
PERFORMANCE AUDIT OF THE CITY'S LEASE MANAGEMENT AND RENEWAL PROCESS

Finding 1: The City allows a much higher share of leases to remain in holdover than other jurisdictions, which may be leading to foregone revenue for the City and potential or perceived favoritism.

Finding 2: DREAM should improve its lease management practices, particularly to protect the City from liability, verify that lessees are utilizing leased property appropriately, and ensure that rent levels align with market conditions.

Finding 3: DREAM should work with the City Attorney's Office to develop a lease template to streamline the lease renewal process and ensure that the appropriate provisions and clauses are included in leases.

**Office of the
City Auditor**

City of San Diego



Performance Audit of the City’s Lease Management and Renewal Process

Why OCA did this study

The Department of Real Estate and Airport Management (DREAM)—formerly known as the Real Estate Assets Department (READ)—manages the City of San Diego’s (City) real estate portfolio for City departments, including the administration of more than 800 properties owned by the City that are leased to third parties. These properties generate more than \$80 million in income for the City per year and provide opportunities for the City to leverage properties and lease them to tenants who provide cultural and community-based services. Therefore, effectively managing the leasing out of City-owned property is essential to maximize the City’s revenues and ensure the best use of the City’s assets.

What OCA found

Finding 1: The City allows a much higher share of leases to remain in holdover than other jurisdictions, which may be leading to foregone revenue for the City and potential or perceived favoritism.

Best practices generally discourage lease holdovers. By allowing leases to fall into and remain in holdover, the City may be losing out on potential revenue that could be generated from appraising a property and renewing or entering into a new lease with the current tenant at current market value, or by entering into new tenancies using a competitive bidding process. Additionally, the City may potentially be conferring an unfair benefit to the current tenant, creating unnecessary uncertainty for both the City and lessees, and limiting the City’s ability to enact and enforce updated contract provisions.

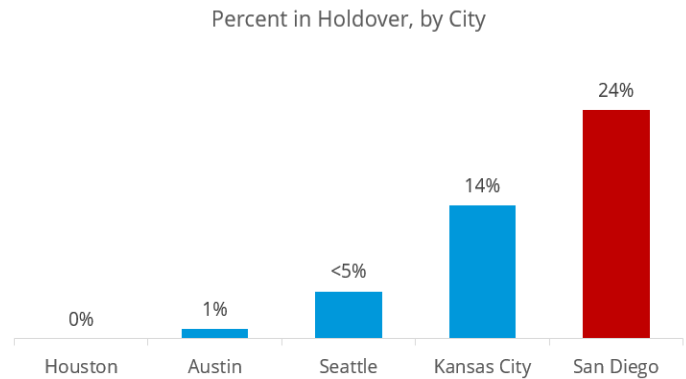
We found the City has made little progress on addressing the prevalence of lease holdovers since a Grand Jury report from 2017. Relevant Council Policies have not been updated, and the proportion of holdovers appears to be little changed—101 of 421 (24 percent) of active leases as of July 15, 2021 were in holdover, including many for over a decade.

In FY2016, DREAM established a key performance indicator (KPI) with a target of keeping holdovers under 20 percent of total lease agreements. In the FY2022 Adopted Budget, the target was increased to 25 percent.

Many of the real estate department managers from the cities we benchmarked against believe that in most cases, it is best to avoid leases falling into holdover. As shown in Exhibit 3 above, these cities’ proportions of leases in holdover appear to be significantly below 20–25 percent.

Exhibit 3

The City of San Diego Has a Much Larger Percentage of Active Lease Agreements in Holdover Than Cities We Benchmarked Against



Note: Jurisdictions may have different portfolio sizes and staffing levels, and may not calculate holdover percentage with the same methodology; figures were compiled using auditors’ best professional judgment and shown for the purpose of providing material comparison and context regarding the percentage of San Diego’s leases in holdover.

Source: OCA generated based on interviews with real estate department’s in cities identified for benchmarking.

We found several factors that are contributing to a high percentage of City leases falling into holdover, including:

- DREAM does not have a formal process for selecting which leases will be prioritized for renewal;
- DREAM is not proactively using its lease management system to initiate the lease renewal process far enough in advance;
- DREAM is not exercising or consistently including in contracts rent-based financial disincentives for holdover, reducing the incentive lessees have to renegotiate leases that are expiring; and
- DREAM appears to be significantly understaffed, limiting its ability to effectively oversee lease management and renewal.

DREAM did not have an estimate of how much revenue the City is foregoing by having so many holdovers. However, with more than 100 properties in holdover and DREAM’s property portfolio collecting approximately \$80 million in lease revenue annually, even a small percentage of undercharging due to holdover could result in potentially millions of dollars in foregone revenue for the City each year.

Finding 2: DREAM should improve its lease management practices, particularly to protect the City from liability, verify that lessees are utilizing leased property appropriately, and ensure that rent levels align with market conditions.

In addition to reducing holdovers, DREAM should ensure that leases throughout its portfolio are managed effectively. Consistent performance and documentation of key practices may mitigate risk of litigation for the City, reduce expensive problems with properties, reduce the risk of lost revenue, and prevent lost institutional knowledge as the City manages its vast property portfolio. However, as shown in Exhibit 6 below, we found that DREAM has not been consistently performing or documenting several important lease negotiation and management practices.

For example, only 23 percent of leases we reviewed had up-to-date insurance documented, increasing the City’s legal liability risk. In addition, while there is no clear-cut standard for the frequency of property inspections, we found that most of the City’s lease-outs we reviewed had gone years since their last documented inspection. DREAM should establish and enforce standards for more frequent inspections to help ensure compliance with lease terms and ensure that City properties are being maintained.

Exhibit 6

DREAM Should Improve Its Performance and Documentation of Key Lease Management Practices — See Each Key Lease Management Practice Below for More Information

Testing Metric	# of Leases that Met Testing Metric	Total Leases in Sample	% of Leases Reviewed that Met Testing Metric
Insurance up-to-date in information systems	7	31*	23%
Inspection(s) conducted from January 2019 – July 2021	10	32	31%
Rent adjustments according to terms	19	26**	73%
Appraisal or Statement of Value documented in information systems for leases renewed within past 5 years	11	14***	79%
Key dates entered into REPortfolio	29	32	91%
Any type of job manually entered in REPortfolio	30	32	94%

*One of the leases, a federal agency, is self-insured; thus DREAM does not track their insurance.

**Six of the leases in the judgmental sample are non-revenue leases, bringing the sample size down from 32 to 26.

***We supplemented our original sample by testing an additional 29 recently renewed leases to obtain these results; 14 were eligible for an appraisal under the San Diego Municipal Code.

Source: OCA generated based on information in DREAM’s REPortfolio and EDRS information management systems from July 15, 2021. For a list of all results see **Appendix C**.

Finding 3: DREAM should work with the City Attorney’s Office to develop a lease template to streamline the lease renewal process and ensure that the appropriate provisions and clauses are included in leases.

We also tested 31 leases from six different categories to identify if several key provisions were included within these contracts. Provisions tested included commencement and termination dates, rental amounts and increases, and others.

Overall, we found that most key provisions were included in all or nearly all of the leases we reviewed. One exception was that financial disincentives for holdover were included in only 61 percent of the leases we reviewed, which we identified as a possible contributing factor to the high number of holdovers discussed in Finding 1.

While DREAM generally includes fundamental contract provisions, not consistently utilizing standard templates creates the risk of other updated clauses being left out or becoming outdated, which may cause legal liability for the City according to the City Attorney’s Office. Incorporating the use of lease templates and an up-to-date database of lease clauses can mitigate potential legal liability concerns and save DREAM and the City Attorney’s Office time during the renewal process.

What OCA recommends

We make 14 recommendations to address the issues outlined throughout the report.

Key recommendation elements include:

- Documenting and executing a strategy for addressing the number of lease holdovers in the City’s portfolio;
- Utilizing financial disincentives or market-rate adjustments where appropriate and including these clauses in new leases;
- Leveraging process improvements, such as automated reminders and increased notice time to tenants that may soon be entering holdover status;
- Re-evaluating staffing levels needed for addressing the high number of holdovers and performing other lease management and renewal functions;
- Establishing, communicating, and enforcing productivity standards or goals for lease management practices such as property inspections, appraisals, and ensuring up-to-date insurance;
- Documenting and publicly-presenting a listing of all City lease outs, their estimated market value, and their actual rent paid to the City; and
- DREAM working with the City Attorney’s Office to create a master lease template(s) and lease clause database.

DREAM agreed to all 14 recommendations. For more information, contact Andy Hanau, City Auditor at (619) 533-3165 or CityAuditor@sandiego.gov



THE CITY OF SAN DIEGO

February 9, 2022

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

Transmitted herewith is a performance audit report of the City's lease management and renewal process. This report was conducted in accordance with the City Auditor's Fiscal Year 2022 Audit Work Plan, and the report is presented in accordance with City Charter Section 39.2. Audit Objectives, Scope, and Methodology are presented in Appendix B. Management's responses to our audit recommendations are presented starting on page 50 of this report.

We would like to thank staff from the Department of Real Estate and Airport Management 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 Niki Kalmus, Shadi Matar, Nathan Otto, and Kyle Elser.

Respectfully submitted,

City Auditor

cc: Honorable City Attorney, Mara Elliott
Jay Goldstone, Chief Operating Officer
Alia Khouri, Deputy Chief Operating Officer
Christiana Gauger, Chief Compliance Officer
Kristi Geitz, Deputy Director, Compliance Department
Heather Ferbert, Chief Deputy City Attorney
David Karlin, Senior Deputy City Attorney
Charles Modica, Deputy Director, Office of the Independent Budget Analyst
Matt Yagyagan, Deputy Director of Policy, Office of the Mayor



OFFICE OF THE CITY AUDITOR
600 B STREET, SUITE 1350 • SAN DIEGO, CA 92101
PHONE (619) 533-3165 • CityAuditor@sandiego.gov

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Background

The City's real estate portfolio includes City-owned properties that are leased out to other tenants.

The Department of Real Estate and Airport Management (DREAM)—formerly known as the Real Estate Assets Department (READ)—manages the City of San Diego's (City) real estate portfolio for City departments, including the administration of more than 800 properties leased to third parties. These properties generate more than \$80 million in income annually and provide opportunities for the City to leverage properties and lease them to tenants who provide cultural and community-based services. Therefore, effectively managing the leasing out of City-owned property is essential to maximize the City's revenues and ensure the best use of the City's assets.

DREAM's Fiscal Year 2022 Budget states three goals relevant to lease management and holdovers. They are:

- Goal 1: Maximize revenue and overall benefit of the City's real estate assets
 - Secure maximum revenue due to the City for leasehold agreements
 - Ensure the best return for the City through long-term agreements where appropriate
- Goal 3: Support the real estate needs of City departments in an effective and timely manner
 - Provide high-quality valuation and consulting services in a timely manner when requested
- Goal 4: Enhance information management about the City's real estate assets decision-making initiatives
 - Inform decision makers regarding the state of the City's real estate assets
 - Publish and enhance open data regarding the City's real estate assets on the City website

What is a lease holdover?

A holdover occurs when a tenant continues to occupy and use the leased premises after the agreement term ends. If the landowner continues to accept rent payments, the holdover tenant can continue to legally occupy the premises. If holdover occurs, and if a new lease is not negotiated, the agreement's

terms remain in effect. Some leases stipulate that such holding over may revert to a month-to-month tenancy, often at a higher rent.

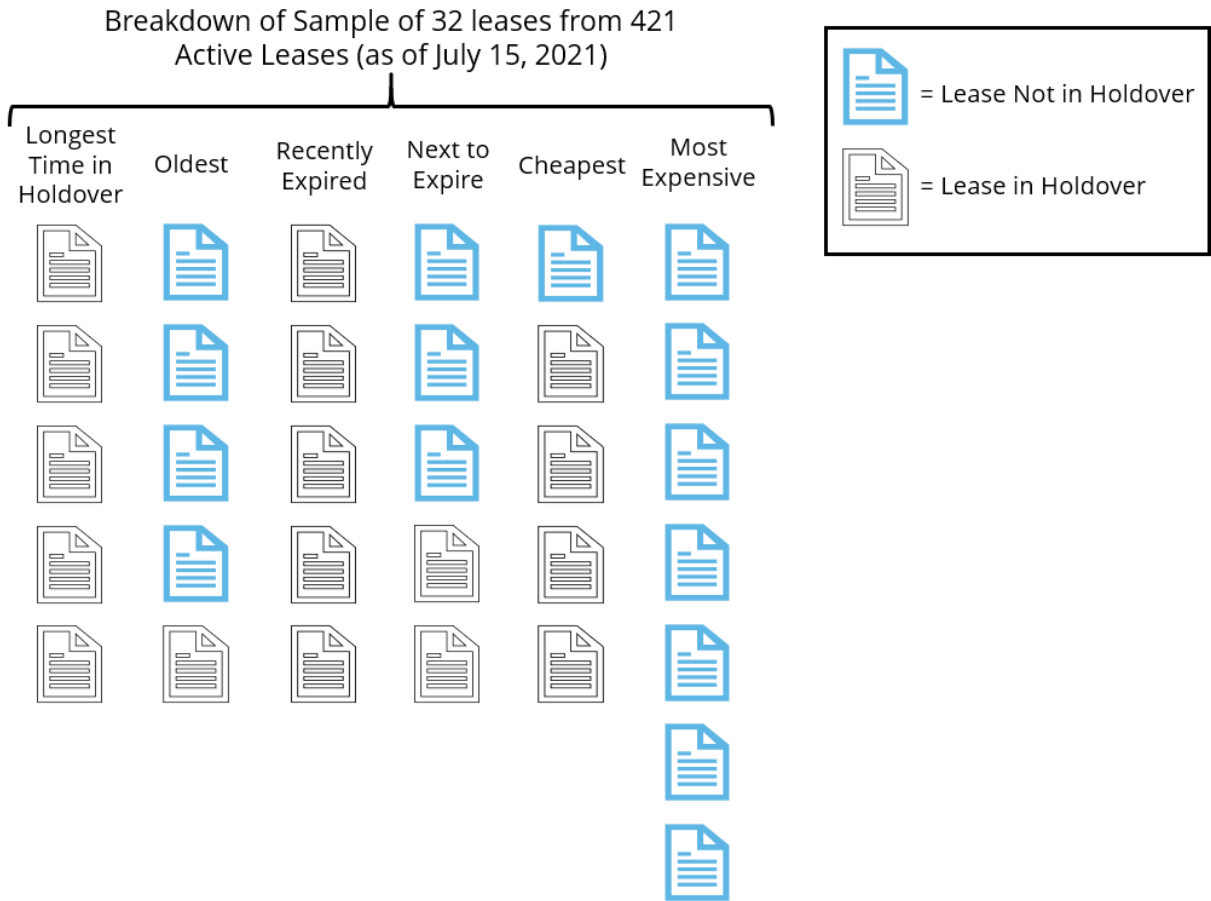
Since part of avoiding holdovers successfully would include proactive and effective lease management, our scope included testing a sample of leases throughout the City's portfolio. Specifically, our scope included 421 leases that were in DREAM's portfolio of active lease agreements as of July 15, 2021.¹ We selected a judgmental sample of 32 lease agreements out of the 421 leases in DREAM's portfolio from various categories and lease types for testing—including both known holdovers and other categories of higher-risk leases.² These categories included: leases that were the oldest in holdover, overall oldest leases, leases that had recently expired, leases that were due to expire next, the cheapest leases, and the most expensive leases. As shown in **Exhibit 1** below, of these 32 leases, 17 were in holdover as of the time the data was extracted from DREAM's information management systems. The 32 leases also represent both revenue leases, where the lessee pays rent to the City, and non-revenue leases, where the City and a lessee have a lease agreement but the lessee does not pay rent.

¹ Since DREAM also has agreements that are negotiated as month-to-month leases initially, those leases are distinct from a lease that now operates on a month-to-month basis after going into holdover. We also excluded licenses, permits, franchises, operating agreements, and subleases, and reviewed only agreements that DREAM classifies in its information system as "leases."

² For more information on these categories and lease types see Finding 1 and Finding 2. Our sample size of 32 was selected based on our professional judgment of the number of different leases we could realistically test given our finite project resources across the six different categories of leases.

Exhibit 1

We Selected a Judgmental Sample of 32 Leases Across Six Different Categories, Including Both Leases in Holdover and Other Active Leases Not Yet in Holdover



Note: We tested several additional leases from the Most Expensive leases category as we judged it to be a higher risk category.

Source: OCA generated based on REPortfolio data.

Leases can be renewed to avoid going into holdover.

Leases are contracts which define the rights and responsibilities of the landlord and the tenant with respect to the leased property. According to DREAM management, when a lease is approaching its expiration date, DREAM determines if the property is needed for City business and if leasing to the tenant continues to be a good use of the property. If the use by the tenant is still proper, depending on the lease type, the City and the tenant should either negotiate a renewal or a new lease, or the City should start a competitive solicitation process inviting

proposals from qualified firms or individuals to lease City-owned real property.

DREAM tracks its portfolio of leases in two different information management systems.

DREAM records and tracks its portfolio of leases in its information management systems called REPortfolio and the Electronic Document Retrieval System (EDRS). EDRS is where documents are scanned and stored, while REPortfolio is where DREAM staff can record notes, track billing, run reports, and store lessee contact information. Staff can also click a button in REPortfolio to go directly to the lease agreement and correspondence stored within EDRS.

We requested and gained access to these systems and used information documented within as the basis for our results and conclusions. We interviewed DREAM to seek clarification regarding the data, compared data between the systems, and met virtually with DREAM several times to review our results and discuss whether our results appeared plausible based on DREAM's operational knowledge of the City's lease management. Throughout this report we also make efforts to note that our results are based on information documented within these systems. For more information regarding data reliability and our scope and methodologies see **Appendix B**.

DREAM property agents regularly work with the City Attorney's Office in drafting lease agreements.

As of late 2021, three full time Deputy City Attorneys work with DREAM on lease agreements. According to DREAM property agents, when DREAM is seeking to enter into a new or renewed lease, a Legal Service Request (LSR) to the City Attorney's Office is initiated by the property agent. Both the assigned attorney and property agent work to incorporate the appropriate lease terms and update legal clauses. According to the City Attorney's Office, these LSR's require a 30-day time period for the lessees to respond back to the proposed lease contract, which can also add delays. The amount of time that the City Attorney's Office works on a lease with the department varies depending on the complexity of the lease.

Prior recommendations remain outstanding from past reports related to lease renewals and holdovers.

The City's management of its owned and leased properties has been the subject of several recent reports by both the Office of the City Auditor (OCA) and the San Diego County Grand Jury. These reports focused on the City's overall portfolio management, as well as staffing capabilities, and the major building acquisition process; they are referred to throughout this report where relevant and are hyperlinked below for reference.

Overall, between the four OCA reports³ listed, we have made a total of 20 recommendations—5 have been implemented and 15 remain to be implemented. In addition, the Grand Jury made 3 recommendations—1 has been implemented, 1 remains to be implemented, and 1 will not be implemented.

- [OCA report 13-009, 2012: Performance Audit of the Real Estate Assets Department: The Department Should Update Its Portfolio Management Plan⁴ and Improve Its Performance Measures to Meet the City's Needs](#)
 - Highlighted the City's need to update Council Policy 700-12 relating to rent subsidies to nonprofit organizations.

- [San Diego County Grand Jury, 2017: City of San Diego's Real Estate Assets Department Leasehold Management Has Weaknesses](#)
 - Highlighted the large percentage of holdover leases and recommended providing resources to DREAM to develop a proactive strategy for bringing held-over nonprofit and for-profit leases current, and for Council Policies 700-10 (procedures for leasing and sale of property) and 700-12 to be revised and updated.

- [OCA report 19-002, 2018: Performance Audit of the Real Estate Assets Department's Portfolio Management Practices: Opportunities Exist to Improve the City's Real](#)

³ DREAM was formerly called the Real Estate Assets Department.

⁴ The Portfolio Management Plan is produced by DREAM to enable the City's management and policymakers to have a better understanding of the City's real estate assets and how they can be best utilized to benefit the citizens of San Diego.

[Estate Data Tracking and Communication of the Property Portfolio](#)

- Highlighted the importance of a publicly presented and transparent Portfolio Management Plan, and updating Council Policy 700-10.

- [OCA report 21-012, 2021: Performance Audit of the Mission Bay And San Diego Regional Parks Improvement Funds, Fiscal Year 2020](#)
 - Found that on-site monitoring of the leaseholds on Mission Bay Boundary lands had not been completed throughout much of 2020 due to the loss of a full-time position as well as due to COVID-19 restrictions.

- [OCA report 22-002, 2021: Performance Audit of the City's Major Building Acquisition Process](#)
 - Most of the report focused on real estate acquisition, but it also highlighted inconsistent use of appraisals and recommended more systematic internal control procedures, such as the use of checklists.

Audit Results

Finding 1: The City allows a much higher share of leases to remain in holdover than other jurisdictions, which may be leading to foregone revenue for the City and potential or perceived favoritism.

Best practices from the U.S. Government Accountability Office (GAO), generally discourage lease holdovers. By allowing leases to fall into and remain in holdover, the City may be losing out on potential revenue that could be generated from appraising a property and renewing or entering into a new lease with the current tenant at current market value. Alternatively, the City could be losing out on additional revenue that could be generated by entering into new tenancies using a competitive bidding process. These concepts are illustrated in **Exhibit 2** below.

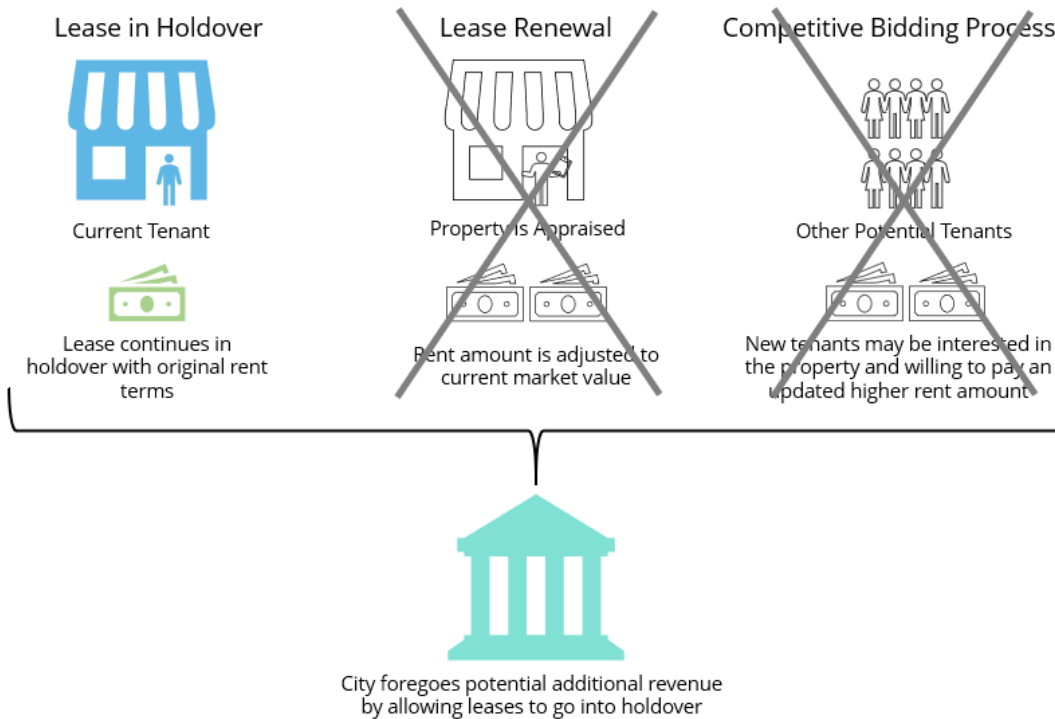
Additionally, the City may potentially be conferring an unfair benefit to the current tenant, while disadvantaging all other potential tenants of the site—particularly if the City is not charging competitive or appropriate rents. The occupying tenant may be one of several possible candidates for a given City lease.

Furthermore, allowing excessive holdovers can also create uncertainty for both the City and lessees. Holdovers can cause problems regarding budgeting, refinancing, and/or identifying suitable new tenants. Being in holdover may also delay or disincentivize completion of general maintenance and potential tenant improvements to City property due to the uncertainty faced while in holdover.

Finally, a large number of agreements in holdover for extensive periods of time can limit the City's ability to enact and enforce updated contract provisions. The City can generally only enforce contract/clauses signed in the original lease, and cannot update lease clauses while agreements are in holdover without a renewal or amendment.

Exhibit 2

Holdover Leases, Lease Renewals, and Competitive Bidding Processes Can Lead to Different Amounts of Revenue When the City Leases Out Its Property



Source: OCA generated based on interviews with DREAM and review of lease renewal revenue.

We found the City has made little progress on addressing the prevalence of lease holdovers since a 2017 Grand Jury report made recommendations to address the issue.

A 2017 Grand Jury investigation of the City's leasehold management found that 125 out of more than 500 leases (about 25 percent) of City-owned properties had expired and were continuing on a month-to-month basis in holdover, many in a state of holdover for a decade or more. The Grand Jury recommended that resources be directed to DREAM (then referred to as the Real Estate Assets Department) to develop a proactive strategy for bringing holdover leases current. The Grand Jury also recommended that Council Policies 700-10⁵ and 700-12⁶ be revised and updated.

⁵ Council Policy 700-10 contains guidelines for the management of City-owned real estate. It was last revised in December 2012.

⁶ Council Policy 700-12 contains guidelines for the disposition of City-owned property to non-profit organizations. It was last revised in April 1985.

More than four years later, we found that these Council Policies have not been updated, and the proportion of leases in holdover appears to be little changed—101 of 421 (24 percent) active leases as of July 15, 2021 were in holdover,⁷ according to their reported status in DREAM's information systems.⁸ Of those leases, 26 had been in holdover status for a least a decade, and 10 had been in holdover since 2001. For example, we found one lease in holdover with an effective date from 1957—more than 60 years ago—and a scheduled termination/holdover date of November 4, 2007. While some holdovers may occur due to competing operational priorities, a high number of holdovers can be problematic, as discussed further below.

The percentage of City lease agreements with tenants in holdover appears to be significantly higher in the City of San Diego than in other cities we benchmarked against.

Best practices⁹ and the GAO generally discourage holdovers though they do not prescribe a set percentage limit for a portfolio. In FY2016, DREAM established a key performance indicator (KPI) with a target of keeping holdovers under 20 percent of total lease agreements; according to DREAM, this target was in alignment with industry practices at the time. However, DREAM was not able to provide these industry practices to us. In the FY2022 Adopted Budget, the target was increased to 25 percent.

Many of the real estate department managers from the cities we benchmarked against believe that in most cases, it is best to avoid leases falling into holdover. As shown in **Exhibit 3** below, these cities' proportions of leases in holdover appear to be significantly below 20–25 percent—the targeted level according to DREAM's KPI. The cities of Houston and Austin reported 0 percent and 1 percent of their portfolios to be in holdover, respectively, for example. The City of San Jose reported having

⁷ As of July 15, 2021, when OCA extracted sample data from REPortfolio, DREAM had 421 active lease agreements. OCA excluded licenses, permits, franchises, operating agreements, subleases, and month-to-month leases, and reviewed only agreements that DREAM classifies in its information system as "leases." The Grand Jury does not specify their sample parameters.

⁸ As we were completing this audit, DREAM stated that one of the properties we had identified as a holdover, using its systems data, had in fact been renewed in 2019 and had just not been updated in DREAM's systems. We note that our calculated holdover percentage of 24 percent as of July 2021 is very close to what DREAM has reported out in its department budget in recent years: e.g., 23 percent in FY2020 and 28 percent in FY2021.

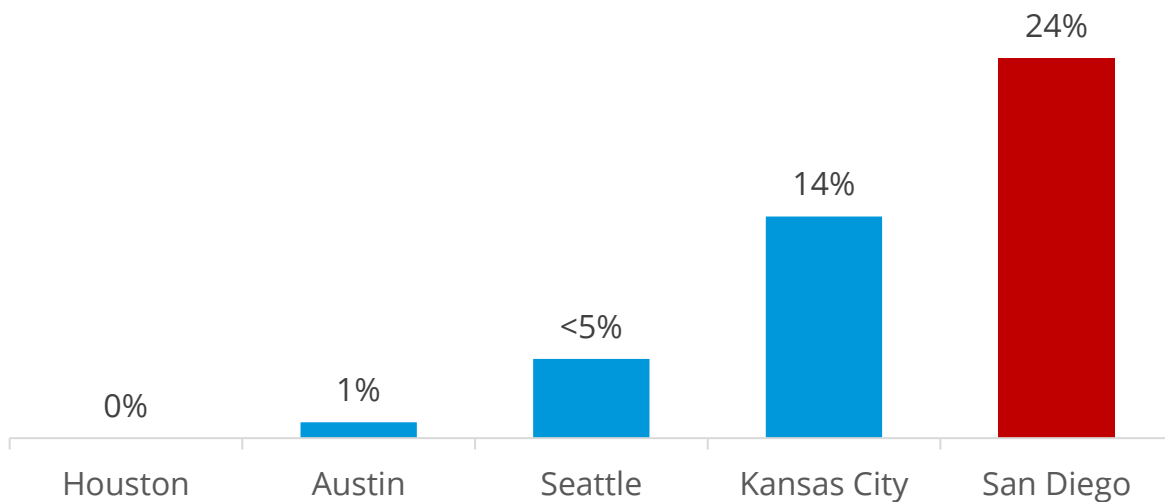
⁹ According to the real estate department managers from the cities we benchmarked against.

no commercial leases in holdover, and stated that property agents must be able to explain how allowing a lease to enter holdover is aligned with their property management goals. Property managers in San Jose stated that too many holdovers may imply portfolio mismanagement.

Exhibit 3

The City of San Diego Has a Much Larger Percentage of Active Lease Agreements in Holdover Than Cities We Benchmarked Against

Percent in Holdover, by City



Note: Jurisdictions may have different portfolio sizes and staffing levels, and may not calculate holdover percentage with the same methodology; figures were compiled using auditors' best professional judgment and shown for the purpose of providing material comparison and context regarding the percentage of San Diego's leases in holdover.

Source: OCA generated based on interviews with real estate department's in cities identified for benchmarking.

Several factors are contributing to a high percentage of City leases in holdover status.

We found several factors that are contributing to a high percentage of City leases falling into holdover, including:

- DREAM does not have a formal process for selecting which leases will be prioritized for renewal;
- DREAM is not proactively using its lease management system to initiate the lease renewal process far enough in advance;

- DREAM is not exercising or consistently including in contracts rent-based financial disincentives; and
- DREAM appears to be significantly understaffed, limiting its ability to effectively oversee lease management and renewal.

DREAM does not have a formal process for selecting which leases will be prioritized for renewal.

Notably, we found that all 7 of the highest-value leases in our sample were current and not in holdover according to DREAM's systems. However, looking at the portfolio of 421 lease agreements, of the 46 leases that bring in more than \$100,000 in revenue annually for the City, 12 (26 percent) were reported as in holdover. This number is similar to DREAM's overall holdover rate throughout its portfolio, and therefore appears to point to a lack of a formal process for selecting which leases will be prioritized for renewal.

Not having a prioritization process for leases in holdover increases the risk of and perception of potential favoritism, particularly when some leases have been in holdover for many years with no definitive plan to be addressed. DREAM acknowledged that political support can be a factor in determining which leases to focus on for renewal. To mitigate the risk of and perception of potential favoritism, DREAM should determine a mechanism for selecting which leases will be prioritized for renewal to include leases that have been in holdover the longest.

DREAM is not proactively using its lease management system to initiate the lease renewal process far enough in advance.

One potential way to avoid holdover is to communicate with tenants well in advance of renewal to ensure that they know they need to renew their lease or vacate the premises. According to the Institute of Real Estate Management (IREM), renewal discussions should commence at least 6 months prior to the lease expiration; for tenants of larger companies, renewal discussions should start 1–2 years prior to the lease expiration and, if both parties agree to renew the lease, the transaction should be completed months before the lease expires.

However, according to DREAM, its information system, REPortfolio, only alerts property agents 90–120 days before the scheduled termination of a lease. This is far less time than the 6 months to 1 year that the City Attorney's Office recommends for

initiating lease renewal discussions, and we found no documented evidence that DREAM was notifying lessees of their upcoming scheduled termination after property agents received an alert. For example, our testing included five leases that were within 16 days to 2 months of expiration as of the time of testing (July 2021); we found that none of the five leases had evidence of DREAM contacting the lessee via letter, telephone, or email to alert them that the lease would soon go into holdover.

Best practices recommend utilizing electronic lease files to promote access to information and facilitate key tasks. However, we also found that DREAM lacks policies and procedures for using the REPortfolio system, and does not consistently leverage system capabilities to facilitate and monitor key lease management and renewal tasks. For example, REPortfolio has the ability to record "Jobs" with notes for additional information. Jobs are specific tasks recorded by staff and can range from rent adjustments and financial audits to site inspections, lease amendments, and correspondence with the lessee. One method that agents can use to indicate they are working on a lease renewal or are aware of holdover status is to add a Job related to the lease renewal/holdover. We tested 32 leased properties from six different categories¹⁰ to identify the extent to which Jobs were being recorded by DREAM property agents. For lease agreements that had ever had a renewal, extension, or a holdover, we expected to find some documented information about that lease action in its record. However, we found that only 12 out of 25¹¹ (48 percent) eligible leases had a Job record that specifically pertained to a lease renewal, extension, or holdover. Therefore, DREAM should better utilize REPortfolio or another lease administration system to communicate about lease renewals farther in advance and to consistently record lease actions/Jobs.

¹⁰ These categories included: leases that were the oldest in holdover, overall oldest leases, leases that had recently expired, leases that were due to expire next, the cheapest leases, and the most expensive leases. We tested an additional 29 lease agreements that were renewed within the past five years (2016–2021). The leases were identified by generating queries from DREAM's information systems, REPortfolio and EDRS/DocuLynx.

¹¹ Of the 32 total leases in the sample, 7 leases had never been renewed, assigned, and/or in holdover in their lifetime and were removed from the testing sample.

DREAM is not exercising or consistently including in contracts rent-based financial disincentives.

The City should utilize financial disincentives as a mechanism to avoid holdovers unless there is a compelling reason not to. IREM cites the holdover provision in contracts as a motivating factor to encourage tenants to renew or vacate when the lease expires by including an increase in rent—anywhere from 1.5 to 4 times the last month's rent. This financial disincentive clause can motivate tenants to come to the negotiating table early to avoid paying more for being in holdover. The greater the rent increases during the holdover period, the greater the likelihood that the tenant will either agree to a lease renewal or vacate the premises.

DREAM management also expressed difficulties renegotiating some leases because lessees believe that they can maintain more favorable lease terms if they stall the process and go into holdover status. Utilizing a financial disincentive clause can motivate lessees to renew their lease rather than going into holdover at much higher rents.

However, as shown in **Exhibit 4**, only 19 of the sample leases that we reviewed included financial disincentives within the holdover clause. Additionally, of these 19 leases, we found 10 leases eligible for utilizing an agreed-upon disincentive by being in holdover for at least one month; however, none had exercised any disincentives in order to motivate tenants to renew or terminate the lease. DREAM stated that the reason many leases are in holdover is because of issues on the City's part, such as a lack of staffing, and that therefore it would not be reasonable for the City to exercise financial disincentives.

Exhibit 4

One-Third of the City Leases We Reviewed Did Not Contain Financial Disincentives and DREAM Did Not Appear to Utilize the Financial Disincentive Option

Testing Metric	# of Leases that Met Testing Metric	Total Leases in Sample	% of Leases Reviewed that Met Testing Metric
Number with financial disincentives in holdover clause	19	31*	61%
Number that used financial disincentives in holdover, if applicable	0	10**	0%

*One lease was removed from the 32 total leases used in testing for Finding 1 due to being a federal agency lease where the lease was provided to, rather than drafted by, DREAM.

**Agreements eligible for this sample were those in holdover longer than one month with financial disincentives included in the lease terms. Of the original 19 agreements with financial disincentives in holdover clauses, 9 were not in holdover at the time of testing and/or had just fallen into holdover within a week of testing.

Source: OCA generated based on information in DREAM's REPortfolio and EDRS information management systems as of July 15, 2021

DREAM appears to be significantly understaffed, limiting its ability to effectively oversee lease management and renewal.

The 2017 Grand Jury investigation and report recommended additional resources for what was then the Real Estate Assets Department to address the high number of leases then in holdover. While the City claimed the recommendation had been implemented in 2017, we found the department's staffing levels have since decreased. In the FY2022 Adopted Budget, DREAM had 28 budgeted positions; this is down from 34 positions in FY2017.

As shown in **Exhibit 5**, we benchmarked DREAM leases per property agent against several comparable jurisdictions, and found that DREAM appears to be significantly understaffed relative to other agencies. Therefore, DREAM should re-evaluate its staffing levels for its lease management practices to ensure the department can meet service demand and performance targets.

Exhibit 5

The City of San Diego Has a Significantly Higher Ratio of Leases per Property Agent Position Compared to Other Jurisdictions

Jurisdiction	Leases per Property Agent Position	Portfolio Size per Property Agent Position
City of San Diego	114 *	\$ 11,428,571
Port of San Diego	67**	\$ 9,211,111
County of San Diego	50*	\$ 1,000,000
San Jose	27 *	\$ 800,000
Kansas City	14 **	\$ 333,333

Note: Portfolio size figures are based on leasing program total revenue and do not reflect differences in revenue type.

* Calculation based on filled positions

** Calculation based on budgeted positions

Source: OCA generated based on benchmarking research and interviews with real estate department management in benchmark jurisdictions as of Summer 2021 (FY2022). City of San Diego figures are as of FY2022 Adopted Budget.

Allowing excessive holdovers can lead to multiple issues, including foregone revenue, increased risk of or perception of favoritism, uncertainty, and diminished ability for the City to add and enforce new contract provisions.

By allowing leases to fall into and remain in holdover, the City may be losing out on potential revenue due to not renewing or entering into new tenancies that could have gone through a competitive bidding process or been appraised and brought to market value. For example, we reviewed 11 agreements¹² that were appraised before renewing to the incumbent tenant. On average, the renewal of the 11 agreements resulted in an 11.0 percent increase in rent between the agreement pre-renewal and post-renewal. When a lease is renewed, rent theoretically should align with market rent at the time of renewal. Allowing a lease to go into holdover can prevent the base rent from aligning with the market; instead, rent will continue down whatever path is built into the lease while it is in holdover. This is important as DREAM has stated goals in its annual budget to “Maximize revenue and overall benefit of the City's real estate assets” and “Secure maximum revenue due to the City for leasehold agreements.”

¹² 8 of the 11 leases were in holdover at the time of renewal.

DREAM did not have an estimate of how much revenue the City is foregoing by having so many holdovers. However, with more than 100 properties in holdover and DREAM's property portfolio collecting approximately \$80 million in lease revenue annually, even a small percentage of undercharging due to holdover could result in potentially millions of dollars in foregone revenue for the City each year.

DREAM stated that some tenants know remaining in holdover may help them avoid new unfavorable terms, but in this case, the City may be potentially conferring an unfair benefit to the current tenant, while disadvantaging all other potential tenants of the site—particularly if the City is not charging competitive or appropriate rents. According to the *Guidebook on Real Property Asset Management for Local Governments*, “the income that the local government forgoes by renting property for below-market rent constitutes the indirect property-related subsidy that tenants of such premises obtain from the government.”

Most of the leases recorded as being in holdover the longest are to non-profit organizations.¹³ A case may be argued that many of these organizations provide public benefits to the City, and/or are responsible tenants. However, leases of City-owned land even to non-profits should be transparent and fair, and a responsible productive tenant can still be offered a renewed lease.

Allowing so many leases to be in holdover for long periods raises the risk of favoritism and potential unfairness. DREAM acknowledged that political will can play a notable role in prioritizing lease renewals, including those in holdover. See **Appendix E** for an individualized listing of properties included in our sample, including their rental amounts as listed in REPortfolio. In Finding 2 we include a recommendation that DREAM publicly present a listing of all City lease outs highlighting properties' market value compared to their actual rent collected.

Holdovers can also cause problems regarding budgeting, refinancing, and/or identifying suitable new tenants. Being in holdover may also delay or disincentivize completion of general

¹³ See **Appendix E** for an individualized listing of our testing results, including non-profit status.

maintenance and potential tenant improvements to City property due to the uncertainty that tenants face while in holdover. Additionally, if DREAM is not updating holdover status in its system, it makes it more difficult for the City to accurately identify its holdovers and to strategically manage its portfolio of properties.

Finally, a large number of agreements in holdover for extensive periods of time limits the City's ability to enforce updated contract provisions. The City can generally only enforce contract/clauses signed in the original lease, and cannot update lease clauses while agreements are in holdover. If the current lease management practices continue, and more leases enter holdover, contract language will need to be updated based on changing policies and could become outdated resulting in potential legal liability for the City according to the City Attorney's Office.

The City of San Diego likely faces additional future challenges regarding holdovers with the passage of the statewide Surplus Land Act (SLA).

As a result of California's Surplus Land Act (SLA), which went into effect in January 2020, the lease renewal process will take longer to complete due to a requirement that the site of lease renewals be considered for affordable housing. The City Attorney's Office estimates the SLA requirements will add an additional 6–8 months of processing time for a typical lease renewal whenever the SLA applies. DREAM property agents have stated that the SLA has already added more steps to their work and, according to DREAM management, the SLA could exacerbate the large number of holdovers going forward since the department will need to determine the legal status of many City properties.

In order to address the issues outlined in this finding, we recommend:

Recommendation 1

The Department of Real Estate and Airport Management (DREAM) should document and execute a strategy for addressing the number of lease holdovers in the City's portfolio, as appropriate. Elements of the strategy that should be considered include:

- a. Re-evaluating or removing the 25 percent Lease Holdover key performance indicator and replacing or supplementing it with an alternative goal relating to on-time lease renewals (such as number of lessees approaching holdover that were emailed a lease expiration reminder);
- b. Setting a target for completing the renewal of a certain percentage or number of leases which are currently in holdover;
- c. Determining a mechanism for selecting which leases will be prioritized for renewal, to include the leases with high potential foregone revenue and leases that have been in holdover the longest; and
- d. Completing or updating a policies and procedures manual for DREAM staff that provides guidance on the issues discussed in this finding, such as determining when property agents and DREAM staff should exercise financial disincentives, prioritizing leases for renewal, improving documentation and alerts within REPortfolio, etc.

(Priority 1)

Recommendation 2

Aside from developing a strategy and internal procedures, the Department of Real Estate and Airport Management should exercise existing financial disincentives or market-rate adjustments for below-market rate agreements for lease outs that have been in holdover for longer than five years or provide a written explanation for each property explaining why it is not doing so.

(Priority 2)

Recommendation 3

The Department of Real Estate and Airport Management should ensure that each new or renewed lease includes a financial disincentive clause regarding holdover status (for example, 150 percent or up to two times the last month's rent and/or market-rate rent for non-profits). The disincentive clause may be written such that the City only exercises the financial disincentive when appropriate.

(Priority 1)

Recommendation 4

The Department of Real Estate and Airport Management (DREAM) should prevent future leases from entering into holdover status by leveraging process improvements such as:

- a. Automated Reminders: 6 months to 2 years before the lease expiration, DREAM's lease administration system should alert a property agent to begin discussions with the tenant and notify them that the agreement is set to expire on a particular upcoming date and will fall into holdover unless the lease is amended, renewed, or terminated; and
- b. If applicable, the lessee should also be informed in writing that their rent may be raised while in holdover but that such a raise in rent can be avoided by renewing the lease prior to the lease expiration date.

(Priority 2)

Recommendation 5

To ensure the Department of Real Estate and Airport Management (DREAM) has the necessary staffing capacity to meet service demand and performance targets, DREAM should perform a staffing analysis to re-evaluate its staffing levels needed for addressing the high number of holdovers and for performing its lease management practices. This assessment could build on or integrate with Recommendation 1 from OCA's 2021 Mission Bay Audit pertaining to staffing resources. If additional resources are needed to address the findings and recommendations from these audits, DREAM should request additional resources accordingly.

(Priority 2)

Finding 2: DREAM should improve its lease management practices, particularly to protect the City from liability, verify that lessees are utilizing leased property appropriately, and ensure that rent levels align with market conditions.

In addition to reducing holdovers, the Department of Real Estate and Airport Management (DREAM) needs to ensure that leases throughout its portfolio are managed effectively. Consistent performance and documentation of key practices may mitigate risk of litigation for the City, reduce expensive problems with properties, reduce the risk of lost revenue, and prevent lost institutional knowledge as the City manages its vast property portfolio. However, we found that DREAM has not been consistently performing or documenting several important lease negotiation and management practices.

We examined 32 leased properties from six different categories to identify the extent to which several key lease management practices were being performed. The categories included not just leases in holdover, but also other categories of leases throughout the City's portfolio.¹⁴ The practices included: ensuring insurance information was up-to-date within DREAM's information systems, conducting inspections to ensure City-owned property was being properly used by tenants, ensuring rent adjustments were made over time according to lease terms, conducting appraisals to ensure City leases were set at competitive rates, and utilizing key capabilities of DREAM's information management system, such as Key Dates and task notes.¹⁵ Summary results are presented in **Exhibit 6** and detailed throughout the finding; further results are presented in **Appendices C and E**.

¹⁴ We used our professional judgment to select categories we believed might be higher risk, including: leases that were the oldest in holdover, overall oldest leases, leases that had recently expired, leases that were due to expire next, the cheapest leases, and the most expensive leases. We note that our results cannot be statistically extrapolated due to the nature of our judgmental sample, but believe they provide an indicator across a variety of different lease types in the City's portfolio.

¹⁵ Key Dates are set up manually by DREAM property agents in REPortfolio, and a report of Key Dates gets emailed to each agent weekly. Task notes are written in manually in the Jobs module in REPortfolio to add more detail to a Job. More detail is provided below in the Jobs and reminders section.

Exhibit 6

DREAM Should Improve Its Performance and Documentation of Key Lease Management Practices — See Each Key Lease Management Practice Below for More Information

Testing Metric	# of Leases that Met Testing Metric	Total Leases in Sample	% of Leases Reviewed that Met Testing Metric
Insurance up-to-date in information systems	7	31*	23%
Inspection(s) conducted from January 2019 – July 2021	10	32	31%
Rent adjustments according to terms	19	26**	73%
Appraisal or Statement of Value documented in information systems for leases renewed within past 5 years	11	14***	79%
Key dates entered into REPortfolio	29	32	91%
Any type of job manually entered in REPortfolio	30	32	94%

*One of the leases, a federal agency, is self-insured; thus DREAM does not track their insurance.

**Six of the leases in the judgmental sample are non-revenue leases, bringing the sample size down from 32 to 26.

***We supplemented our original sample by testing an additional 29 recently renewed leases to obtain these results; 14 were eligible for an appraisal under the San Diego Municipal Code.

Source: OCA generated based on information in DREAM’s REPortfolio and EDRS information management systems from July 15, 2021. For a list of all results see **Appendix C**.

The vast majority of lease agreements in our sample do not have up-to-date insurance documented, resulting in increased litigation risk for the City.

City lease agreements typically require lessees to maintain insurance during the entire duration of the lease. Maintaining up-to-date insurance certificates is important because it ensures that lessees have effective insurance coverage throughout the duration of the lease term.

Below is an example of an insurance clause used by the City:

“LESSEE agrees to take out and maintain during the entire term of this agreement, public liability insurance with an insurance carrier satisfactory to City... Such public liability and property damage insurance shall be maintained in full force and effect during the entire term of this lease.”

According to the City Attorney's Office, while most of the City leases are drafted to require the lessee to be responsible for all damages incurred, if a lessee does not have insurance (or has insufficient insurance because the lease provisions are outdated), and/or lacks the financial resources available to pay any damages, the City may end up responsible or may become involved in litigation that could have been avoided. Many of the City's lessees are non-profit organizations (19 percent of all active leases as of July 15, 2021) or small businesses that may be unable to secure the City against legal liability for their actions without adequate insurance. Thus, ensuring the lessees maintain the required insurance coverage may mitigate the risk to the City in case of a fire, someone is hurt on the premises, or other liabilities.

However, we found that only 7 out of 31—less than one-quarter—of the lease agreements in our sample had up-to-date insurance documented in either REPortfolio or EDRS; while this cannot be extrapolated due to the nature of our judgmental sample categories, it indicates that many City lessees may be out of compliance with their lease terms.

DREAM reported that it can be time-consuming to acquire updated insurance information from lessees, who may be unresponsive or not understand the request. This issue is exacerbated by the understaffing discussed in Finding 1; for example DREAM reports a backlog in scanning insurance documents into EDRS. According to DREAM property agents, they frequently have to make repeated requests for the lessee to send updated insurance certificates. Additionally, DREAM reported that insurance certificates often come directly from insurance companies, who may send certificates for former lessees; DREAM has to sort through the irrelevant insurance certificates to identify the ones they actually need, leading to additional time needed to ensure lessee insurance is up to date.

DREAM stated that some entities utilize a third-party agent who specializes in collecting and documenting up-to-date insurance; DREAM should also consider retaining a third-party agent or pursuing other efforts to improve its management of the process of collecting and reviewing insurance certificates.

Many of the City lease-outs we reviewed have gone years since their last documented inspection.

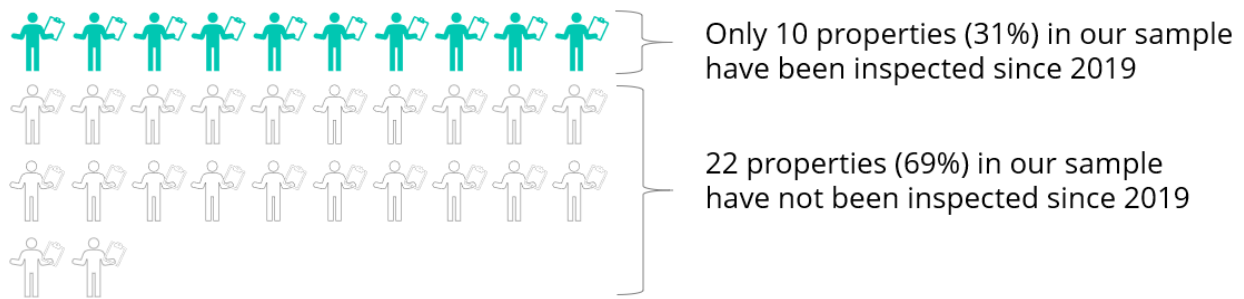
DREAM should inspect properties more frequently to prevent issues from becoming expensive problems or lawsuits.

City lease agreements often include an "Entry and Inspection" clause which allows the City the right to enter the premises for the purpose of viewing and ascertaining the condition of the property, or to inspect the operations conducted on the property. These visits are necessary to ensure compliance with lease terms and to ensure the property is being properly maintained.

From the Mission Bay Regional Parks Improvement Funds Audit for FY2020, OCA learned that on-site monitoring of the leaseholds on Mission Bay Boundary Lands had not been completed throughout much of 2020 due to the loss of a full-time position as well as due to COVID-19 restrictions. However, we found that this issue is more widespread than Mission Bay. As shown in **Exhibit 7** below, according to EDRS and REPortfolio, only 10 out of the 32 leases (31 percent) in our sample had a record of an inspection from January 2019 to July 2021.

Exhibit 7

Less Than One-Third of the Leases in Our Sample Had a Documented Inspection Since 2019

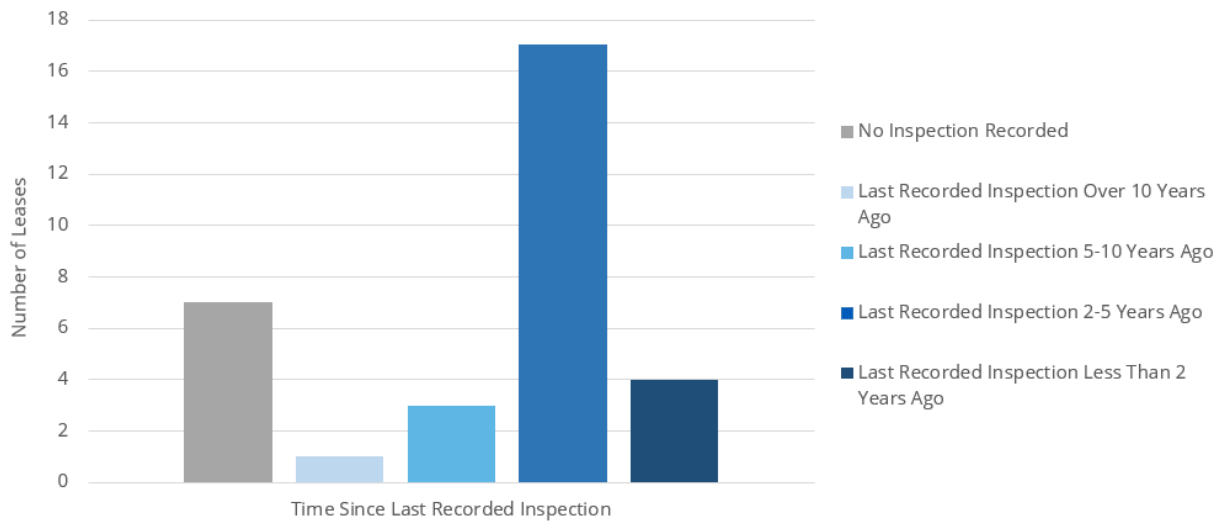


Source: OCA generated based on information in DREAM's REPortfolio and EDRS information management systems from July 15, 2021.

We found that the properties in our sample that had record of any inspection were only inspected on average once every three years over the period from September 2011 to March 2021, and as shown in **Exhibit 8**, 7 of the 32 properties in our sample had no record of any inspections at all over that period.

Exhibit 8

In Our Sample of 32 Leases, Many Properties Have Gone Years Since Their Last Documented Inspection and Many Had No Record of Any Inspection Date



Source: OCA generated based on information in DREAM's REPortfolio and EDRS information management systems from July 15, 2021.

DREAM stated that the lack of inspections was due to understaffing and property agents not having enough time to go into the field and inspect the properties in their individual portfolios, as well due to the recent global pandemic. Additionally, the property agents mentioned that due to their many duties and the slow rate of property alterations, inspections have become a lower priority.

DREAM also believes that site visits could be sufficient alternatives to inspections. However, DREAM lacks formal guidance and requirements for how often inspections and/or site visits should occur—according to property agents, the target is at least once a year, but DREAM management stated separately that that target was not realistic. Conducting timely inspections allows the City to assess the maintenance and upkeep of City property, potentially preventing small problems from becoming larger and/or more expensive problems. In addition, by conducting inspections, the City can be sure to enforce provisions contained in a given lease. For example, one of the leases in our testing sample, Campland LLC, was issued a notice of violation from the California Coastal Commission in

June 2020 for inappropriately restricting public access to Mission Bay. According to the Coastal Commission, these violations were occurring without the City's knowledge. We found that the last documented City inspection date for the property was December 2018.

Most rent adjustments we reviewed appeared to be exercised and in accordance with lease terms; however DREAM should create additional internal controls to verify that agreements are charged accurately and on time.

DREAM management stated that rent adjustments, which are increases in rent based on the agreed terms in the lease, are a top lease management priority; further, increasing lease revenue to the City has been a department objective per DREAM's Portfolio Management Plan¹⁶ and the FY2022 Budget. Council Policy 700-10 states, "The City shall obtain fair market rents for its leases commensurate with the highest and best use of the property." CP 700-10 also sets intervals and limits for rent adjustments. Lease agreement terms often contain required rent payments and minimum rent and/or percentage rent adjustments.

Revenue leases have scheduled rent adjustments that are recorded in REPortfolio. DREAM supervisors review the data entered into REPortfolio for accuracy. The City Treasurer is responsible for auditing percentage leases, but not for auditing flat-rate leases.¹⁷ In the active lease agreements as of July 15, 2021, DREAM had 309 flat-rate lease agreements out of 421 agreements (73 percent); this means that the City Treasurer's audit function does not cover the majority of the City's lease agreements.

As shown in **Exhibit 9** below, we found that DREAM accurately adjusted rent for 19 out of 26 of the leases in our sample.¹⁸ Our sample included 17 flat-rate leases and 9 percentage leases; all 7

¹⁶ The Portfolio Management Plan is produced by DREAM to enable the City Management and policymakers to have a better understanding of the City's real estate assets and how they can be best utilized to benefit the citizens of San Diego.

¹⁷ A "percentage lease" is an agreement with rent based off a percentage of the tenant's gross sales, income, or profits. The City defines a percentage lease as an agreement in which the City receives either a percentage of what the tenant earned or a fixed minimum rate, whichever is higher. A flat-rate lease is an agreement with fixed rent set within the lease and is not dependent on income.

¹⁸ There were 6 non-revenue agreements in our initial sample of 32 leases; thus they were removed from the sample.

of the leases that were not adjusted appropriately were flat-rate leases.

Exhibit 9

Of the Leases We Reviewed, 73 Percent Had Rent Adjustments in Accordance with Lease Terms; the Remainder Were Missing Adjustments



Source: OCA generated based on information in DREAM’s REPortfolio and EDRS information management systems from July 15, 2021.

Notably, the missed estimated rent adjustment amounts were small, and we did observe several occasions where DREAM identified an error in billing and took corrective measures to recover the missed rent. According to DREAM management, to ensure rent is adjusted appropriately, agents rely on billing information to be entered accurately into REPortfolio. Agents are emailed reports with due dates for rent adjustments and can schedule their own reminders. However, DREAM did not share any formal process narratives for the rent adjustment process. Though we did not find significant missing revenue with late rent adjustments, the results raise the question of whether internal controls are adequate for flat-rate leases, and we recommend DREAM work with the City Treasurer to develop better controls over these leases.

Nearly every lease we reviewed had an appraisal in accordance with San Diego Municipal Code requirements;

DREAM should consistently document appraisals or Statements of Value to ensure that this critical aspect of lease management is being performed for all leases. Both San Diego Municipal Code §22.0901 and Council Policy 700-10 emphasize the importance of the City using appraisals or Statements of Value to ensure

**however, DREAM
acknowledged
shortcomings with its
documentation and
record-keeping.**

competitive and appropriate rent payments for City-leased land. For example, San Diego Municipal Code Section §22.0901 states:

“No real property belonging to the City shall be leased except in pursuance of a resolution passed by a majority vote of all members of the Council, which shall contain...a statement of the market value of such real estate as appraised by an independent fee appraiser or City staff.”

CP 700-10 also states that the fair market rent shall be based on an appraisal that complies with the definition of market rent. It also clarifies that if the cost of an appraisal is not justified by the anticipated rents, the City may choose an alternative method to establish rent.

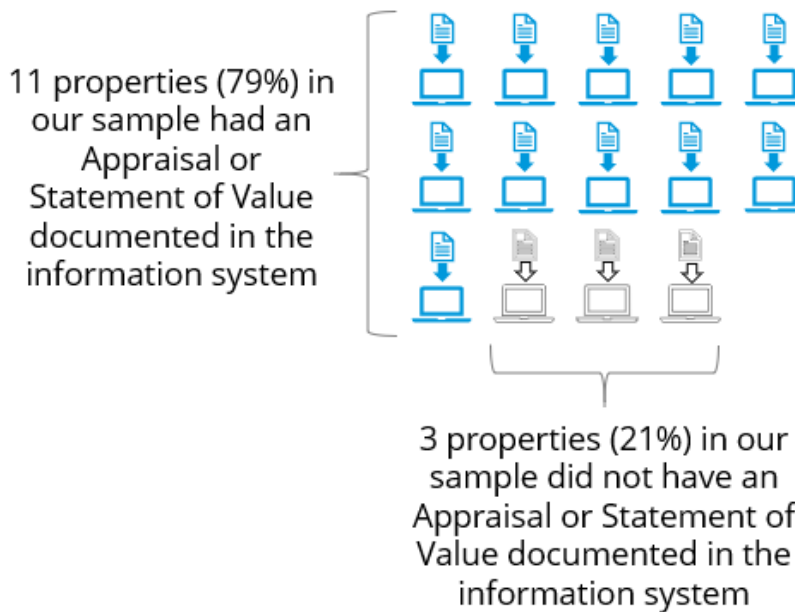
For example, according to DREAM, some leases are too small in value to justify the cost of an appraisal, which DREAM estimated at approximately \$10,000. Instead, those leases should have a Statement of Value to estimate and communicate approximate market value. We note that San Diego Municipal Code §22.0901 does not appear to allow that exemption; while our testing did not find any instances of the City relying solely on a Statement of Value when a formal appraisal was required, we recommend that the requirements within the San Diego Municipal Code and Council Policy be brought into alignment when Council Policy 700-10 is updated.

As shown in **Exhibit 10** below, we found that 11 of the 14 lease renewals we reviewed had a documented appraisal or Statement of Value.¹⁹ Of the three lease renewals that did not have appraisals or Statements of Value documented in DREAM's information systems, one had evidence outside of DREAM's systems indicating that an appraisal was performed, one was a non-revenue telecom lease that exceeded the usual duration for an appraisal exemption, and according to DREAM, there was no appraisal required for the remaining lease (an airport hangar) as rates had been established by the City Council.

¹⁹ The sample of eligible properties was smaller than the others as telecom leases and short-term leases are exempted from some appraisal requirements.

Exhibit 10

Of the Recently Renewed Leases We Reviewed, 79 Percent Had a Documented Appraisal or Statement of Value



Source: OCA generated based on information in DREAM's REPortfolio and EDRS information management systems from July 15, 2021.

DREAM acknowledged several issues and limitations with its record-keeping of appraisals for properties. Specifically, DREAM reviewed our testing results and determined that the Appraisal field in REPortfolio was not being regularly updated, and that some DREAM staff were not aware it existed.

Knowing and reporting the value of City-owned property is important to ensure that the amount of rent charged is appropriate and fair, and to improve the strategic management of the City's vast real estate portfolio.

Though DREAM publishes data about property the City of San Diego owns, including the cost and year of purchase to the City's Open Data Portal, we found no evidence that DREAM has published the recorded value of City lease-outs to enable the comparison between rent and appraised value. *The Guidebook on Real Property Asset Management for Local Governments* notes that the income that the local government forgoes by renting property for below-market rent constitutes an indirect property-related subsidy that tenants of such premises obtain from the government, and recommends that cities monitor and evaluate the amount of subsidies for each property and each property portfolio.

DREAM, when it was formerly organized and referred to as the Real Estate Assets Department, previously compiled and shared a strategic overview known as the Portfolio Management Plan (PMP), which summarizes and communicates key information about the City's property portfolio. While the PMP has much useful information, the City's recent real estate challenges,²⁰ and high number of holdovers discussed in Finding 1, indicate the need for publicly-transparent accountability regarding appropriate rent for lessees, including the amount compared to market rent based on appraisal or valuation by City staff. Including a listing of all City lease-outs with their most recent appraised or estimated market value, date of said value, and their actual rent paid, would help improve oversight of potentially foregone revenue from non-competitively priced leases, and demonstrate the basis upon which the City is valuing its properties. Including this information in the annual PMP or other publicly-presented document would also improve public transparency given the City's high number of holdovers.

To mitigate the risk of lost institutional knowledge and ensure key actions are performed and communicated, DREAM should utilize reminders and notes, and/or similar features within its lease management systems.

According to IREM, the ability to report a lease task or Job as complete is a major benefit of computer-aided maintenance management programs such as REPortfolio. As mentioned in Finding 1, REPortfolio has the ability to record "Jobs," i.e., specific tasks recorded by staff that can range from rent adjustments and financial audits to site inspections, lease amendments, and correspondence with the lessee. Similarly, REPortfolio "Key Dates" and "Key Dates reminders" can act as cues for property managers and DREAM management about key lease management tasks such as rent increases, scheduled termination dates, and inspection due dates.²¹

As shown in **Exhibit 11** below, we found that DREAM is using the Key Dates and Jobs features in REPortfolio for most, but not all,

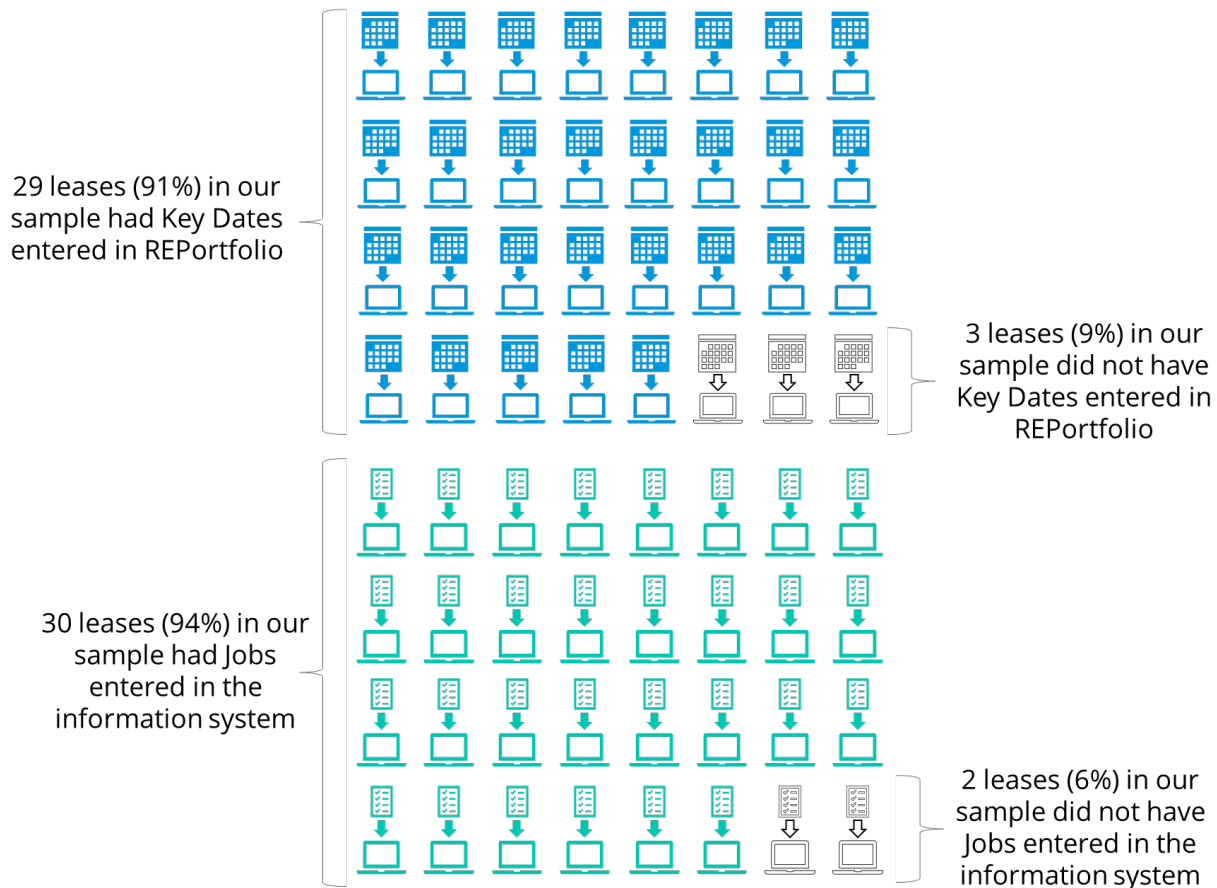
²⁰ For example, see OCA's July 2021 Performance Audit of the City's Major Building Acquisitions Process. The report profiled five case studies of property acquisitions, three of which had not utilized an independent appraisal, with significant financial consequences for the City. Available at: https://www.sandiego.gov/sites/default/files/22-002_building_acquisition_process.pdf

²¹ When a key date is entered by an agent—a manual process—REPortfolio will send a reminder to the assigned agents 90 or 120 days before it is due, depending on the type of key date. Agents are also able to add their own additional reminders for another date.

leases—29 of 32 leases (91 percent) in our sample had at least one manually entered Key Date in REPortfolio, and 30 of 32 (94 percent) had at least one entered Job. Finding 1 details Jobs related to leases and holdovers; however, this test was for the use of *any* manually entered Job, reminder, and/or Key Date.

Exhibit 11

DREAM is Using the Key Dates and Jobs Features in REPortfolio for Most, But Not All, Leases



Source: OCA generated based on information in DREAM's REPortfolio and EDRS information management systems from July 15, 2021.

These results indicate that DREAM is generally using REPortfolio at least to some extent for storing and communicating information for most leases; however, there is room for DREAM to improve its use of REPortfolio by utilizing additional features and providing additional training. For example, while we did not test for specific types of Key Dates or Jobs (other than those

related to lease renewals or holdovers), we observed many instances in which Key Dates were past due, indicating that property agents may have pushed out reminders to complete a Job.

When we asked why the features have not been used more frequently, DREAM staff responded that no formal trainings have been conducted in recent years on how to best use the system. Trainings could allow agents to utilize the Job/Task import and the Key Dates and reminders feature to help them stay on top of key lease management tasks, such as lease renewals and inspection due dates. One training opportunity to utilize REPortfolio more efficiently might center on a feature allowing agents to import pre-determined Job tasks/checklists for lease administration, inspections, and assignment administration. Once a task is complete, an agent can mark the Job as done. DREAM currently uses this import feature minimally, instead often opting to take notes in the Notes log in open Jobs. The import feature would add pre-determined Jobs to the agreement, which can be reported on in a variety of reports and may streamline the process by offering only pre-determined Jobs. Overall, DREAM should research and implement the use of REPortfolio or another lease administration system's available features to better support the department's goals and performance targets.

DREAM's staffing challenges are also a likely contributor to its lease management challenges.

In addition to contributing to the high number of holdovers discussed in Finding 1, DREAM's staffing level is a likely contributor to the results within this finding as well. For example, in the FY2020 Mission Bay Regional Parks Improvement Funds Audit, OCA found that on-site inspections of the Mission Bay Boundary Land leaseholds had not been completed due to the loss of a full-time position. However, we found that the lack of inspections extends to leases throughout the City. As recommended in Finding 1, DREAM should re-evaluate its staffing levels for its lease management practices to ensure the department can meet service demand and performance targets.

In order to address the issues outlined in the finding, we recommend:

Recommendation 6

To improve productivity, oversight, and accountability, the Department of Real Estate and Airport Management (DREAM) should establish and enforce productivity standards, goals, or similar performance targets and procedures based on reasonable expectations for conducting property inspections, ensuring up-to-date insurance and/or indemnification of the City, adjusting rent timely, and documenting appraisals. Finalized performance targets should be communicated to all appropriate employees within DREAM so that all are aware of these expectations and monitored via routine reporting by DREAM management/supervisors. Deviations from agreement terms should be documented and maintained within REPortfolio, EDRS, or another information management system.

(Priority 1)

Recommendation 7

The Department of Real Estate and Airport Management should consider retaining a third-party agent or other efforts to improve the process for collecting and reviewing insurance certificates.

(Priority 1)

Recommendation 8

The Department of Real Estate and Airport Management should perform and document a property inspection for all properties that have not had a documented inspection within the last 3 years.

(Priority 1)

Recommendation 9

To improve oversight of potentially foregone revenue from non-competitively priced leases, the publicly-presented Portfolio Management Plan or similar publicly-presented plan should include a listing of all City lease-outs. The list should include leases' most recent market rental value, the date of said value, and the actual annual rent paid to the City. The results should be presented both by lease as well as grand totals, and leases with the largest differences between market value and actual rent paid should be highlighted for public transparency. The Department of Real Estate and Airport Management should work with City leadership to include a control, such as a requirement within updated Council Policy, to ensure that this reporting continues periodically.

(Priority 1)

Recommendation 10

The Department of Real Estate and Airport Management should ensure that when Council Policy 700-10 is updated, its allowance of a statement of value instead of an appraisal is permitted by the San Diego Municipal Code, or should ensure that the policies are aligned accordingly.

(Priority 3)

Recommendation 11

The Department of Real Estate and Airport Management (DREAM) should work with the City Treasurer's Office to create additional internal control(s) to verify that charges for flat-rate lease agreements are charged accurately and on time. Potential outcomes could include:

- a. Adding flat-rate lease review to the City Treasurer's Office's audit responsibilities; and
- b. DREAM providing the City Treasurer's Office with draft agreements to ensure new agreements do not limit the City's ability to audit in compliance with Council Policy 700-10.

(Priority 2)

Recommendation 12

The Department of Real Estate and Airport Management should research and implement the use of REPortfolio or another lease administration system's capabilities, as appropriate, to:

- a. Create task/checklist imports available for property agents that can also act as checklists for each of the following lease management practices: inspections, insurance updates, appraisals, rent adjustments, and other recurring obligations/tasks under the lease; and
- b. Require agents to use the Job Notes (or similar) feature to record interactions or notes regarding the leasing process for each tenant. Notes could be added for each interaction and agreement action, such as updated information regarding the status or completion of inspections, requests and receipts of insurance certificates, appraisals ordered and completed, and rent adjustments, and can link to the City's electronic lease file where other correspondence is housed.

(Priority 2)

Recommendation 13

The Department of Real Estate and Airport Management should conduct or facilitate a formal training of its staff on the capabilities and limitations of REPortfolio, EDRS, and/or another lease administration system, as appropriate.

- a. Training topics for consideration should include: timely uploading of documentation, consistent naming conventions, and a post process review by supervisory staff to ensure adherence to system usage procedures.

(Priority 2)

Finding 3: DREAM should work with the City Attorney's Office to develop a lease template to streamline the lease renewal process and ensure that the appropriate provisions and clauses are included in leases.

In addition to mitigating the number of holdovers and ensuring effective lease management, best practices recommend key contract provisions to be included in leases to ensure mutual expectations for all parties. In many cases, key provisions also provide legal protection.

We tested 31 leases from six different categories to identify if several key provisions were included within these contracts.²² The categories of contract provisions tested included: the number with financial disincentives in holdover clause (discussed in Finding 1 in conjunction with the issue of holdovers); defined rent, and the presence of step-up charges (i.e., rent increases); insurance requirements; sublease terms; and the commencement, termination, and duration of the lease. Results are shown in **Exhibit 12**; further results are presented in **Appendix D**.

As with the lease management practices discussed in Finding 2, provisions such as holdover and step-up charges incentivize the City to renew contract terms and keep agreements up-to-date. Consistent inclusion of these provisions may mitigate risk of litigation for the City, reduce expensive problems with properties, reduce the risk of lost revenue, and prevent lost institutional knowledge as the City manages its vast property portfolio.

²² One lease was removed from the 32 total leases used in testing for Findings 1 and 2 due to being a federal agency lease where the lease was provided to, rather than drafted by, DREAM.

Exhibit 12

Most Key Contract Provisions Were Included in the Vast Majority of Leases We Reviewed

Key Contract Provision	# of Leases with Contract Provision	Total Leases in Sample	% of Leases Reviewed that Included Contract Provision
Financial Disincentives in Holdover Clause	19	31	61%
Step-Up Charges (Rent Increases)	23	26*	88%
Commencement Date of Lease	31	31	100%
Duration and Termination of Lease	31	31	100%
Rental Amount of Lease	31	31	100%
Insurance Requirements	31	31	100%
Sublease Terms/Prohibitions	31	31	100%

*Five of the leases in the judgmental sample are non-revenue leases, bringing the sample size down from 31 to 26.

Source: OCA generated based on DREAM lease contracts. For a list of all results see **Appendix D**.

Financial disincentives for holdover were only included in 61 percent of the leases we reviewed.

As discussed in Finding 1, financial disincentives can motivate tenants to come to the negotiating table to avoid paying more for being in holdover. In our sample, only 19 out of 31 contracts reviewed (61 percent) had a financial disincentive clause in the holdover provisions section. This contract provision scored the worst from all of our contract provision testing and could be a factor in the large percentage of holdovers discussed in Finding 1.

According to DREAM, the clause regarding financial disincentives in holdover is missing for any lease that is not new or has not been renewed since the City started adding the holdover financial disincentive provision to leases. Financial disincentives can encourage the tenant to keep their lease current or vacate the lease if a new agreement cannot be reached. Additionally, having clearly defined holdover or lease renewal terms is important to keep contracts current so that the City can collect the most optimized lease rent.

Most leases in our sample included step-up charges language.

Step-up charges are fixed adjustments of the base rent at certain stages of the lease. We found that 23 of 26 (88 percent) of the leases in our sample included appropriate step-up charges language.²³ Of the three leases that did not include these step-up charges, all were for non-profit organizations; two, according to DREAM, used to be charged an annual fee of \$600 per year, and the third was a lease dating back to 1957 for a tenant known as Camp Fire, a non-profit youth development organization. Step-up charges represent the landlord's estimate of what the market value of the leased entity will be at a particular time of the lease and can protect from inflation.

Commencement dates, termination dates, and rental amounts were included in all leases we reviewed.

We found that all contracts in our sample of 31 leases included the commencement date, termination date, and rental amount that the tenant agreed to pay. Defining the rent is perhaps the most important provision in a lease; this is the amount that a tenant agrees to pay and is generally defined as a base or minimum rent. The commencement, duration, and termination of the lease is the period of time in which a tenant has the exclusive right to possession of the leased premises. Including the commencement, duration, and termination of a lease is important because it may make the terms of the lease unenforceable.

All City leases we reviewed contained insurance requirements and clear sublease terms.

Best practices also suggest that lease contracts include "special renewal provisions that pertain to financial covenants affected by inflation, such as the level of required insurance coverage."²⁴ We found that all 31 of the leases in our sample included insurance requirements. Insurance requirements are critical for protecting the City from liabilities and for protecting the lessees from potential financial risk due to not having insurance. Although all contracts in our sample included insurance requirements, our testing in Finding 2 found that DREAM was not ensuring that tenants were complying with these requirements.

²³ Six of the leases in the judgmental sample are non-revenue leases, bringing the sample size down from 31 to 26.

²⁴ See for example, "Commercial Leases" American Bar Association, January 2016. Available at: [https://www.americanbar.org/publications/gpsolo_ereport/2016/Ja \(sharepoint.com\)](https://www.americanbar.org/publications/gpsolo_ereport/2016/Ja (sharepoint.com))

We also found that all leases in our sample included subleasing terms. Lease contracts should be clear about the terms and criteria that will be acceptable for the owner's approval of a sublease. According to Council Policy 700-10, a lessee may sublease all or part of a property unless it is detrimental to the City's rights or is not consistent with the uses in the master lease.

While DREAM does a good job of including fundamental contract provisions, other clauses could be left out or become outdated, causing legal liability for the City according to the City Attorney's Office.

As shown above in **Exhibit 12**, based on our sample, DREAM generally made sure that its leases included several key contract provisions that a lease must contain. However, leases often should include many other provisions beyond those we tested above, such as clauses related to the Americans with Disabilities Act (ADA), hazardous substances, etc.

Due to the varying length of leases, new or updated clauses may be implemented during the lifecycle of the lease. Provisions for leases in holdover may not reflect updated clauses related to updated policies; the City Attorneys who work with DREAM stated that the requirements related to these additional clauses are updated from time to time, but only become updated for a given lease when the lease is renewed. According to the City Attorney's Office, the original lease provisions are still valid, but regular updates to the lease clauses during the renewal process will help ensure that the lessee and the City remain in compliance with all jurisdictional policies.

Incorporating the use of lease templates and an up-to-date database of lease clauses can mitigate legal liability concerns and save DREAM and the City Attorney's Office time during the renewal process.

As described in Finding 1, DREAM has a large number of holdovers in its portfolio. Saving time during the renewal process could allow DREAM to have more time to address the lease management issues discussed in Findings 1 and 2, such as potential foregone revenue from the large number of holdovers, being able to conduct property inspections more frequently, etc.

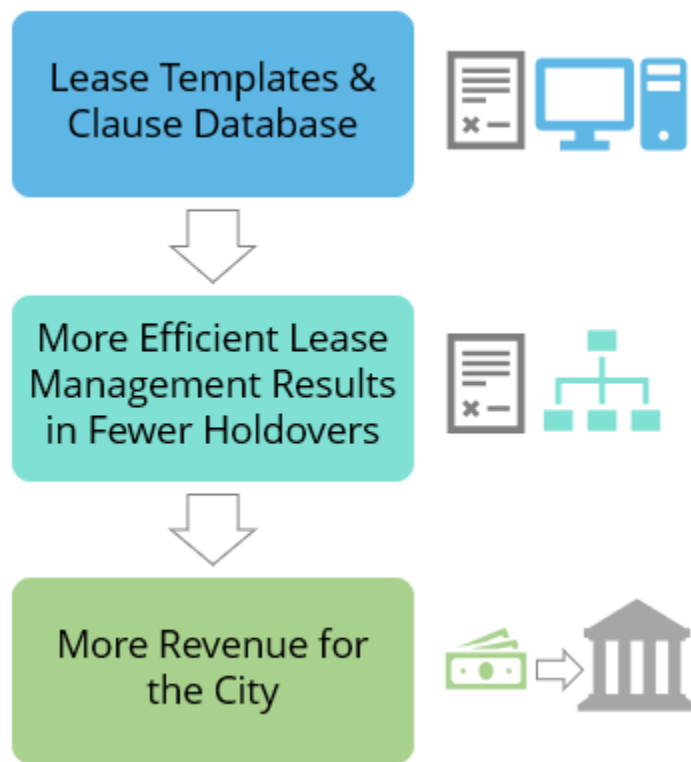
As illustrated in **Exhibit 13**, one method to save time in the renewal process is to use a standardized lease template and an up-to-date lease clause database that DREAM staff and the City Attorney's Office can utilize when drafting leases. This could improve efficiency by reducing the often-lengthy back-and-forth between DREAM property agents and the City Attorney's Office. Templates and a clause database could ensure that standard

provisions and updated clauses are included as a baseline in all contracts, while also allowing for customization to the specificities a particular lease requires.

According to DREAM and the City Attorney's Office, the practice of using a template is already informally being utilized for some leases; however, a formalized process and/or template should be developed to make sure that all contracts include updated provisions and to enhance institutional knowledge and efficiency so that agents can optimize their time between contract drafting and key lease management practices discussed in Findings 1 and 2.

Exhibit 13

Improving the Drafting Process for Lease Contracts May Allow for More Time to Devote to Lease Management and Could Result in Fewer Holdovers



Source: OCA generated based on interviews with DREAM and the City Attorney's Office.

In order to address the issues outlined in the finding, we recommend:

Recommendation 14

In order to maintain uniform lease clauses throughout the City of San Diego's lease portfolio, the Department of Real Estate and Airport Management should work with the City Attorney's Office to create a master lease template(s) and a lease clause database, and should ensure that the database is updated at least every 3 years to account for changes in clauses.

(Priority 2)

Appendix A: Definition of Audit Recommendation Priorities

DEFINITIONS OF PRIORITY 1, 2, AND 3

AUDIT RECOMMENDATIONS

The Office of the City Auditor maintains a priority classification scheme for audit recommendations based on the importance of each recommendation to the City, as described in the table below. While the City Auditor is responsible for providing a priority classification for recommendations, it is the City Administration's responsibility to establish a target date to implement each recommendation taking into consideration its priority. The City Auditor requests that target dates be included in the Administration's official response to the audit findings and recommendations.

Priority Class ²⁵	Description
1	Fraud or serious violations are being committed. Significant fiscal and/or equivalent non-fiscal losses are occurring. Costly and/or detrimental operational inefficiencies are taking place. A significant internal control weakness has been identified.
2	The potential for incurring significant fiscal and/or equivalent non-fiscal losses exists. The potential for costly and/or detrimental operational inefficiencies exists. The potential for strengthening or improving internal controls exists.
3	Operation or administrative process will be improved.

²⁵ 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 priority.

Appendix B: Objectives, Scope, and Methodology

Objectives In accordance with the Office of the City Auditor's Fiscal Year 2022 Audit Work Plan, we conducted a performance audit of the Department of Real Estate and Airport Management's (DREAM) lease holdovers and renewals process.

Our objectives were to:

- Determine whether DREAM's process for monitoring and transitioning expiring and holdover agreements to renewed or terminated leases aligns with best practices; and
- Determine whether leases contain key/best practice clauses.

Scope Our scope included DREAM's portfolio of active lease agreements as of July 15, 2021. If the scoping period was limited for a specific test, we noted the time frame in the discussion, for example, for appraisals, we reviewed leases that had been renewed within the past 5 years as of July 2021.

Because DREAM's information systems and portfolio are constantly changing, we limited our review to lease records with normal, extended, and holdover statuses. When reviewing DREAM's cheapest lease agreements, we removed the Airports – Hangar lease use category due to hangars having rent requirements set by federal grants.

Methodology We tested 32 lease agreements from six different categories to identify if several key provisions were included within the agreements and to determine if DREAM was following critical lease management practices. We used our professional judgment to select categories we believed might be higher risk, including: leases that were the oldest in holdover, overall oldest leases, leases that had recently expired, leases that were due to expire next, the cheapest leases, and the most expensive leases. We tested an additional 29 lease agreements that were renewed within the past 5 years (2016–2021) for appraisals given the

City's recent challenges with appraisals specifically.²⁶ The leases were identified by generating queries from DREAM's information systems, REPortfolio and EDRS/DocuLynx (EDRS). We note that our results cannot be statistically extrapolated due to the nature of our judgmental sample, but believe they provide an indicator across a variety of different lease types in the City's portfolio.

We also researched and reviewed reports, budget documents, municipal laws and regulations, and policies and procedures related to the City's holdover leases, and interviewed relevant personnel from DREAM and the City Attorney's Office involved in the lease holdovers and renewals process.

Our methodology is described in the following table.

Objective	Methodology
Determine whether DREAM's process for monitoring and transitioning expiring and holdover agreements to renewed or terminated leases aligns with best practices.	<ul style="list-style-type: none">• Identified criteria articulating best practices, particularly for large municipalities and other similar entities.• Requested and gained access to DREAM's data and information management systems to identify a judgmental sample consisting of leases from six different categories: the most expensive leases,²⁷ the cheapest leases, the oldest leases,²⁸ the oldest holdovers,²⁹ the last leases to reach scheduled termination date as of July 15, 2021 (the date of our data extract), and the next leases due to end as of July 15, 2021.• Interviewed DREAM about data reliability and preliminary results from the data.

²⁶ For example, see OCA's July 2021 Performance Audit of the City's Major Building Acquisitions Process. The report profiled five case studies of property acquisitions, three of which had not utilized an independent appraisal, with significant financial consequences for the City. Available at: https://www.sandiego.gov/sites/default/files/22-002_building_acquisition_process.pdf

²⁷ Based on an export on July 15, 2021 of REPortfolio billing records.

²⁸ Based on lease effective date.

²⁹ Based on scheduled termination date of the lease.

- Compared DREAM's use of holdovers to industry standards and/or other municipalities via research and benchmarking:
 - Identified criteria articulating best practices, particularly for large municipalities and other similar entities;
 - Benchmarked with a sample of other west coast/Southwest cities to identify how DREAM's holdover prevalence and department staffing (e.g., property managers) compares; and
 - Interviewed DREAM on the origins of its Key Performance Indicator.
- Used DREAM's data and information management systems to identify a judgmental sample consisting of higher-risk leases:
 - Because the objective included the lease renewal process (e.g., possibly before a property becomes a holdover), we extracted high-risk leases on July 15, 2021.³⁰
- For the samples, we utilized REPortfolio/EDRS to test for:
 - Was the agreement in holdover?
 - Renewal information entered into REPortfolio, if applicable
 - When they were/are supposed to be renewed?
 - Was there a holdover disincentive in the contract?
 - Was holdover prohibited?
 - Were Key Dates and alerts sent/scheduled?
 - Were Jobs entered into REPortfolio with reminders?
 - When was the last on-site inspection?
 - Were inspections recorded in REPortfolio and EDRS?
 - Is insurance up-to-date in REPortfolio and EDRS?
 - Was rent appropriately adjusted?
 - Was an appraisal performed/scheduled in REPortfolio and EDRS?
- If no appraisal was noted in REPortfolio and EDRS, was there a statement of value in REPortfolio and EDRS?

³⁰ Extraction date selected for two weeks after the end of the fiscal year to account.

Determine whether leases contain key/best practice clauses.

- Researched and identified best practices for lease clauses.
- Interviewed DREAM property agents and management to understand their role in lease drafting and management.
- Interviewed the City Attorney's Office to about its process of drafting and reviewing leases.
- Benchmarked leases with other cities to identify key clauses that should be included in leases, and used DREAM's data and info management systems to test each lease from our sample to identify if the key provisions were included in the leases and record.
- We tested to see if each lease agreement contained:
 - Commencement Date
 - Duration and termination of the lease
 - Rental Amount
 - Rent Increases
 - Lease renewal and/or holdover terms
 - Holdover Prohibitions
 - Holdover Rent Increases
 - Insurance Requirements
 - Sublease Terms

Data Reliability Testing

We tested the reliability of lease data from REPortfolio and EDRS to ensure it was sufficiently complete and accurate for the purpose of forming conclusions about DREAM's lease portfolio and lease management practices. We selected a judgmental sample of leases that we considered higher risk from the REPortfolio system filters. We tested if these leases were in holdover; how long the leases had been in holdover; and if DREAM was using its information systems to record appraisals, Jobs, and Key Dates. We then verified the accuracy of the lease management data related to appraisals and insurance by comparing EDRS to the data recorded in REPortfolio.

We also interviewed DREAM to discuss issues of data reliability in the systems, and whether our results appeared plausible

based on DREAM's operational knowledge of the City's lease management. We shared a spreadsheet of our results and invited DREAM's scrutiny towards the end of fieldwork, and met with DREAM to discuss and review the results and conclusions as we approached publishing.

DREAM confirmed that 55 of 56 results matched our holdover count. The discrepancy was because DREAM's system identified one lease as "Held Over" on July 15, 2021, even though the lease expired on July 31, 2021. DREAM did not confirm listed rent amounts despite our request; we included in **Appendix E** the amounts as listed in REPortfolio as a matter of public interest. Finally, DREAM confirmed that it does not have access to any appraisals made prior to 2008 and that the appraisal field in REPortfolio is not being consistently utilized by staff. Issues with use and organization of the information systems are discussed in Finding 2. However, DREAM did confirm that our testing of the additional sample for appraisals was accurate.

**Internal Controls
Statement**

Our review of internal controls was limited to those controls relevant to the audit objectives described above. Specifically, we reviewed policies and procedures, interviewed DREAM management and City Attorneys involved in the lease renewal process, and reviewed lease data in both of DREAM's information management systems to understand how the department manages its portfolio.

Compliance Statement

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: Detailed Results of Lease Management Testing Presented in Finding 2

Testing Metrics										
	Percent with at least one manually-entered key date in REPortfolio	Percent with at least one reminder scheduled for key dates in REPortfolio	Percent with rent adjustments according to terms	Percent with Jobs in REPortfolio (for tracking lease actions)	Percent with Jobs in REPortfolio related to lease renewal/extension/holdover	Percent with appraisal documented in data systems for corresponding lease	Range of Length of Time Since Latest Inspection Date in Months:	Percent with latest inspection in data systems	Percent with insurance up to date in data systems	Percent Not in Holdover
Sample Name	Reminders/Alerts		Rent Adj.	Job/Lease Action Tracking		Appraisal	Inspections		Insurance	Not in Holdover
MOST EXPENSIVE LEASES Average monthly revenue: \$358,619	100%	100%	100%	100%	25%	Not tested	18 - 57 months	100%	29%	100%
CHEAPEST LEASES Average monthly revenue: \$57	100%	80%	40%	100%	50%		23 to 32 months ago	100%	20%	20%
LEASES NEXT TO EXPIRE Scheduled Termination date between 7/31/2021 and 9/30/2021, tested on 7/28/2021 Average monthly revenue: \$1,148	40%	0%	33%	60%	40%		not noted - 61 months ago	20%	0%	60%
LEASES RECENTLY EXPIRED Scheduled termination dates from 2/28/2021 to 5/31/2021, on 7/28/2021 Average monthly revenue: \$2,479	100%	80%	100%	100%	60%		not noted - 118 months ago	40%	0%	0%
OLDEST LEASES Based on lease effective date Average monthly revenue: \$203	100%	80%	100%	100%	100%		4 - 45 months ago	100%	40%	80%
OLDEST HOLDOVER LEASES Based on scheduled termination date Average monthly revenue: \$15,304	100%	0%	33%	100%	40%		17 - 39 months ago	100%	40%	0%
*LEASES RENEWED WITHIN THE PAST 5 YEARS 2016-2021	Not tested						79%	Not tested		

*We supplemented our original sample of 32 by testing an additional 29 recently renewed leases to obtain more recent results on appraisals.

Appendix D: Detailed Results for Contract Provision Testing

Sample Name	Testing Metrics						
	Financial Disentive in Holdover Clause	Step-Up Charges (Rent Increases)	Commencement Date of Lease	Duration and termination of Lease	Rental Amount of Lease	Insurance Requirements	Sublease Terms/Prohibitions
MOST EXPENSIVE LEASES Average monthly revenue: \$358,619	86%	100%	100%	100%	100%	100%	100%
CHEAPEST LEASES Average monthly revenue: \$57	100%	60%	100%	100%	100%	100%	100%
LEASES NEXT TO EXPIRE Scheduled Termination date between 7/31/2021 and 9/30/2021, tested on 7/28/2021 Average monthly revenue: \$1,148	N/A	100%	100%	100%	100%	80%	80%
LEASES RECENTLY EXPIRED Scheduled termination dates from 2/28/2021 to 5/31/2021, on 7/28/2021 Average monthly revenue: \$2,479	20%	100%	100%	100%	100%	100%	100%
OLDEST LEASES Based on lease effective date Average monthly revenue: \$203	0%	67%	100%	100%	100%	100%	100%
OLDEST HOLDOVER LEASES Based on scheduled termination date Average monthly revenue: \$15,304	100%	100%	100%	100%	100%	100%	100%

Appendix E: Individual Property Testing Results

Property name	Non-Profit Rate	Most Recent Billing Record in Information Systems	Most Recent Billing Record in Information Systems Annual Rent	In Holdover	Holdover Disincentive in Contract	Lease Effective Date	Latest Inspection Recorded in Information Systems	Appraisal Record in Information Systems, Most Recent Date
AIR TOURS OF SAN DIEGO LLC	No	\$540.38 fixed monthly in advance	\$ 6,484.56	No	Yes, "the then market value"	10/01/2018	None	No
ALEXANDER COURT TRUST	No	\$72,823.01 annual minimum, percentage monthly in arrears	\$72,823.01 annual minimum	No	No	10/01/1971	Dec - 2018	Yes, 2021
AMERICAN BICYCLE ASSOCIATION	Yes	\$326.46 fixed monthly in advance	\$ 3,917.52	Yes	Yes, to fair market value	01/22/1991	Dec - 2018	No
AMERICAN MESSAGING SERVICES LLC/02	No	non-revenue agreement	non-revenue agreement	Yes	No	08/01/2011	None	No
AVIATOR GLOBAL FLIGHT GROUP LLC	No	\$590.77 fixed monthly in advance	\$ 7,089.24	No	Not tested	07/01/2019	Not tested	No
BLACK CONTRACTORS ASSOCIATION	No	\$195 fixed quarterly in advance	\$ 780.00	Yes	Yes, rent up to two (2) times the fair market value	06/01/2018	None	No
BOYL, MAXINE (TRUSTEE)	No	\$646.62 fixed annually in advance	\$ 646.62	Yes	Yes, fair market value	07/01/1987	Nov - 2018	Yes, 1985
CAMP FIRE SAN DIEGO	Yes	\$326.46 fixed monthly in advance	\$ 3,917.52	Yes	No	11/05/1957	Oct - 2017	Yes, 2015
CAMPLAND, LLC	No	\$1,201,574.00 percentage monthly in arrears	\$ 14,418,888.00	No	Yes, 125% of fair market rent	11/08/2017	Dec - 2018	Yes, 2017
CENTRO CULTURAL DE LA RAZA	Yes	non-revenue agreement	non-revenue agreement	Yes	Yes, to fair market value	05/01/1991	Apr - 2018	No
CHSP MISSION BAY LLC	No	\$227,039.21 percentage monthly in arrears	\$ 2,724,470.52	No	Yes, 125% of fair market value	01/09/2006	Mar - 2019	Yes, 2005
EDUCATIONAL ENRICHMENT SYSTEMS INC/02	Yes	\$3,852.50 fixed annually in advance	\$ 3,852.50	Yes	Not tested	03/12/2019	Not tested	Yes, 2018
FAMILY HEALTH CENTERS OF SD INC/02	Yes	\$321.04 fixed monthly in advance	\$ 3,852.48	Yes	Yes, to fair market value	06/01/1988	Feb - 2020	Yes, 2005
FAMILY HEALTH CENTERS OF SD, INC./01	Yes	\$321.04 fixed monthly in advance	\$ 3,852.48	Yes	Yes, to fair market value	03/01/1989	Feb - 2020	Yes, 2005
FEIFER, KATIE & RICHARD	No	\$651.09 fixed annually in advance	\$ 651.09	Yes	Yes, fair market value	03/01/1986	Nov - 2018	Yes, 1985
FIT ATHLETIC - CMR, LLC	No	\$100 fixed monthly in advance	\$ 1,200.00	Yes	Not tested	02/01/2017	Not tested	No
FRIENDS OF BALBOA PARK/02	Yes	\$3,852.50 fixed annually in advance	\$ 3,852.50	Yes	Not tested	07/01/2017	Not tested	No
GRAHAM, JOSEPH W/01	No	\$85.16 fixed monthly in advance	\$ 1,021.92	No	Not tested	07/01/2020	Not tested	No
HERNON FORTUNADA LLC	No	\$13,201.42 fixed monthly in advance	\$ 158,417.04	Yes	Not tested	02/01/2017	Not tested	No
LA JOLLA COMMUNITY CENTER	Yes	\$3,852.50 fixed annually in advance	\$ 3,852.50	Yes	Not tested	08/20/2018	Not tested	Yes, 2014
LHO MISSION BAY HOTEL, L.P.	No	\$247,138.09 percentage monthly in arrears	\$ 2,965,657.08	No	Yes, fair market value	06/01/2000	Oct - 2016	Yes, 2018
LODGE AT TORREY PINES PARTNERSHIP	No	\$196,344.00 percentage monthly in arrears and \$99,577.44 fixed monthly	\$ 3,551,057.28	No	Yes, fair market value	06/05/1995	Jan - 2020	Yes, 2014
MENTAL HEALTH ASSOC IN SD COUNTY	Yes	\$3,852.50 fixed annually in advance	\$ 3,852.50	No	Yes, fair market rent value	08/01/2014	Jun - 2016	Yes, 2014
MG STONEWOOD GARDEN APARTMENTS LP	No	\$22,487.07 percentage monthly in arrears	\$ 269,844.84	No	Not tested	04/01/2017	Not tested	No
MORLEY FIELD DGC, LLC	No	\$63,005 percentage annually in arrears, \$100.50 and \$50 fixed monthly in arrear	\$63,005 annual minimum + \$1806	Yes	Not tested	09/01/2017	Not tested	No
MYF HOLDINGS LLC	No	\$31,600 and \$3,822.12 fixed monthly in advance	\$ 425,065.44	No	Not tested	06/01/2016	Not tested	Yes, 2007
NEAL, ROBERT	No	non-revenue agreement	non-revenue agreement	Yes	Not tested	04/18/2019	Not tested	No
NEW CINGULAR WIRELESS PCS/ADAMS PARK	No	\$40,317.18 fixed annually in advance	\$ 40,317.18	Yes	No	03/01/2011	Mar - 2012	No
NEW CINGULAR WIRELESS/ROW NORTH	No	\$18,293.84 fixed annually in advance	\$ 18,293.84	Yes	Not tested	04/01/2018	Not tested	No
NEW CINGULAR WIRELESS/ROW SOUTH	No	\$18,293.84 fixed annually in advance	\$ 18,293.84	Yes	Not tested	04/01/2018	Not tested	No
PEBBLEBROOK HOTEL TRUST	No	\$1,920,000 annual minimum, percentage monthly in arrears	\$1,920,000 annual minimum	No	Yes, 125% of the then rental rate	07/27/2018	Feb - 2018	Yes, 2018
PIONEER HOOK & LADDER CO.	Yes	non-revenue agreement	non-revenue agreement	Yes	Yes, to fair market value	11/01/1985	Dec - 2019	Yes, 1998
PROBUILD COMPANY LLC	No	\$47,730.31 fixed monthly in advance	\$ 572,763.72	Yes	Not tested	12/01/2016	Not tested	Yes, 2013
SD COMM COLLEGE DIST/06	No	\$4,280.15 fixed monthly in advance	\$ 51,361.80	Yes	No	08/01/2018	None	No
SD ROWING CLUB/INTERCOLLEGIATE	Yes	\$2,165.76 fixed monthly in advance and \$8,500.75 fixed annually in advance	\$ 34,489.87	Yes	Not tested	11/29/2018	Not tested	No
SD UNIFIED SCHOOL DIST/01	No	non-revenue agreement	non-revenue agreement	No	No	07/01/1974	Jul - 2018	No
SD UNIFIED SCHOOL DIST/02	No	non-revenue agreement	non-revenue agreement	No	No	10/31/1974	Nov - 2018	No
SEA WORLD, LLC	No	\$10,401,305.69 annual minimum, paid by percentage monthly in arrears	\$10,401,305.69 annual minimum	No	No	07/01/1998	Dec - 2019	Yes, 2003
SEAFORTH SPORTFISHING CORPORATION	No	\$865,812.52 annual minimum, percentage monthly in	\$865,812.52 annual minimum	No	Yes, fair market value	11/08/2007	Dec - 2018	Yes, 2019
SOUTHEAST COUNSELING & CONSULTING	Yes	\$300.00 fixed semi-annually in advance	\$ 600.00	Yes	Yes, fair market value	05/01/1999	Aug - 2019	Yes, 1984
SPORTS ARENA VILLAGE LTD	No	\$743,068.22 annual minimum, percentage monthly in arrears	\$743,068.22 annual minimum	No	No	01/01/1974	Mar - 2021	Yes, 2000
SPRINT PCS ASSETS LLC/FS 19	No	\$45,819.51 fixed annually in advance	\$ 45,819.51	Yes	Not tested	05/01/2019	Not tested	No
STATE OF CA/CHP/05	No	\$25,614.28 fixed annually in advance	\$ 25,614.28	Yes	Not tested	06/01/2019	Not tested	No
T-MOBILE WEST LLC/PRESIDIO PARK	No	\$40,317.18 fixed annually in advance	\$ 40,317.18	Yes	No	04/01/2011	None	No
TOBEY, STEVE & CHRISTOPHER	No	\$4,090.41 percentage monthly in arrears	\$ 49,084.92	Yes	Not tested	09/06/2019	Not tested	No
UDELL, TODD R & SHERI L	No	\$900.00 fixed monthly in advance	\$ 10,800.00	Yes	Not tested	08/01/2019	Not tested	No
US CUSTOMS & BORDER PROTECTION/05	No	non-revenue agreement	non-revenue agreement	No	Not tested	10/01/2017	Not tested	No
US FAA/21	No	non-revenue agreement	non-revenue agreement	No	No	10/01/2001	None	Yes, 2004
VERIZON WIRELESS/CAMINO RUIZ PARK	No	\$40,317.49 fixed annually in advance	\$ 40,317.49	Yes	No	05/01/2011	Sep - 2011	No
VERIZON WIRELESS/ENCANTO RESERVOIR	No	\$41,861.08 fixed annually in advance	\$ 41,861.08	Yes	Not tested	04/01/2018	Not tested	Yes, 2011
VERIZON WIRELESS/PENASQUITOS RESERVOIR	No	\$40,317.49 fixed annually in advance	\$ 40,317.49	Yes	No	06/01/2011	None	No
VERIZON WIRELESS/RANCHO PENASQUITOS	No	\$40,706.55 fixed annually in advance	\$ 40,706.55	Yes	Not tested	12/01/2018	Not tested	No
VERIZON WIRELESS/UNIVERSITY BRCH	No	\$41,931.36 fixed annually in advance	\$ 41,931.36	No	Not tested	03/01/2019	Not tested	No
VICTOR J SCHULMAN TRUST	No	\$10,991.99 fixed monthly in advance	\$ 131,903.88	Yes	Not tested	12/01/2016	Not tested	Yes, 2020
WESTON, ROBERT L & SUSAN E	No	\$651.08 fixed annually in advance	\$ 651.08	Yes	Yes, fair market value	03/01/1986	Nov - 2018	Yes, 1985
YOUTH TENNIS SAN DIEGO	Yes	\$600.00 fixed annually in advance	\$ 600.00	No	Yes, fair market value	07/01/1994	Apr - 2019	Yes, 1991




THE CITY OF SAN DIEGO

MEMORANDUM

DATE: February 3, 2022

TO: Andy Hanau, City Auditor

FROM: Penny Maus, Director, Real Estate and Airport Management 

SUBJECT: Management Response to the Office of the City Auditor's *Performance Audit of the City's Lease Management and Renewal Processes*

Management appreciates the opportunity to respond to the recommendations set forth in the Office of the City Auditor's *Performance Audit of the City's Lease Management and Renewal Processes*.

As a general note, Management appreciates that the audit acknowledges the need for additional staffing and a more robust lease administration system to help address some of the recommendations.

Management agrees with the City Auditor's recommendations and the specific responses to the recommendations follow below.

RECOMMENDATION 1: The Department of Real Estate and Airport Management (DREAM) should document and execute a strategy for addressing the number of lease holdovers in the City's portfolio as appropriate. Elements of the strategy that should be considered include:

- a. Re-evaluating or removing the 25 percent Lease Holdover KPI and replacing or supplementing it with an alternative goal relating to on time lease renewals (such as number of lessees approaching holdover that were emailed a lease expiration reminder);
- b. Setting a target for completing the renewal of a certain percentage or number of leases which are currently in holdover;
- c. Determining a mechanism for selecting which leases will be prioritized for renewal, to include the leases with high potential foregone revenue and leases that have been in holdover the longest, and;
- d. Completing or updating a policies and procedures manual for DREAM staff that provides guidance on the issues discussed in this finding, such as determining when property agents and DREAM staff should exercise financial disincentives, prioritizing leases for renewal, improving documentation and alerts within REPortfolio, etc.

(Priority 1)

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Management Response: Agree. DREAM will develop a strategy to address and reduce the number of lease holdovers in the City's portfolio. The strategy and implementation will include an update to procedures and consider these recommendations.

Target Implementation Date: February 1, 2023

RECOMMENDATION 2: Aside from developing a strategy and internal procedures, the Department of Real Estate and Airport Management should exercise existing financial disincentives or market-rate adjustments for below-market rate agreements for lease outs that have been in holdover for longer than five years or provide an explanation for each property in a report explaining why it is not doing so.
(Priority 2)

Management Response: Agree. DREAM will exercise financial disincentives, when available under the agreement terms, and when the holdover is not at the request of the City. Upon implementation of a new or upgraded software system, this information will be tracked with the ability to generate a new report.

Target Implementation Date: February 1, 2024

RECOMMENDATION 3: The Department of Real Estate and Airport Management should ensure that each new or renewed lease includes a financial disincentive clause regarding holdover status (for example, 150 percent or up to two times the last month's rent and/or market-rate rent for non-profits). The disincentive clause may be written such that the City only exercises the financial disincentive when appropriate.
(Priority 1)

Management Response: Agree. DREAM will work with the City Attorney's to ensure renewals and new leases incorporate a clause for financial disincentives related to holdovers.

Target Implementation Date: Immediately

RECOMMENDATION 4: The Department of Real Estate and Airport Management (DREAM) should prevent future leases from entering into holdover status by leveraging process improvements such as:

- a. Automated Reminders: 6 months to 2 years before the lease expiration, DREAM's lease administration system should alert a property agent that they need to begin discussions with the tenant and notify them that the agreement is set to expire on a particular upcoming date and will fall into holdover unless the lease is amended, renewed, or terminated; and
- b. If applicable, the lessee should also be informed in writing that their rent may be raised while in holdover but that such a raise in rent can be avoided by renewing the lease prior to the lease expiration date.

(Priority 2)

Management Response: Agree. DREAM will work on process improvements to minimize future leases from entering holdover. DREAM is in the process of requesting additional funding to support a new lease administration system that could further improve these processes.

Target Implementation Date: February 1, 2024

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RECOMMENDATION 5: To ensure the Department of Real Estate and Airport Management (DREAM) has the necessary staffing capacity to meet service demand and performance targets, DREAM should perform a staffing analysis to re-evaluate its staffing levels needed for addressing the high number of holdovers and for performing its lease management practices. This assessment could build on or integrate with Recommendation 1 from OCA's 2021 Mission Bay Audit pertaining to staffing resources. If additional resources are needed to address the findings and recommendations from these audits, DREAM should request additional resources accordingly.
(Priority 2)

Management Response: Agree. DREAM has performed an analysis of additional staffing resources needed and submitted the requests for the Fiscal Year 2023 budget. The City Attorney's Office unit that supports DREAM will also need additional resources in the Fiscal Year 2023 budget to ensure they are able to support the department increasing its transaction volume.

Target Implementation Date: January 1, 2023

RECOMMENDATION 6: To improve productivity, oversight, and accountability, the Department of Real Estate and Airport Management (DREAM) should establish and enforce productivity standards, goals, or similar performance targets and procedures based on reasonable expectations for conducting property inspections, ensuring up-to-date insurance and/or indemnification of the City, adjusting rent timely, and documenting appraisals. Finalized performance targets should be communicated to all appropriate employees within DREAM so that all are aware of these expectations and monitored via routine reporting by DREAM Management/Supervisors. Deviations from agreement terms should be documented and maintained within REPortfolio, EDRS, or another information management system.
(Priority 1)

Management Response: Agree. DREAM will formalize productivity standards and targets through the implementation of a new or upgraded lease administration software system, which is envisioned to include performance dashboards.

Target Implementation Date: February 1, 2024

RECOMMENDATION 7: The Department of Real Estate and Airport Management should consider retaining a third-party agent or other efforts to improve the process for collecting and reviewing insurance certificates.
(Priority 1)

Management Response: Agree. DREAM will explore utilizing a third-party agent or implementing process improvements to address outdated insurance certificates.

Target Implementation Date: January 1, 2023

RECOMMENDATION 8: The Department of Real Estate and Airport Management should perform and document a property inspection for all properties that have not had a documented inspection within the last 3 years.
(Priority 1)

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Management Response: Agree. DREAM will compile a list of properties with no inspections for more than three years and prioritize and create an action plan to conduct the inspections, or informal site visits, when safe to do so under covid protocols.

Target Implementation Date: January 1, 2023

RECOMMENDATION 9: To improve oversight of potentially foregone revenue from non-competitively priced leases, the publicly-presented Portfolio Management Plan or similar publicly-presented plan should include a listing of all City lease-outs. The list should include leases' most recent market rental value, the date of said value, and the actual annual rent paid to the City. The results should be presented both by lease as well as grand totals, and leases with the largest differences between market value and actual rent paid should be highlighted for public transparency. The Department of Real Estate and Airport Management should work with City leadership to include a control such as a requirement within updated Council Policy to ensure that this reporting continues periodically.
(Priority 1)

Management Response: Agree. This is currently in process under the 2021 Acquisitions Audit and will be automated through the upgrade or replacement of the outdated lease administration system currently in use.

Target Implementation Date: July 1, 2022

RECOMMENDATION 10: The Department of Real Estate and Airport Management should ensure that when Council Policy 700-10 is updated, its allowance of a statement of value instead of an appraisal is permitted by the San Diego Municipal Code, or should ensure that the policies are aligned accordingly.

Management Response: Agree. This is currently in process under the 2021 Acquisitions Audit and DREAM will incorporate the recommendations to align the council policy with the San Diego Municipal Code.

Target Implementation Date: July 1, 2022

RECOMMENDATION 11: The Department of Real Estate and Airport Management (DREAM) should work with the City Treasurer's Office to create additional internal control(s) to verify that charges for flat-rate lease agreements are charged accurately and on time. Potential outcomes could include:

- a. Adding flat-rate lease review to the City Treasurer's Office's audit responsibilities; and
- b. DREAM providing the City Treasurer's Office with draft agreements to ensure new agreements do not limit the City's ability to audit in compliance with Council Policy 700-10.

(Priority 2)

Management Response: Agree. DREAM will conduct a review to strengthen internal control(s) and work in collaboration with the City Treasurer to evaluate incorporating additional compliance audit reviews for flat-rate lease agreements.

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February 3, 2022

Target Implementation Date: January 1, 2023

RECOMMENDATION 12: The Department of Real Estate and Airport Management should research and implement the use of REPortfolio or another lease administration system's capabilities, as appropriate, to:

- a. Create task/checklist imports available for property agents that can also act as a checklist for each of the following lease management practices: inspections, insurance updates, appraisals, rent adjustments, and other recurring obligations/tasks under the lease; and
- b. Require agents to use the Job Notes (or similar) feature to record interactions or notes regarding the leasing process for each tenant. Notes could be added for each interaction and agreement action, such as updated information regarding the status or completion of inspections, requests and receipts of insurance certificates, appraisals ordered and completed, and rent adjustments, and can link to the City's electronic lease file where other correspondence is housed.

(Priority 2)

Management Response: Agree. DREAM has submitted a request for the Fiscal Year 2023 budget to replace or update the lease administration system. If approved, DREAM will develop a Scope of Work that includes the recommendations and issue an RFP due to the current system having not been updated in many years, which prohibits staff from effectively managing the portfolio.

Target Implementation Date: February 1, 2024

RECOMMENDATION 13: The Department of Real Estate and Airport Management should conduct or facilitate a formal training of its staff on the capabilities and limitations of REPortfolio, EDRS, and/or another lease administration system, as appropriate.

- a. Training topics for consideration should include: timely uploading of documentation, consistent naming conventions, and a post process review by supervisory staff to ensure adherence to system usage procedures.

(Priority 2)

Management Response: Agree. As part of the implementation of a new or upgraded lease administration, DREAM will include training as part of its implementation

Target Implementation Date: February 1, 2024

RECOMMENDATION 14: In order to maintain uniform lease clauses throughout the City of San Diego's lease portfolio, the Department of Real Estate and Airport Management should work with the City Attorney's Office to create a master lease template(s) and a lease clause database, and should ensure that the database is updated at least every 3 years to account for changes in clauses.

(Priority 2)

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Andy Hanau, City Auditor

February 3, 2022

Management Response: Agree. DREAM is currently working with the City Attorney's Office to create templates for frequently used agreements, such as leases, and an associated database.

Target Implementation Date: February 1, 2023

Thank you again for the opportunity to provide responses to these recommendations. Management appreciates the City Auditor team's professionalism and collaborative approach throughout this review.

Thank you,


Penny Maus (February 4, 2022 17:49 PST)

Penny Maus
Director, Real Estate and Airport Management

PM/nc

cc: Paola Avila, Chief of Staff, Office of the Mayor
Jay Goldstone, Chief Operating Officer
Matthew Vespi, Chief Financial Officer
Alia Khorui, Deputy Chief Operating Officer
Jessica Lawrence, Director of Policy, Office of the Mayor
Liz Correia, City Treasurer
Christiana Gauger, Chief Compliance Officer
Kevin Reisch, Chief Deputy City Attorney
Heather Ferbert, Chief Deputy City Attorney
Melissa Ables, Deputy City Attorney
Lucy Contreras, Deputy Director, Real Estate and Airport Management
Jorge Rubio, Deputy Director, Real Estate and Airport Management
Niki Chalfant, Program Manager, Real Estate and Airport Management