FINAL

AUDIT REPORT

OF

VENDOR COMPLIANCE WITH

THE HISTORIC DISTRICT IMPROVEMENT COMPANY MASTER DEVELOPMENT AGREEMENT

REPORT NO. 01-106HDIC

Internal Audit

CITY OF ALBUQUERQUE
OFFICE OF INTERNAL AUDIT

Internal Audit

City of Albuquerque

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September 24, 2004

Internal Audit Committee
City of Albuquerque
Albuquerque, New Mexico

Audit: Vendor Compliance with the Historic District Improvement Company Master Development Agreement
01-106HDIC

FINAL

INTRODUCTION

The Office of Internal Audit reviewed the vendor compliance with the Historic District Improvement Company (HDIC) Master Development Agreement. HDIC has an agreement with the City for the master development of the Alvarado Transportation Center.

This audit and its conclusions are based on information provided through interviews, tests and reviews of current procedures.

AUDIT OBJECTIVES

The objective of our audit was to determine if HDIC is complying with the terms of the agreement with the City.

SCOPE

Our audit did not include an examination of all the functions, transactions and activities related to the City's agreement with HDIC. Our audit testwork was limited to the documentation and other information that was available related to the City and its relationship with the organization. The audit covered the period from the inception of the agreements and leases through the most current documents available; in most cases through December 31, 2003.

The audit was conducted in accordance with Government Auditing Standards, except Standard 3.49, which requires an external quality review.

METHODOLOGY

We identified the obligations and performance requirements for HDIC as specified in the agreement, Ordinances and approved plans and budgets. We verified compliance through examination and analysis of available documents and interviews with key personnel at the City, and HDIC.

HDIC Background Information

The City and HDIC, LLC (HDIC), entered into the Master Development Agreement For the Alvarado Transportation Center (Master Development Agreement) on November 29, 1999. The purpose of the Master Development Agreement is to:

> ". . . effectuate the Alvarado Metropolitan Transportation Redevelopment Plan ('Redevelopment Plan') for the Alvarado Metropolitan Redevelopment Project ('Project') by providing for the disposition and redevelopment of certain real properties included in the boundaries of the Alvarado Transportation Metropolitan Redevelopment Area ('Project Area)."

As part of the project, the City will convey some of the parcels of real property in the Downtown area to HDIC. Parcels are conveyed at "fair value" as provided for by City ordinance. Other parcels are to be purchased by HDIC from the City, for the City's cost to acquire the same.

The City Council approved the selection of HDIC as the Master Developer for the Project Area. As the Master Developer, HDIC may enter into contracts with third party entities in order to form a "Building Developer" to implement the projects. For example, HDIC Theater Block, LLC (Theater Block) was formed on November 16, 2000, by the HDIC and other parties as a "Building Developer" to purchase, own, develop, operate, lease, sell and otherwise deal with real property related to the Master Development Agreement. HDIC Gold Avenue, LLC (Gold Lofts) was formed to build a high-end residential project. Gold Lofts is owned by HDIC and will be built on property conveyed by the City.

The City does not receive any net operating proceeds in project years one through five other than what the Master Development Agreement refers to as "preferred returns." This is a 1% preferred return from net operating income derived from the project on a non-cumulative annual basis.

In project years six through 12 the City receives 25% of any profits. In project years 13 through 25 the City receives 50% of any profits. Project years are determined on a parcel-by-parcel basis rather than for the overall redevelopment project. Distributions to the City cease in year 20 or upon repayment of 125% of the City's Capital Account, whichever occurs first.

In the event HDIC defaults under project loan documents or is otherwise unable to perform under the Master Development Agreement or any Joint Venture Agreement, the City may be substituted for HDIC in the loan documents with a special warranty deed delivered to the City for the applicable real estate parcel.

In April 1999, Enactment No. 47-1999 created an "Alvarado Transportation Center Project Task Force" that was ". . . charged with reviewing all aspects of this project. This Task Force shall consist of one or two City Councillors (sic), the Chief Administrative Officer, the Director of Council Services and the Chair of the Albuquerque Development Commission. This Task Force shall be charged with making recommendations to the City Council on the Alvarado Transportation Center Projects."

Albuquerque Development Services, a division of the Planning Department, performs some contract administration functions relating to the Master Development Agreement between the City and HDIC. In July 2002, Albuquerque Development Services was moved from the Department of Family and Community Services to the Planning Department. The previous managers of Albuquerque Development Services, and its subsequent Acting Manager, were involved in the preparation of the Request for Bid that resulted in the Master Development Agreement between the City and HDIC.

For each parcel of real property being redeveloped, if there is a construction cost overrun requiring additional funds, HDIC is exclusively obligated to provide such additional debt or equity capital to complete the construction. The City has relied upon the obligations of HDIC for performance without requiring a surety bond or other similar agreement or arrangement. In connection with this reliance, HDIC agreed that it will not sell or pledge more than 49% ownership of HDIC without City Council approval and that sale or transfers of real estate parcels prior to completion may only occur with approval by the City Council.

The Master Development Agreement also requires that HDIC develop a labor force plan. The plan would outline the total number and types of full time equivalency jobs created throughout the project, together with anticipated wages and personnel hire dates for each employment position. The plan was to be submitted to the City within 90 days of the execution of the agreement.

HDIC is owned in part by the DAT, which has a 2.86% ownership in HDIC. In addition to the DAT's ownership interest in HDIC, the other two principals are a charitable foundation (McCune Charitable Foundation – 20% ownership) and a for-profit corporation (Arcadia Land Company – 77.138% ownership).

FINDINGS

The following findings concern areas that we believe could be improved by the implementation of the related recommendations.

1. HDIC SHOULD ACCURATELY RECORD THE VALUE OF THE CITY CAPITAL ACCOUNT IN ITS FINANCIAL RECORDS AND STATEMENTS.

   HDIC is required by the Master Development Agreement to maintain records of the City's Capital Account. The City's Capital Account consists of the fair market value of each City parcel conveyed to HDIC, the amounts of HDIC's tax abatements, the infrastructure costs paid by the City under the agreement, and the amount of any operating deficit for a parking structure incurred as a result of the guarantee of parking spaces. The final cumulative total of the City's Capital account has been estimated at between \$8 and \$12 million when all property has been transferred and other City paid costs are included.

   It is important that accurate records be kept of the City's Capital Account, because the amount of money that is repaid to the City from profits of the project is dependent upon the total amount of the City's Capital Account. The maximum distribution to the City will be 125% of the value of the City's Capital Account.

   The December 31, 2002 and 2003, financial statements for the Theater Block discuss the City's Capital Account in Note 11. The 2002 financial statements only include the \$1.37 million of land transferred in 2002 as the City's capital account. The 2003 financial statements include the value of land and infrastructure costs, but do not include the operating deficit for the parking structure.

   As of February 28, 2002, the City's Capital Implementation program records reflect that the City had \$328,231 of expenditures and an encumbrance for \$103,134; relating to infrastructure costs.

   The August 20, 2003, HDIC business plan states, "The actual experience of the first full year of operations by the Transit Department has been approximately \$75,000 loss." Albuquerque Development Services personnel did not know which 12-month period this statement referred to or from whom HDIC obtained this information.

   In February 2004, because of an audit request, HDIC provided the City with an estimate of the value of the City's capital account as of July 1, 2003. The HDIC letter to the City stated, "Based on HDIC's calculations the City Capital Account value on 7/1/2003 was \$1,765,455." Albuquerque Development Services personnel prepared an estimate of the City's capital account, and sent a March 5, 2004 memorandum to HDIC, which stated, "Accordingly, the value of the City Capital Account as of June 30, 2003 is \$1,820,596."

Although the Master Development Agreement states that HDIC is to maintain the record of the City's Capital Account, the information needed to determine the losses from operation of the parking garage must be obtained from the City. Albuquerque Development Services informed HDIC by a memorandum dated March 5, 2004, that ". . . in the future the City will provide by December 31 of each year, data for the end of the City's fiscal year, June 30. We will also recommend that the final figures be reviewed and accepted by the Alvarado Task Force within 90 days of each calendar year." However, this arrangement has not yet been formalized by an amendment to the agreement or a Memorandum of understanding between the parties.

The Capital Account is not recorded on the Theater Block financial statements. The notes to the financial statements refer to "the accompanying consolidated financial statements" for HDIC. HDIC did not provide the City with a financial statement for HDIC itself until Internal Audit obtained a Legal Opinion stating that the consolidated statement was necessary to complete an Internal Audit. On June 25, 2004, HDIC provided Internal Audit the consolidated financial statements for HDIC for the years ended December 31, 2000, 2001, 2002 and 2003. Previously, HDIC has only provided the City with financial statements for the Theater Block and the Gold Lofts projects.

According to HDIC officials, HDIC and the City agreed that financial statements for the individual projects were all that would be required. As evidence of the agreement, HDIC provided a letter dated September 2003, from the HDIC Chief Operating Officer to Albuquerque Development Services. The letter states, "As we discussed in our meeting last week with [the Associate Planning Director], HDIC will provide Albuquerque Development Services an annual financial statement on each project within the Alvarado District as they come on line." There is no evidence that the Task Force agreed to modify the reporting requirement. Providing only project financial statements does not appear to comply with the contractual requirement for "Master Developer" annual financial statements.

The City and HDIC have both understated the City's Capital Account by more than $75,000. In December 2001, a construction contractor performed work on the transformer vault on 1st and Gold Street. The two entities using power from the vault are 1) the City of Albuquerque for the parking structure and Alvarado Transportation Center and 2) HDIC for the Theater Block. The utility company estimated that the Theater Block would use 65% the power from the transformer vault.

The CAO sent the Chief Operations Officer of HDIC a letter dated December 31, 2001, stating that the total funds available for infrastructure costs would be reduced by HDIC's prorated share of the costs of the transformer vault, which was $75,161. The City paid the entire cost directly to the contractor. Although the Capital Improvement Program Application for Payment forms show the decrease in the funds available to HDIC for infrastructure improvements, neither HDIC nor the City included the $75,161 in the City's Capital Account.

RECOMMENDATION

HDIC should ensure that the value of the City's Capital Account is accurately reflected in its financial records and statements.

EXECUTIVE RESPONSE FROM HDIC

"Internal Audit's recommendation that 'HDIC should ensure that the value of the City's Capital Account is accurately reflected in its financial records and statements' has to be split into two parts. The Capital Account can be accurately reflected in HDIC's financial records. It cannot be accurately reflected in HDIC's financial statements. Land Contributions and infrastructure reimbursements are items that appropriately will appear on HDIC financial statements. Parking structure deficits and the value of tax abatement are items that can be reflected in financial records but there is no Generally Accepted Accounting Principals method to account for these amounts on HDIC Financial Statements. HDIC welcomes the opportunity to comply with the first part of Internal Audit's recommendation.

"To the extent that HDIC's Consolidated Financial Statements do not contain a complete representation of the value of the City's Capital Account and contain information regarding HDIC projects that are not in the area covered by the Master Development Agreement HDIC continues to believe that the submission of Consolidated Statements to the City is inappropriate. The legal opinion that Internal Audit received regarding these statements limited the scope of reasons that would legally require HDIC to disclose the statements to: "if doing so is necessary for Internal Audit to determine that costs are properly apportioned". Internal Audit herein states that the Consolidated Financial statements were to be used to ensure that the City Capital Account is properly recorded. In June 2004 HDIC provide its Consolidated Financial statements to Internal Audit in the spirit of cooperation. HDIC continues to believe it has no legal obligation to do so under the terms of the Master Development Agreement, however, HDIC is considering moving its non City related projects out of HDIC and into a new company in order to avoid this issue in the future.

"When HDIC entered into the Master Development Agreement with the City the form for representing the City's Capital Account was provided in Exhibit F of the Agreement. This Exhibit provided estimates of items that would eventually become part of the City's Capital Account as HDIC's redevelopment efforts progressed. Until early 2004 HDIC management received no guidance from the City that it should report the Capital Account in any other manner. Section 701 of the Master Development Agreement describes the City Capital Account as follows:

"Section 701. City Capital Account. The Master Developer shall maintain records of the City's capital account ('Capital Account'") in conjunction with its obligations under Section 103. The Capital Account shall be consist of the fair market value, as shown upon the appraisals heretofore obtained by the City, of each City Parcel conveyed to the Master Developer, the amounts of the Master Developer's tax abatements, the infrastructure costs paid by the City under this Agreement, and the amount of any operating deficit for the parking structure located on Parcel D incurred as a result of the guarantee of parking spaces described in Section 606. The City's capital account is stated on Exhibit 'F'. Operating deficit is defined as gross revenues from monthly and daily rate parking revenues, less the direct garage operating expenses attributable to spaces provided to the Project. The balance of the Capital Account may be increased as provided for by any subsequent negotiations for redevelopment in the Project Area, including but not limited to the cost of the podium parking spaces described in the Master Plan for Phase II/Residential. Additionally, estimated amounts shown on Exhibit 'F' shall be adjusted to reflect the actual amounts of each component.

"The language 'The City's capital account is stated on Exhibit "F".' implies that the format of Exhibit F is the format that should be used to report the Capital Account. From 2000 through 2004 HDIC on several occasions provided the City with schedules in the form of Exhibit F to comply with the Master Development Agreement reporting requirements. In early 2004 HDIC was informed by the City that this form was not what the City needed. Rather the City required a cumulative account of the Capital Account through the end of its fiscal year on an annual basis.

"In February 2004 HDIC attempted to determine the value of the City's Capital Account as of July 1, 2003. At that time the City had contributed

land Parcels B & B-1, expended amounts from the Infrastructure Fund, incurred the Gold Street Parking Structure operating deficit through June 30, 2003, and provided the value of tax abatement that had accrued through June 30, 2003. The value of the contributed land parcels could be determined from values set forth in Exhibit F. Infrastructure expenditures could be determined based on checks that HDIC had requisitioned that were paid by the City. HDIC had no means to determine the parking deficit or the value of tax abatement since these values could only be determined with access to City accounting records. HDIC provided the City with its best estimate that then was subsequently refined by Albuquerque Development Services.

"HDIC used its best efforts to secure estimates from the City for both the parking deficit and tax abatement. In repeated telephone conversions with various members of the Parking Division HDIC received numerous different values for the Parking Deficit through June 30, 2003. These figures ranged from $66,472 to $75,000. It became evident that without City assistance HDIC could not determine this figure. With respect to the value of tax abatement, HDIC is not the current titled owner of Theater Block, the only project with tax abatement during the period, and therefore did not have any valuation statements to use to estimate tax amounts. The City as the titled Theater Block owner had access to this material. Once again City assistance is necessary to determine this value.

"On a go forward basis the following suggestion by Albuquerque Development Services is welcomed by HDIC.

"We agree the current process to establish accurate values, as you have stated, is difficult to determine because of several limiting factors. Specifically, HDIC does not have ready access to government accounting records. We recognize this fact and will prepare an agreement that will address how the annual value of the Account will be determined. For example, in the future the City will provide by December 31 of each year, data for the end of the City's fiscal year, June 30. We will also recommend that the final figures be reviewed and accepted by the Alvarado Task Force within 90 days of each calendar year.

"HDIC willingly will maintain records of the City's Capital Account if the City will provided (sic) us with the information as stated.

"The reason that both HDIC and the City did not include $75,161 in the Capital Account is because that amount is in dispute between the parties. A December 31, 2001 letter from the CAO unilaterally stated that the infrastructure fund would be reduced by this amount. HDIC immediately (January 15, 2002) responded that it did not agree with this reduction. Thereafter HDIC on several occasions (4/9/02, 7/25/02 and 12/29/03) brought the issue up in writing to the CAO with no response being returned by the City. As of today this dispute remains unresolved. When HDIC and the City prepared estimates of the City's Capital both did not include this disputed amount. Until such time as both parties can collectively agree on the amount that should be added to the City's Capital Account it is appropriate that this amount not be included in the Capital Account calculations."

2. HDIC SHOULD COMPLY WITH THE REPORTING AND DOCUMENTATION REQUIREMENTS OF THE MASTER DEVELOPMENT AGREEMENT.

The Master Development Agreement requires that HDIC deliver various reports and documents to the City throughout the life of the projects. Some documents were provided to the City, but not in a timely manner. Other documents were not provided to the City as required until they were requested as a part of our audit.

A. Letters of Commitment for Construction Financing

Section 303 of the Master Development Agreement states:

> "The Master Developer shall provide the City with a (sic) irrevocable of commitment for the construction financing, which shall include a statement of the Lender's requirement for Master Developer's equity capital investment and any other conditions of the commitment, for the improvements to be made to each City parcel . . .
>
> "For each City Parcel being conveyed to the Master Developer, Lender's certification shall be provided to the escrow agent, and to the City, that the Master Developer: (1) has complied with and satisfied all required terms and conditions contained in the irrevocable letter of commitment, including any and all equity capital requirements . . . ."

In June 2000, Albuquerque Development Services transferred a piece of property with an appraised value of $1.37 million to the HDIC for the Theater Block project. According to the Master Development Agreement, a lender's certification should have been provided to the City stating that HDIC had complied with all of the terms and conditions in the associated lender's letter of commitment.

Albuquerque Development Services personnel did not have a copy of the lender's certification. In September 2002 Albuquerque Development Services requested and received a letter from the lender which stated, "In regards to Section 303 (b) of the Development Agreement, please use this letter at (sic) confirmation that HDIC has 'satisfied all required terms and conditions contained in the irrevocable letter of commitment . . .'"

B. Financing Certifications

Section 609 of the Master Development Agreement states:

> "Master Developer agrees to pay any Lender providing funding for the Project, or a part thereof, on or before the due date, any amounts required to be paid to Lender and to comply with all terms and conditions of the mortgage or other security instrument delivered to such Lender. Master Developer shall execute and furnish a certificate to the City, one hundred eighty (180) days after execution and delivery of the note evidencing the loan and each succeeding one hundred eighty (180) days thereafter, that the loan is in good standing and that no default exists in any of the terms or provisions thereof."

HDIC had not provided copies of the certificates that were required to ensure compliance with loan agreements. In February 2004, at the request of Albuquerque Development Services personnel, HDIC provided the City and Internal Audit with five (5) certificates regarding HDIC's compliance with loan agreements. These 5 certificates that were prepared by the HDIC Chief Financial Officer covered six-month periods beginning in November 2000.

In February 2004, HDIC sent Albuquerque Development Services a letter that stated, "Enclosed you will find the Loan Certification due the City as of November 15, 2003." The Certification required by the Master Development Agreement was three months late. The Certification from HDIC only addresses the status of bank loans. However, the Master Development Agreement requires a certification regarding amounts due to any Lender.

C. Annual Progress Reports

Section 105 of the Master Development Agreement states, "Master Developer shall provide the City with an annual written report describing, in such detail as reasonably required by the City, the actual progress of the construction of the Project. The report shall be delivered to Albuquerque Development Services."

The Annual Progress and Financial Reports for calendar year 2001 were dated April 23, 2002. The Annual Progress Report was prepared on a project-by-project basis for nine projects. The report provided information on progress to date for each project as well as future plans.

In August 2003, HDIC has not yet submitted the annual report for 2002. Albuquerque Development Services personnel contacted HDIC, and HDIC then provided the City with the "Second Revised Alvarado Transportation Center Project Area Business Plan" (Revised Business Plan) dated August 20, 2003. According to HDIC officials, the Revised Business Plan is the progress report for 2002.

The Revised Business Plan does not provide information about the progress of construction on a project-by-project basis; the report deals primarily with the financing for the projects. The Revised Business Plan was delivered seven months after the year end and does not appear to meet the requirement for an annual progress report.

D. Insurance Requirements

Section 610 of the Master Development Agreement states, "During the construction period and throughout the term of this Agreement, Master Developer, or through its contractors, subcontractors or agents, shall keep the Project insured against loss or damage by maintaining policies of insurance naming the City as a co-insured . . .

Master Developer shall provide evidence to the City of the required insurances before any notice to proceed is given to commence work on the Project." The agreement also states that the "Master Developer shall cause any contractors to maintain performance and payment bonds during construction of the Project in which the City is named as obligee."

HDIC personnel informed us that evidence of the required insurances and payment/performance bonds were not given to the City prior to the start of the Gold Lofts construction project. They indicated that they did not know if evidence of the required insurances and payment/performance bonds was given to the City prior to the start of the Theater Block construction project. Albuquerque Development Services did not enforce the contractual requirements relating to insurance coverage.

The Master Development Agreement requires that the City be named as a co-insured on the insurance policies covering the projects. HDIC provided copies of certificates of insurance relating to the projects. The certificates of insurance for the general liability and property insurance coverage for the Theater Block for the two years from November 2002 through November 2004 did not name the City as co-insured. The certificate of insurance for the property insurance coverage for the Theater Block for the period from November 2001 through November 2002 also did not name the City as co-insured.

HDIC provided us with copies of the payment and performance bonds for the Gold Loft Project and Theater Block Project. The performance and payment bonds do not name the City as an obligee, as required by the Master Development Agreement.

E. Labor Force Plan

Section 101.h. of the Master Development Agreement states: "Master Developer agrees to develop a labor force plan, outlining the total number and types of full time equivalency ('FTE') jobs (by occupational title) created throughout this project, together with anticipated wages and personnel hire dates for each employment position, to be submitted to the City within 90 days of the execution of this Agreement." The agreement was executed on November 29, 1999. HDIC did not submit the "labor force plan."

In June 2000, HDIC requested labor force information from the operator of the new downtown theater. The theater's corporate office provided a schedule with positions and anticipated numbers of employees. The letter accompanying the schedule stated ". . . these figures should be viewed as 'best guess' estimates." In July 2002, the City's Department of Family and Community Services prepared a letter to Albuquerque Development Services with the results from a monitoring visit. The letter informed Albuquerque Development Services "HDIC needs to provide the actual numbers concerning the people hired by Century Theaters." Albuquerque Development Services did not pursue the matter until July 22, 2003, when personnel sent a letter to HDIC asking that the labor force plan be submitted "immediately."

HDIC obtained information from the movie theater in July 2003; however, there are nine lessees in the Theater Block, including four restaurants and several offices. Information from these other businesses should be reported to provide the City complete data on the jobs that resulted from the project.

F. Preferred Return to City

Section 702 of the Master Development Agreement states, "Master Developer shall be entitled to a 4%, and the City to a 1% preferred return from net operating income derived from the Project, on a noncumulative, annual basis. Net Operating Income from the Project shall mean all income produced from the redevelopment and operation by Master Developer or Building Developer of each parcel of Real Property in the Project Area."

The December 31, 2001, financial statement for the HDIC Theater Block LLC indicates that it had a "net operating income" of $35,237 during calendar year 2001. Therefore, according to the terms of the Master Development Agreement, HDIC should have paid the City 1% of this net operating income. HDIC informed us that they had not made this payment to the City. Although the unpaid amount that was due to the City was nominal, this indicates that HDIC did not comply with the Master Development Agreement.

G. Lease Agreement between the City and HDIC Theater Block, LLC

There is a "Lease Agreement", dated December 28, 2001, between the City and the Theater Block relating to the $250,000 Metropolitan Redevelopment Revenue Bond (Series 2001). The lease states in Section 4.20:

> "**Reporting Requirements.** The Company will submit to Issuer's Office of Economic Development or such other office of the Issuer as the Issuer may direct, on an annual basis beginning December 28, 2002, a report describing: . . .(ii) any economic benefit(s) arising out of the Project for the benefit of the metropolitan area or its residents, including, but not limited to, number of jobs created and gross payroll; and (iii) any community benefit(s) arising out of the Project, for the benefit of the metropolitan area or its residents."

Neither Albuquerque Development Services nor the City of Albuquerque Office of Economic Development received the required reports in 2002 and 2003.

The requirements for reporting are included in the Master Development Agreement to protect the City's interest in the projects and provide notice of potential problems that may be developing. HDIC did not submit the required documents timely, thus exposing the City to increased risk.

RECOMMENDATION

HDIC should comply with the reporting and documentation requirements of the Master Development Agreement.

EXECUTIVE RESPONSE FROM HDIC

"In connection with reporting on HDIC's progress in pursuing projects related to the Master Development Agreement regular meetings with the City's Task Force have been held since HDIC entered into the Agreement. The City Task Force is comprised of the City COA, 2 City Councilors, a representative of Albuquerque Development Commission, and the Head of Council Services. In addition to the Task Force members, frequently City staff members from, The City's Attorney's Office, Department of Finance, Albuquerque Redevelopment Department, and Albuquerque Public Works Department are in attendance. These meetings generally occur monthly with HDIC briefing all parties attending on its progress in fulfilling the requirements of the Master Development Agreement. At these meetings many of the reporting deficiencies described by Internal Audit are verbally addressed to ensure that the City is fully aware of HDIC's redevelopment progress. As to specific reporting issues, HDIC makes the following comments:

"A. Letters of Commitment for Construction Financing

"Subsequent to the conveyance of land by Albuquerque Development Services to HDIC for the development of the Theater Block project in June 2000 HDIC started construction of the project. Through March 2001 HDIC funded approximately $2.3 million in cash to meet the cumulative equity requirements that the construction lender had set forth in its Letter of Commitment. Thereafter funds for the construction of the project were advanced by the construction lender. By advancing funds for the construction of the project the lender provided an implied certification that HDIC had complied with the terms of its Letter of Commitment. Between June 2000 and the project's completion no changes were made to the conditions of the Letter of Commitment. The Lender by its letter of late 2002 further reaffirmed that from the moment the City conveyed the Theater Block property to HDIC the conditions of the Letter of Commitment were met.

"B. Financing Certifications

"Until 2004 HDIC was remiss in not providing the funding Certifications required. At the coaxing of Albuquerque Development Services HDIC brought these Certifications up to date in October 2003. As indicated by the

Certifications provided the City HDIC has continuously been in compliance with the terms and conditions of all of its loans on redevelopment projects.

"The closing of the Gold Loft Project financing and various yearend accounting requirements delayed HDIC's preparation of the November 15, 2003 Loan Certification report until February 10, 2004. The content of the report continued to reaffirm HDIC's compliance with the terms and conditions of its loans. During the period from November 15, 2003 through February 10, 2004 at its meetings with the Task Force HDIC verbally conveyed the positive status of its financing arrangements to the City.

"The Certification Report for May 15, 2004 was submitted to the City on June 15, 2004. HDIC on a go forward basis will use its best efforts to ensure that the Certification reports are submitted within thirty days of the Certification date.

"Internal Audit states: "The Certification from HDIC only addresses the status of bank loans. However, the Master Development Agreement requires a certification regarding amounts due to any Lender." In both the November 15, 2003 and May 15, 2004 Certification Reports the NM Urban Initiatives Fund is listed as a lender. The NM Urban Initiatives Fund is a mezzanine loan fund. It is not a Bank. The loans listed on HDIC's Certifications are all loans made to projects in the redevelopment area including loans that are made by entities other than banks. The assertion by Internal Audit in this finding is incorrect.

"C. <u>Annual Progress Reports</u>

"HDIC's understanding of the language in section 105 is that "Project" refers to the collective projects in the redevelopment area. The revised Business Plan of August 20, 2003 was intended to update the City on the anticipated completion dates of all projects contemplated and the anticipated financial returns that these projects would generate for the City. Inherent in this presentation are estimates of when projects will be completed as well as estimates of how operating projects currently are performing and are expected to perform in the future. The August 20, 2003 Business Plan depicted all projects in the Development Phases that remained consistent with the initial Business Plan that was submitted to the City in 2000. HDIC felt that it was important that these Phases be presented in a consistent manner to enable the City to accurately gauge any changes that had

occurred over the years as HDIC converted hypothetical redevelopment projects into actual projects. Several of the nine projects scheduled in the annual report for 2001 have been changed. For the 2002 annual report HDIC felt that an annual report that corresponded to the proposed redevelopment phases would better inform the City of the progress of the overall development relative to representations HDIC made when it first entered into the Master Development Agreement. If the City has a specific preference as to the form of the annual reports HDIC will provide reports in that form. To date, other than the comments by Internal Audit, the City has not indicated any dissatisfaction with HDIC's annual reporting.

"D. Insurance Requirements

"HDIC demonstrated, as evidenced by the insurance certificates and payment and performance bonds it has submitted to the City, that all of its projects are presently and have historically been adequately insured. To the extent that the City is not named as co-insured or an obligee on current insurance policies or bonds, HDIC will get the policies and bonds updated appropriately.

"E. Labor Force Plan

"Section 101.h of the Master Development Agreement states: "Master Developer to develop a labor force plan, outlining the total number and types of full time equivalency ('FTE') jobs (by occupational title) created throughout this project, together with anticipated wages and personnel hire dates for each employment position, to be submitted to the City within 90 days of the execution of this Agreement." The agreement was executed on November 29, 1999.

"HDIC provided the City with a Labor Force Plan in early 2000 from Century Theatres, as required pursuant to Section 101(h) of the Master Development Agreement. At that time, Century Theatres was the only known tenant for the Theatre Block project. The requirement was for a one-time submittal, which was met.

"It should be noted, however, that HDIC has a continuing responsibility, pursuant to the Metropolitan Redevelopment Bond issued on this project, to provide an annual report indicating any economic benefits arising out of its projects, which includes jobs created. So, in reality, the City will receive

reports on labor force created by the project annually.

"F. Preferred Return to City

"HDIC's records are consistent with Internal Audit's finding regarding the 2001 Theater Block NOI Fee due the City. It is HDIC's intention to make the $352.37 2001 Theater Block NOI payment to the City immediately. The Theater Block NOI payment for 2002 in the amount of $3,286.46 was made to the City in October 2003. Presently HDIC is awaiting the issuance of the final 2003 Audited Financial Statement to allow it to calculate and issue payment to the City for the 2003 Theater Block NOI Fee.

"G. Lease Agreement between the City and HDIC Theater Block, LLC

"Section 606.e. of the Master Development Agreement states:

"e. Tax Abatement. By the issuance of Metropolitan Redevelopment Bonds or an equivalent and authorized manner, Master Developer shall be entitled to seven year tax abatement for the parcels of Real Property conveyed to the Master Developer, as provided for by law.

"HDIC engaged bond counsel in late 2001 to draft all of the documents necessary to implement tax abatement for the Theater Block Project. Although HDIC management executed all of the Metropolitan Redevelopment Bond documents, it did not realize that there are reporting requirements associated with the lease agreement that is part of the Metropolitan Redevelopment Bond transaction.

"The Master Development Agreement provides for Tax Abatement. The mechanics by which this Tax Abatement was obtained for Theater Block obscured the reporting requirements associated with it. HDIC has no problem in providing the required historical reports or any future reports required. The fact that it did not provide these reports resulted from HDIC simply being unaware that they were required."

3. HDIC SHOULD ENSURE THAT THE CITY'S CAPITAL ACCOUNT REFLECTS THE APPROPRIATE APPRAISED VALUE OF THE LAND.

The City conveyed ¼ acre of land to HDIC for the Gold Lofts project in August 2003. According to the Settlement Statement, the value of the land was $175,576. HDIC transferred the land to Gold Lofts prior to December 31, 2003. According to both the Gold Lofts and the HDIC Consolidated Financial Statements for the year ended December 31, 2003, the land was recorded at a value of $1,100,947. HDIC provided us with an appraisal performed in June 2003, to support the value of the land as recorded on the financial statements.

Statement of Financial Accounting Standards No. 67 states that when allocating capitalized costs to the components of a real estate project, "Land cost and all other common costs (prior to construction) shall be allocated to each land parcel benefited. Allocation shall be based on the relative fair value before construction." The Statement defines relative fair value before construction as "The fair value of each land parcel in a real estate project in relation to the fair value of the other parcels in the project, exclusive of any value added by on-site development and construction activities."

RECOMMENDATION

HDIC should ensure that the City's capital account reflects the appropriate appraised value of the land.

HDIC should determine if the method used to record the value of the conveyed property was appropriate.

EXECUTIVE RESPONSE FROM HDIC

"Section 701 of the Master Development Agreement states: '…The City's capital account is stated on Exhibit "F"…' Exhibit F schedules the value of the Gold Loft Land as parcel D2 to be valued in the City's Capital Account at $156,000. Section 701 further defines this value to be 'the fair market value, as shown on the appraisals heretofore obtained by the City' of each parcel. Those appraised values are shown on Exhibit 'F'. In establishing the cumulative value of the City's Capital Account for fiscal 2003 HDIC will use this land value in preparing its Capital Account report for the City.

HDIC booked Gold Loft Land on its Financial Statements at its current appraised value of $1,100,947. This was done because the two project lenders, Wells Fargo Bank and the NM Urban Initiatives Fund required that it be reflected in this manner.

"While negotiating financing with Wells Fargo one the criteria that needed to be met for the loan to be approved was that the Loan to Value ratio not exceed 65%. The June 2003 appraisal for the property when stabilized was

$11,380,000. This meant that the Loan to Value ratio for the construction loan of $7,200,000 is 63.27%. As a pre-funding requirement for the construction loan Wells Fargo required that HDIC inject additional equity, above the appraised Land Value, of $1,450,000 in cash to maintain the required Loan to Value ratio. HDIC accomplished this injection by using the proceeds from Mezzanine financing.

"Both project lenders required that HDIC present its Financial Statements in a manner that would show the Wells Fargo required loan to value ratio. To accomplish this HDIC recorded the contribution of the Gold Loft Land to HDIC and subsequent transfer to HDIC Gold Lofts at it's the post development appraised value of $1,100,947 established by the bank's independent appraiser.

"In preparation of HDIC's 12/31/2003 Reviewed Financial Statement and in the subsequent Audit of the 12/31/2003 Financial Statement both CPA firms concurred that HDIC's booking of the land at this value complied with Generally Accepted Accounting Principals. The auditor of HDIC's Financial Statements went further and provided HDIC with a clean opinion regarding how HDIC reflected its operations through its financial statements."

4. <u>HDIC SHOULD PROVIDE THE CITY DOCUMENTATION THAT PREFUNDING REQUIREMENTS ARE MET PRIOR TO RECEIVING CITY LAND.</u>

The financial institution that is providing construction financing for the Gold Lofts project sent a letter to Gold Lofts on August 22, 2003. The letter states that the financing has been approved subject to several terms. The pre-funding conditions include, "Borrower shall provide evidence that a minimum of 10 reservation holders (24.4%) have been pre-qualified for financing and have deposited into an escrow account 10% of the purchase price of the units…."

However, it appears that when the City transferred the land for the Gold Lofts project to HDIC (which is currently under construction); HDIC had not met all of the pre-funding conditions of the construction lender.

As of August 2004, HDIC had 14 reservation holders; the lender's pre-funding requirement that 10 percent of the purchase price of the units be deposited into an escrow account was not complied with. HDIC had 5 purchase agreements and had collected 10% of the purchase price for 4 of the agreements. Consequently, it appears that HDIC would not have been able to make the required certification to the City and to the escrow agent that HDIC "has complied with and satisfied all required terms and conditions contained in the irrevocable letter of commitment . . . ."

The success of the Gold Lofts project is dependent upon the actual sale of lofts. According to the Gold Lofts financial statements, Note 7, "HDIC, LLC and HDIC-Theater Block, LLC have guaranteed the construction loans and security agreement with Wells Fargo Bank, New Mexico, N.A." If the Gold Lofts project is not successful, it could negatively impact other HDIC projects in which the City has an interest. Inflated reports of the number of lofts reserved and/or purchased could result in a misrepresentation to the lenders and investors in the project.

RECOMMENDATION

HDIC should provide the city documentation that prefunding requirements are met prior to receiving city land.

EXECUTIVE RESPONSE FROM HDIC

"Subsequent to Wells Fargo issuing its August 22, 2003 Letter of Commitment HDIC, the Bank and the NM Urban Initiatives Fund worked to prepare final documentation for the Gold Loft financing. This process continued through October 2003 when both the Wells Fargo and NM Urban Initiatives Fund financings were closed. Throughout this process of documentation of the pre-funding requirements set forth in Wells Fargo's Letter of Commitment were renegotiated. Specifically the requirement Internal Audit cites: "Borrower shall provide evidence that a minimum of 10 reservation holders (24.4%) have been pre-qualified for financing and have deposited into an escrow account 10% of the purchase price of the units. . ." was changed to a lesser number of reservations and a fixed amount of escrowed cash. The amended pre-funding conditions were guaranteed to be met when documentation could be complete and the bank and mezzanine financings could be closed.

"The bank and mezzanine financings were closed in October 2003. At the time of closing the mezzanine lender funded 100% of it $1,489,899 commitment based upon satisfaction of the agreed upon prefunding requirements. Subsequently, after all of the mezzanine proceeds had been invested in project related items, Wells Fargo made its first construction

advance in December 2003. Since Wells Fargo's first advance nine additional advances have been made as the construction progressed. The latest advance was on September 7, 2004 in the amount of $517,899. On no occasion since the loan closing has HDIC been out of compliance with any Wells Fargo pre-funding or subsequent funding requirements.

"Internal Audit further assert:

"The success of the Gold Lofts project is dependent upon the actual sale of lofts. According to the Gold Lofts financial statements, Note 7, 'HDIC, LLC and HDIC Theater Block, LLC have guaranteed the construction loans and security agreement with Wells Fargo Bank. New Mexico, N.A.' If the Gold Lofts project is not successful, it could negatively impact other HDIC projects in which the City has an interest. Inflated reports of the number of lofts reserved and/or purchased could result in a misrepresentation to the lenders and investors in the project.

"The City has been continuously advised the revitalization of its Downtown, one that had been clinically dead for several decades, requires that extraordinary development risk must be taken in the pursuit of any redevelopment project. HDIC took this risk when it developed the Theater Block. Prior to Theater Block's construction no successful retail or office facilities comparable to it existed. The average Downtown retail rent was $10-$12 per square foot, triple net, with office gross rents being about the same. Vacancies for both retail and offices spaces were high. Any rational developer would not have considered building Theater Block in this environment.

"HDIC undertook the Theater Block project in an environment of considerable risk. The outcome fortunately has been positive. Presently, Theater Block commands retail rents in the middle $20 per square foot range and office rents in the high teens. It has 92% of the retail space occupied and 100% of the office space occupied. Overall it has been a great success and has become the cornerstone of the Downtown revitalization process. Theater Block's cash flow is strong. The facility is presently perceived as a low risk asset by the lending community.

"Gold Lofts at the start of its construction was perceived to be just as risky as Theater Block was when construction was started on it. HDIC has leveraged the Theater Block's success to allow the continued pursuit of

additional redevelopment projects by having Theater Block guarantee the Gold Loft loans. The methodology of leveraging the success of one project to mitigate the risk of the next has to be used by a catalytic developer to allow it to continue to develop projects that no market developer would pursue. HDIC hopes that Gold Lofts will follow the pattern of Theater Block and be successful. There is no guarantee that this will happen. There is no reason to inflate reports of numbers of lofts reserved and/or purchased and HDIC has not done so. Because state law allows Condominium buyers a great deal of leeway, the numbers of reservations fluctuate greatly over time."

5. HDIC SHOULD PROVIDE AUDITED FINANCIAL STATEMENTS TO THE CITY.

The Master Development Agreement states, "Master Developer shall provide the City with annual financial statements approved by the Master Developer's certified public accountant." The Master Development Agreement did not require that the financial statements that were submitted by HDIC be audited.

HDIC submitted financial statements to the City that were "reviewed" by a certified public accountant. This provides much less assurance to the City, than audited financial statements would provide. A review of financial statements is performed to determine whether the financial statements are plausible in the circumstances. The review process consists of inquiries and discussions with company personnel. Ratios and trends are considered and used to assess the overall plausibility of the financial statements. A review is not a substitute for an audit. An audit requires obtaining an understanding of internal controls and an examination of evidence to support the information supplied to auditors. A true audit function consists of the auditor expressing his opinion as to the fairness in which the financial statements present the financial position and operating results of the organization.

The McCune Foundation (Foundation) required HDIC to hire a CPA firm to conduct an audit of HDIC for the year ended December 31, 2003. HDIC has provided a draft copy to the City.

The City will have more than $8,000,000 invested in the Alvarado Transportation Center projects. If HDIC were to have an annual audit of its financial activities will reduce the risk of loss of the City's investment.

RECOMMENDATION

HDIC should provide annual audited financial statements to the City transactions, in order to ensure that the City is fully and accurately informed about financial activities that affect the City's interest in the Master Development Agreement.

EXECUTIVE RESPONSE FROM HDIC

"Internal Audit correctly states: 'The Master Development Agreement did not require that the financial statements that were submitted by HDIC be audited.' HDIC has elected to prepare reviewed financial statements in an effort to reduce the overhead costs of the organization. The current audit requested by the McCune Foundation has cost in excess of $100,000 for the single year period ending 12/31/2003. Since an audit is not required by the Master Development Agreement it is HDIC management's belief that it is following a prudent course by marshalling its funds for redevelopment investment rather than expending them on increased overhead costs. The net effect is that higher financial returns will accrue both to the City and HDIC members. If in the future the McCune Foundation, as a member of HDIC, requests additional annual audits of HDIC it is the intention of management that the audit reports will be provided to the City.

"It should be noted that the product of the Audit for the period ending 12/31/03 is a Financial Statement that does not materially differ from the reviewed statement for the same period. Additionally, the auditor's opinion is a clean one indicating that HDIC's accounting and internal controls are acceptable.

"The City is requesting annual audits to reduce its investment risk on the ultimate $8,000,000 it will invest in the redevelopment area. The City should be reminded that nationwide when Downtown redevelopments are undertaken the municipality involved generally makes redevelopment investments with no expectation of direct financial returns from the investment. In general the returns take the form of increased economic activity in Downtown and a fulfillment of the City's civic obligations to its residents. HDIC is breaking new ground nationwide by trying to figure out a sustainable method for municipalities to invest in Downtown revitalizations that provided direct financial returns of capital invested that then can be reinvested in future municipal projects. It never was intended that HDIC should assume a role like an investment manager, one that requires an attempt to preserve capital, maximize financial returns on capital, and minimize financial risks."

6. HDIC SHOULD OBTAIN TASK FORCE APPROVAL IN ADVANCE OF RELATED PARTY TRANSACTIONS.

The December 31, 2003, draft consolidated financial statements for HDIC, Theater Block and Gold Lofts include notes to the financial statements, which disclose related party transactions. A related party transaction is a business deal in which an entity makes a payment to a different business entity; and there are individual(s) who are officers and/or directors in both business entities. These types of transactions are disclosed in financial statements because they are generally considered to lack the "arms-length" or un-biased characteristic, which is normal in typical business transactions.

Note 8 to the **HDIC Consolidated** Financial Statements disclosed that:

> "HDIC - Theater Block, LLC paid a leasing commission of $88,768 to HDIC Asset Management in 2003 in connection with the Chamber of Commerce lease. The commission was calculated based on 6% of gross potential rent for the first 5 years, 4% of gross potential rent for the second 5 years, and 0% of gross potential rent for the final 5 years of the Chamber of Commerce's 15 year lease with HDIC – Theater Block, LLC. The percentages used for the calculation of the commission are at or below comparable percentages used to calculate commissions to outside brokers that were paid on other retail and office spaces within the Theater Block project.
>
> "HDIC, Theater Block, LLC has entered into an operating lease with the firm of Bryan & Flynn O'Brien for the lease of the office space. Bryan & Flynn O'Brien is a law firm whose principals are members of Arcadia at Albuquerque, L.P. The lease is on terms that are comparable with other similar space rented to unrelated third parties. HDIC has entered into an agreement with the law firm of Bryan, Flynn O'Brien. The company pays a legal retainer of $6,000 per month to cover the law firm's overhead costs that have been allocated to HDIC by the law firm based on the work performed for HDIC. This includes covering the cost of support staff necessary to conduct HDIC business. In addition to the legal retainer, HDIC is paying the rent ($4,434 per month) for the Bryan, Flynn O-Brien office space in the Theater Block project, since three of four members of the firm work primarily on HDIC business.
>
> "In 2002, HDIC Theater Block, LLC entered into an agreement to pay service fees to HDIC Asset Management, LLC. The aggregate amount of service fees to be paid is capped at $420,000 based on the appraised value of the Theater Block property. The services provided by HDIC Asset Management, LLC relate to the initial development of the property and its ongoing successful operation. The full value of the capped service fee was capitalized as part of the Theater Block building in 2002. Payments of the service fees have junior priority to the NOI fees, City distributions, preferred returns to LLC members, and cash flow splits to members other than HDIC. As a result, payment of

service fees has no financial impact on City distributions and returns to non-HDIC Theater Block, LLC members which are based on Theater Block Cash Flow. HDIC Asset Management, LLC has a related agreement with the McCune Foundation that stipulates that no service fee payments will be made unless cash flow distributions from Theater Block, that flow through HDIC to the McCune Foundation, are made. The service fee payments are restricted to be part of the split of HDIC distributable cash flow made to HDIC members: Arcadia at Albuquerque and The McCune Foundation. No service fee payments were made in 2003. HDIC Asset Management, LLC is owned by Christopher B. Leinberger and George R. Bryan who are the President and Chief Operating Officer, respectively, of HDIC.

"During 2003, HDIC Theater Block, LLC advanced monies to HDIC. The advances are treated as a loan, bearing interest at 5% per year, compounded Monthly. All advances were made using idle funds that HDIC Theater Block, LLC would otherwise have placed in bank interest bearing accounts yielding less than 2% per year. These advances had no impact on HDIC Theater Block, LLC's ability to make timely distributions to any LLC members or the City of Albuquerque. HDIC will repay the advances as distributions are made available by HDIC Theater Block, LLC. Management believes that in 2004, cash distributions based on 2003 operations, will allow HDIC to repay at least $220,000 of these advances and accrued interest. It is anticipated that the balance of these advances plus interest will be paid in 2005 based on 2004 operations."

"The HDIC - Gold Avenue, LLC Agreement requires that a construction management fee be paid to HDIC - Asset Management, LLC. The construction management fees were payable commencing in October of 2003. Management fees paid to date under this agreement total approximately $190,000. In addition, there is a total due of $17,500, as of December 31, 2003.

There is currently no provision in the Master Development Agreement that requires that the Master Developer disclose related party transactions, prior to entering in these business arrangements. Further, it appears that the Task Force may not be aware of the number of related party transactions related to HDIC and its principals.

RECOMMENDATION

HDIC should obtain Task Force Approval in advance of related party transactions, in order to ensure that the City is fully informed about related party transactions that affect the City's interest in the Master Development Agreement.

EXECUTIVE RESPONSE FROM HDIC

"Internal Audit defines Related Party transactions as follows:

"A related party transaction is a business deal in which an entity makes a payment to a different business entity; and there are individua1(s) who are officers and/or directors in both business entities.

"In reciting parts of Note 8 from both HDIC's Reviewed and Audited Financial Statements Internal Audit has disclosed transactions that fit into this definition and others that do not. The schedule below clarifies the nature of the identified transactions:

Business Relationship	***Related Party Transaction***	***Transaction Nature***
HDIC – HDIC Asset Management $88,768 Leasing Commission	***Yes***	***Below Market Leasing Commission***
HDIC – Bryan, Flynn O-Brien Law Firm Monthly Overhead Reimbursement $6,000	***NO***	***Overhead Reimbursement (based on 80% of Bryan Flynn-O'Brien's historic overhead – % of firm's resources used by HDIC)***
HDIC – Bryan, Flynn O-Brien Law Firm Monthly Payment of Theater Block rent $4,434 by HDIC to HDIC Theater Block	***NO***	***Inter-company Rent Payment Eliminated in Consolidation (for the entire space – the majority of which is occupied by HDIC employees)***
HDIC Theater Block – HDIC Asset Management Service Fee Agreement $420,000	***NO***	***Cash Flow split Agreement between HDIC members – does not effect City cash flow***

		split (NO payments made to date)
HDIC – HDIC Theater Block Subsidiary to Parent Loans	***NO***	***Inter-company Loans Eliminated in Consolidation***
HDIC Gold – HDIC Asset Management Construction Management $190,00 – 3% of Hard Cost	***Yes***	***Below Market Construction Management Agreement***

"In preparing its Financial Statements HDIC provided notes that disclosed both Related Party and Inter-company Transactions. HDIC was advised by its accountants that any recorded transaction that is eliminated in the process of preparing its Consolidated Financial Statement is an Inter-company Transaction not a Related Party Transaction. Internal Audit appears to have classified several Inter-company transactions as Related Party Transactions. Since HDIC is either 100% or the majority owner of all of its subsidiaries any transaction made amongst companies it owns is tantamount to it being done by HDIC itself.

"The Service Fee Agreement between HDIC Theater Block and HDIC Asset Management was approved in the 1st Amendment to the HDIC Operating Agreement. The voting members of HDIC, The McCune Foundation and Arcadia at Albuquerque crafted this Amendment. The Service Fee is intended to be a split of funds that are allocable to the McCune Foundation after all other members and the City have been paid. The Service Fee is directed to HDIC Asset Management to allow for a further split amongst the Asset Management members. The Service Fee is only paid when funds are available for distribution to the McCune Foundation. Of funds to be distributed to the Foundation 88% of these funds flow to the Foundation. The balance goes to HDIC Asset Management until the Service Fee is paid. This distribution mechanisms between the members of HDIC that does not effect distributions to any other HDIC Theater Block members or the City. As of September 2004 no Service Fee payments have been made.

"The majority of the Related Party Transactions scheduled by Internal Audit are out of pocket cost reimbursements to the Principals of HDIC. The

two remaining transactions, the leasing commission on Theater Block and the Construction Management Agreement on Gold Lofts are below market rates for the same service.

"In the case of the Theater Block leasing commission the tenant's desire for confidentiality during its property search precluded the use of outside leasing brokers. The result was that Chris Leinberger and Pat Bryan undertook the leasing broker role and were paid a commission by Theater Block at rates well below those that would have been paid to third party leasing brokers.

"HDIC Asset Management (a company owned by Chris Leinberger and Pat Bryan) was created to handle construction management because of the poor experience HDIC had with using architects as the construction managers of Theater Block. In the case of Theater Block HDIC staff had to be deployed to do construction management to get the project completed, yet it still had to pay construction management fees to architects. To avoid this duplicating of effort and cost again HDIC Asset Management assembled a trusted team to manage the Gold Loft construction. HDIC Gold Lofts awarded the Construction Management to this team and has been rewarded with the timely within budget construction of the project. The 3% of hard cost fee is at the bottom of the scale of market rate construction management fees in this market.

"The Master Development Agreement does not contemplate HDIC obtaining pre-approval of Related Party Transactions from the City. HDIC is not an arm of the City or a quasi-governmental entity – it is a for profit development company operating under a development agreement with the City. The protection to the City is that no Related Party Transaction should be at above market costs."

7. HDIC SHOULD ENSURE THAT DEVELOPMENT PLANS COMPLY WITH THE STATE STATUTE ON METROPOLITAN REDEVELOPMENT.

Section 3-60A-12.A of the state statute on Metropolitan Redevelopment states, "A municipality may sell, lease or otherwise transfer real property or any interest therein acquired by it in a metropolitan redevelopment area . . . The purchasers or lessees and their successors and assigns shall be obligated to devote the real property only to the uses specified in the metropolitan redevelopment plan for a period of years as set out in the sale or lease agreement . . . ."

Section 3-60A-9 D. states, “A metropolitan redevelopment plan may be modified at any time…. Any proposed modification which will substantially change the plan as previously approved by the local governing body shall be subject to the requirements of this section, including the requirement of a public hearing before it may be approved.”

Section 101.f. of the Master Development Agreement states, "Compliance with Metropolitan Redevelopment Plan requirements. The Master Developer agrees for itself, and its successors and assigns, and every successor in interest to the Project or any part thereof, that the Master Developer and such successors and assigns shall devote the Real Property conveyed to it and the Project to the applicable uses and restrictions specified in the Metropolitan Redevelopment Plan as it exists on the date of submission by the Master Developer of an application for a building permit for the Project, or part thereof."

Section II.B.8 of the “Alvarado Transportation Center Metropolitan Redevelopment Plan”, which is an attachment to the Master Development Agreement, states, “Housing development in the Plan will include a minimum of 20% of the dwelling units affordable to households less than 80% of median income.”

HDIC informed the auditors that 10% of the housing units in the Silver Court Apartment project would be low income housing. An August 25, 2003, letter from the CAO to HDIC stated:

> “Section 408 of the Alvarado Master Development Agreement between the City of Albuquerque and the Historic Development Improvement Corporation (HDIC) designated that Phase I of the master plan include a ‘low income housing’ component. We have all agreed that that component would be built into the Silver Court Apartment project. Over the past several months’ considerable discussion has occurred around the low income housing issue. It is time to bring closure to this issue.
>
> “Following is a concise recap of the outstanding items and final resolutions:
>
> “1. Number of Low Income Units --- 17 of the apartment units will meet the 10% low income housing set aside.”

The HDIC Chief Operating Officer stated that the Gold Lofts project was not subject to the low-income housing component. He justified the departure from the plan for the Silver Court Apartments project (the next project to be developed under the Master Development Agreement) in a letter to an Assistant City Attorney dated December 12, 2002. The letter states in part:

"The Redevelopment staff believes that the low income housing component should be 20% of the units because that was their desire when they put out the original RFP. That condition was not included in the Master Development Agreement. The reality is that the only promise made by HDIC in the Master Development Agreement was to provide a low income housing component.

"To cut to the chase, however, we are proposing to set aside 10% of the approximately 174 units (17 units) as the component of low income housing for the project. Had we set even 20% of the original 60 townhouses, that would have been 12 units. The reality is that we are providing nearly 50% more affordable units than was originally envisioned (by Redevelopment Staff)."

The CAO agreed to the changes without modifying the Metropolitan Redevelopment Plan. State statute 3-60A-9 D. requires specific hearings and approvals for any proposed modification, which substantially changes the approved plan. If the change in the percentage of low-income housing units from 20% to 10% is considered a substantial change, the modification should be the subject of public hearings and approved by the City Council.

RECOMMENDATION

HDIC should ensure that development plans comply with the state statute on metropolitan redevelopment, which requires that "The purchasers or lessees and their successors and assigns shall be obligated to devote the real property only to the uses specified in the metropolitan redevelopment plan . . . . "

EXECUTIVE RESPONSE FROM HDIC

"The Metropolitan Redevelopment Plan set goals for redevelopment of the Alvarado Plan Area. After a competitive bid process, the City picked HDIC to be the Master Developer of that Redevelopment Area and negotiated a Master Development Agreement with HDIC. That agreement specifically addresses HDIC's affordable housing obligation in section 408. That obligation is specifically limited to certain parcels within the Alvarado Plan Area (Parcels E-2, E-3, F-1 and F-3. HDIC through the referenced correspondence with the City came to an agreement that a 10% low income housing component satisfies the conditions of Section 408 of the Master Development Agreement. This same correspondence further reaffirms that

the project which will provide this low income housing component will be the Silver Court Apartment project.

"The letter between HDIC's COO and the City's CAO goes further to define the parameters of what was an acceptable low income housing component between parties. The Silver Court project is economically fragile. Two developers (Don Tishman and Phoenix Properties) have tried to make it work. Both have found the project to be economically infeasible. HDIC recently approached yet a third developer to look at the project – assuming the same negotiated incentives and obligations as the prior developers. To change those parameters (by increasing the negotiated 10% low income housing component) at this stage would be disastrous to the larger goal of increasing downtown housing stock."

CONCLUSION

HDIC should improve its compliance with the requirements of the Master Development Agreement. HDIC should also consider providing the City with the additional information discussed above, in order to ensure that the City's interest in the various projects is better protected.

We appreciate the assistance and cooperation of HDIC personnel during the audit.

____
Principal Auditor

REVIEWED AND APPROVED:	**APPROVED FOR PUBLICATION:**
________________________________	________________________________
Carmen L. Kavelman, CPA, CISA, CGAP	Chairman, Audit Committee

Acting Internal Audit Officer