DATE: September 23, 2021

TO: Honorable Members of the Audit Committee

FROM: Andy Hanau, City Auditor

SUBJECT: Revised Management Response to the July 2021 Performance Audit of the City’s Major Building Acquisition Process

At the July 28, 2021 Audit Committee Meeting, the Audit Committee requested the City Administration work with the City Auditor to revise the management response to the Performance Audit of the City’s Major Building Acquisition Process, and return to the September Audit Committee meeting with those revisions. The City Administration provided a revised response to the audit (attached) and agrees to fully implement the audit recommendations.

We greatly appreciate the Mayor’s Office and City Management’s commitment to correcting the serious deficiencies identified in the audit. The City Management’s revised response to the audit is attached in the following pages. Office of the City Auditor staff met with the Mayor’s Office and City Management several times to ensure our understanding of the intent of the response, as the revised response suggests some alternative methods of implementation to still meet the intent of the recommendation, and in some areas did not address specific components of the recommendations. To that end, City Management confirmed the following for clarifications to the revised response:

- City Management agrees to fully implement the best practices checklist outlined in Recommendation 1 through Council Policy. The Council Policy will apply to major building purchases, lease-to-own agreements, and leases for buildings the City intends to purchase or make significant tenant improvement investments in. This is a narrower definition of building acquisitions than in our audit, but this definition appears to meet the intent of the audit recommendations. City Management is still evaluating how to define more specific parameters for which leases will be subject to the checklist requirements, and we plan to

1 In the audit recommendations, we defined ‘major’ acquisitions as those requiring City Council approval.
review these parameters as part of our recommendation follow-up process to confirm the intent of our recommendation will be met.

- In Recommendation 2, City Management agrees to implement in an Administrative Regulation that it will notify the Office of the Independent Budget Analyst (IBA) early in the process, to be defined as when a viable building acquisition has been identified. City Management will identify a clear triggering event in the Administrative Regulation, and we believe this will meet the intent of the recommendation. Again, we plan to review these parameters as part of our recommendation follow-up process to confirm the intent of our recommendation will be met.

- City Management agrees to fully implement Recommendation 4, which requires that all contractors and advisors with significant input on real estate acquisition decisions have a contract with the City and are disclosed to City Council in the building acquisitions best practices checklist, to be included in the Council Policy. In addition, per the recommendation, City Management agrees to also include in the Council Policy that the department contracting with such real estate advisors file a determination form with the City Clerk identifying which financial disclosures the advisor must make.

However, this recommendation will be directed to City Management and the Office of the Chief Operating Officer, rather than narrowly directed at the Department of Real Estate and Airport Management. We agree this will better ensure implementation of the recommendation.

- City Management agrees to fully implement Recommendation 5, which requires that Management develop a due diligence checklist in an Administrative Regulation that sets out required items.

- City Management will work with our office through the recommendation follow-up process to ensure the recommendations, as implemented, address the issues identified in the audit. City Management will submit the Council Policy drafted in response to the recommendations to Audit Committee, if requested, before the policy is submitted to the Land Use and Housing Council Committee and the City Council.

Again, I wish to express my gratitude to City Management for continuing to work with our office throughout this process.
Respectfully submitted,

Andy Hanau, MPP, CIA, CFE
City Auditor

cc: Honorable Mayor Todd R. Gloria
    Honorable Members of the City Council
    Honorable City Attorney Mara Elliott
    Jay Goldstone, Chief Operating Officer
    Paola Avila, Chief of Staff, Mayor's Office
    Jessica Lawrence, Director of Policy, Mayor's Office
    Andrea Tevlin, Independent Budget Analyst
    Christiana Gauger, Chief Compliance Officer
    Penny Maus, Director, Department of Real Estate and Airport Management
    Jim McNeil, Assistant City Attorney
    Heather Ferbert, Chief Deputy City Attorney
This memorandum provides background information and a revised management response regarding the Audit of the City's Major Building Acquisition Process. We would like to thank the Office of the City Auditor for their thorough review of five acquisitions that occurred under the prior Administration and with prior Management of the Department of Real Estate and Airport Management (Department) formerly known as Real Estate Assets Department (READ). This item was presented to the Audit Committee on July 28, 2021 where a robust discussion occurred around management's proposed responses to the recommendations. Prior to this discussion, City management modified its response in order to provide better clarity.

Below is an excerpt from a memorandum, released July 27, 2021, from Mayor Todd Gloria and Chief Operating Officer Jay Goldstone, regarding this performance audit.

We want to clarify that this administration agrees with your conclusions on the transactions and strongly agrees with creating a path forward for real estate transactions and acquisitions that is more transparent. The Department, under the leadership of this administration, intends to embark upon a comprehensive overhaul to the outdated leasing policy, Council Policy 700-10 (Policy), which has not been updated in decades. We are committed to seeing this happen to ensure that failed transactions, such as those covered in your audit, do not happen again. This update will include many of your recommendations and updates will be regularly provided to the Audit Committee.

Management agrees that the City should formalize its acquisition process through a comprehensive update of its current leasing policy, Council Policy 700-10, (Policy) and the real estate Portfolio Management Plan (PMP) as these are documents that have not been updated in many years. Both the Policy and PMP can not only be revised to be current, they can be more transparent for the benefit of the City Council and the public.

We agree with the City Auditor's conclusions that the City's major building acquisition process should be improved to clarify roles and responsibilities, establish clearer processes, and provide greater disclosure and transparency over these types of transactions. Further, management agrees to a baseline checklist for major building acquisitions to be incorporated into the revised Policy. More common real estate transactions such as leases, easements, open space acquisitions, etc. will utilize a different process. City management will add guidelines and best practices for these types of transactions to the revised Policy; with the goal to have clearly documented and comprehensive processes for all real estate transactions.
There are some recommendations (see Recommendations 1 & 2) that include specific recommendations that are not within Mayoral Jurisdiction.

This revised response memorandum provides specific details of what City management intends to implement as a response to the recommendations.

We look forward to working with the City Auditor on implementing the recommendations, and putting the City in a better position as we approach future real estate transactions including, but not limited to, acquisitions.

**Recommendation #1:** As the lead department, we recommend the Real Estate Assets Department (READ), in consultation with the Independent Budget Analyst (IBA), City Attorney’s Office, and other departments as needed, create a new or amended Council Policy for City Council’s approval that requires a best practices checklist for building acquisitions. READ and other departments as detailed in the new or amended policy would complete and present the checklist to City Council for every building purchase or lease agreement that requires City Council approval. The checklist in the Council Policy should establish the following steps to be taken and presented to City Council:

a. Determination of how a building acquisition fits in the strategic plan detailed in Recommendation 3.

b. Determination of what the building will be used for and to what extent the building fits the business case.

c. Completion of a funding method analysis, with input from the Debt Management Department.

d. Determination of estimated tenant improvement costs supported by relevant data. Tenant improvement proposals should be presented and approved with the building acquisition. Tenant improvements proposals should include detail on how the tenant improvements will ensure the building meets the City’s needs and detail on the anticipated cost and timeline.

e. Completion of an overall economic analysis including consideration of other acquisition options, with input from the Chief Financial Officer.

f. Completion and presentation of a due diligence checklist (see details in Finding 2, Recommendation 5), including a high-level summary of the due diligence materials obtained by READ and their findings. The due diligence materials obtained by READ and provided at least in summary to City Council should include but not be limited to appraisals, building condition and environmental assessments, and the assessments’ findings. Findings from assessments may include the building’s Americans with Disabilities Act compliance, the presence of hazardous materials, the results of a building systems investigation, and the results of an asbestos inspection.

g. Identification and designation of a set City Council committee to oversee building leases or purchases that require City Council approval.

h. Presentation of the City Attorney’s Office’s written analysis of the significant legal risks of the contract.

i. Review of completion of items on the checklist by the IBA or the IBA’s as-needed consultant to the best of their knowledge. This review may include an analysis of how well the best practices have been conducted.

j. City staff may note in the checklist if steps required in the checklist were not completed and why. City staff should provide material to the IBA to support each component of the checklist, including the rationale to not complete checklist steps. (Priority 1)

**Management Response: Agree**

Agree: We agree that the Policy should be updated to reflect the process for a major building acquisition. DREAM management will also update the policy to include guidelines and due diligence best practices for other acquisition types including: dispositions, lease administration, municipal asset services and valuation. These transaction types occur much more often than major building acquisitions and City management is eager to improve transparency and guidelines on all real estate transactions.

It is envisioned that the Department will thoroughly review the Policy and PMP, benchmark it against other agencies and the private sector to become a comprehensive real estate policy. It would be optimal to fold other Council policies in, either in whole or in reference, such as leasing to non-profits in Balboa Park.
We also envision that our staff reports will be more transparent moving forward and due diligence that is completed as part of a transaction, will either be attached or be referenced so a Council Member or member of the public could request the document to review it (such as a Phase 1 Environmental Report).

The Department will create a robust and long-lasting Policy that governs real estate transaction of many types; however, the Policy may not cover all real estate transactions that may arise. The revised Policy will serve as a guideline and tool for City Council and City management to abide by even when specific transactions are not envisioned today.

Not Applicable to the Department: There are also components of this recommendation (g, h and i) that would be the responsibility of other non-mayoral departments so we will defer to those departments for their response. Regarding recommendation g, while Department staff is ultimately not in control of docketing, we concur that staff should make its best efforts to docket items for presentation at the designated committee (currently LU&H), prior to presenting to the full Council. Further, staff will comply with the docketing guidelines as set forth by the Council President.

Target Date: July 1, 2022

Recommendation #2: When drafting the Council Policy set out in Recommendation 1, we recommend that the Real Estate Assets Department (READ), in consultation with the Independent Budget Analyst (IBA), City Attorney’s Office, and other departments as needed, create an Administrative Regulation to establish clear roles and responsibilities for City departments involved in the acquisition process or with expertise to contribute to the acquisition process. The Administrative Regulation that correlates to the Council Policy in Recommendation 1 should, at minimum, include roles and responsibilities for the departments listed below.

a. Acquisition lead. The policy should set out the role and responsibilities of the acquisition decisionmaker, as well as the acquiring department, if the parties are different. READ can require the acquisition decisionmaker to provide information to READ for the checklist, such as the business case for the building and the desired funding method.

b. READ. READ’s role in transactions should be clearly defined, including its responsibility in taking the lead on negotiations and conducting due diligence. READ should conduct an economic analysis of purchasing the building in question compared to other options, as well as an economic analysis of using the funding method recommended compared to other funding methods. READ should consult with the Department of Finance and the Debt Management Department for the economic analysis. READ should be the party responsible for completing the due diligence checklist and ensuring the information presented is accurate.

c. City Attorney’s Office. The City Attorney’s Office should prepare and present a written legal analysis of the significant risks in each building’s acquisition contract for all buildings that require City Council approval. The written legal analysis may be included as a dedicated section within the staff report to City Council or may take the form of a separate memo.

d. Independent Budget Analyst (IBA). The IBA should be notified and provided all relevant information on building purchase acquisitions at the time a building has been identified and prior to the start of negotiations. The IBA would not be involved in the operations and management side of acquiring the building, but should be provided information to conduct a sufficient and timely analysis of the best practices followed or not followed. The IBA should also review the best practices checklist (as described in Recommendation 1) and hire a consultant for review of the checklist as needed. (Priority 1)

Management Response: Agree

Agree: We agree with the recommendation that the policy shall clearly identify roles and responsibilities. Regarding recommendation d, City management agrees to work collaboratively with the City Council and the IBA and provide timely briefings and information as appropriate.
Not Applicable to Department: City Attorney’s Office or IBA will need to respond to the recommendation with regards to recommendations c and d.

Target Date: July 1, 2022

Recommendation #3: We recommend that the Real Estate Assets Department (READ), in consultation with the City Administration, develop and use a strategic real estate and office space plan. The plan should include the current space usage and a plan for future office space usage for City properties. The Council Policy described in Finding 1 should require READ to present the plan to the designated City Council committee and the City Council for input, changes, and approval every two years. (Priority 2)

Management Response: Agree

Agree: We agree with the recommendation to develop and use a comprehensive strategy regarding space needs. Given the size of the City with its 11,000+ employees and over 1,600 facilities, implementation of this recommendation will require extensive work and the Department will need to retain a third-party consultant to assist with initial data gathering. Additional staff will also be needed to assist the Municipal Asset Services team to effectively develop, implement and manage such a plan, including a person with expertise in space needs planning for both office and industrial space types.

Target Date: February 1, 2023

Recommendation #4: We recommend that the Council Policy set out in Recommendation 1 also require all contractors or advisors with significant input on real estate transactions to have a signed contract with the City and a determination form filed with the Office of the City Clerk by the contracting department. Additionally, we recommend that the policy in Recommendation 1 require the best practices checklist presented to City Council for real estate acquisitions to include a section disclosing any consultants or advisors to the City that were involved in the acquisition. Before presenting the checklist to City Council, the lead department on the acquisition should confirm with the Office of the City Clerk that each consultant or advisor listed has a Consultant Determination Form on file, and that any consultants and advisors have filed a Statement of Economic Interests form if necessary. (Priority 1)

Management Response: Agree (See Note below)

Agree: We agree that contractors or advisors should have a signed contract with the City, as required by the City Charter and Municipal Code. Further, the Political Reform Act (Gov. Code sections 81000-91014) which requires disclosure of personal assets as well as self-disqualification from participating in decisions which may affect their personal economic interests. The City’s Conflict of Interest Code for the Office of Mayor and the Department also require the same self-disqualification and are expected to be followed. The specific guidelines mentioned in the recommendation are the steps required under these existing policies.

Management unequivocally agree that DREAM as the lead Department in major building acquisitions shall be responsible for having signed contracts for consultants offering “significant input on real estate transactions” as described in Finding 1 of the Performance Audit Report and further described in the Office of the City Auditor’s Comments on the Response from City Administration (OCA Response), dated July 22, 2021 (page 103) of the Performance Audit Report of same date.

Target Date: July 1, 2022
Recommendation #5: We recommend that the Real Estate Assets Department (READ) create a due diligence checklist in an Administrative Regulation to ensure that the due diligence items (as recommended in Recommendation 1f) are accounted for prior to purchase and presentation to a designated oversight committee. READ should be responsible for completing this checklist, and if READ determines an item is unnecessary for a particular acquisition, READ should be responsible for reporting with supporting information why READ chose not to complete the required item. The checklist should include, but is not limited to, the following items:

a. Independent Appraisals. READ should contract for an appraisal for the building early in the negotiations on purchase price, before the purchase price is agreed upon.

b. Independent Building Condition Assessments. READ should create a policy on what assessments (e.g., facilities, systems, hazardous materials, ADA, plumbing, geotechnical, etc.) are required and when and who is responsible for ensuring they are conducted.

c. Environmental Assessment. READ should hire a contractor and/or have qualified City staff perform a Phase 1 environmental assessment.

d. Independent Asbestos Assessment. READ should engage the Asbestos and Lead Management Program to determine if an asbestos inspection is necessary before entering into a purchase and sale agreement. Asbestos inspection conclusions should be considered in the building’s negotiated purchase price and/or for future tenant improvements.

e. Test fit. READ should create a policy on when a test fit is required and when and who is responsible for ensuring it is completed and included in the tenant improvement cost and cost/benefit analysis. (Priority 1)

Management Response: Agree

Agree: We agree that an appraisal shall be completed prior to a purchase price for a major building acquisition is agreed upon, however it may be at different points in time based upon the property itself and the level of due diligence that is required to properly inform the appraiser. As in the example of the 101 Ash transaction, an appraisal was conducted prior to final purchase price agreement (via City Council authorization), however that appraisal lacked the due diligence reports, in this case, an independent and thorough condition assessment, to properly inform the City and the appraiser of the condition and overall value of the building. Therefore, we agree to have appraisals completed prior to presenting a recommendation to Committee and/or City Council on a transaction. We will also agree to contract for an appraiser early on in the acquisition process as recommended.

As previously noted, we also envision that our staff reports will be more transparent moving forward and due diligence that is completed as part of a transaction, will either be attached or be referenced so a Council Member or member of the public could request the document to review it (such as a Phase 1 Environmental Report).

Further, as noted to the response to Recommendation 1, City management agrees to update/create a Council Policy to reflect the process for a major building acquisition. We would also like to offer that DREAM management will also update the policy to include guidelines and due diligence requirements for other acquisition types including: dispositions, lease administration, municipal asset services and valuation. These transaction types occur much more often than major building acquisitions and City management is eager to improve transparency and guidelines on all real estate transactions. It is envisioned that the Department will thoroughly review the Policy and PMP, benchmark it against other agencies and the private sector to become a comprehensive real estate policy. It would be optimal to fold other Council policies in, either in whole or in reference, such as leasing to non-profits and in Balboa Park. The Policy could note that examples of “due diligence” may include, but are not limited to items a-e.

The Department intends to create a robust and long-lasting Policy that governs real estate transactions of many types. It should be noted that the Policy may not cover all real estate transactions that may arise; however, the revised Policy will serve as a guideline and tool for City Council and City management to abide by even when specific transactions are not envisioned today.
Target Date: July 1, 2022

**Recommendation #6:** We recommend that the Council Policy set out in Recommendation 1 also require that the Real Estate Assets Department (READ) or the acquisition lead present the best practices checklist to City Council and demonstrate that all pertinent departments have signed off on all aspects of the acquisition process. The due diligence supporting materials, including those listed in Recommendation 4, must also be made available to City Council members and the public. (Priority 1)

Management Response: Agree

Agree: See responses to Recommendations #1, 2, 4, 5, & 10.

Target Date: Immediately

**Recommendation #7:** We recommend that the Independent Budget Analyst, in consultation with the City Attorney’s Office, create and bring forward to City Council for approval a section to be added to the San Diego Municipal Code to provide an enforcement mechanism for Charter Section 32.1, to ensure that City staff accurately represent and inform City Council of all material facts or significant developments relating to real estate acquisitions under the jurisdiction of City Council. (Priority 2)

Management Response: Not Applicable to the Department

**Recommendation #8:** We recommend that the Council Policy set out in Recommendation 1 require the Independent Budget Analyst (IBA) to review the best practices checklist before City staff present the checklist to City Council committee and determine if staff completed the steps outlined in Recommendation 1. The IBA’s assessment should be conducted in writing and presented with sufficient time for City Council to review its conclusions. (Priority 1)

Management Response: Not Applicable to the Department

**Recommendation #9:** If determined to be necessary, we recommend that the Independent Budget Analyst (IBA) consider requesting budget approval from City Council for an as-needed consultant contract to assist the IBA in reviewing the City’s best practices set out in Recommendation 1. The consultant could evaluate whether the checklist itself is fully developed and appropriate. The consultant could also evaluate proposed acquisitions and how well the City completed the checklist with regards to specific future acquisitions. (Priority 2)

Management Response: Not Applicable to the Department

**Recommendation #10:** We recommend that the Council Policy set out in Recommendation 1 require the Real Estate Assets Department (READ) to take all building purchases and leases that require City Council approval to the same City Council committee identified and designated in Recommendation 1. The Council Policy should also require that if the acquisition is not taken to the committee overseeing acquisitions, the City Administration should explain in writing why and the action taken by City Council should include an express waiver. (Priority 2)

Management Response: Agree

Agree: See response to Recommendation #1.

Target Date: July 1, 2022
Conclusion: As stated previously, the Department intends to create a robust and long-lasting Policy that governs real estate transaction of many types. The City is a large organization with miles and miles streets, acres of parks, beaches and open space and several reservoirs, as well as tons of easements. Needs of this growing and diverse City change constantly and a Policy may not cover all real estate transactions that may arise, however the revised Policy will serve as a guideline and tool for City Council and City management to abide by even when specific transactions are not envisioned today and shall be a document that will instill confidence and trust in the City as transactions are presented for years to come.

Thank you again for the opportunity to provide input and clarification on these issues. Staff are available for follow-up discussion with your team, as needed.

Jay Goldstone
Chief Operating Officer

cc: Honorable Mayor Todd Gloria
Honorable City Attorney Mara Elliott
Andrea Tevlin, Independent Budget Analyst
Matt Vespi, Chief Financial Officer
David Nisleit, Chief, Police Department
Colin Stowell, Chief, Fire-Rescue Department
Alia Khouri, Deputy Chief Operating Officer
Kristina Peralta, Deputy Chief Operating Officer
Jeffrey Sturak, Deputy Chief Operating Officer
Matt Helm, Chief Compliance Officer
Jessica Lawrence, Director of Policy, Office of the Mayor
Randy Wilde, Senior Policy Advisor, Office of the Mayor
Matt Yagyagan, Deputy Director of Policy, Office of the Mayor
Rolando Charve, Department of Finance Director and City Comptroller
Lakshmi Kommi, Director, Debt Management
Kyle Elser, Assistant City Auditor