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# Performance Audit of the Real Estate Assets Department

THE DEPARTMENT SHOULD UPDATE ITS PORTFOLIO MANAGEMENT  
PLAN AND IMPROVE ITS PERFORMANCE MEASURES TO MEET THE  
CITY'S NEEDS

DECEMBER 2012

**Audit Report**  
Office of the City Auditor  
City of San Diego



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## THE CITY OF SAN DIEGO

December 20, 2012

Honorable Mayor, City Council, and Audit Committee Members  
City of San Diego, California

Transmitted herewith is an audit report on the Real Estate Assets Department. This report is in accordance with City Charter Section 39.2. The Results in Brief is presented on page 1. The Administration's response to our audit recommendations is presented on page 27 of the report.

We would like to thank staff from the Real Estate Assets Department as well as representatives from other City departments for their assistance and cooperation during this audit. All of their valuable time and efforts spent on providing us information is greatly appreciated. The audit staff members responsible for this audit report are Toufic Tabshouri, Sunny McLernon, and Chris Constantin.

Respectfully submitted,

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## Results in Brief

The Real Estate Assets Department (READ) has made progress in developing a more systematic approach to managing the City's real estate and leasing space needed by City departments, but additional actions—both by READ and by other City officials—are needed. The Department's efforts to improve its performance were taken in response to a consultant's report that was completed more than four years ago, but changing circumstances require additional response—specifically:

- **Updating the management plan to meet changing needs.** Two other City entities with real estate expertise—the City's Redevelopment Agency and the Center City Development Corporation—were dissolved or reorganized, potentially depriving the City of significant expertise in conducting major real estate transactions. READ needs to ensure it can supply this expertise.
- **Reducing the City's space requirements and relocating some employees out of downtown when leases for office space expire.** READ's Corporate Service Division must juggle two potentially conflicting roles: controlling the City's rent costs while helping City departments move or reconfigure their space in response to changing needs. At present, this means trying to fit many departments into aging downtown buildings, often with departmental resistance. Leases for more than 530 thousand square feet of downtown office space in three buildings will expire soon, and the City has a good opportunity to save on rent since the commercial real estate market currently favors tenants.
- **Establishing a system to evaluate performance.** READ has started to report on its activities and accomplishments, but its stated goals are vague and cannot be readily measured. To better achieve its mission, READ needs to establish measures, targets, outcomes and outputs for each goal it sets.

- **Developing a policy on rent subsidies.** The City subsidizes rents for many nonprofit organizations but lacks a policy for determining which organizations should qualify, recovering the City's facilities maintenance and upkeep costs for the subsidized space, or recovering the costs of preparing, processing, and monitoring leases. READ should take the lead in working with the City Administration and City Council to establish a policy.



# Background

The Real Estate Assets Department (READ) manages the City's real estate portfolio (including leased space) and oversees the operations of Qualcomm Stadium, PETCO Park, and the Montgomery Field and Brown Field Airports. READ is organized by function into four divisions: Acquisition/Disposition, Asset Management, Corporate Services, and Valuation. The following is a brief description of the key functions of each division.

**Acquisition/Disposition** This division provides acquisition services for public facilities, parks, open space, and rights-of-way. It also maintains property records and evaluates City assets to determine which properties are essential for the City's core mission and which can be considered surplus and handles the disposition of surplus properties. The division has five positions.

**Asset Management** This division manages the City's properties and leases them to tenants, and it administers the City's existing ground leases, permits, operating agreements, use and occupancy agreements, and sub-leases. It is also responsible for redeveloping existing leaseholds, negotiating new leases and permits, renewing expired leases and permits, implementing rental adjustments, and ensuring lease compliance. Additionally, this division oversees the Community Concourse and the City's parking garage. It is the largest division in READ, with eight positions.

**Corporate Services** This division plans, organizes and executes transactions that support the City's facilities needs. Its staff work with individual City departments to determine their space requirements and whether these requirements can be best accommodated through occupancy of City-owned properties, a lease from an outside entity, or the acquisition of a new facility. The division has three positions.

**Valuation Division** This division provides valuations to support property sales, property acquisitions, rental rates, market rent adjustments, annual valuations of properties held for investment to the Comptroller's Office for inclusion in the Comprehensive Annual Financial Report (CAFR), and valuations of properties for the

Debt Management Department which serve as security for major bond issuances. It has two positions.

The City owns over 120,000 acres, including open park spaces and facilities such as fire and police stations, libraries, maintenance yards, office space, and sewer and water treatment plants. Of the 120,000 acres, approximately 30 percent are beach and adjacent properties. Approximately half of the remaining acreage is owned by the Public Utilities Department, and the other half by departments funded from the General Fund. Of the latter properties, more than 90 percent are park and open space lands. Although READ administers properties for the Public Utilities and Park & Recreation Departments, it does not control their land use.<sup>1</sup>

The City also owns and leases office space in downtown and suburban locations totaling over one million square feet. City-owned buildings include the City Administration Building, the Development Services Center, and facilities in Chollas and Kearney Mesa. Leased buildings include Civic Center Plaza, Executive Complex, and 600 B Street, all three of which are located in downtown.

Most READ divisions are headed by an Asset Manager and staffed by Supervising Property Agents and Property Agents. READ also employs support personnel in administrative and clerical positions. READ's budget and workforce have declined slightly over the past few years, as shown in Exhibit 1.

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<sup>1</sup> The Public Utilities Department has more autonomy of the management of its assets than other City departments because it finances its operations through enterprise funds that are separate from the City's General Fund. The Park & Recreation Department has a similar degree of autonomy because the San Diego City Charter imposes more restrictions on the use of park land than on other City properties.

**Exhibit 1**

**READ Budget and Workforce**

	2009	2010	2011	2012
Number of Employees	34.5	32	28	27
Budgeted Expenses (in millions)	\$4.1	\$3.8	\$4.5	\$4.3

Source: City budget documents.

Note: Excludes figures for the Concourse and Parking Garages Operating Fund.

**The current City Administration has made reforms to READ**

In September 2005, the San Diego Union Tribune ran an article titled “Land of Confusion: Inaccurate records have San Diego officials guessing how much real estate the cash-strapped city owns,” which detailed problems in the recordkeeping of City-owned property.<sup>2</sup>

In March 2006, Mayor Sanders issued a press release where he pledged to overhaul READ and to address many issues raised in the article, including the demolition of a rat-infested house in La Jolla. As part of the Mayor’s plan to reform READ, the City hired a new department director for READ, and, subsequently, READ retained a private real estate consultant to assess the Department and to help provide a roadmap for improving it. The consultant issued a report in January 2007,<sup>3</sup> and some of its significant findings are summarized below:

- Until recently, READ has addressed the City’s real estate needs as situations arose, without a central plan.
- The City's large portfolio of income-producing real estate was managed without a formal portfolio plan.
- Departmental space was provided as needed, without a cohesive plan and without considering use by other departments, availability, or possible changes in the portfolio.

<sup>2</sup> After the article was published, READ commissioned a property records assessment to reconcile City property data with records from other sources. The assessment concluded that only two out of over 3,500 property records were unaccounted for.

<sup>3</sup> Grubb & Ellis, *Best Practices Methodology for Real Estate Assets Department*, (Chicago, IL: January 31, 2007).

- Public service properties were acquired on an as-requested basis, without reference to an overall plan.
- READ lacked the authority to manage its portfolio, and instead conducted transactions to provide services as best it could.

The report concluded that current management practices do not achieve optimal performance from the City's assets or provide optimal customer service. It recommended that the City adopt a new business model for managing its real estate assets that is focused on three areas: real estate investment portfolio performance, operating portfolio planning, and customer service. The report also made specific recommendations for improving business processes, training staff, implementing performance measures, adopting new technology tools, and seeking a more expansive authority to conduct real estate transactions.

## Audit Results

### ***Finding 1: The City Should Strengthen and Clarify the Real Estate Assets Department's Role in Addressing the City's Space Needs***

Although management from the Real Estate Assets Department (READ) has taken steps to respond to recommendations made in a consultant's 2007 report, the City has not defined a strategic role for READ, and READ operates without the benefit of comprehensive City policies to guide its operations. Additionally, READ faces many factors that are beyond its immediate control. For example, the Corporate Service Division (CSD) is challenged to plan relocations for client departments and is constrained by the downtown real estate the City currently occupies, which is old and relatively expensive to lease or maintain. READ management is also concerned about noncompliance by City departments with an administrative requirement to submit all requests for space to READ for review.<sup>4</sup>

The City has an opportunity to use READ more effectively in addressing City space needs over the coming years. The City's leases for downtown office space are expiring soon, offering an opportunity to secure better facilities at potentially lower cost. In addition, continuing consideration of whether to build a new city hall could have repercussions for the length and type of leases the City should be seeking. Making READ more effective in addressing these opportunities requires a combination of actions, some of which are within READ's power to accomplish, and others that require policy guidance from the City Administration and City Council. Each of these actions is discussed in turn below.

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<sup>4</sup> Administrative Regulation 56.00 governs department requests for space. It has been amended to require that requests for space by departments be submitted to READ along with a business case and an identified funding source.

**READ's Portfolio  
Management Plan  
Should be Updated to  
Meet the City's  
Changing Needs**

In its 2010 Portfolio Management Plan, READ defined its mission as:

*To acquire and manage real estate for the highest public use and benefit, generate revenue through leasing and sales of surplus assets and maximize the overall financial return of the City's real estate portfolio.*

Like any mission statement, this one cannot capture all the details of READ's work, but it does reflect management's philosophy about how to run the Department. In our discussions with READ's management, they informed us that they viewed READ as a real estate holding company, and that they sought to manage it as an efficient business, while also meeting the needs of the City and its stakeholders. Running a City department efficiently is an appropriate goal, and it reflects the previous career experiences of READ's senior management team in the private commercial real estate industry.

However, READ faces many constraints in trying to operate like a private business. City regulations and policies prevent READ from focusing solely on the financial bottom line as the driver for its decisions, and READ's management is well aware of these limitations and of the need to maximize the value of City assets for the public benefit. In the past, READ has not been the primary actor making real estate decisions for the City. Many of the significant real estate redevelopment plans and transactions conducted by the City have been directed by the Center City Development Corporation on behalf of the City's Redevelopment Agency.<sup>5</sup> Furthermore, most of the City's real estate holdings are controlled by the Public Utilities and the Park & Recreation Departments, which are focused on their

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<sup>5</sup> The Redevelopment Agency of the City of San Diego was dissolved in February 2012 per Assembly Bill 26 (AB 26). The City of San Diego, serving as the successor agency, has assumed the former agency's assets, rights, and obligations under the California Community Redevelopment Law, subject to some limitations, and is winding down the former agency's affairs and taking other actions in accordance with the dissolution provisions in AB 26.

Centre City Development Corporation—now known as Civic San Diego—is a public, nonprofit corporation working on behalf of the City of San Diego to oversee downtown San Diego's planning and permitting functions, to manage the downtown community parking district, and to administer the winding down of redevelopment activities. Another public benefit corporation, the Southeastern Economic Development Corporation, now operates as a subsidiary of Civic San Diego.

respective missions and not on maximizing income from the land they control. See Appendix C for a listing of City codes, policies, and regulations governing public real estate.

As discussed in the Background section of this report, READ hired a real estate consultant to assess READ and provide a roadmap for improving the Department. READ's management embraced the consultant's report and has taken steps to implement some of its recommendations. Namely, READ replaced its old mainframe-based information technology system with modern software solutions for managing its real estate that allowed all its paper lease and property records to be scanned and electronically stored. READ also published a Portfolio Management Plan in 2010 that detailed the efforts and accomplishments of its four divisions and described their future goals; READ's management asserts that this is the only such plan in the United States.

Notwithstanding the accomplishments noted above, we found that READ has not made as much progress in improving the utilization efficiency of leased downtown office space and in developing good performance measures, as we detail in the report. This is largely because the City has been locked into long-term contracts for the majority of space that the City leases in downtown. Nonetheless, READ reports saving the City approximately \$1.8 million per year in rent by relocating departments from leased space to City-owned space, subleasing, taking advantage of surrender options in leased buildings, and negotiating new leases under favorable terms.

**Recommendation #1    The Real Estate Assets Department should update its Portfolio Management Plan to insure that it meets the City's changing needs. (Priority 3)**

**The City can Save on Rent by Reducing its Space Requirements and Moving Some Employees Out of Downtown When Leases for Office Space Expire**

READ's Corporate Services Division (CSD) is responsible for planning for the City's facility needs and executing transactions that support them; departments cannot execute leases on their own. This responsibility has rested with CSD since 2007. CSD works with individual City departments to determine their space needs and whether their requirements can be best accommodated through occupying City-owned property, leasing private property, or acquiring a new facility.

Much of the current space that the City has leased is in three downtown office buildings: Civic Center Plaza, Executive Complex, and 600 B Street. Together, these three buildings account for more than half-million square feet of City-leased space housing 1,633 City workers. The annual lease cost for this space is approximately \$12 million (see exhibit 2). The original leases for these buildings date from the 1990s, and the current leases expire in 2013 and 2014.

**Exhibit 2**

**Summary Occupancy Information for Downtown Office Space Leased by the City**

Building	Original Lease Date	Lease Expiration Date	Annual Expense <sup>1</sup>	Number of Employees
<b>Civic Center Plaza</b>	October 1991	July 2014	\$4,671,730	8,179
<b>Executive Complex</b>	January 1999	March 2014	\$2,901,600	403
<b>600 B Street</b>	October 1991	May 2013	\$4,185,007	413

Sources: READ and various published reports.

<sup>1</sup> Includes fiscal year 2012 rent and operating expense.

CSD faces two main limitations arising from the City’s current leases: meeting the Departments’ needs and controlling costs to the City. First, the three buildings are old and difficult to reconfigure.<sup>6</sup> Although there is substantial unused capacity, empty spaces are generally small and scattered, which makes it difficult to capture and use this space efficiently. Creating significant contiguous space usually requires relocating multiple departments. READ reports that most employee moves arise from department mergers or reorganizations.

The relative inflexibility of the space also makes it less efficient than newer space, meaning that the City ends up renting more space than it would if the leased space could be more readily reconfigured. For newer, more flexible office buildings, conservative benchmark figures suggest a maximum of 225 square feet of office space for each employee. As Exhibit 3 shows, the amount of space per City employee in the three leased buildings ranges from 298 square feet to nearly 336 square feet. In total, the excess cost per employee represents about 29 percent of the total annual lease cost for the three buildings.

<sup>6</sup> Civic Center Plaza, Executive Complex, and 600 B Street were built in 1972, 1963, and 1974, respectively.



**Exhibit 3**

**Utilization Efficiency in Downtown Buildings is Lower Than Modern Office Standards of Less Than 225 Square Feet Per Employee**

Building	Rented Space <sup>1</sup>	Space Per Employee	Cost Per Square Foot	Excess Cost Per Employee <sup>2</sup>
<b>Civic Center Plaza</b>	243,176	298 ft <sup>2</sup>	\$19	\$1,396
<b>Executive Complex</b>	132,959	330 ft <sup>2</sup>	\$22	\$2,290
<b>600 B Street</b>	138,962	336 ft <sup>2</sup>	\$30	\$3,357

Sources: Auditor calculations based on data from READ and various published reports.

<sup>1</sup> We used figures for rentable space in our calculations. Alternative industry terms are usable space and gross space.

<sup>2</sup> We calculated excess space based on a conservative figure of 225 square feet per employee. The City’s revised Administrative Regulation 56.00 and the new Facilities Strategy Plan call for 180 square feet for most employees.

Second, even if the City leased newer space that can be more easily altered with changing needs, the cost of such space is higher in the downtown area than in other areas of the City. Office space in the downtown area costs up to 20 percent more than similar space in some other areas of the City.<sup>7</sup>

As the City Council and City Administration continue to assess the City’s needs for space and READ’s role in securing this space for City departments, they may find it beneficial to move more employees to less expensive space outside the downtown area.

*Relocating City Employees Out of Downtown*

Approximately one third of the City’s workforce is currently located downtown, either in the three leased buildings discussed above or in City-owned buildings. Other employees are located in facilities throughout the City. Employees of some large departments such as Fire-Rescue, Library, Park & Recreation, and Police occupy facilities that are distributed throughout the City. Employees of departments that operate heavy equipment or industrial facilities such as Public Utilities and Transportation & Storm Water are located onsite. Additionally, the Public Utilities Department has a significant number of employees located in an office complex in Kearney Mesa.

Given the inefficiency of current leased facilities and the

<sup>7</sup> Commercial real estate industry practice grades buildings on a scale of A-D according to their condition. The Civic Center Plaza and Executive Complex are rated “C”; 600 B Street is rated “B.”

generally higher costs of leasing in the downtown area, the City may want to give consideration to reducing the concentration of City workers in the downtown area. We note that none of the reports that the City commissioned or prepared to evaluate its facilities needs or to present alternatives for constructing a new city hall evaluated the impact of relocating a portion of City employees outside the downtown area. Rather, their unstated premise was that the existing City workforce in downtown would remain in place.

We raised the issue of moving a portion of City employees from downtown to other areas in the City with READ, and staffers cautioned that such a move would have implications for downtown redevelopment and an economic impact on downtown businesses. They also noted that most City employees located downtown utilize public transit, a claim that we were not able to substantiate.<sup>8</sup>

The City may well have legitimate policy reasons for maintaining a sizeable presence in downtown. However, the City Administration and City Council should be fully informed of the fiscal impact of such a choice on the City's budget and of the availability of other alternatives. Relocating from downtown may also impact the services delivered by any departments that move, and therefore the decision to relocate should be studied on a case-by-case basis.

A decision to relocate City employees from the downtown core is not READ's to make, but it could help the City Council and City Administration to evaluate this option by preparing a market and financial analysis addressing the costs and benefits of doing so.

The upcoming expiration of the City's leases for three downtown office buildings should be understood within the context of the public debate about the construction of a new city hall.

There has been a lively debate about the feasibility of building a new city hall. The City has hired consultants and commissioned

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<sup>8</sup> The City sells approximately 1,100 to 1,400 subsidized transit passes to its employees every month. Assuming that these are all purchased by employees who work in downtown, this would account for 40 to 50 percent of the City's downtown workforce.

technical reports, and various Councilmembers and members of the public have expressed their views on the subject. The local newspaper continues to cover this topic regularly, and even the San Diego County Grand Jury weighed in on the issue. A discussion of the possible construction of a new city hall is beyond the scope of this report. However, a listing of relevant reports and documents regarding city facilities needs is provided in Appendix D.

Gensler Architects recently completed a City-wide Facilities Strategy Plan (plan) that was commissioned by READ. The plan suggests strategies for the City to maximize the performance and cost-effectiveness of its leased and owned real estate and to reduce the City's lease footprint. The plan incorporates new workplace standards, such as standardized workstations, and presents options for moving more of the City workforce outside of downtown by reconfiguring or developing City facilities and lands. The plan is a good foundational step towards improving the efficiency of the City's real estate use. It should be rapidly followed by other actions in order to realize its potential.

**Recommendation #2**    **The Real Estate Assets Department should prepare a market and financial analysis for the City Administration and City Council to reduce leased office space and move a portion of the City's workforce out of downtown to less expensive office space. (Priority 3)**

**READ can Improve its Performance Measurement System**

A robust performance measurement system is crucial to insure that plans proceed on schedule and achieve desired outcomes. The consultant hired by the City in 2006 to help revamp READ recommended that READ implement performance measures for monitoring its activities, including:

- Creating standard real estate performance measures, including calculation of rates of return, occupancy, space quality, and comparison to market.
- Establishing a set of measures relating to execution, including response times, unresolved transactions, histories of negotiation, and accuracy and completeness of property records.

The consultant's report also noted that the data to create many of these measures already existed in READ but not in a format that permits portfolio analysis. However, READ has since implemented a new information technology system and is able to create management reports.

In its 2010 Portfolio Management Plan, READ stated that it has embarked on a number of major initiatives that have generated revenue, streamlined operations, improved service levels, and generally enhanced the Department. It also stated that one purpose of this plan is to enable the City's management and policy makers to have a better understanding of the City's real estate assets and how they can best be utilized. As part of this plan, each division listed its accomplishments and its action plan for the upcoming fiscal year.

We assessed the goals and accomplishments for all divisions listed in the Portfolio Management Plan against established criteria for performance measurement. The terminology for performance measurement is defined in Exhibit 4.

**Exhibit 4**

**Essential Elements of a Performance Measurement System**

Term	Definition
Performance Goal	Target level of performance over time expressed as a tangible, measurable objective, against which actual achievement can be compared. A performance goal is comprised of a performance measure with targets and timeframes.
Performance Measure	Indicators, statistics, or metrics used to gauge program performance.
Target	A quantifiable or measurable characteristic that tells how well or at level a program aspires to perform.
Outcome Measures	Outcomes describe the intended result of carrying out a program or activity.
Output Measures	Output describes the level of activity that will be provided over a period of time, including a description of the characteristics (e.g., timeliness) established as a standard for the activity.

Source: U.S. Office of Management and Budget Circular A-11.

We found that READ has established annual goals for each division and reported on its accomplishments, but that these goals generally provided vague targets that could not be readily measured. For example, the Asset Management Division reported completing 402 job assignments of various kinds in fiscal year 2009. However, absent any contextual information on workload levels or comparisons to prior year achievements, it is difficult to tell whether this level of activity is indicative of good productivity or not. The Asset Management Division also listed 14 notable accomplishments, including the completion of a Request for Proposals to select six qualified operators for kayak concessions at La Jolla Shores. However, the Portfolio Management Plan does not explain why these accomplishments are notable, and the reasons are not readily discernible to stakeholders.

**Recommendation #3** The Real Estate Assets Department (READ) should improve its performance goals by establishing measures, targets, outcomes, and outputs for each goal. READ should also annually report its performance and achievements to the City Administration and City Council. (Priority 3)

***Finding 2: The City Incurs Administrative and Other Costs in Providing Free Leases to Nonprofit Groups***

The City of San Diego currently provides 126 subsidized leases to nonprofit groups, and these leases are approved by the City Council on a case-by-case basis as they expire. Most of those leases are provided at no cost, and many of them have been in existence for a long time and have been perpetually renewed.

***Exhibit 5***

**Subsidized City Leases to Nonprofit Organizations<sup>1</sup>**

Number of Leases	Total Acreage	Percent Paying Rent	Total Rent
126	2,656	44 %	\$ 993,298

Source: Office of the City Auditor, based on data provided by READ.

<sup>1</sup> Fiscal year 2010.

While there are good public policy reasons for the City to subsidize rents for many nonprofit groups, the City nonetheless incurs costs for providing free rent in addition to the forgone lease income. Examples of such costs are the staff time required to prepare and service leases and the regular maintenance and upkeep costs for facilities (other than capital improvement costs). However, none of these costs are currently being tracked, reported, or recovered.

The consultant hired in 2006 to help revamp READ suggested a methodology for reviewing all leases to nonprofit organizations, but READ has not taken any steps to implement it. The consultant recommended that, for all nonprofit tenants, READ 1) gather lease data on all the portfolio and identify contract rents and adjustment dates, 2) identify and prioritize the review of leases with adjustments in process or due to occur in the next two years, and 3) make a preliminary estimate of market rent for adjusting leases. The report recommended classifying nonprofit tenants into the following three categories:

- *Nonprofit tenants that provide services that mitigate City responsibilities*
- *Nonprofit tenants that support City goals*

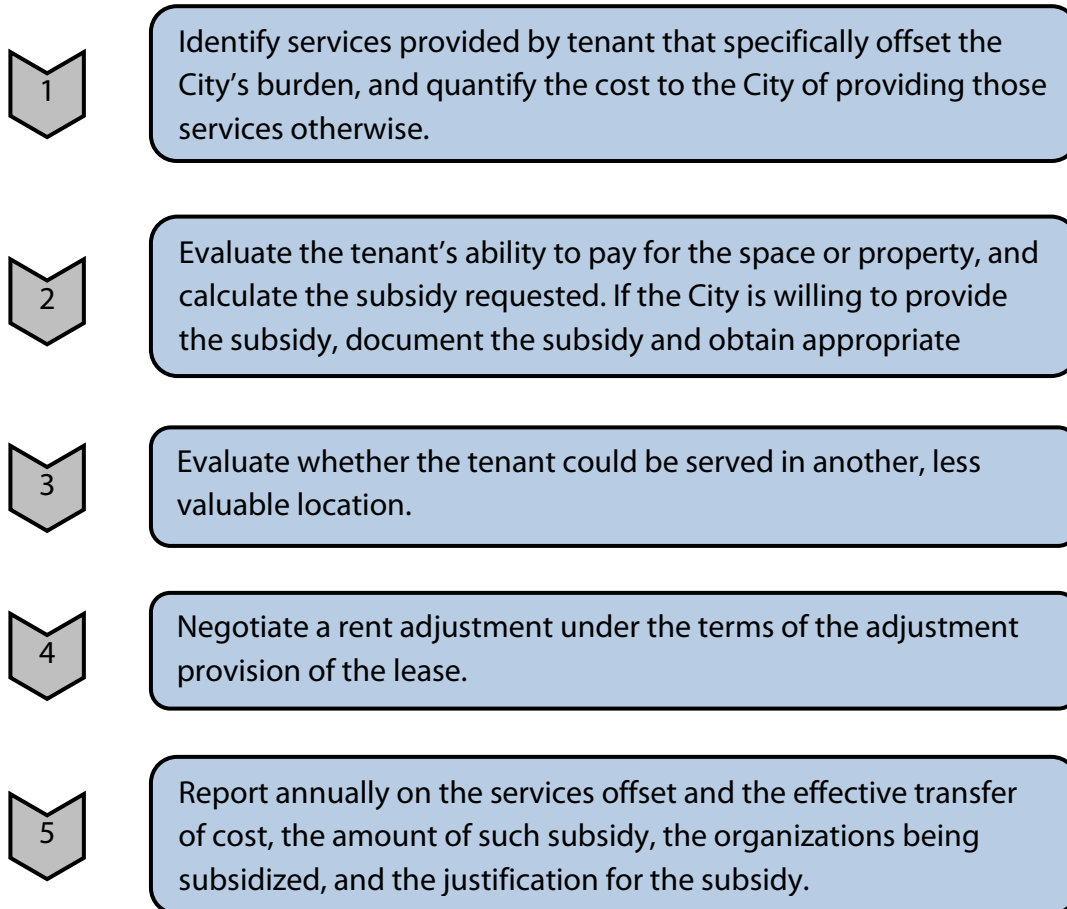
- *Other nonprofit tenants*

The report recommended evaluating rent subsidies to the first two groups of tenants as shown in the following exhibit.

**Exhibit 6**

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**Decision Process for City Subsidies to Nonprofit Tenants that Provide Services that Mitigate City Responsibilities or Support City Goals**



Source: Office of the City Auditor, based on the Grub & Ellis consultant report.

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For other nonprofit tenants, the report recommended negotiating lease renewals at market terms, as there is no justification for subsidy or offset.

We asked READ management why they have not taken any steps to implement the report's recommendation. They responded that many nonprofits enjoy considerable community support and that it would be difficult to recover any fees from them. READ management added that READ has other work priorities and that it has not been able to devote the resources

to tackle this issue. READ has started to include an administrative fee into non-profit leases to help partially cover the staff costs for administering these leases. However, READ staff informed us that the nonprofit organizations that lease from the City have been very outspoken about their opposition to this fee. Consequently, READ staff are not sure that they will be allowed to continue to assess this fee.

**Recommendation #4** The Real Estate Assets Department should work with the City Administration and the City Council to draft a policy on rent subsidies to nonprofit organizations that establishes eligibility criteria for recipients, recovers the City's facilities maintenance and upkeep costs for the subsidized space, and a fee to recover the costs of preparing, processing, and monitoring leases. (Priority 3)



# Conclusion

Six years ago, the City Administration began an effort to reform the Real Estate Assets Department (READ). The management team that the Administration hired to lead the Department took important steps to set READ on a good course, starting by commissioning an assessment of the Department, implementing a modern information technology system, and publishing a management plan. In several respects, however, these efforts need additional attention.

Some of the problems we identified are difficult to address and may require changes in the City's approach to securing space for its operations. READ's Corporate Services Division faces the tricky balancing act of controlling the City's rent costs while simultaneously providing customer service to client departments. This challenge is made more difficult by current leases that tie many City departments to older, less efficient buildings in the downtown area. In addition, while the Corporate Services Division is tasked with planning the space needs for all City departments, its decisions can be overruled. Staff in other divisions are burdened with processing leases for nonprofit organizations, many of which provide no known benefit to the City.

READ can take some steps on its own to improve the quality of operations, but it will also need direction from the City Administration and City Council. This is a crucial time for the City Administration and City Council to provide such direction. The upcoming expiration of downtown office leases and public discussions about the possible construction of a new city hall entail significant financial commitments, and any misstep could cost the City dearly. While READ is not the driver of these significant real estate transactions, it should serve as a technical resource for the City on these matters. The recommendations we are making are designed both to strengthen READ's operations and to help the City Council and other City officials provide strategic direction to READ's efforts.

# Recommendations

- Recommendation #1** The Real Estate Assets Department should update its Portfolio Management Plan to insure that it meets the City's changing needs. (Priority 3)
- Recommendation #2** The Real Estate Assets Department should prepare a market and financial analysis for the City Administration and City Council to reduce leased office space and move a portion of the City's workforce out of downtown to less expensive office space. (Priority 3)
- Recommendation #3** The Real Estate Assets Department (READ) should improve its performance goals by establishing measures, targets, outcomes and outputs for each goal. READ should also annually report its performance and achievements to the City Administration and City Council. (Priority 3)
- Recommendation #4** The Real Estate Assets Department should work with the City Administration and the City Council to draft a policy on rent subsidies to nonprofit organizations that establishes eligibility criteria for recipients, recovers the City's facilities maintenance and upkeep costs for the subsidized space, and fee to recover the costs of preparing, processing, and monitoring leases. (Priority 3)

# Appendix A: Definition of Audit Recommendation Priorities

## DEFINITIONS OF PRIORITY 1, 2, AND 3 AUDIT RECOMMENDATIONS

The Office of the City Auditor maintains a classification scheme applicable to audit recommendations and the appropriate corrective actions as follows:

Priority Class <sup>9</sup>	Description <sup>10</sup>	Implementation Action <sup>11</sup>
1	Fraud or serious violations are being committed, significant fiscal or equivalent non-fiscal losses are occurring.	Immediate
2	A potential for incurring significant or equivalent fiscal and/or non-fiscal losses exist.	Six months
3	Operation or administrative process will be improved.	Six months to one year

<sup>9</sup> The City Auditor is responsible for assigning audit recommendation priority class numbers. A recommendation which clearly fits the description for more than one priority class shall be assigned the higher number.

<sup>10</sup> For an audit recommendation to be considered related to a significant fiscal loss, it will usually be necessary for an actual loss of \$50,000 or more to be involved or for a potential loss (including unrealized revenue increases) of \$100,000 to be involved. Equivalent non-fiscal losses would include, but not be limited to, omission or commission of acts by or on behalf of the City which would be likely to expose the City to adverse criticism in the eyes of its residents.

<sup>11</sup> The implementation time frame indicated for each priority class is intended as a guideline for establishing implementation target dates. While prioritizing recommendations is the responsibility of the City Auditor, determining implementation dates is the responsibility of the City Administration.

## Appendix B: Audit Objectives, Scope, and Methodology

In accordance with the City Auditor's Fiscal Year 2012 Work Plan, we conducted an audit of the Real Estate Assets Department (READ). Based on a risk assessment we conducted, we decided to focus our audit on the overall management of READ and on the activities of the Corporate Services Division. Our audit objectives were to:

- Determine the extent to which READ is achieving its mission and effectively and efficiently managing the City's real estate needs.
- Assess the extent to which READ is adequately measuring its performance.

Due to audit resource constraints, we did not examine the leasing of City-owned property to private entities, but we plan to do so in a future audit. We did, however, review the leasing of City-owned property to nonprofit organizations, as we became aware of concerns about these leases during the course of our audit.

To determine whether READ is achieving its mission and meeting the City's real estate needs, we met with and interviewed Department management and staff, reviewed a consultant best practices report, reviewed READ's 2010 Portfolio Management Plan, and assessed the progress that READ has made in implementing consultant recommendations. To determine whether downtown office space leased by the City is economical and meets the City's needs, we reviewed various technical reports on the City's facilities needs, reviewed audit reports from other government agencies on real estate management, and met with real estate professionals in the private sector and government.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Appendix C: City Council Policies on Real Estate

Policy Number	Overview
700-03	Provides guidance for encouraging and making available unused City-owned land for youth sports organizations. The policy includes criteria for land use.
700-04	Sets eligibility guidelines for using buildings within Balboa Park. Included in this policy are specifics for the types of businesses that are eligible for tenancy.
700-10	Addresses disposition of City-owned property and establishes procedures for leasing or sale of the property. Specifies that it is the City's intent to manage property for City needs, not to speculate in real estate. It also addresses broker requirements, lessee selection, rate-of return, setting rental rates and market rate adjustments.
700-12	Establishes guidelines for the disposition of City-owned property to nonprofit organizations in areas other than Balboa Park and Mission Bay Park. The policy sets specific criteria related to land, discount exceptions, lease costs, and City Council involvement/approval requirements.
700-21	This policy sets forth usage allowance and fee guidelines for the use of the San Diego Stadium.
700-22	Establishes ticket policy for Qualcomm Stadium, PETCO Park and other City entertainment. The purpose of this policy is to establish conformance policies with section 18944.1 of the California Code of Regulations.
700-32	Allows for the acquisition of real property from private residents, including actions of eminent domain. Specifies that the City should, to the greatest extent possible, adhere to California Government Code section 7260 through section 7267 (Relocation Assistance).
700-41	Aims to insure that the use of a Request for Proposal (RFP) for leasing City-owned land is open, competitive and consistent with the best interest of the City. Addresses utilization of the RFP process, advertisement, and criteria for lease selection when the RFP process is used.

## Appendix D: Significant Reports on City Real Estate

The following is a list of memoranda and reports concerning the construction of a new city hall or related topics. This list is not comprehensive, but it represents significant documents that we reviewed in our audit work.

Report Title	Author	Date	Description
<i>Facilities Needs Assessment For A New Downtown Civic Center</i>	Gensler Architects	April 2008	Facilities needs assessment to support the possible development of a new Civic Center and Mixed-Use Complex.
<i>Facilities Condition Assessment - San Diego Civic Center Complex</i>	DMJM H&N	April 2008	Facilities condition assessment for five buildings in downtown: City Administration Building, City Operations Building, Civic Center Exhibition Building, Parkade Parking Garage, and Civic Center Plaza.
<i>Alternative Scenarios to Redevelopment</i>	Jones Lang LaSalle	December 2008	Alternative occupancy scenarios with cost estimates, including renovation and rehabilitation costs for City-owned buildings.
<i>Analysis of the Jones Lang LaSalle Civic Center Development Analysis</i>	Ernst & Young	March 2009	Peer review of the Jones Lang LaSalle report.
<i>Updated JLL Civic Center Development Models</i>	Councilmember Carl DeMaio	April 2009	Memo to CCDC urging a reevaluation of figures and assumptions in the JLL report.
<i>Updated Civic Center Complex Financial Projections</i>	Center City Development Corporation	May 2009	Response from CCDC to Councilmember DeMaio.
<i>Additional Concerns Regarding New City Hall Project</i>	Councilmember Carl DeMaio	May 2009	Memo to CCDC urging a reevaluation of figures and assumptions in the JLL report.
<i>Civic Center Redevelopment Proposal</i>	Irving Hughes	May 2009	Analysis by a private firm challenging some of the assumptions and figures in the Jones Lang LaSalle report.

Report Title	Author	Date	Description
<i>CCDC-09-14</i>	Center City Development Corporation	September 2009	Staff report recommending the authorization of an exclusive negotiation agreement between the City and Gerding Edlan.
<i>A New City Hall: To be, or not to be? That is the question....</i>	San Diego County Grand Jury	May 2011	Report with five findings and six recommendations regarding the construction of a new city hall.
<i>Proposed Response to Grand Jury Report Titled "A New City Hall: To be, or not to be? That is the question...."</i>	Office of the Independent Budget Analyst <sup>12</sup>	October 2011	Required City Council response to the Grand Jury report.
<i>The City of San Diego Facilities Strategies Plan</i>	Gensler Architects	September 2012	Assessment of City-wide facilities needs.

<sup>12</sup> Prepared with assistance from Centre City Development Corporation and input from the Mayor's Office and the City Attorney's Office.

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## Appendix E: Management's Response

The Real Estate Assets Department (READ) is in receipt of the City auditor's draft audit report. The report contains four recommendations listed below.

1. READ should update its Portfolio Management Plan to insure that it meets the City's changing needs.
2. READ should prepare market and financial analyses for the City Administration and City Council to reduce leased office space and move a portion of the City's workforce out of downtown to less expensive office space.
3. READ should improve its performance goals by establishing measures, targets, outcomes and outputs for each goal. READ should also annually report its performance and achievements.
4. READ should work with the Administration and the City Council to draft a policy on rent subsidies to nonprofit organizations that establishes eligibility criteria for recipients, recovers the City's costs for facilities maintenance and upkeep of the subsidized space, as well as the costs of preparing, processing and monitoring leases.

**The following is READ's response to the Auditor's recommendations:**

### **Recommendation 1:**

**READ should update its Portfolio Management Plan to insure that it meets the City's changing needs.**

### **Agree:**

In 2010, READ produced a comprehensive Portfolio Management Plan (PMP) that described the City's extensive real estate portfolio; the four core business of the department; and the management structure that was put in place to administer those functions. Also included in the report was a list of the department's accomplishments, as well as transactions currently ongoing, and future goals for each of the core business units. Like any plan, the PMP requires periodic updating. READ plans to have an update for the PMP available by the beginning of FY-2014, July 1, 2013.

While READ agrees with the Audit Report that the Portfolio Management Plan should be updated periodically, we disagree with the statement in the Report that it "...READ has not made much progress in improving the utilization efficiency of leased downtown office space..." Despite the City being locked into long term lease contracts that have created the inefficiencies referenced by the Auditor, READ has managed to lower the City's yearly rent budget from \$14 million to \$12.2 million (approximately 13% savings). These savings were

accomplished by relocating departments from leased space to City- owned space; taking advantage of surrender provisions in existing leases; subleasing; and negotiating a new lease for the Family Justice Center. In addition, READ will soon be implementing a Facility Strategies Plan which outlines a number of methods by which the City can significantly reduce its need for office space.

**Recommendation 2:**

**READ should prepare market and financial analyses for the City Administration and City Council to reduce leased office space and move a portion of the City's workforce out of downtown to less expensive office space.**

**Partially Agree:**

READ is in complete agreement with the Auditor that all lease or acquisition transactions receive a through financial analysis when presented to the City's Administration and Council. However, without a full investigation of the real estate market and determining the total cost of occupancy, it would be premature to determine where City employees would best be located.

As noted above, the City is now in possession of a strategic plan for housing the City workforce. The goal of the plan is to reduce the City's need for office space from its current 330 square feet per employee to 225 square feet per employee. To accomplish this, the plan employs four strategies:

- Standardizing offices, workstations and furniture
- Consolidating small vacancies in existing spaces, vacating unused spaces and negotiating new leases
- Redeveloping City- owned facilities to increase densities
- Acquiring facilities to replace leased space when cost effective

Currently, most of the City's employees who occupy office space are located downtown. Maintaining them in their current location has a dual advantage of proximity to City Council and public transportation. While the buildings that the City currently occupies are inefficiently configured, their efficiency can be improved significantly by constructing tenant improvements that reflect the City's new office space standards. Ultimately, a financial analysis that takes into account the total cost of occupancy will advise the City's decision makers where to house its staff.

**Recommendation 3:**

**READ should improve its performance goals by establishing measures, targets, outcomes and outputs for each goal. READ should also annually report its performance and achievements.**

**Disagree:**

Real Estate as an asset class differs from stocks, bonds and other investments in that each property has unique qualities that make it different from other properties. Because each property is unique, transactions involving properties are also unique. The City has a very diverse real estate portfolio. It is the diversity of the portfolio and the uniqueness of the transactions that make meaningful performance standards virtually impossible. Real Estate transactions are also unpredictable. They are unlike other business transactions where outcomes are standardized and have predictable time elements. Many times a seemingly simple transaction with a low monetary value can become extremely complex and time consuming. A good example of this is the lease the City recently negotiated with the owners of Carlton Oaks golf course which took four years to consummate. It initially started as a sale transaction, but at the direction of Council, ultimately became a lease.

Layered on top of unpredictability of the transactions are the vagaries of the real estate market. For example, a goal may be established to sell a certain number of properties a year for a certain total value. If the real estate market takes a severe downturn, as it did in 2008, it would be imprudent to attempt to meet this goal because the City would not realize the full value of the properties it sold.

Currently, READ informs Council of its output in three ways. The Portfolio Management Plan lists the department's major transactions and accomplishments when it is updated. The department's yearly budget document tracks lease revenues as well as service efforts and accomplishments. Finally every property sale and lease transaction with a term of over three years requires the approval of City Council. We believe that this is an appropriate level of reporting.

**Recommendation 4:**

**READ should work with the Administration and the City Council to draft a policy on rent subsidies to nonprofit organizations that establishes eligibility criteria for recipients, recovers the City's costs for facilities maintenance and upkeep of the subsidized space, as well as the costs of preparing, processing and monitoring leases.**

**Partially Agree:**

The City has approximately 125 leases with non-profit organizations. These groups typically pay significantly below market rents (approximately \$3200/yr) which is used to defray the expenses associated with the issuance and administration of these leases.

Currently, Council Policy 700-12 provides the guidelines that govern the issuance of these agreements. The below market rents are justified by the premise that the non-profits are providing benefits to the citizens of San Diego that would normally cost the tax payers.

READ believes that a review and possible revision of CP 700-12 could be beneficial. However, the determination as to which non-profit groups should qualify for less than market rents and criteria for their selection is a polity decision. Since READ is an implementer of policy and not a maker of policy, READ believes that it is not the right group to spearhead this effort.

Should the Council choose to amend CP 700-12, the logical way to do it would be to assemble a task force consisting of members of City Council, the Mayor's staff, prominent member of the non-profit community and other stake holders to address the myriad of issues surrounding this and formulate recommendations that meets the needs of all of the concerned parties. We believe that READ should rightfully be a part of this task force, but should not be the leader of this effort. READ is also aware that the Council President is reviewing council policies. Should CP700-12 be chose for review as part of this initiative, READ would be a willing participant in the process.