The Commonwealth of Massachusetts

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NO. 2010-0583-3A

INDEPENDENT STATE AUDITOR'S REPORT ON CERTAIN ACTIVITIES OF THE MASSACHUSETTS BAY TRANSPORTATION AUTHORITY'S MONITORING OF THE OPERATIONS OF THE SOUTH STATION GROUND LEASE

AS OF SEPTEMBER 30, 2010

OFFICIAL AUDIT REPORT

MARCH 1, 2011

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March 1, 2011

2010-0583-3A

Richard A. Davey, General Manager
Massachusetts Bay Transportation Authority
10 Park Plaza
Room 3910
Boston, Massachusetts 02116

Dear General Manager Davey:

Enclosed is an audit report for your review. This audit of the Massachusetts Bay Transportation Authority covers the monitoring of the operations of the South Station ground lease as of September 30, 2010. This is one of a number of audits commenced and largely completed during the tenure of my predecessor, State Auditor A. Joseph DeNucci. Should you desire more information relative to this audit, please contact me.

I look forward to fostering a cooperative relationship between our respective offices. If my staff or I may be of assistance at any time, please do not hesitate to call upon us. I know we both share the goal of making government work better.

Sincerely,

Suzanne M. Bump
Auditor of the Commonwealth

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The Massachusetts Bay Transportation Authority (MBTA) is the owner of the land and buildings at South Station, which houses the MBTA public transit facility, the federal Amtrak railroad operation, and office and retail rental space The MBTA entered into a ground lease with Beacon South Station Associates, a wholly owned entity of Beacon Properties Corporation, on January 28, 1988. The lease in effect created a public-private partnership whereby Beacon South Station Associates would redevelop and manage South Station and generate income. The MBTA's share of the income is currently used to help offset its transit station operation costs. Beacon South Station Associates financed the renovation of South Station with a $22.5 million loan from Citicorp, supervised the rehabilitation of the building, and provided property management services for the MBTA. Beacon Properties Corporation was acquired by Equity Office Properties Trust in 1997. The Blackstone Group, LP, a large private equity firm, purchased Equity Office Properties Trust in 2007. EOP Operating, LP (EOP), a subsidiary of Equity Office Properties Trust, manages the leased property.

According to the MBTA and Transit Realty Associates, LLC (TRA), the real estate asset manager for the MBTA, the South Station project was never intended to be a conventional, profit-making commercial real estate lease, but rather a lease to provide a public service as well as to help offset the cost of operating the facility. The objective of this review was to determine whether the MBTA and EOP South Station ground lease is being managed efficiently and effectively and whether generated income is being shared equitably under the terms of the lease.

Our review indicates that EOP is managing the South Station office, retail, and railroad property in accordance with the terms of its ground lease with the MBTA that was negotiated more than 20 years ago. The lease still has 14 years remaining, with two 15-year options for renewal. However, although recent performance under the lease has been favorable to the MBTA, there remains opportunities for improvement if both parties to the agreement are willing to reevaluate certain operating conditions as they currently exist with a view toward enhancing the efficiency and effectiveness of the operations.

INTRODUCTION

Background

Effective November 1, 2009, a five-member Board of Directors was appointed by the Governor to oversee the new Massachusetts Department of Transportation (MassDOT). This board is the governing body of both MassDOT and the Massachusetts Bay Transportation Authority (MBTA), which is part of MassDOT but will retain a separate legal existence. MassDOT, administered by the Secretary of Transportation, oversees four new divisions (the Highway Division, Mass Transit Division, Aeronautics Division, and the Registry of Motor Vehicles), in addition to the Office of Planning and Programming. The Governor and the MassDOT Secretary appointed a General Manager to manage the day-to-day operations of the MBTA and MassDOT's Transit Division.

The MBTA, which is the owner of the land and buildings at South Station, entered into a ground lease[1] with Beacon South Station Associates, a wholly owned entity of Beacon Properties Corporation, on January 28, 1988. The lease in effect created a public-private partnership whereby Beacon South Station Associates would redevelop and manage South Station and generate income. The MBTA's share of the income is currently used to help offset its transit station operation costs. Beacon South Station Associates financed the renovation of South Station with a $22.5 million loan from Citicorp, supervised the rehabilitation of the building, and provided property management services for the MBTA. Beacon Properties Corporation was acquired by Equity Office Properties Trust in 1997. The Blackstone Group, LP, a large private equity firm, purchased Equity Office Properties Trust in 2007. EOP Operating, LP, (EOP), a subsidiary of Equity Office Properties Trust, manages the leased property.

According to the MBTA and Transit Realty Associates, LLC (TRA)[2] officials, the South Station project was never intended to be a conventional, profit-making commercial real estate lease, but rather a lease to provide a public service as well as to help offset the cost of redeveloping and

[1] A ground lease is a legal contract for the lease of land and any buildings and other improvements on the land. The ground tenant is obligated to pay rent each year to the ground landlord for the use of the land for the term of the contract. The ground tenant sometimes builds on the land, and those buildings, as well as the buildings and other improvements that were on the land at the beginning of the term, must be turned over to the ground landlord at the termination of the contract. During the lease period, the ground tenant, rather than the ground landlord, controls the land.

[2] Transit Realty Associates, LLC is the designated real estate asset manager for the MBTA since 1996 and, as such, represents MBTA management in connection with the EOP - South Station ground lease.

operating the facility. In an interview published on July 25, 2009, the former state Secretary of Transportation stated, in part:

> *During the 1980s, my predecessors had rescued South Station from serious decay and secured federal funds to restore this important landmark. In the later 1980s, when I was state transportation secretary, we were concerned that the station be properly maintained to provide a clean and pleasant environment for MBTA customers and thereby help attract riders. Prior direct MBTA management of real estate and customer concessions had proved to be an unhelpful distraction from the agency's core mission of public transit.*
>
> *The public-private partnership was therefore created to manage the passenger service concessions and real estate at South Station -- not to generate a profit for the [MBTA], but to provide high-quality services for MBTA customers.*

The South Station property houses essentially three activities: the MBTA public transit facility, the federal Amtrak railroad operation, and office and retail tenant rental space. The rental agreements and financial control cost centers are structured accordingly.

Leased Terms

Under the terms of the ground lease, each year EOP must pay the MBTA the greater of (1) a minimum guaranteed rent of $330,000 or (2) the Percentage Rent, which is 50% of the difference between the Net Available Income and the annual capital improvement contribution. In addition to revenues received for rental space, South Station generates income from advertising signage and tenant services. The MBTA also receives income under its electricity management program, through which it resells electricity to South Station tenants.

Audit Scope, Objectives, and Methodology

We reviewed the MBTA and Equity Office Properties Trust South Station ground lease and amendments to determine whether the lease agreement is being managed efficiently and effectively and whether income is being shared equitably under the terms of the lease. We met with MBTA, TRA, and EOP officials to discuss the lease operations at South Station and toured the premises as well. We also reviewed financial records, correspondence files, and other internal reports and external consultant studies relative to the lease agreement. We were provided with and focused on the 2008 calendar year certified financial statements and supporting schedules prepared by a nationally recognized private accounting firm. This data was the most recent available at the time of our review.

Our examination was made in accordance with applicable generally accepted government auditing standards for performance audits. At the conclusion of our review, we provided the MBTA with a draft report for comment, and considered their responses in the preparation of this final report.

AUDIT RESULTS

A REEVALUATION OF CERTAIN SOUTH STATION ACTIVITIES COULD RESULT IN OPPORTUNITIES FOR IMPROVEMENTS

Our review indicates that EOP Operating, LP (EOP) is managing the South Station office, retail, and railroad property in accordance with the terms of its ground lease with the Massachusetts Bay Transportation Authority (MBTA) that was negotiated more than 20 years ago. The lease still has 14 years remaining, with two 15-year options for renewal. Although recent performance under the lease has been favorable to the MBTA, there remains opportunity for improvement if both parties to the agreement are willing to reevaluate certain operating conditions as they currently exist with a view toward enhancing the efficiency and effectiveness of the operations.

A Financial Overview

The financial overview below shows that the MBTA realized a profit of $516,271 during calendar years 2002 through 2009. This seems to support the MBTA's and TRA's statement that the project was not intended to be a conventional profit-making real estate lease, but rather a lease to provide a public service and to help offset the cost of operating the facility.

A FINANCIAL OVERVIEW OF MBTA PERFORMANCE AT SOUTH STATION SINCE 2002										
		2002	2003	2004	2005	2006	2007	2008	2009	Total
Income										
	Fixed Ground Rent	$330,000	$330,000	$330,000	$330,000	$330,000	$330,000	$330,000	$330,000	
	Electricity Program Income	93,117	73,350	68,493	(36,383)	247,611	279,184	300,339	347,832	
	Additional Percentage Rent	324,220	225,474	_	_	_	_	_	_	
	Debt Reduction to Facilitate Blackstone Acquisition of EOP	_	_	_	_	_	197,121	_	_	
	Total MBTA Income	747,337	628,824	398,493	293,617	577,611	806,305	630,339	677,832	$4,760,358
Expenses										
	MBTA Costs- R/R	274,463	281,070	295,611	524,642	413,831	646,386	384,779	346,275	
	Other Commuter Rail and Maintenance Area Costs	124,902	65,106	90,346	116,162	124,695	174,296	139,602	108,654	
	MBTA Capital Reserve Contributions	_	_	32,121	32,568	33,986	34,592	_	_	
	Total MBTA Expenses	399,365	346,176	418,078	673,372	572,512	855,274	524,381	454,929	$4,244,087
	Net Gain or (Loss)	$347,972	$282,648	($19,585)	($379,755)	$5,099	($48,969)	$105,958	$222,903	$516,271

Railroad Space Operation Costs

The total railroad space operating cost for 2008 was $2,085,054. Of this total, $1,076,443 was allocated to the private space share, whereas the remaining $1,008,611 was allocated to the railroad share. Amtrak paid $623,832 of the allocation, whereas the remaining $384,779 was paid by the MBTA. Overall, the program is favorable to the MBTA.

Railroad space operation costs at South Station are split between the private tenants and the railroad operators (i.e., Amtrak and the MBTA). The private space share is determined by applying a set of criteria that essentially assigns 50% of the total railroad space operating costs to the private share. This amount is subtracted from the total railroad space operating cost to determine the remaining balance to be shared by the MBTA and Amtrak. The Amtrak allocation of the railroad space cost is based on the Consumer Price Index (CPI) increase in the Boston area applied to Amtrak's prior year's base rent. That amount is subtracted from the total railroad space share to determine the MBTA's share of the railroad space cost.

Approximately 80% of the South Station railroad operating costs is absorbed by EOP and other South Station tenants, including Amtrak. The remaining MBTA 20% share has been fully recovered by the MBTA during calendar years 2002 through 2009.

We determined that there is currently an unresolved issue involving the reliability of certain cost allocations being made based on estimates of square footage of space in use. EOP has proposed certain changes to the calculations based on a study it had recently completed of the South Station property. TRA advised EOP that the information provided was insufficient for purposes of determining whether or not the proposed square footages are accurate and that until there is agreement regarding the square footage measurements, calculations, and methodologies, EOP should continue to allocate costs as previously agreed. TRA indicated that it recommended that the MBTA consider hiring an architect to confirm the current square footages in use and also to review the equitableness of the calculations recently prepared by EOP's consultant.

In addition to the above issue, the terms of the lease (Section 10.01) signed in 1988 required EOP to make its best efforts to negotiate a Payment in Lieu of Taxes (PILOT) agreement with the City of Boston for the South Station property. However, it was not until 2009 that EOP attempted to obtain a PILOT agreement, and the potential benefits of doing so are only now being pursued.

Electricity Management Agreement

The current Electricity Management Agreement dated December 12, 1997 is a reinstatement, with some modification, of an earlier agreement between the MBTA and former leasehold parties to manage the electricity program at South Station. The MBTA is responsible for having electricity provided to the South Station facility under section 20.01G of the ground lease agreement. The MBTA contracted with Boston Edison Co. (BECO) to supply the power, which is distributed within South Station via MBTA-owned primary switchgear, transformers, and distribution equipment. Under the Electricity Management Agreement, South Station Electricity Management (SSEM), an entity operated by EOP, calculates and bills South Station tenants on a monthly basis, based on meter readings submitted by the MBTA. Management and record keeping for this activity are located at EOP's Chicago office. In 2008, the MBTA received a profit of $300,339 to help offset its South Station operating costs.

TRA indicated that the existing metering system has resulted in approximately $493,000 of utility costs that cannot be directly billed to the actual user, but rather is charged to the building overhead because the existing metering system is old and inadequate and approximately 25% to 30% of the space is unmetered. Further, TRA indicated that no independent electrical studies have been made since 2001 and that an independent auditing firm has never audited the electricity management program at South Station. At the conclusion of our field work, TRA indicated that it has no confidence that EOP is employing the best energy management practices with respect to the monitoring and billing for electricity, since this is not EOP's primary business, and that it should be replaced by a professional energy management specialist to manage the South Station electricity program.

Net Available Income Statement (NAI)

Section 6.07 of the ground lease agreement discusses the calculation of Net Available Income (NAI). It describes what comprises gross revenue and what types of deductions are allowed in the computation of Net Available Income used to determine the distribution of income to the MBTA and EOP.

We reconciled EOP's audited 2008 financial statements to the Net Available Income Statement, a key supplemental schedule used to determine the MBTA's share of South Station's actual rental income and operating costs. Our review identified an error whereby EOP allowed $138,926 in excess debt service costs to be included in the 2008 NAI calculation that allocates operating and other expenses between EOP and the MBTA.

EOP currently holds a 25-year, 7.5% mortgage note used to finance South Station's renovation under the provisions of the original 1988 ground lease. The current book value of the note is $13.4 million. According to TRA officials, the usual term of a commercial loan of this nature is three to 10 years. Section 18.01B (c) 7 of the Third Amendment to the lease limits shared debt principle and interest payments to $1,667,112 per year. EOP applied its actual 2008 charges of $1,806,038 to the NAI calculation, which resulted in the $138,926 overstatement. TRA, the MBTA's contracted owner representative, indicated that it agrees with our finding and has directed EOP to take corrective action.

Our review of the 2008 NAI schedule also identified a significant increase in tenant improvement and leasing costs from the previous year. In response to our inquiry questioning this increase, TRA indicated that the charge was mostly brokerage commissions paid for two recent lease renewals and that it was consistent with real estate industry practice. Later in our review, TRA acknowledged that one of the commissions had exceeded the maximum allowed under the South Station management agreement and indicated that it had taken corrective action to recover the $132,448 overcharge.

In further discussions with TRA we learned that it had other unresolved issues involving the subleasing and financial activities of EOP, including the following:

- Noncompliance with the management agreement commission schedule approved under the ground lease.
- Inadequate documentation of brokerage commission payments.
- Incomplete financial data to assure compliance with selected lease terms and conditions.

The above errors do not result in additional rental income to the MBTA because the amounts are covered by the MBTA's "guaranteed" minimum rent of $330,000. In accordance with the ground lease terms, EOP and the MBTA evenly split South Station's NAI with the provision that the MBTA will receive a minimum rent of $330,000 per year. Until net available income exceeds $660,000 ($330,000 x 2) and any capital improvement contributions due, the MBTA will receive no additional rent. Increasing the NAI by the amount of the errors identified above would still result in an amount below the level needed for an additional rent payment.

As discussed above, the debt service is subtracted in the NAI calculation to determine the income to be split between EOP and the MBTA. TRA officials recently indicated that they believe that rental revenues may be insufficient in the future to service the mortgage loan debt because three state agencies vacated South Station office rental space in May 2010. We were advised by TRA that in accordance with the terms of the ground lease, a subsidiary of the parent company will loan South Station the shortfall at the prime rate (currently 3.25%) plus two points. This raises the issue of whether the entire note could be refinanced at the 5.25% rate. The difference in interest rates would significantly reduce debt servicing costs by $2.3 million over the life of the loan and would favorably impact the NAI computation during those later years. Subsequent to our inquiry about the note terms, TRA recommended that the MBTA consider exploring refinancing the entire note at more favorable terms.

Conclusions and Recommendations

In summary, EOP is managing South Station in accordance with the terms of its long-standing ground lease. Since 2002, the MBTA has recovered its share of the costs of operating South Station and in addition is receiving a small profit and fulfilling a necessary public service. In recognition that there is always opportunity for improvement if both parties to the lease are willing to enhance the efficiency and effectiveness of their operations, the following recommendations are offered:

We recommend that the MBTA:

- Obtain the services of an architect to validate the equitableness of the square footages and computations used in the cost allocation of space.
- Monitor EOP's efforts to obtain a PILOT agreement with the city of Boston.
- Obtain an independent financial audit and an electrical study of the electricity management program.
- Review the accuracy of EOP's debt servicing costs under Section 18.01B (c) 7 of the lease and the reasonableness of the current interest rate being charged in light of present market conditions.
- Timely resolve the outstanding issues involving subleasing practices and procedures.

Auditee's Response

After reviewing a draft of this report, MBTA management indicated that it had "directed TRA to identify and engage an appropriate professional energy management specialist to take over the management of the South Station electricity program with the goal to 1) fully sub-meter the entire building with new state of the art sub-metering equipment, and 2) provide state of the art sub-meter billing methods."

In commenting on our recommendation to review the accuracy of EOP's debt servicing costs, MBTA management indicated that TRA "believes that EOP made one extra monthly payment than provided for under Section 6.07B(k) of the ground lease which "limits such payments to those permitted (i.e. approved) per the Annual Operating Plan or otherwise consented to by the Landlord. The 2008 Budget that was approved included only 12 payments and EOP made 13."

MBTA management also indicated that "TRA's recommendation to [the MBTA] concerning refinancing [the 7.5% note] was subject to 1) EOP agreeing to refinance its note which it is not obligated to do by the Ground Lease and 2) the property's ability to support such a refinancing--both unlikely at this time unless the MBTA and EOP entered into a renegotiation of the entire lease. EOP has expressed some interest in the past for such a lease renegotiation as part of a program to re-develop the property. If markets continue to improve, we believe that EOP will reignite an interest in renegotiation and the subject of the refinancing will be revisited at that time."

The MBTA did not specifically comment on the remaining recommendations but indicated that it agrees with them and plans to monitor their implementation.

Auditor's Reply

We concur with the MBTA's planned actions regarding the electricity management program and its review and explanation of the debt servicing overpayment issue. We also concur with its planned efforts to monitor the implementation of a PILOT agreement, the resolution of the outstanding subleasing practices and procedures and the square footage allocation issues. Nevertheless, we continue to recommend that the MBTA pursue the refinancing of the lease's current 7.5% loan rate.