



THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Smart Growth and Land Use Committee Meeting Date: March 15, 2017

Item Number: TBD

Proposed Response to Grand Jury Report “City of San Diego's Real Estate Assets Department Leasehold Management Has Weaknesses”

OVERVIEW

On December 13, 2016, the San Diego County Grand Jury filed a report, directed to the San Diego City Council, entitled “City of San Diego's Real Estate Assets Department Leasehold Management Has Weaknesses.” The report discusses issues related to the number of City leases that are in a hold-over or month-to-month status. The Grand Jury report includes four findings and three recommendations directed solely to the City Council.

Per the Grand Jury report, the City Council is required to provide comments to the Presiding Judge of the San Diego Superior Court on the applicable findings and recommendations within 90 days. However, the Council President’s office requested and received an extension for the response to May 1, 2017.

In responding to each Grand Jury finding, the City is required to either (1) agree with the finding or (2) disagree wholly or partially with the finding. Responses to Grand Jury recommendations must indicate that each recommendation (1) has been implemented; (2) has not yet been implemented, but will be in the future; (3) requires further analysis; or (4) will not be implemented because it is not warranted or is not reasonable. Explanations for responses are requested when applicable.

The Office of the IBA worked collaboratively with the Real Estate Assets Department to develop a proposed Council response to the Grand Jury report, which is included as Attachment 1 to this report. The proposed Council response addresses the four findings and three recommendations.

We request that the Smart Growth and Land Use Committee provide feedback and forward its approved proposed response to the full Council.



Charles E. Modica, Jr.
Fiscal & Policy Analyst



Lisa Byrne
Fiscal & Policy Analyst



APPROVED: Andrea Tevlin
Independent Budget Analyst

Attachments:

1. Proposed City Response to San Diego County Grand Jury Report Entitled “City of San Diego’s Real Estate Assets Department Leasehold Management Has Weaknesses”
2. San Diego County Grand Jury Report Entitled “City of San Diego’s Real Estate Assets Department Leasehold Management Has Weaknesses”

**City Response to
San Diego County Grand Jury Report Entitled
REAL ESTATE ASSETS DEPARTMENT LEASEHOLD MANAGEMENT HAS WEAKNESSES**

Pursuant to California Penal Code section 933(c), the San Diego City Council provides the following responses to the findings and recommendations pertaining to the City of San Diego that are included in the above referenced Grand Jury Report:

FINDINGS 01 THROUGH 04

Below are the City Council's responses to Findings 01 through 04:

Finding 01: *The lag in renewing expired leases does not allow the City to maximize its revenue potential on leased properties and prevents lessees from developing secure, long-term plans.*

Response: The City Council partially disagrees with the Grand Jury's finding.

Although the backlog of expired leases does create the potential for inefficient management of leased properties, the Real Estate Assets Department (READ), works to mitigate any negative impacts. Maximizing revenue for the City is a critical goal for READ; therefore, READ's Asset Management Division continually evaluates agreements that have expired or are approaching expiration in order to prioritize accordingly.

It is important to note that many City leases are held by non-profit entities that provide important services to City residents that the City is otherwise unable to provide, and many of these leases do not produce revenue. Over 50% of the City's expired or holdover leases/agreements are non-revenue agreements which do not impact revenue, or generate less than \$5,000 per year. Higher income producing properties, when approaching the end of their leases or upon becoming vacant, are given the highest priority.

In some circumstances, holdover agreements are kept month-to-month to allow the City the flexibility necessary to strategically review how those properties fit into anticipated future City needs. One example of this is the Naval Training Center site in Liberty Station: some leases remained on a month-to-month basis because the City expects to use some of those properties in the future as a component of the Pure Water program. Another example is a management agreement currently held on a month-to-month basis to operate the recreational vehicle park located at DeAnza Cove, as the City is currently evaluating the long-term uses for this location within Mission Bay Park.

**City Response to
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Finding 02: *READ's inability to bring the backlog of expired leases current demonstrates a lack of adequate resources.*

Response: The City Council partially disagrees with the Grand Jury's finding.

Resources provided to any City operation must be balanced against many competing urgent citywide priorities. Because of the need for additional resources to efficiently manage the workload, READ's Asset Management Division added two positions in FY 2017, including an Associate Property Agent and a Property Agent. After a period of training, education, and mentoring, the additional staff are now beginning to work on priority assets and toward reducing the number of agreements in holdover status. READ now believes it has adequate resources to maintain optimum workload and address the most critical asset management needs.

Finding 03: *A policy for time-sensitive issuance of RFPs would promote fairness and accountability.*

Response: The City Council partially disagrees with the Grand Jury's finding.

Many factors impact the prioritization of RFP issuances, and a standardized time frame for RFP issuance may not be realistic or efficient given the variety of properties managed by READ, and the many unique circumstances surrounding those properties. READ works to balance the goal of maximizing income with the City's future real estate needs for its departments and initiatives, and these goals have different timelines associated with them.

Processes that can impact the timeline for issuing RFPs include community plan updates and reviews of uses and future plans by other City departments and potential lessees. The importance of ensuring the proper use and disposition of properties is essential for a successful RFP. As noted in the response to Finding 01, the potential change in uses for the NTC properties and the DeAnza Cove site could be negatively impacted if RFPs for leases at those properties were to be issued immediately.

Finding 04: *Council Policy 700-10 is too rigid and needs revising, and Council Policy 700-12 is outdated, preventing READ officials from making sound leasing decisions that accurately reflect current economic conditions.*

Response: The City Council agrees with the Grand Jury's finding.

**City Response to
San Diego County Grand Jury Report Entitled
REAL ESTATE ASSETS DEPARTMENT LEASEHOLD MANAGEMENT HAS WEAKNESSES**

RECOMMENDATIONS 17-01 THROUGH 17-03

Below are the City Council's responses to Recommendations 17-01 through 17-03:

Recommendation 17-01: *Within fiscal year 2018, provide resources to the Real Estate Assets Department – either additional personnel or through outsourcing – to develop a proactive strategy for bringing held-over nonprofit and for-profit leases current.*

Response: The recommendation has been implemented.

During Fiscal Year 2017, additional resources including two new staff positions were added to READ's Asset Management Division in order to assist with transition of holdover leases to new longer term agreements. READ has made substantial progress in transitioning agreements and will continue to make improvements. In Fiscal Year 2016, 27% of agreements managed by READ were on holdover status. In Fiscal Year 2017, READ is on track to reduce that amount to 25% and has a target of 20% for Fiscal Year 2018.

It is important to note that a goal of 0% leases in holdover or on a month-to-month status is unrealistic, because holdover leases are an important component of READ's overall real estate strategy for the City. This strategy allows the City to maintain flexibility and to balance the goal of obtaining the highest possible incomes with ensuring that land is available if it is needed for a future City use.

Recommendation 17-02: *Direct the Real Estate Assets Department to establish, within fiscal year 2018, a standard time frame for issuing RFPs on expiring leases.*

Response: The recommendation will not be implemented because it is not warranted.

As noted in the response to Finding 03, a standard time frame for issuing RFPs would not be efficient or reasonable in most instances where RFPs are used. The variety of property types READ manages and unique property circumstances generally lead to timeframes specific to each site. Examples of varying property types include dedicated parks, hotels, museums, and recreational facilities. The unique nature of different properties must be considered to ensure their proper use and disposition.

READ did issue a portfolio management plan on May 23, 2016, which reviews the City's overall real estate portfolio, including the operating plan for the City's properties, a disposition plan for surplus property, and an overall strategy for City occupied real estate.

**City Response to
San Diego County Grand Jury Report Entitled
REAL ESTATE ASSETS DEPARTMENT LEASEHOLD MANAGEMENT HAS WEAKNESSES**

Recommendation 17-03: *Work with the Real Estate Assets Department to revise and update Council Policies 700-10 and 700-12 within fiscal year 2018.*

Response: **The recommendation has not yet been implemented, but will be implemented in the future.**

READ is in the process of updating Council Policies 700-10 and 700-12, which it plans to present to City Council for consideration and adoption by June 30, 2017.

CITY OF SAN DIEGO'S REAL ESTATE ASSETS DEPARTMENT LEASEHOLD MANAGEMENT HAS WEAKNESSES

SUMMARY

Over the past decade, San Diego's Real Estate Assets Department (READ) has been subject to intense scrutiny, beginning with a critical *San Diego Union-Tribune* article in 2006, which prompted the City to commission a Grubb & Ellis study of the department. The core issue of the newspaper article as well as the Grubb & Ellis report was that READ had been unable to accurately track and effectively manage the inventory of City-owned property. The 2006/2007 San Diego County Grand Jury also weighed in, recommending that READ fully implement the findings contained within the Grubb & Ellis study.

The 2016/2017 San Diego County Grand Jury (Grand Jury) evaluated the department to see how well READ is currently functioning and found that the department has made substantial improvement in its operations and tracking abilities. The Grand Jury commends READ for being responsive to the mandate for change.

However, the Grand Jury found that weaknesses persist in READ's ability to manage the City's leaseholds in a timely manner with maximum return. The Grand Jury recommends that READ develop a strategy for renewing its leases in a well-timed manner. The Grand Jury further recommends that READ adopt a policy to issue Requests for Proposals, when appropriate, in an adequate period of time in advance of a lease's expiration. Finally, the Grand Jury recommends that the San Diego City Council work together with READ to revise Council Policies 700-10 and 700-12, two of READ's governing documents, so that they are current and provide the guidance needed to effectively operate the department.

INTRODUCTION

At the request of the City, the real estate firm of Grubb & Ellis produced an in-depth report that addressed READ's need for a new business model. The Grand Jury became interested in evaluating how well READ has implemented the recommendations in the Grubb & Ellis report and if it is now operating in an efficient manner and can accurately account for and manage the City's real estate inventory.

PROCEDURE

The Grand Jury reviewed the following documents:

- The 2007 Grubb & Ellis report, "Best Practices Methodology for Real Estate Assets Department"
- The City Auditor's fiscal year 2012 READ Performance Audit #13-009
- Council policies 700-10 and 700-12
- READ's Portfolio Management Plan for fiscal year 2016

The Grand Jury also interviewed officials from the City's financial department, the City Auditor's office, and the Real Estate Assets Department.

DISCUSSION

In 2006, San Diego's Real Estate Assets Department was in disarray and lacked the ability to account for and properly manage City-owned property. The City of San Diego owns more than 4,000 properties, approximately 500 of which are leased to both for-profit and nonprofit entities. At that time, READ's software was antiquated and ineffective, and the department lacked strong leadership, resulting in an inability to produce an accurate inventory of its properties and to manage them effectively.

A 2006 *San Diego Union-Tribune* watchdog report¹ exposed these weaknesses within READ. In response, the City commissioned the real estate firm of Grubb & Ellis to conduct a study, "Best Practices Methodology for Real Estate Assets Department,"² to assess READ's weaknesses and suggest a restructuring of the department. A 2006/2007 Grand Jury report recommended that the City implement the Grubb & Ellis recommendations.

Since then, READ has undertaken a major reorganization, acquired new leadership, implemented modern software, and overcome most of the inadequacies outlined in the 2007 Grubb & Ellis report. The Grand Jury believes that READ deserves a commendation for its receptiveness to the mandate for change and for the fact that it is currently operating at a high level.

Leaseholds

Nevertheless, certain areas that READ oversees are still in need of attention, specifically, the management of its leaseholds. At the time of this report, approximately 125 out of more than 500 existing leases³ had expired and were continuing on a month-to-month basis. Some of these leases have been in a state of nonrenewal for a decade or more. The Grand Jury acknowledges that some expired leases are for nonprofit entities, which typically lease for a nominal rate and may lack the urgency for lease renegotiation. Nonetheless, the Grand Jury believes that all leases should be kept current and that negotiations should commence at an appropriate time prior to any lease's expiration.

The Grand Jury recognizes that preparing and issuing a Request for Proposals (RFP) is an arduous task, and READ officials have indicated that they are working through held-over leases and issuing RFPs in an effort to bring them current. However, a proactive plan for doing so is not apparent, and the backlog is being addressed in a piecemeal and reactive manner. Because progress appears to be slow, the Grand Jury believes that READ may not have adequate resources to accomplish this task. The lack of resources and a strategy to bring leases current places lessees of held-over leases at a disadvantage because they do not know from one month to another if their lease will continue or if it will be summarily discontinued. The Grand Jury furthermore believes that held-over leases place the City at a disadvantage because, presumably,

¹ Brooke Williams and Danielle Cervantes, "Land of Confusion," *San Diego Union-Tribune*, September 18, 2006, http://legacy.sandiegouniontribune.com/uniontrib/20050918/news_1z1n18land.html (accessed 8/23/16).

² "Best Practices Methodology for Real Estate Assets Department," Grubb & Ellis, January 31, 2007, <https://www.sandiego.gov/sites/default/files/legacy/real-estate-assets/pdf/grubbellis070131.pdf> (accessed 8/24/16).

³ <https://www.sandiego.gov/real-estate-assets/portfolio-management-plan> (accessed 11/2/16).

many held-over leases could continue at less than fair-market value, thereby reducing potential revenue for the City.

The City Auditor conducted a performance audit of READ in 2012. One of its recommendations was for READ to draft a policy for nonprofit leases that “recovers the City’s costs for facilities maintenance and upkeep of the subsidized space, as well as the costs of preparing, processing and monitoring leases.”⁴ Although READ has begun assessing this fee in renewed nonprofit leases, the lag in renegotiating many expired leases is preventing the City from recouping actual costs associated with administering such leases.

READ’s Fiscal Year 2016 Portfolio Management Plan⁵ includes a goal to “transition month-to-month agreements to long-term leases where appropriate.” This is a fitting philosophy, but it again lacks a strategic plan for accomplishing the goal.

Governing Documents

The primary governing documents for READ’s leased properties are Council Policies 700-10⁶ and 700-12⁷. In discussion with City officials, the Grand Jury learned that Council Policy 700-10, in particular, needs added flexibility to allow READ to make leasing decisions that are in line with current economic conditions. Council Policy 700-12 dates back to 1985 and is sorely in need of revision to reflect current realities. READ officials have assured the Grand Jury that the department is spearheading an effort to revise both policies, and the jury encourages the completion of this task.

FACTS AND FINDINGS

Fact: Approximately 125 of 500 READ leases are in held-over status.

Fact: READ attests that the department is working on renewal of held-over leases, but progress in that regard is slow.

Finding 01: The lag in renewing expired leases does not allow the City to maximize its revenue potential on leased properties and prevents lessees from developing secure, long-term plans.

Finding 02: READ’s inability to bring the backlog of expired leases current demonstrates a lack of adequate resources.

Fact: READ has no established standard time period for issuing RFPs prior to lease renewal.

⁴ “Performance Audit,” https://www.sandiego.gov/sites/default/files/13-009_read.pdf, p. 29 (accessed 11/3/16).

⁵ “Portfolio Management Plan,” <https://www.sandiego.gov/sites/default/files/portfoliomangementplan.pdf>, p. 23 (accessed 10/11/16).

⁶ Council Policy 700-10, http://docs.sandiego.gov/councilpolicies/cpd_700-10.pdf (accessed 9/14/16).

⁷ Council Policy 700-12, <https://www.sandiego.gov/sites/default/files/legacy/park-and-recreation/pdf/bptf/18.cp700-12dispositionofcityproperty.pdf> (accessed 9/14/16).

Finding 03: A policy for time-sensitive issuance of RFPs would promote fairness and accountability.

Fact: Council Policy 700-10 does not allow downward lease rate adjustments.

Fact: Council Policy 700-12 has not been updated since 1985.

Finding 04: Council Policy 700-10 is too rigid and needs revising, and Council Policy 700-12 is outdated, preventing READ officials from making sound leasing decisions that accurately reflect current economic conditions.

RECOMMENDATIONS

The 2016/2017 San Diego County Grand Jury recommends that the San Diego City Council:

- 17-01:** **Within fiscal year 2018, provide resources to the Real Estate Assets Department—either additional personnel or through outsourcing—to develop a proactive strategy for bringing held-over nonprofit and for-profit leases current.**
- 17-02:** **Direct the Real Estate Assets Department to establish, within fiscal year 2018, a standard time frame for issuing RFPs on expiring leases.**
- 17-03:** **Work with the Real Estate Assets Department to revise and update Council Policies 700-10 and 700-12 within fiscal year 2018.**

REQUIREMENTS AND INSTRUCTIONS

The California Penal Code §933(c) requires any public agency which the Grand Jury has reviewed, and about which it has issued a final report, to comment to the Presiding Judge of the Superior Court on the findings and recommendations pertaining to matters under the control of the agency. Such comment shall be made *no later than 90 days* after the Grand Jury publishes its report (filed with the Clerk of the Court); except that in the case of a report containing findings and recommendations pertaining to a department or agency headed by an elected County official (e.g. District Attorney, Sheriff, etc.), such comment shall be made *within 60 days* to the Presiding Judge with an information copy sent to the Board of Supervisors.

Furthermore, California Penal Code §933.05(a), (b), (c), details, as follows, the manner in which such comment(s) are to be made:

- (a) As to each grand jury finding, the responding person or entity shall indicate one of the following:
 - (1) The respondent agrees with the finding
 - (2) The respondent disagrees wholly or partially with the finding, in which case the response shall specify the portion of the finding that is disputed and shall include an explanation of the reasons therefor.
- (b) As to each grand jury recommendation, the responding person or entity shall report one of the following actions:

- (1) The recommendation has been implemented, with a summary regarding the implemented action.
 - (2) The recommendation has not yet been implemented, but will be implemented in the future, with a time frame for implementation.
 - (3) The recommendation requires further analysis, with an explanation and the scope and parameters of an analysis or study, and a time frame for the matter to be prepared for discussion by the officer or head of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This time frame shall not exceed six months from the date of publication of the grand jury report.
 - (4) The recommendation will not be implemented because it is not warranted or is not reasonable, with an explanation therefor.
- (c) If a finding or recommendation of the grand jury addresses budgetary or personnel matters of a county agency or department headed by an elected officer, both the agency or department head and the Board of Supervisors shall respond if requested by the grand jury, but the response of the Board of Supervisors shall address only those budgetary or personnel matters over which it has some decision making authority. The response of the elected agency or department head shall address all aspects of the findings or recommendations affecting his or her agency or department.

Comments to the Presiding Judge of the Superior Court in compliance with the Penal Code §933.05 are required from the:

<u>Responding Agency</u>	<u>Recommendations</u>	<u>Date</u>
San Diego City Council	17-01 through 17-03	03/02/17