for the City to have the right to approve the appointment of successors to QSDI's Chief Executive Officer/President position.

Development Credits and Capital Cost Recovery

The current lease provides for a rent credit accruing to QSDI for costs incurred in the development of the adjacent properties. QSDI is entitled to a cumulative rent credit of up to 9 percent of costs it incurs in developing the adjacent property in accordance with an agreed upon development plan. In addition, QSDI has been reimbursed for qualifying on-ship capital improvements from the Queen Mary Reserve Account (Reserve) maintained by the City. Amounts currently in the Reserve were funded from QSDI rents.

The Carnival sublease and certain Port of Long Beach agreements require QSDI to move the electrical substation, the energy plant and related conduits that run throughout the property. The electrical substation and energy plant are critical to the daily operation of the Queen Mary, but the current lease is silent as to the eligibility for reimbursement to QSDI of costs incurred for the replacement of these facilities. The proposed lease amendment clarifies that these costs are eligible for reimbursement from the Reserve.

Carnival's operation is anticipated to bring in excess of 300,000 tourists each year to the Queen Mary property. A large majority of those will be directed onto the ship where Carnival's main ticket counter will be located. This increased activity on the Queen Mary will translate into significant new revenue accruing to the Queen Mary operations and then to the City's Tidelands Operating Fund.

The magnitude of the investment by QSDI in the Carnival-related improvements was not contemplated in the abovementioned development rent credit, nor does the lease delineate that certain of these capital costs be eligible for reimbursement from the Repair Reserve even though they are critical to the operation of the Queen Mary. The proposed lease amendment provides for a rent credit for these costs in an amount not to exceed \$1.5 million. No rent credit mentioned in this proposed lease amendment shall ever be taken, whether in combination with any other part of the lease or otherwise, to require the City to have to provide QSDI with a rent credit in excess of rent due from QSDI.

In addition, requests for rent credits related to these Carnival-related costs will be reviewed by the City in conjunction with the Tidelands Operating Fund financial condition. QSDI must also be current on all rents, fees, taxes and charges in order to qualify for these credits.

Capital Improvement Projects

QSDI will develop and submit to the City a rolling five-year Capital Improvement Project Plan (CIP Plan) for the ship. The CIP Plan will be submitted by November 30 of each year, and is subject to review and approval by the City. Qualifying capital costs incurred by QSDI for on-ship capital projects will be eligible for rent credits, on a go forward basis (On-ship Capital Credit). Costs incurred by QSDI prior to the signing of the amended lease, including those previously addressed in this letter, are not eligible for On-ship Capital Credits. Qualifying costs may also include certain off-ship capital projects if such improvements directly support the functionality of the ship (e.g. electrical power or steam generation). In no event will the City approve rent credits for costs related to ongoing repair and routine maintenance of the ship. QSDI must submit a detailed description of each proposed project, including costs, timelines and other information deemed necessary by the City in order to qualify for the On-ship Capital Credit, and the City must approve, in writing, these specific projects prior to commencement of work.

Project costs eligible for the On-ship Capital Credit must increase the useful life of the ship and/or increase the ship's capacity to operate profitably. The City will not be required to provide QSDI On-ship Capital Credits in excess of the rent due the City in any given fiscal year. The On-ship Capital Credit will be reduced by amounts reimbursed to QSDI by the City from any other source for the same project. The City cannot unreasonably withhold approval of such credits, but may take into account the fiscal condition of the City, including the Tidelands Operating Fund, when approving projects eligible for On-ship Capital Credits. QSDI must be current on all rents, fees, taxes and charges due the City in order to qualify for On-ship Capital Credits.

Queen Mary Repair Reserve

The City's intent of depositing the Catalina Express rent pass-through to the Reserve was to ensure that funds were accumulated to pay for on-ship capital improvements. The current lease ties this pass-through to the Catalina Express lease, which may expire on December 31, 2002, or at a later date. The proposed lease amendment provides that revenue generated by the property and docks currently in the Catalina Express sublease will continue to be passed-through to the City's Reserve for the duration of the master lease, regardless of the then current sub-tenant.

This matter was reviewed by Deputy City Attorney James McCabe and Budget Manager Annette Hough on November 11, 2002.

TIMING CONSIDERATIONS

Immediate review of this matter is requested. Clarification of these lease issues is necessary to close QSDI's private financing. Carnival loaned QSDI funds for QSDI's portion of the Carnival-related improvements and repayment of that loan is incorporated in QSDI's refinancing. Also, the reasonable rent credits incorporated in this proposed lease amendment address the City's obligation, as landlord, to the ship's capital infrastructure.

FISCAL IMPACT

To the extent that rent credits are granted, the Tidelands Operating Fund would receive less revenue. The City retains the right to take into consideration the fiscal condition of the Tidelands Operating Fund prior to approving any On-ship Capital Credit. In addition, the Repair Reserve has been and will continue to be restricted as to use for Queen Mary-related improvements, and payments from this account do not affect the City or the Tidelands Operating Fund.

IT IS RECOMMENDED THAT THE CITY COUNCIL:

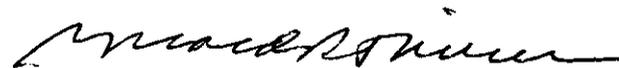
Authorize the City Manager to execute an amendment to the Lease and Operations Agreement of the Queen Mary, Adjacent Lands and Improvements, Dome and Queen's Marketplace, in a form substantially as delineated in this letter.

Respectfully submitted,



ROBERT S. TORREZ
CFO/DIRECTOR OF FINANCIAL MANAGEMENT

APPROVED:



GERALD R. MILLER
ACTING CITY MANAGER