



THE CITY OF SAN DIEGO

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## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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**Date Issued:** June 14, 2018

**IBA Report Number:** 18-19

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**Item Number:** 202

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# IBA Review of 101 Ash Project, Proposed CIP Appropriations, and Consideration of Alternative Funding Approach

## OVERVIEW

On June 18, 2018, the City Council is scheduled to hear an update on progress towards completing tenant improvements at the 101 Ash Building and the timeline for occupying the building, and will be requested to approve appropriations to the 101 Ash CIP project. A separate item scheduled for the same Council meeting will include a request to increase to Development Services Department fees, in part to fund improvements at 101 Ash.

This report includes an overview of past decisions regarding 101 Ash, and notes key areas where staff communication to the City Council regarding 101 Ash fell short. We also include a brief discussion of the potential scenarios for going forward that are included in the staff report.

A Request for Proposals for work on tenant improvements at 101 Ash is currently outstanding, and includes alternate scopes of work; staff has pledged that it will bring responses to that RFP to the City Council before entering into a contract with any respondent. Our office recommends approving CIP appropriations to the 101 Ash project of \$13.2 million, and that City staff consider using Tobacco Settlement Revenue Bond refinancing proceeds currently dedicated to a fire helicopter hangar project to fund any additional funding needed for 101 Ash, and that the hangar project receive any commercial paper proceeds that would otherwise have gone to 101 Ash.

Our office also recommends that staff update the Council on the status of the 101 Ash project either in a quarterly memorandum to the full City Council or to the appropriate Council Committee.

## BACKGROUND

### Initial Consideration of 101 Ash Lease-to-Own Agreement

On October 17, 2016, the City Council approved the Mayor's proposal to enter into a 20-year \$72.5 million lease-to-own agreement to acquire the 101 Ash Street Building (101 Ash). 101 Ash is a 21 story (19 stories of office space), 315,000 square foot commercial building formerly owned

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and occupied by Sempra Energy. The City's acquisition was intended to address concerns regarding the large number of City employees currently housed in leased space, as well as upcoming lease expirations and rising lease costs in the downtown area.

One of the key goals of the acquisition is to relocate the Development Services Department (DSD) from subpar space in the City Operations Building (COB) to 101 Ash, and to provide the public an efficient and user-friendly one-stop DSD shop. Other important goals are to address the City's office space needs on a long-term basis, to reduce the City's risks in an increasingly volatile office space rental market downtown, and ultimately to save taxpayer money. In October 2016, savings from this acquisition were estimated at \$44.0 million over 20 years as compared to other downtown lease options.

At the time of its acquisition, 101 Ash was described by City staff as Class A office space in excellent condition, with upgraded mechanical systems and excellent interior finishes. All office furniture was in good condition and was included in the acquisition agreement, and a tenant improvement allowance of \$5.0 million was also included in the lease to fund retrofit of the first two floors for DSD, as well as the top three floors. Staff also noted that tenant improvements could exceed the \$5.0 million. The staff report for the item noted that planned tenant improvements for the five floors would maximize the space in the building and allow it to accommodate approximately 1,100 employees. The City would take possession of the building on January 1, 2017, and the occupancy date for City employees was estimated to be July 1, 2017.

This is the proposal that was approved by the City Council on October 17, 2016.

### **History of Changes in Project Scope, Schedule, and Project Costs**

After Council approved the lease-to-own agreement in October, City staff made major decisions about the 101 Ash project which significantly changed the scope of the tenant improvements and the schedule for move-in. These decisions – made from December 2016 through March 2018 – led to significant increases in costs for tenant improvements. During this time no clear information was provided to the Infrastructure Committee or Council about these changes.

The largest change in the project scope was recommended by Gensler Architecture, which had been hired in December 2016 to consult on space planning. Gensler advised that completing tenant improvements on just five floors was not sufficient to maximize use of 101 Ash. To house 1,100 employees, Gensler assessed that all 19 floors of office space would need to be renovated. Staff accepted Gensler's evaluation and moved forward with plans for the renovation of all floors. Council was not notified of these changes in scope.

Gensler and staff began working with City departments to determine the specific needs for all floors, a process that took several months. By April 2017 staff realized that the July 2017 move-in date was not going to be feasible.

During the FY 2018 budget hearing process – April through May of 2017 – City staff requested \$2.1 million in funding for 101 Ash move-in costs, but the changes to the project scope and impacts to a move-in schedule were not mentioned. In responding to our inquiries during the budget process regarding project status, staff noted that the project was on schedule and moving costs would be needed in FY 2018. Based on staff input, in our "Review of the Mayor's FY 2018 Proposed Budget" issued April 28, 2017, we stated "all departments currently located at the Executive Complex and the City Operations Building are anticipated to move to 101 Ash during FY 2018."

While Council had approved the addition of the 101 Ash project to the Capital Improvement Program on February 21, 2017, the approved CIP project budget was for \$5.0 million. Volume 3 of the FY 2018 Adopted Budget – the “FY 2018 Capital Improvement Program” included the addition of renovations to all 19 floors and a potential FY 2019 project completion, but costs for the project remained at \$5.0 million and the statement “total project costs have not yet been determined” was added to the project description. This updated CIP project was not available to the Council until September 2017 when the Adopted Budget was released to the public.

Over the summer of 2017, construction drawings were developed based on Gensler’s space planning for all 19 floors. In August 2017 the construction drawings were submitted to DSD. In preparation for the bid process for tenant improvements, staff developed a preliminary cost estimate of \$17 million for 19 floors of tenant improvements. Staff did not inform Council of the scope change or new cost estimates. In October 2017, DSD approved the building permits for 101 Ash based on 19 floors of tenant improvements.

In November 2017 the CIP Mid-Year Monitoring Report was released. It noted, “\$5.1 million in uncommitted capital outlay fund balance has been identified and preliminarily set aside to pay for the general fund capital improvement tenant improvements for 101 Ash Street Building. The specific request to appropriate funding for this project will occur when the funds are needed, closer to the expected award date for the construction contract.” There was no mention of the scope change or the revised estimated costs of \$17 million. The CIP Mid-Year Monitoring Report was presented to Council on December 11, 2017. At this point, staff was in the process of preparing to issue a Request for Proposals (RFP) for 19 all floors of tenant improvements at 101 Ash.

On January 8, 2018 City staff released an RFP for construction of 19 floors of tenant improvements, but did not notify the Council. Bidders were required to prepare proposals that would make renovations to all 19 floors while maintaining a 24/7 construction schedule. Estimated costs remained at \$17.0 million. Bidders were not asked to prepare an alternative bid for renovating only five floors.

On January 29, 2018 staff issued the FY 2018 Mid-Year Budget Monitoring Report which stated that 101 Ash construction drawings had been completed and permits had been approved by DSD, and “it is anticipated that the contract for construction will be awarded in March or April 2018 with tenant improvements commencing in April 2018.” This report was presented to Council on February 12, 2018. No mention was made of the scope change or increased cost estimates. Council was not aware that the RFP issued on January 8, 2018 addressed only the expanded Ash project and was based on a significantly higher cost estimate.

By February 20, 2018, two bids had been received. It is likely that the 24/7 construction requirement reduced the number of bidders, especially given other factors such as a strong construction market. The lowest responsive bidder for the tenant improvements bid roughly \$22 million. Staff estimates that the 24/7 construction requirement contributed roughly \$4 million in expenditures to the bid. When all costs (i.e. IT services, fiber optics, security systems, ADA requirements, moving costs, soft costs, etc) were recognized, the total project was estimated at \$32 million. Staff planned for construction to begin in early April 2018.

## **Growing Awareness of Project Changes**

On March 14, 2018, the Budget and Government Efficiency Committee was scheduled to consider a request from the Purchasing and Contracting Department to purchase up to \$12.5 million in office furniture for various city facilities over a five-year period. The \$12.5 million proposal included \$2.6 million for furnishing 101 Ash. When this request was made, our office began inquiring about the status of the 101 Ash project. We were for the first time provided detailed and complete briefings on the project by the Public Works, Real Estate Assets, Financial Management, Development Services, and Purchasing and Contract departments, as well as the ACOO and the COO. Due to the many questions that arose in these briefings, our office recommended to Budget and Government Efficiency Committee Chair Bry that the furniture request for Ash be continued to a future meeting.

In these briefings, our office learned of the various changes the 101 Ash project went through since Council authorized acquisition of the building in October 2016. It became clear that staff's primary goal – to maximize use of the office space and to save taxpayers and the City further cost increases in the future – was the right goal. It also became clear, however, that critical communications to the City Council on important and costly changes to the project from October 2016 to March 2018 were not made.

On March 26, 2018 staff cancelled the existing bids and began briefings with all City Council members.

## **Communication of Large Project Changes is Critical**

From our office's perspective, the following key information and decisions for 101 Ash should have been brought before the Infrastructure Committee for input and/or approval:

- Staff's decision to expand the scope tenant improvements to all 19 floors and abandon the plan for five floors that was originally proposed and presented to Council.
- The potential impact of this decision on the move-in schedule.
- Staff's preliminary cost estimate of \$17 million to make improvements to all 19 floors.
- Submittal of only one set of construction drawings to DSD for all 19 floors, and DSD's approval of the plans.
- Issuance of the January 2018 RFP, and staff's decision to include only the 19-floor option and to require a 24/7 construction schedule.
- A new funding plan for increased costs given new staff estimates, brought forward prior to release of the RFP.
- The impact of the increased costs on DSD fees.

## **FISCAL AND POLICY DISCUSSION**

Upon the changes to the 101 Ash project's scope, schedule, and costs being made public, significant discussion on the project was held both at the Budget and Government Efficiency Committee and during the City Council's hearings on the FY 2019 Proposed Budget. These discussions were followed by a May 23, 2018 meeting of the City Council's Infrastructure Committee, during which staff provided a full update on the 101 Ash project and potential ways to move forward.

Staff’s presentation included 4 possible scenarios:

- 1) Move City staff into the building as-is; or
- 2) Make improvements to only the first floor so that it could serve as a ‘one-stop shop’ for the Development Services Department; or
- 3) Make tenant improvements to the bottom two and top three floors of the building, as was originally contemplated when the City took possession of the building; or
- 4) Make tenant improvements to the entire building to maximize the number of personnel that could be moved into the building.

Staff recommended moving forward with Scenarios 3 and 4, and the Infrastructure Committee tentatively agreed and moved the item forward to Council. After the Committee meeting, City staff issued a new RFP for tenant improvements at 101 Ash, which does *not* include a 24/7 work schedule, and requests bids on two potential scopes of work – a base scope of work with improvements to 5 floors of the building (Scenario 3), and an alternate scope of work that includes improvements to all 19 floors (Scenario 4).

### Comparing Scenarios 3 and 4

Expected capital costs associated with tenant improvements, financing costs, and move-in expenses provided by staff for Scenarios 3 and 4 are shown below:

|                          | Scenario 3    | Scenario 4    |
|--------------------------|---------------|---------------|
| <b>Expenditures</b>      |               |               |
| Capital Costs            | \$ 15,452,391 | \$ 27,647,261 |
| Financing Costs          | 1,492,767     | 3,582,641     |
| Moving Costs             | 1,510,960     | 1,510,960     |
| <i>Total</i>             | \$ 18,456,118 | \$ 32,740,862 |
| <b>Employee Capacity</b> | 955           | 1,157         |

The staff report notes that over 20 years, Scenario 3 would be expected to save \$6.1 million over not occupying 101 Ash at all and instead using entirely leased outside space; Scenario 4 would be expected to save \$40.4 million.<sup>1</sup>

<sup>1</sup> These expected savings are based on a large number of assumptions, including a need for 250 sq ft of office space per employee (inclusive of common area space) in outside leased spaces, and a cost of \$3.00 per sq ft per month for outside leased space.

Of note – staff estimates for total costs in Scenario 1 (moving 801 employees into the building as-is and leasing outside space for 493 remaining employees; this is not recommended by staff)<sup>a</sup> and Scenario 2 (only making tenant improvements to the first floor, moving in 821 employees to the building, and leasing outside space for 336; also not recommended by staff) actually *exceed* the costs of simply leasing outside space for all employees. This is despite staff’s assumption that outside lease rates will start at \$3.00 per sq ft per month, which is significantly higher than our \$1.70 per sq ft per month rate at 101 Ash. The tables in staff’s expenditure projections show an *additional* \$0.80 per sq ft per month in operating expenditures at 101 Ash, however, which increases our *effective* costs under the lease-to-own agreement to \$2.50 per sq ft per month.

<sup>a</sup> Note also that staff’s report assumes that DSD will not move into 101 Ash in Scenario 1, and the City will need to find office space for a total of 1,294 employees. All other scenarios only assume a need to find space for 1,157 employees. This inflates staff’s costs projections for Scenario 1 by an average of \$1.7 million per year over the 20-year projected timeline.

While the City workforce has grown significantly over the last several years, and rents in the City have been increasing since the beginning of the economic recovery and the current economic expansion, it is uncertain the how long these trends will continue. It is also currently uncertain whether space for employees not relocated to 101 Ash will need to come entirely from leased space – many employees who were relocated earlier this year from the Executive Complex building were accommodated at other City-owned facilities.<sup>2</sup> Additionally, renovations to office space at the Civic Center Plaza building – which are anticipated to begin once DSD moves out of the City Operations Building – are expected to provide space for an additional 100 employees.

Regardless, maximizing the efficient use of space in City owned buildings is generally a positive thing, provided that cost effective means to accomplish this exist. Staff have stated that they will return to Council in early August with the results of their RFP, and request direction from Council on how to proceed. Once bids are received, the City and Council will have much greater certainty of potential costs for the two scopes of potential tenant-improvements, and be better able determine how to proceed.

### **Proposed Financing Plan/Request for CIP Appropriation Adjustments**

As noted in the staff report, Financial Management has identified \$18.2 million in available funding sources for 101 Ash: \$5.0 million from the original tenant allowance already appropriated, and \$13.2 million in FY 2018 CIP Year-End appropriation adjustments. As part of this item, Council is being asked to approve this proposed \$13.2 million CIP appropriation adjustment. The \$13.2 million is made up of \$9.5 million in capital outlay funds, \$2.1 million in previously budgeted General Fund moving costs, and small fund balances from several departments that are expected to occupy 101 Ash in the future.

Based on cost estimates of Scenarios 3 and 4, and depending on the bids, \$18.2 million may cover the full costs of Scenario 3, but may only partially cover the costs of Scenario 4. Because it is likely that this project will require at least \$18.0 million in funding, our office recommends approving the appropriation requests for \$13.2 million in the Year-End CIP appropriation adjustments as outlined in the staff report on page 9.

Should additional funds be needed, Debt Management plans to request additional commercial paper financing. DSD, which will occupy 40.9 % of the building, will be responsible for paying debt service on commercial paper issuances of up to \$12.0 million. In a follow-up item that is also scheduled to be heard on Council on June 18, DSD will be requesting increases to their fees over the next three fiscal years to pay for their portion of the City's annual pension payment *as well as* their portion of 101 Ash rental costs and tenant improvement costs. Our office has issued a separate report - IBA Report #18-18 on this item.

Our office generally supports pursuing additional commercial paper for 101 Ash should it be necessary. However, at the Infrastructure Committee meeting on May 23, 2016 our office also suggested an alternative to commercial paper for 101 Ash that may be more cost effective: using proceeds from the Tobacco Settlement Revenue Bonds. This bond restructure was approved by the Council in January 2018 and resulted in \$25.0 million in additional funding for three capital projects. Projects were chosen at the time based on their readiness. One of those projects, the fire

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<sup>2</sup> Many of those relocations are expected temporary, however.

helicopter hangar, was allocated approximately \$12.0 million. We recently learned that this project will likely not begin construction until FY 2020.

As the \$12.0 million to construct the helicopter hangar will not be needed until FY 2020, it may be more cost effective to use these idle dollars now to fund the more immediate needs at 101 Ash, and then use commercial paper borrowing for the fire helicopter hangar when funds are needed. This would more effectively use available funds in FY 2019, and could save interest expense on commercial paper that would not need to be issued until required for the helicopter hangar in FY 2020.

At the Committee meeting, Chair Kersey asked Financial Management if they were open to considering this option. Committee members expressed their desire for staff to consider this option. Financial Management Director Tracy McCraner responded that the CFO and Debt Management department have started to look into this option and that it may be feasible based on the revised schedule for the fire hangar. As the staff report before Council does not reference consideration of this alternative, we bring this to Council's attention for consideration.

## CONCLUSION

After the City Council approved the \$72.5 million lease-to-own agreement for 101 Ash in October 2016, the communication from City staff to the City Council on changes to the scope, schedule, and cost for tenant improvements at the building was inadequate. Our office appreciates that City's management and staff have recognized this and pledged to be more open and communicative with the City Council in the future.

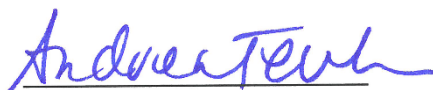
Moving forward, staff has presented four potential scenarios, and recommends moving forward with completing tenant improvements to either five or all nineteen floors of 101 Ash. An RFP that contains these alternate scopes of work has been issued. Staff plans to bring the results of that RFP to Council in early August, and to seek guidance on which scope of work it should ultimately pursue.

In the interim, our office recommends that the Council approve the \$13.2 million appropriation request for the 101 Ash CIP Project, and that City staff pursue using Tobacco Settlement Revenue Bond refinancing proceeds that are currently dedicated to the fire helicopter hangar project to fund any funding gap for 101 Ash, as 101 Ash expenses are more immediate, and that the hangar project receive any additional commercial paper proceeds that would otherwise have gone to 101 Ash.

Our office also recommends that staff provide updates to the City Council on the status of the 101 Ash project on a quarterly basis, either as a memorandum to the full Council or at the appropriate Council Committee.



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