

DATE ISSUED: September 17, 2003 REPORT NO. 03-188
ATTENTION: Honorable Mayor and City Council
Docket of September 22, 2003
SUBJECT: Sea World Lease - Rental Rate Adjustment

SUMMARY

THIS IS AN INFORMATION ITEM ONLY. NO ACTION IS REQUIRED ON THE PART OF THE CITY COUNCIL.

BACKGROUND

In accordance with the direction given to the City Manager by Council on July 9, 2002, this report provides an analysis of the provisions within the Sea World lease for the adjustment of the rent paid to the City.

Sea World first opened to the public on March 21, 1964. It is located on land leased from the City in the South Shores area of Mission Bay Park. Comprised of 172 acres of land area and 17.9 acres of water area, Sea World has been owned and operated by Anheuser-Busch since 1989. With annual attendances over the last ten years averaging 3.78 million, Sea World is ranked the 13th most popular theme park in the United States and the 4th most popular in California behind Disneyland, Universal Studios and Disney's California Adventure.

Over the years, the leasehold has been expanded to facilitate Sea World's development of additional exhibits and facilities. The lease was amended on June 29, 1998, to facilitate Sea World's latest proposal for expansion by including an adjacent 16.5 acre parcel and a portion of Perez Cove Way.

Sea World's proposed improvement projects, the first phase of which includes a 'splashdown' ride, an education center, a special events center and a new front entrance, require development above the 30 foot height limit enforced in the coastal zone.

The 'splashdown' ride, currently under construction, is a water flume and tracked ride attraction. The structure will include three towers, the highest of which will be 95 feet high. The attraction will incorporate a main entry plaza, covered queuing area, dolphin exhibit, gift shop, snack stand, ride photo sales area and a facility support structure. The proposed education center will consist of a three storey building approximately 22,000 square feet in size and up to 45 feet in height. The facility will offer classroom space, wet lab facilities and a 130-seat auditorium.

The first phase of the planned special events center will provide ballroom, catering facilities and meeting rooms with capacity for up to 1,000 people in a "Monterey Cannery Row" style building. A second phase is proposed to subsequently double the size of the facility. The center will be up to 40 feet in height, with one icon structure of no more than 60 feet permitted. Finally, the proposed front gate renovation will include structures of a nautical theme up to 40 feet in height except for a single icon structure permitted up to 60 feet.

On November 3, 1998, voters approved Proposition D (The Sea World Initiative) which amended the 30 foot height limit to allow development to a maximum of 160 feet on the Sea World leasehold. On July 10, 2001, the City Council approved the Sea World Master Plan Update and amendment to the City's Local Coastal Program (LCP), revising the height limit. On February 7, 2002, the California Coastal Commission ("Coastal Commission") voted to certify the City's LCP Amendment subject to suggested modifications and additionally required the City and Sea World to make amendments to the lease.

One of the Coastal Commission's significant modifications requires the City to prepare and complete, no later than two years from the effective certification of its LCP Amendment, a capital improvement program for the development of significant public recreational facilities including, but not limited to, necessary infrastructure improvements at Fiesta Island and South Shores.

The program must identify strategies for funding in addition to the mitigation funds already available for recreational improvements and will include a phasing component to ensure such improvements will be developed commensurate with new commercial development approved in Mission Bay Park. The City further agreed to make recreational improvements on Fiesta Island and South Shores the highest priority. The implementation cost of this program is estimated at \$243 million in current dollars.

Another of the Coastal Commission's modifications requires utilization of the Caltrans Project Study Reports for traffic improvements at the I5/Sea World Drive interchange to determine the phasing and funding of improvements to relieve peak summer recreational congestion and address the effects of increased commercial development. The Project Study reports will be funded out of the first mitigation dollars received.

Sea World is required to pay in advance a total amount of \$10,656,900 in traffic mitigation funds to the City in five annual installments adjusted by a 3% increment or the CPI index, whichever is greater, to be used for the traffic mitigation measures identified in the Environmental Impact Report. As the specific traffic thresholds are met, the City would utilize the deposited funds to pay for the corresponding mitigation measure. If the traffic impacts do not attain or exceed the

identified thresholds, the unspent balance, including interest, remaining in the fund after the five year period will be returned to Sea World over the proceeding five years.

On July 9, 2002, the City approved the Coastal Commission's suggested modifications and an amendment to the lease. The associated Manager's Report No. 02-153 dated July 3, 2002, provides further information. The Coastal Commission's effective certification of the City's LCP amendment took place January 9, 2003.

SCHEDULED PERCENTAGE RENT ADJUSTMENT

The rent paid by Sea World to the City is computed on the basis of various percentage rate categories of Sea World's gross income. When the lease was amended in 1983 a new provision was included to adjust these rates beginning January 1, 1994 and every ten years thereafter to reflect fair market rental rates then generally in effect.

The provision includes language that limits adjustments to the general admission ticket percentage rate category. This category is limited to an increase of no more than 1% for any one adjustment period and is capped at 4%. When the City and Sea World entered into the 1998 lease amendment, the percentage rate adjustment provision was revised to begin January 1, 2004.

Sea World's reported gross income in fiscal year 2002 was \$184,626,224 and the resulting total rent paid to the City was \$7,150,580 or 3.87% of Sea World's gross income. The following table lists the annual rent paid by Sea World over the last nine years:

Year	Annual Rent Paid
1994	\$4,374,542
1995	\$4,533,541
1996	\$5,005,362
1997	\$5,507,823
1998	\$5,545,997
1999	\$5,822,305
2000	\$6,251,387
2001	\$6,803,883
2002	\$7,150,580

In accordance with the percentage rate adjustment provision of the lease, the City was required to determine the percentage rates presently found in the open marketplace. The following table summarizes the current rates used to calculate Sea World's rent:

CATEGORY	% RENT	CATEGORY	% RENT
Admissions	2.5%	Diesel Fuel	1.5%
Alcoholic Beverages	5.0%	Food & Beverage	2.5%-3.0%
Activities, Services & Operations	7.0%	Games	5.0%
Animal Food	3.0%	Institutional Advertising	2.5%
Boats & Motors (sales)	2.0%	Parking Lots/Merchandise	7.0%
Boats & Motors (services)	4.0%	Petroleum Products	3.0%
Boat Storage	7.0%	Ride Operations	3.0%
Boat Slip Rentals	20.0%	Surcharge	3.0%
Coin-op. Vending Machines	2.5%-5.0%		

MINIMUM RENT ADJUSTMENT UPON CHANGE OF ENTITLEMENTS

Irrespective of the amount of Sea World’s gross income, rent paid to the City can not be lower than an annual minimum rent calculated pursuant to Article IV Subsection 2 of the lease. The current annual minimum rent is \$5,130,612.

The 1998 amendment added an additional provision to the lease for adjusting the minimum rent payable by Sea World upon a “substantial change in its entitlements”. This entails any change in entitlements for the property that enables a use different to that contemplated in the lease immediately prior to the change that adds value to Sea World’s leasehold interest. The California Coastal Commission’s recent certification of the City’s LCP Amendment No. 2-01C (Sea World Master Plan) constitutes a substantial change in entitlements for the Sea World leasehold and, therefore, triggers this adjustment clause. The City and Sea World have agreed to address the minimum rent adjustment concurrently with the percentage rate adjustment.

ARBITRATION PROCESS

The percentage rate adjustment language contained in Article IV, Subsection 5 of the lease stipulates a specific time line for the City and Sea World to determine whether one or more or none of the percentage rates should be adjusted and to what extent. The lease specifies that if a determination cannot be reached by mutual consent of the parties prior to October 1, 2002, either party may refer the matter to arbitration and provide the other party with written notice prior to January 1, 2003. Sea World provided such notice to the City on December 27, 2002, in order to preserve the ability to resolve any disputes, if an agreement cannot be reached.

Since the matter was referred to arbitration by Sea World, the City and Sea World were required to select a mutually acceptable arbitrator prior to March 1 or if a mutually acceptable arbitrator was not selected then the lease requires each party to appoint an arbitrator and give written notice of the appointment to the other party by March 10. Pursuant to this section of the lease, the City has appointed Ms. Frances Mason, MAI as its arbitrator and Sea World has selected Mr. Arthur E. Gimmy, MAI. The lease also states that the two arbitrators shall select a third arbitrator to

work with them. On April 3, the two arbitrators selected Mr. Tom Clark, MAI as the third arbitrator.

The arbitration will be conducted under and subject to the California Arbitration Statute. Each party is responsible for the expense of its own appointed arbitrator and will share equally the cost of the third. For the purposes of determining the appropriate percentage rates, the arbitrators will consider the property to be vacant and available in the open market for new leasing purposes, pursuant to a lease similar to the Sea World lease. The arbitrators are to use and analyze only that rental data found in the open marketplace for same or similar uses.

A decision agreed upon by at least two of the arbitrators is required. If this does not occur, the arbitrators shall be discharged and the process repeated to select new arbitrators until a decision is made. Once reached, a decision is binding on the parties and shall be effective on January 1, 2004.

If the City and Sea World cannot mutually agree upon a new minimum rent, the matter will also be decided through arbitration. In the event a decision can not be made by at least two of the arbitrators, the minimum rent shall be increased by the average of the two increases in minimum rent proposed by the arbitrators which are closest in amount, and the third arbitrator's proposal shall be discarded. If one proposed increase is equally higher or lower than the other two proposed increases, then the middle amount shall be used. The City and Sea World have agreed to use the same arbitration panel for purposes of both the minimum and percentage rate adjustments.

INDEPENDENT CONSULTANT WORK PRODUCT

The City has enlisted the support of several independent consultants to obtain market data and prepare recommendations in order to approach this exercise. The team of Don Stewart, an economic consultant with Economic Consulting Services, and Kent Lemasters of AmusementAquatic Management Group was asked to determine an appropriate rent based upon its economic analysis of the Sea World leasehold and a review of comparable market data from the theme park industry. Don Stewart began his economic consulting career in 1963 and has particular expertise in the recreation and leisure industry. His previous assignments include consultation on projects such as: Soak City Waterpark at Knott's Berry Farm in Buena Park, Circus Circus in Las Vegas and Everland in Seoul, South Korea. Kent Lemasters has provided marketing and management services to some of the most successful amusement, theme and water parks in North America including; Silver Dollar City, Branson MO., Dollywood, Pigeon Forge, TN, Calaway Park, Calgary, and Raging Waters, San Dimas & San Jose, CA.

David Riach and William Shrewsbury from the commercial appraisal division of First American Tax Valuation were retained to evaluate the current market percentage rental rates for the various categories of Sea World's gross income. David Riach and William Shrewsbury are both Members of the Appraisal Institute and each have over 30 years of appraisal experience. Both have completed numerous complex appraisals on property for such uses as: shopping centers, hotels, golf courses and marinas.

Maurice Robinson & Associates were commissioned to conduct further analysis and to determine a new annual minimum rent arising from the additional value to Sea World's leasehold interest as a result of the January 9, 2003 substantial change in entitlements. Maurice Robinson is a nationally recognized expert in the field of hospitality consulting and valuation. He is a State Certified Appraiser in California and has been conducting market studies and appraising hotels, national parks and other real estate for nearly 25 years. He is also a mediator and arbitrator in hospitality and real estate disputes.

Lastly, Alan Nevin, Director of Economic Research at MarketPointe Realty Advisors was asked to analyze the impact to Sea World of adding major thrill rides on a planned continuing program and to assess the potential for increases to Sea World's attendance as a result of these additional attractions. Alan Nevin has an extensive background in demographic and economic forecasting, business valuations, real estate development and investment analysis.

City staff will submit the conclusions of these independent consultant reports to the Mayor and Council in Closed Session on September 23 and will seek direction on the City's position pertaining to the appropriate percentage and minimum rents to present to Sea World. City staff will then present the City's position to Sea World and if agreement can be reached within the parameters authorized by Council, the arbitration process will not be utilized. If Sea World's position is sufficiently close to the parameters set by Council, then staff may return to closed session to seek further direction. If the City's and Sea World's positions are so far apart that an adjustment of the rent can not be mutually agreed upon, staff will refer the matter to arbitration and the arbitration process will commence.

Respectfully submitted,

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Real Estate Assets Director

Approved: Bruce Herring
Deputy City Manager