LITTLE HOOVER COMMISSION

CALIFORNIA'S REAL PROPERTY MANAGEMENT: A CORNERSTONE *for* STRUCTURAL REFORM

December 1995

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LITTLE HOOVER COMMISSION

December 5, 1995

The Honorable Pete Wilson
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The Honorable Brian Setencich
Speaker of the Assembly
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The Honorable Willie L. Brown Jr.
Assembly Democratic Floor Leader

Dear Governor and Members of the Legislature:

Over the last decade, the Little Hoover Commission has advocated repeatedly that the State reform its management of real property. Sincere efforts have been made to make the current system function better, but those attempts have failed. The consequences include higher state costs and lost revenue.

While ambitious office projects are being launched, dozens of existing state buildings are deteriorating into unhealthy and dangerous places to work. While the State holds more than 2,000 leases, only 2 percent of those leases have been renegotiated to capture lower rental rates. While the Legislature has sought a comprehensive search for surplus lands, only a small fraction of the State's properties have been evaluated.

Problems like these will not go away until the State restructures the organization expected to meet its space needs. At the very least, the State should create a unified and independent department to meet the real property needs of state agencies. The State also should consider a quasi-public corporation that would have the authority to act as a private entity, yet be held accountable as a public one. In either case, the State should move from a monopoly to the marketplace, relying on competition as the cornerstone for building a responsive and efficient organization.

Given the State's perennial fiscal woes, the government must seize ways to save money and generate revenue. Given the evolution of public organizations, the marketplace and technology, the State must systematically change how real property is provided by internal bureaucracies, accounted for in budgets and used by individual departments. Toward that end, the Commission's report, which is being transmitted to the State's top policy makers with this letter, makes three findings and three recommendations, and provides short-term and long-term measures that can be taken:

Limited Progress. The State is still not pro-actively managing property. While efforts have been made to identify surplus property, renegotiate leases, consolidate state agencies and reconfigure workplace standards, the track record of these reforms reveals more about the potential for better management than what has been achieved.

- The Commission recommends that the State adopt market-based management techniques, infuse competition wherever possible to encourage innovation, and aggressively tap private-sector services.

Inadequate Review. The State's office consolidation efforts and construction projects, while subjected to much political scrutiny, lack effective economic review. Efforts to coordinate state office space have been troubled by unclear policies for deciding when the State should lease or own, where buildings will be located, how they will be financed and how the Legislature will review and approve projects.

- The Commission recommends that the State establish a streamlined, yet rigorous process for independently analyzing and winning legislative approval of large projects. That process will be enhanced if policies are clarified as to where public buildings will be sited, how agencies will be assigned space and how short-term higher costs will be budgeted.

Structural Woes. The State's major property management problems will be difficult, if not impossible, to resolve without significant organizational restructuring. At best, the structural problems have made it hard for the State to be a pro-active manager. At worst, recent efforts have shown that overall improvements will not be accomplished until the State structurally changes how it manages real property.

- The Commission recommends that the State unify its management of developed property. The new agency should be independent yet accountable, allowed to use market mechanisms and private business practices, and free from day-to-day political influence.

While the Capitol Area Development Authority (CADA) was beyond the scope of this study, the Commission became concerned during its investigation that the joint powers authority that was established to manage state property near the Capitol may not be serving the State's best interests. Even a cursory review shows that CADA does not calculate rates of return on its investments and that the State may have yielded too much control to the CADA Board of Directors. These issues reflect the lack of accountability that permeates the State's larger property management system.

For nearly half a century, the State has hoped to capture the economies of scale by relying on an internal monopoly with limited authority. In the next half century, how property is managed will not only influence how much the State pays for its space, but also how well public agencies serve the public. Without reforms, the State can expect higher costs and facilities that do not contribute to the betterment of government services. The Commission stands ready to work with the Governor and the Legislature to make these policy changes a reality.

Sincerely,

Rich Terzian

Chairman Richard R. Terzian

California's Real Property Management:

A Cornerstone for Structural Reform

December 1995

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Executive Summary

The State's management of its real property assets has been plagued for many years by intractable problems. Recently, sincere efforts have been made to put those assets to better use and to better provide the facilities needed to make government effective. But those efforts have been hobbled by institutional inertia, political controversy and an organizational structure that provides neither accountability nor control.

Traditionally, attempts to improve real property management have been inspired by the need to stretch the State's resources and generate revenue. Those reasons are more important today than ever before.

Increasingly, however, it also is clear that reforming how state government functions internally -- through property management, through procurement of goods and services and through personnel systems -- is an essential precursor to improving the efficiency of those departments that directly serve the public.

The Little Hoover Commission believes some administrative and legislative changes could make the existing system function better. However, the Commission believes significant organizational restructuring is needed if significant improvements are to be realized.

At a minimum, the existing offices now within the Department of General Services (DGS) should be realigned and unified into a new department. But the State also should give serious consideration to establishing a quasi-public corporation to manage its properties and provide needed facilities.

In either case, the State should look to competition, incentives and out-sourcing as ways to encourage innovation and provide managers with the tools needed to make good decisions and to implement state policies.

Toward that end, the Little Hoover Commission makes the following findings and recommendations:

Finding 1: The State is still not pro-actively managing property.

Despite years of constructive criticism from a variety of sources, the State has not evolved from a caretaker of its vast real estate assets to a pro-active manager. Efforts have been made to identify surplus property, renegotiate leases, consolidate state agencies and reconfigure workplace standards. But the track record of these efforts reveals the untapped potential for managing the State's property.

> **Recommendation 1: The State should aggressively pursue more efficient and market-based management. It should infuse competition whenever possible to encourage innovation and economy. And it should more aggressively tap private-sector services to take advantage of unique opportunities.**

The success of any attempts to pro-actively manage property will rest greatly on the mechanisms the State uses to pursue those goals. Pro-active management cannot be legislated, but the Legislature can provide the tools that property managers need to do a better job. Ambition also cannot be legislated, but departments and individuals can be expected to respond to economic and institutional incentives.

The Department of General Services could immediately implement this recommendation by taking the following actions:

- The department should more aggressively renegotiate leases, particularly as part of its efforts to execute some small-scale consolidation programs. The department should contract with private firms when necessary to take advantage of short-term market conditions.

- The department should expand its pilot project using private brokerage firms to gain more quickly the necessary experience needed to implement a statewide program that efficiently meets client needs while protecting taxpayers against contract abuses.

- The department should redesign the Building Rental Account to establish individual building rents that reflect the market rates of occupancy. The department and its customers should negotiate adjustments to those rates to finance deferred maintenance projects. The department and its customers also should negotiate adjustments to those rates to finance tenant improvements that might facilitate organizational restructuring. The Legislature should be billed for its space costs, or those costs should be allocated over all state agencies, not just those in DGS-owned buildings. This would be the first step toward implementing earlier Commission recommendations that buildings be appraised regularly and that facility managers calculate an annual return on investment to evaluate the performance of significant state assets.

- To the extent allowed by law, private maintenance firms should be able to compete against DGS-supplied maintenance for service contracts. The contracts should provide a level of service that minimizes long-term maintenance needs. The bidding process should be reviewed to ensure that public workers have a fair opportunity to compete for maintenance contracts, to consider the policy concerns of differing wages and to provide the State with the best possible value.

The Governor and the Legislature could further implement this recommendation by taking the following actions:

- Legislation should be enacted granting all departments the option of contracting with DGS, other government agencies or private-sector firms for meeting their space needs. DGS should have the opportunity to bid on all proposals.

- All out-sourcing contracts should be reviewed by a central authority, such as the Department of Finance. The authority's obligation would be to determine that the decision to use a private-sector provider was in the best interest of the State.

- Legislation should be passed that allows departments to redirect 20 percent of the revenue from property-related activities or savings from space-related decisions to enhance existing programs.

Finding 2: The State's office consolidation efforts and construction projects, while subjected to much political scrutiny, lack effective economic review.

The State has long had a strategy of trying to consolidate office space -- to avoid the usually escalating costs of leasing, to accrue the equity of ownership and to remedy the fragmentation of its agencies. But efforts to coordinate the office space needs of the State have been troubled by an unclear process for deciding when to lease and when to own, an antiquated financing and legislative approval process, the lack of coherent siting policy -- and overall, inadequate review of what should be built where.

Recommendation 2: The State should establish a streamlined, yet rigorous, process for independently analyzing and winning legislative approval of large projects.

The process needs to reaffirm the Legislature's role of setting policy and funding priorities for construction of state facilities, while recognizing needs of property managers for expeditious review and approval. An effective process also would require clear strategies for siting, awarding design and construction bids and financing such projects.

The Governor and the Legislature could implement this recommendation in the short term by taking the following actions:

- Consolidation plans should be financially fashioned and physically sized after a review of both leasing and purchase options of existing structures are explored, as well as the program needs of prospective tenants and non-building alternatives for meeting those needs.

- The department should more aggressively assist departments to reassess their long-term space needs and explore alternatives for satisfying those needs, including telecommuting and space sharing.

- The Department of General Services should have the agreement of all tenant agencies needed to fill a new building before construction begins. Tenant agencies should agree to pay rent equal to the actual costs of occupying the new structure, including a long-term maintenance plan. (If a statewide interest exists in providing additional public spaces or architectural stature, an appropriation from the state capital outlay budget could be used to augment tenant contributions.)

- Legislation should be enacted clearly establishing a state policy of how and where state buildings will be constructed, the procedures for setting qualifications and awarding bids, and designating the appropriate point for legislative approval for all large projects and under various financing scenarios.

- The Legislature should create a standing joint committee to review and approve large construction projects and long-term leases. The committee and its staff would have the opportunity to build a greater expertise in order to provide thoughtful review, while providing the new department with the opportunity to build trust with the Legislature. Upon approval by the committee, the full Legislature would have 45 days to act on the proposal.

- The Department of General Services should adopt internal procedures for reviewing the rationales for a project prior to the commencement of construction to ensure that assumptions used in the planning process are still valid.

Finding 3: The State's major property management problems will be difficult, if not impossible, to resolve without significant organizational restructuring.

More than five years of effort on the part of the Executive Branch to reform property management practices without changing the organizational structure has failed to show substantive improvements. At best, the structural problems have made it hard for the State to be a pro-active manager and have created resistance to those reforms. At worst, the experience of recent years has shown that overall improvements will not be made until the State makes structural changes in real property management.

Recommendation 3: The State should unify its management of developed property. The unified entity should be independent yet accountable. It must be free to use market mechanisms and business practices and free from day-to-day political influence.

At a minimum the State must tear down the walls within the real estate arm of the Department of General Services so that it can more efficiently plan for and deliver property services. But the potential for reform is far greater, and the State should seize the opportunity to create a new organization that can profitably manage its multi-billion-dollar property portfolio.

The Governor and the Legislature could implement this recommendation in the short term by taking the following actions:

- Legislation should be enacted creating a Department of Real Property Services separate from the Department of General Services. Planning, construction, leasing and maintenance should be unified to make more coordinated decisions about how to meet space needs of customer agencies, how to manage existing structures and how to blend technology, space design and management techniques to reduce space needs.

- The legislation should provide that employees of the new department will have a separate bargaining unit and the initial contract should include greater flexibility for offering merit-based compensation, broad classifications and expedited disciplinary appeals.

The Governor and the Legislature could implement this recommendation over the long term by taking the following actions:

- Legislation should be enacted creating a public corporation similar to the British Columbia Buildings Corp. The corporation should be financially independent and fee-based. It should be governed by a board appointed by the Governor and Legislature and could include constitutional officers, including the Controller and Treasurer. Its independence would allow it to make business-oriented decisions and to respond to market and technological changes to better serve customers. The corporation could be expected to provide services efficiently through economy of scale and access to public financing tools. While revenues could be reinvested in corporate programs, profits would be turned over to the General Fund.

- The corporation should be free to hire employees outside of the civil service system, and to enter into contracts with the private sector without approval from control agencies including the State Personnel Board and the Department of General Services.

- The corporation should purchase from the State all developed office space. After a period of organizational development, the corporation would have to compete for the services of all customer agencies. At that time, departments would be free to turn to the private sector, other government agencies, or to the corporation to satisfy their space needs. This would provide the corporation with the time to organize, while ultimately providing the competition necessary to achieve even greater efficiencies than a unified monopoly can provide.

- The corporation should be granted the authority to decide building location, design and financing. Before the client agency could enter into an agreement with the corporation, however, it must prove that it has the funds to pay for any additional facility-related costs.

- The corporation should be directed to site buildings in compliance with the State's siting policy, while granting the corporation the authority to size and specify buildings to meet a client agency's needs and budget.

- The legislation should grant the corporation the authority to float revenue bonds and to tap private financing sources in order to provide the organization as much flexibility as possible.

Introduction

Introduction

The Little Hoover Commission has long advocated that the State should improve its management of real property. Of keen interest over the years has been the prospect for savings and the potential for revenue associated with more efficiently using the property the State owns and disposing of those lands that it no longer needed. Other states and nations have faced the same dilemma, and like California have struggled to better administer real property assets.

Contemporary concerns, however, go beyond the cost effectiveness of individual property-related decisions. Many public-sector veterans and end-of-the century reformers believe the overall effectiveness of public programs will be determined in part by how well general service agencies provide for the mission-oriented agencies.

Office space is no longer merely a line-item in the budget. It is an ingredient of performance. Redefining the workplace can not only save money, but also can increase productivity and improve public service.

Over the years, the Little Hoover Commission has identified problems with how the State manages its properties -- some of which have been solved, some of which persist today. Solving these problems is more important now than ever. Fiscally, the State must stretch the resources at hand. Organizationally, a system must be created that encourages better decision making.

Many of these problems are inter-related. To take just one example, the success or failure of the Department of General Services' office space consolidation and construction effort will be influenced by the management framework by which the projects are conceived, by the economic and policy reviews through which they are scrutinized, and by the organizational structure in which they are implemented.

In conducting this review, the Commission and its staff interviewed dozens of past and present property management officials, including those in the Department of General Services and other agencies with significant landholdings. It interviewed private developers and property managers. It interviewed officials who are responsible for similar duties at the federal level and in other national governments, as well as a va. ety of consultants and experts who have been involved in property management reforms.

The Commission conducted a public hearing in Sacramento in August 1995. (Please see **Appendix A** for a list of witnesses). The hearing explored efforts by the Department of General Services to pro-actively manage the State's assets, and its program to consolidate far-flung state departments into centralized and often new facilities. The Commission heard testimony from representatives of the British Columbia Buildings Corporation, a former General Services Administration official, and a representative of the Urban Land Institute.

As a result of these efforts, the Commission concluded that it is unlikely that significant improvements will be made in how the State manages its property until significant structural changes are made to the bureaucracy. At the same time, it is clear that the State cannot wait to improve the system until there is consensus and political will to bring about the fundamental reorganization that property management programs warrant.

Therefore the Commission's recommendations include both short-term and long-term measures that could be taken to improve property management. The administrative remedies that are recommended will treat the symptoms, until support can be mustered for a real cure.

The Commission's report begins with a transmittal letter, an Executive Summary, this Introduction and a Background section. In the following three Chapters -- Limited Progress, Inadequate Review and Structural Woes -- three findings and three recommendations are made. The first chapter identifies chronic problems with the system. The second chapter identifies more recent problems related to the State's efforts to consolidate office space. The third chapter identifies significant problems that cannot be remedied without significant structural changes to the way the State manages its real property and meets its space needs. The report ends with a Conclusion, Appendices and Endnotes.

Background

- *The State owns 19,000 buildings, 158 million square feet of space, the equivalent of 16 New York World Trade Centers.*
- *The State leases 19 million square feet of space at an annual cost of $291 million.*
- *The Little Hoover Commission has previously advocated that the State become a pro-active manager -- by creating a centralized administrative structure, improving preventive maintenance, requiring better planning, and creating incentives for better decision making.*
- *The federal government, as well as other national governments, have dramatically restructured property management agencies to create responsive, accountable and efficient organizations.*
- *While some governments have created separate corporations for making property decisions, most are using competition as the catalyst for encouraging better service from their real property agencies.*

Background

In symbol and stature, public property is one measure of government. State buildings house government workers, serve the citizenry and define public spaces -- the halls of justice, the pillars of democracy, the bowels of the bureaucracy. Some buildings are ornate; some are state of the technical arts; and some are battered edifices, the beleaguered countenance of a government lacking public confidence.

Beyond the physical, property is often a forgotten asset and unscrutinized expense of government. In most departmental budgets, space needs are deeply overshadowed by resources spent on personnel. But in a government the size of the State of California, even 1 percent of the budget represents hundreds of millions of dollars annually.

As governments restructure, aggressive property management is critical to reform. From a budget perspective, effectively providing space needs can save millions of dollars a year. From an operational standpoint, property decisions influence how well an agency does its job: its accessibility to the public; its proximity to other agencies with related missions; its faculty to encourage internal efficiency and cooperation. And from a civic standpoint, state decisions affect investments made by private and other public landowners. The State's choices can bolster or erode urban revitalization efforts and a community's sense of place.

This background describes the extent and breadth of the State's property holdings, recent developments in the State's management approach, the Commission's involvement in this issue, and some property management trends that create the context for the property management debate.

Property Defined: A Multitude of Assets

The State owns 3,509 individual properties encompassing 2.4 million acres. Pieced together, they would comprise a land mass roughly equal in size to Los Angeles County. But as they are, the parcels reflect the diversity of the Golden State: windy hillsides populated by oaks and acorn woodpeckers, rocky cliffs pounded by the Pacific surf, rectangles of downtown San Francisco and Los Angeles that are valued by the square foot, sprawling suburban university campuses and patch-worked farm fields.

The State owns 19,000 buildings, 158 million square feet of space, the equivalent of 16 New York World Trade Centers. The holdings are as diverse in their purpose as they are in their nature: highway maintenance stations, employment development offices, fish hatcheries, mental institutions, universities, prisons and the veterans home.

This accounting is provided by the Statewide Property Inventory -- a basic and only recently developed management tool. The computerized listing took several years to compile, and the difficulty in collecting the data exemplifies the difficulty that state government has had in trying to manage its real estate assets effectively.

And despite years of effort, the inventory is incomplete. It does not include rights of way, most holdings of the State Lands Commission, property held by the Legislature, owned by the Lottery Commission or leased by Community Colleges and the University of California, tax-deeded and escheated properties held by the Controller, or elementary and high school properties administered by the Department of General Services (DGS), Office of Local Assistance. Yet for the first time, in one place, the inventory provides to state decision makers definitive information on what the State physically owns and occupies -- from remote forest fire-fighting stations to downtown high-rises.[1]

Collectively, the land and buildings represent a multi-billion-dollar portfolio. The actual investment is unknown because the State does not routinely appraise even its urban holdings, let alone its expansive rural holdings. This portfolio costs hundreds of millions of dollars a year to maintain and operate. In addition to the challenges associated with ownership, the State also is a significant renter. The State leases 19 million square feet of space at an annual cost of $291 million.[2]

Administering this portfolio requires thousands of judgment calls that over the years have created waves of controversy. And in response, the Legislature and various administrations periodically have attempted to make these decisions more strategic, more business-like, more pro-active.

By their nature, property-related decisions are difficult to make and even more difficult to make right. But mixed with the external political process through which projects are approved and funded, and the internal political process in which departments vie for resources, property decisions become even more confounding.

Some of the controversy has evolved over the management of property by dozens of special-purpose agencies. Controversy has evolved over when the State should own property and when it should lease property. And controversy has evolved over the appropriate role and authorities that should be granted the Department of General Services, often regarded as the State's landlord.

The Department of General Services was formed to improve the State's ability to provide for itself -- to consolidate the provision of services and goods required by other agencies, to accrue for the State the savings associated with economies of scale and the product of specialized professionals.

Seventy-seven departments own their own facilities. For every structure owned by DGS, there are 130 other structures in the State's inventory.

Most state departments and agencies must rely on DGS to negotiate leases for private-sector space. The Department also "owns" a substantial number of state office buildings, including nearly all of the multi-tenant buildings that contain branch or regional offices of state departments.

However, it is erroneous to think of DGS as the controller of state property. Seventy-seven other departments own their own facilities, some of them have extensive real estate portfolios, and all have varying degrees of property expertise.[3] For every structure controlled by DGS, there are 130 other structures in the State's inventory. And because most of the property that DGS controls is in urban areas and most of the State's landholdings are in rural areas, the department controls even less of the State's acreage -- one out of every 7,200 acres. But for many state agencies, DGS is effectively their landlord. And for most private building owners, DGS is the State's property agent.

In the state of California, experience has shown that the diffusion of property ownership has worked against efforts to pro-actively manage property. While an agency may be good at acquiring and maintaining property central to its specific mission, the chances are that it lacks the expertise and incentives to manage under-used property for some other purpose. Property-holding agencies, which are often trying to increase services with fewer employees, also are reluctant to redirect staff and energy to producing revenue or selling off property when the proceeds go to the General Fund.

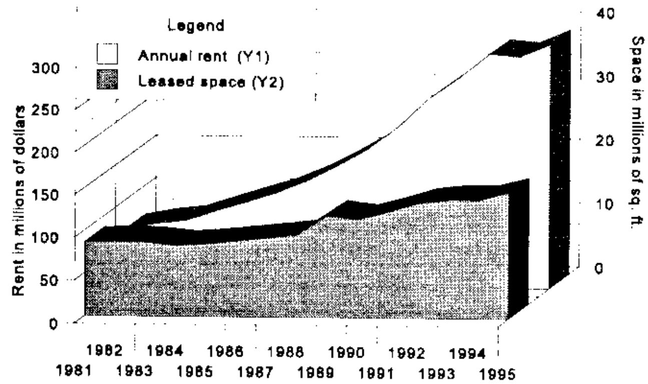
Individual departments are discouraged from worrying too much about the money spent providing space for mission-oriented tasks. From a budget perspective, a department's "rent" is a line in the budget that is paid for from the General Fund or a variety of special fund sources. That "rent" may be paid in the form of private-sector lease payments, or the maintenance costs for a debt-free public building controlled by their agencies. In some cases, agencies are budgeted enough to pay for the debt and operational expenses of the building they occupy. And in the case of a DGS building, tenants pay a flat rate historically intended to cover occupancy costs.

While that process allows for property expenditures to be considered as part of the budget process, it limits the ability for market-like cues to shape decisions. Reducing occupancy costs may allow a department to alleviate a budget crunch in a given year. But in general, departments that lower their property-related costs will be allocated less for that category of spending in future years. Departments seldom have the ability to reallocate long-term savings to other program needs.

From a fiscal standpoint, the key decision is not made during the budget cycle, but when the department makes the decision of where it will locate. An essential variable in that decision -- and one that has caused perennial debate, particularly when it comes to office space -- is whether the State should own or lease property. The issue is predictably cyclical, with the volume of the debate rising any time state employment grows rapidly and that growth is accommodated with often-expensive, short-term leases.

Chart 1

More Space, Higher Rents



Source: Department of General Services

While efforts have been made to reduce the State's dependence on leased space, both the amount of leased space and the costs continue to climb.

That was the case in the 1960s, when population growth and an expansion of social service programs increased the State's office space needs, and again in the late 1970s, as maturing environmental programs required office space.

In the late 1980s, rapid population growth, a super-heated real estate market and a constricting state budget reignited the debate over how best to curtail the soaring cost of housing state workers. In 1993, the administration formally launched a plan to consolidate state offices in the major urban centers. The program was expected to save money by reducing the number of leases, by developing shared facilities such as hearing rooms, and by reducing the space allocated individual workers and the total space allotted to shrinking departments. In most instances, the program also relied on new construction to accommodate the consolidations, providing the added benefit of creating 50,000 private-sector jobs.

By 1994, DGS had plans to construct before the turn of the century more than 5 million square feet of office space, nearly doubling the department's owned inventory. While calling for a reduction in leased space by 3.5 million square feet, the plan provided for a net gain of nearly 2 million square feet of office space.

The political context of the consolidation program includes a growing backlog of other unmet capital needs, such as new schools and universities. Meanwhile, a sagging real estate market and depressed lease rates diminished the benefits of constructing state-owned buildings. The soundness of any decision to lease or to own is based in large measure on the assumptions used in the analysis -- including the costs of financing, the availability of lease space, whether the economy is expected to boom or bust, the ability to maintain state-owned buildings, and the long-term need for office space in light of downsizing and telecommuting trends.

By 1994, DGS had plans to construct by the turn of the century more than 5 million square feet of office space, nearly doubling the department's owned inventory.

The ability of the Department of General Services to implement the consolidation program and be a pro-active manager of property it does not formally control, is limited by its legal authority and its political role in the bureaucracy. The Government Code and the State Administrative Manual describe DGS as a quartermaster -- striving to efficiently provide units with the material needed to fulfill their mission. But the organizational leadership has more recently tried to a create service-oriented culture, on the premise that government would be better served by a department that was responsive to the needs of its customers.

The conflict complicates even simple day-to-day transactions: Should DGS, for instance, find a department the best office space for the money it has budgeted, or should DGS find a department the least costly space that meets state standards? The conflict is further confused by the legal authorities: While DGS is directed to "assign" space in state buildings, "customer" departments can refuse such assignments.

And finally, whether the department is trying to act like a centralized provider of goods and services, or a private business-like organization, its ability to make decisions is limited by its interaction with the Legislature. As the appropriator of funds and the definer of policies, the Legislature expects to play a significant role in determining how the bureaucracy will be housed. At best, there is a tension between the laborious legislative process and the department's need to function effectively in the private sector. At worst, the personalities and politics of other issues distort the decision-making process.

The Commission's Long-Standing Concerns

The Little Hoover Commission has been active in reviewing the State's property management for many years. In 1985 and 1986, the Commission conducted a study modeled after the federal Grace Commission, which had successfully identified ways the federal government could better manage its property. The Little Hoover Commission, in its report *California State Government's Management of Real Property,* concluded that the State was not strategic in its planning, management and use of property: The State did not have a central inventory; did not know what it cost to maintain or operate buildings; did not evaluate its management efforts; did not provide incentives to reduce costs or dispose of surplus property; did not have an accountable authority for property-related decisions; and missed an abundance of opportunities to generate revenue from under-used or surplus parcels. To remedy this "undisciplined decentralization," the Commission recommended that the State:

- ***Establish a pro-active management pilot project.*** The project would collect data on property for a specific geographic area, determine its value, analyze alternatives, estimate revenue and propose an asset management system.

- ***Centralize policy development.*** Individual departments should prepare their own property management plans that would be approved by DGS.

- ***Develop incentives.*** Both departments and individuals should be granted incentives to increase revenue generated from property-related activities and reduce occupancy costs.

- ***Reduce redundant staffing.*** Property management staffs in those agencies with major property management duties should be reviewed, and positions duplicative of DGS positions should be eliminated.

- ***Create a centralized inventory.*** The inventory should contain physical descriptions, uses and values of state-owned properties.

In 1990, the Commission revisited the issue. In its report *Real Property Management in California: Moving Beyond the Role of Caretaker*, the Commission found that the State had not reorganized the structure enough to facilitate pro-active property management. The system for planning capital outlay needs was fragmented and incomplete. The statewide inventory needed additional improvement. And the State had not reformed policies that discourage pro-active management. As a remedy, the Commission recommended structural reforms to:

- ***Reconstitute the Public Works Board.*** The current Public Works Board should be reconstituted to make it the central administrative structure for a pro-active real property management system.

- ***Reinvest property-related revenue.*** Revenue generated from pro-active management of real property should be reallocated to capital outlay needs.

- ***Require capital outlay plans.*** Each state agency should be required to submit a five-year and 10-year capital outlay plan, and the Public Works Board should prioritize the projects.

- ***Step-up preventive maintenance.*** The Public Works Board should establish a preventive maintenance program for state facilities.

- ***Review all property authorities.*** The Public Works Board should review all property-related authorities and recommend legislative changes to ensure thoroughness and consistency.

- ***Expand the inventory.*** The Statewide Property Inventory should be expanded to include current and expected use, and the estimated value for urban properties.

- ***Use savings as incentives.*** Legislation should be enacted to allow state agencies to retain 20 percent of revenues from the management of their property, and to create incentives for individuals and groups to pro-actively manage property.

In June of 1992, the Commission released an issue paper, "Squeezing Revenues out of Existing State Assets," that reiterated the need for pro-active management in light of the State's fiscal crisis. The paper recommended ways that the State could make short-term changes to reduce costs and generate revenue from the State's property assets. Among the recommendations:

- ***Grant DGS short-term authorities.*** For a period of three to five years, the Department of General Services should be granted the authority to dispose of surplus lands, negotiate lease-purchase agreements and negotiate long-term leases.

The Commission has recommended both structural changes and administrative changes to the property management system. While some of the administrative changes have been adopted, the structural changes have not.

In recent years, two executive orders have declared the importance of more strategic use of the State's property and have laid out principles for reform. Those efforts resulted in the creation of an Office of Asset Management and a high-level Asset Management Coordinating Council. The game plan, as described by the director of the Office of Asset Management, was to "inventory, cooperate, plan, consolidate, refinance and privatize."[4]

The Department of General Services was directed by Senate Resolution 39 of 1991 to assess the long-term space needs of state agencies and to prepare a consolidation plan to best accommodate those needs. The Department of General Services also was directed by the Budget Act of 1993 to re-evaluate the Capitol Area Plan to assess the need for increasing the development of state office space in Sacramento.

The Office of Asset Management no longer exists. The duties of the director of that office have been reassigned to the assistant to the Secretary of the State and Consumer Services Agency. And the Asset Management Coordinating Council is dormant.

The consolidation plans have run into increasing trouble in the Legislature and within the administration. In an attempt to find a neutral authority to resolve some of these disputes, the State and Consumer Services Agency in early 1995 invited a panel of the Urban Land Institute (ULI) to review the State's plans and policies for consolidating state offices in Sacramento into multi-tenant state-owned structures.

The ULI panel found problems in both how the State was making its decisions and the choices that it was making: It urged the State to give greater consideration to the effect its decisions have on urban policies. It urged it to give better consideration to the changing and smaller space needs of the workplace of the future. And it recommended that the State develop more value-oriented and less political ways to make property-related decisions.[5]

Reforms Elsewhere: A World of Change

California is not alone in its need to manage property more effectively. In response to changing economic forces and technical innovations, some public and private sector organizations are radically changing how they manage property and satisfy their space needs.

The federal government is working to eliminate the monopoly that the General Services Administration has had over its "customers," with the belief that competition will encourage efficiency and innovation. Other governments, including British Columbia, have set up separate corporations that operate like independent businesses, insulated from day-to-day politics yet accountable to elected officials.

Large private companies also are rethinking the role of their real property units: Rather than assessing value based on how well they support the production line, their value is assessed on what they contribute to the bottom line. That distinction requires managers to think of property as an asset with value separate from the firm's traditional production goals.

When the federal government set out on the path of reform, it looked to those who had already blazed the trail. The U.S. General Accounting Office (GAO), in examining reforms in Australia, Great Britain, Sweden and Canada, found that property agencies in those nations all shared common problems that precipitated reforms: Poor business practices, inadequate strategies for managing real property assets, conflicting roles as both the building service provider and oversight agency, customer dissatisfaction, and barriers to the timely acquisition, maintenance and disposal of real property.[6]

All four countries separated policy oversight and development from the providers of government building services, eliminating the conflict of regulating a customer. All of the governments introduced competition as a mechanism for improving service, often without a significant loss of "business" to the private sector:[7]

"Probably the most fundamental change these countries made was to give the customer departments and agencies the freedom to choose between a government agency or a private sector firm to provide building services."

-- U.S. General Accounting Office

> *Probably the most fundamental change these countries made was to give the customer departments and agencies the freedom to choose between a government agency or a private sector firm to provide building services, such as maintenance and alterations. In addition, the Australian and Swedish real property organizations have to compete in the provision of office space itself.*

All of the nations identified savings, some turning deficits into profits. Most of them attributed the savings to fees that more accurately reflected the market rather than government's cost, and greater productivity by accomplishing the same tasks with fewer people.

The GAO report was considered when the National Performance Review (NPR) examined the General Services Administration.[8] The NPR recommended that the federal property authority be restructured from a monopolistic bureaucracy to several enterprises required to compete for the business of other public agencies. NPR recommended that the federal government:

- ***Eliminate GSA's monopoly.*** GSA's monopoly on commercial space would be eliminated and other agencies given the choice of where to spend their appropriations.

- ***Create competitive enterprises.*** GSA would be broken into a number of competitive enterprises, such as property management, leasing and asset management, to sink or swim based on the ability to earn fees for their services.

- ***Commercialize practices.*** GSA would commercialize more of its property and financial management activities to make it better able to compete.

- ***Maximize yields.*** The asset management enterprises would be run so as to maximize the yield of assets.

In testimony from a former GSA official and participant in the National Performance Review, the Commission was told that competition in itself can be a great agent of reform, while reforms that try to mimic competitive forces will likely fail.

> *There will be great temptation to become "competitive like," which must be avoided. The structure must be truly competitive. We do not need bureaucracies managing artificial systems to safeguard against the consequences of real competition. The market effect is the goal. There should be a date certain for the change to a competitive structure and it should be made clear there is no going back. Gradual approaches seem to lose their steam under the constant force of resistance to change.*[9]

The official said that federal reformers were trying to institute lessons learned in other democracies as well as the private sector. For instance, Corporate Real Estate 2000, a project of the Industrial Development Research Foundation, found that some private corporations are requiring their real estate arms to compete for the company's business, and are expecting them to actively find ways to save money and generate revenues. At Xerox, individual business units are not required to use in-house real estate services. The real estate staff competes with the private sector to provide and manage the company's 40 million square feet of office space.[10]

But moreover, the task force found that private-sector property managers were trying to find ways to put those company assets to better use. The trend is away from viewing real estate operations as a "cost center" to increasingly considering it as a "profit center," meaning that those managers are actively working to reduce costs and increase efficiencies -- by redefining work space, creating shared facilities and developing opportunities for telecommuting.

From Costs to Profits

The Corporate Real Estate 2000 task force review of cutting-edge companies identified five stages of real estate unit evolution:

1. **Taskmaster** -- Supplies the corporation's need for physical space as requested.

2. **Controller** -- Satisfies senior management's need to better understand and minimize real estate costs.

3. **Deal maker** -- solves real estate problems in ways that create financial value for the business units.

4. **Entrepreneur** -- Operates like an internal real estate company, proposing real estate alternatives to the business units that match those of the firm's competitors.

5. **Business Strategies** -- Anticipates business trends, monitors and measures their impacts; contributes to the value of the corporation as a whole by focusing on the company's mission rather than on real estate.

To make that transition, property managers have to change their mind-set from procurement and accounting to production. Their relationship with other units in the corporation must change from bureaucratic to collaborative; from waiting for requests from other business units to offering solutions to problems that those units may not have recognized as being related to space or property.

The State's Challenge

The Director of the Department of General Services likened the task awaiting the State's property managers to taking apart a modern jet liner in mid-air, redesigning it, and putting it back together -- without harming a passenger or losing a piece of luggage.[11]

The challenge may be formidable, but it is not unique to California. As federal and international studies show, the problems associated with property management are pervasive and persistent in many large organizations. Finding new solutions to these problems is a large part of recent efforts to reinvent government. Historically, the solution was to create central control agencies that doubled as monopolistic providers. That model yielded the federal General Services Administration and the State's Department of General Services. While experience may provide different answers today, the questions of a generation ago remain:

- ***Who should do this work?*** Public agencies, either centrally controlled or decentralized? Private enterprise under contract with public agencies? Public agencies in competition with private agencies? Quasi-public agencies that function like private enterprise?

- ***Who should be in control?*** Should the public agencies that provide the service also be controlling their clients. Should an independent control agency oversee and approve the decisions of individual departments. Should individual departments be held accountable for the outcomes of their programs, and be left free to derive those outcomes any way they chose?

- ***How can policy makers and executives best ensure efficiency?*** Are central controls and rigid regulations the only way to ensure compliance with procedures? Are incentives appropriate and effective in the public sector? Where should incentives be applied -- to individual departments, programs, workers? What is the role of competition?

The success of reforms made to those systems that provision government -- procurement, property management, civil service and fiscal oversight -- are expected to have a large effect on how successful other government agencies will be in their attempts at reinvention. In the quest to develop better expertise, to be more responsive and decisive, those agencies that directly serve the public need to be served by internal organizations that possess those same attributes.[12]

Limited Progress

- *While the State has renegotiated some leases to lock in the savings of a weak real estate market, roughly 98 percent of the leases have not been renegotiated.*
- *A uniform building rental rate that is burdened with covering the construction cost of the Ronald Reagan building and the ongoing costs of the Capitol has resulted in inflated rents for many state agencies while hindering proper maintenance.*
- *Millions of dollars in maintenance projects have been put off, making some buildings dangerous and cutting short the useful life of many buildings.*
- *While the State has traditionally underestimated its space needs, changes in technology, workplace designs and the role of government agencies will require even better planning.*

Limited Progress

Finding 1: The State is still not pro-actively managing property.

The State has tried to evolve from a caretaker of its vast real estate assets to a pro-active manager. At the highest level, the State Office of Asset Management and the short-lived Asset Management Coordinating Council, tried to create a government-wide interest in pro-active management, and the Department of General Services (DGS) has tried to implement these reforms in its daily activities. The creation of the Pro-active Management or PAM unit within DGS was inspired by the belief that money invested in aggressively managing property would pay big returns. Legislatively-directed efforts to search for under-used property, efforts to renegotiate leases, to reconfigure workplace standards, and to consolidate offices are all the product of this collective ambition.

To their credit, state property managers maintain they are saving money over what is often described in analyses as "the status quo" -- that is, if management continued as it used to be. But the Commission found that none of these efforts are unqualified successes. And in fact, their track record reveals the untapped potential for managing the State's property. The renegotiating of leases, the accounting of costs through the Building Rental Account, the problem of deferred maintenance, the surplus property and the future planning efforts are all examples of places where still more energy needs to be expended to make the State's management more pro-active.

Pro-Active Defined

The State has had a tradition of being a custodial manager of its property, doing the minimum necessary to provide and maintain space and seldom taking advantage of opportunities, to the extent they are appropriate, to generate revenue or otherwise maximize the use of the State's real property assets.

The alternative to that, as defined in past reviews of the state's system and as used elsewhere in the world, is pro-active management. Pro-active management means making sure property is being put to the highest and best use. Pro-active management recognizes that the present use or exchange value of real property can be increased, maintained or diminished depending on market conditions and the availability of resources to maintain or improve the property.[13] Executive Order W-18-91, using the term "asset management" defined it as "the comprehensive, planned management of the State's diverse portfolio of real estate to assure optimum use for the State's operations and maximum value from the surplus."[14]

> ***"Asset Management is the comprehensive, planned management of the State's diverse portfolio of real estate to assure optimum use for the State's operations and maximum value from the surplus."***
> ***-- Executive Order W-18-91***

In day-to-day operations, this strategy may mean better preventive building maintenance to protect the State's equity, provide the intended level of service and protect the public health and welfare. It may mean ensuring that state agencies have the right space in the right place to function efficiently, serve the public and work well with other government agencies. It may mean selling valuable land the State no longer needs.

Some systemic factors have worked against efforts to improve property management, such as the Department of General Services' limited authorities and sometimes confusing role in a system that can be derailed by the slightest legal ambiguity.

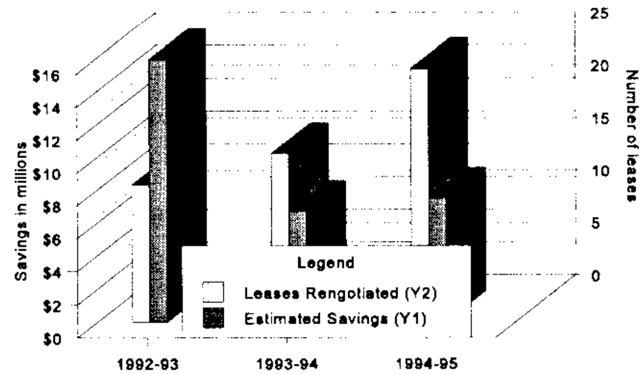
Renegotiating Leases: Missed Opportunities

The Department of General Services manages more than 2,300 leases for other public agencies occupying privately-owned space. While that does not represent all of the leases held by the State, the vast majority of state agencies are required to use DGS to locate and negotiate leases on their behalf. Even those agencies that own their own facilities must rely on the department to handle their leasing needs.

During the recent economic recession, the State, like all renters, particularly those in the commercial market, were presented with the opportunity to renegotiate leases. With vacancy rates in many markets in the double digits, large lease holders had significant leverage in redefining the terms -- most commonly, the monthly rent. Landlords to the extent that they could seek anything in return, preferred to renew or extend the lease -- willing to trade less rent for a longer period to prevent a vacancy for the term of the soft market. Representing tenants, the Department of General Services took just that action, with the goal of saving 15 percent on the leases it renegotiated. Over the next three years, the department averaged 20 percent savings on the leases it renegotiated, but it was only able to renegotiate 53 rental agreements, less than 2 percent of the State's leases.[15]

Chart 2

Renegotiated Leases



Source: Department of General Services

DGS has saved the State millions by renegotiating leases, but has renegotiated less than 2 percent of the leases that it manages.

- ***In fiscal year 1992-93:*** The department renegotiated 13 leases that over the term of the new agreements are expected to save the State $15.9 million.

- ***In fiscal year 1993-94:*** The department renegotiated 16 leases that over the term of those new agreements are expected to save the State $6.7 million.

- ***In fiscal year 1994-95:*** The department renegotiated 24 leases that over the term of the new agreements are expected to save the State $7.5 million.

As the effort progressed, the department renegotiated more leases each year and realized fewer total savings per lease. That would indicate that the department had targeted first those leases where it stood to save the most money. And in 1994, leasing costs dropped by 4 percent, in part because of renegotiated agreements -- the first reduction in state facility costs since World War II.[16]

But by 1995, the State's leasing costs were again on the rise. And property managers concede that the number of leases renegotiated was not limited by the market. Instead, they offered three reasons why more of the leases have not been renegotiated.

- ***Lack of tenant agency cooperation.*** Officials in the DGS Office of Real Estate and Design Services (OREDs) said the most successful renegotiations are those where the tenant will extend the term of the lease. In several cases, attempts by OREDs to renegotiate leases were rebuffed by tenant agencies that wanted to preserve the flexibility of moving in the short-term.

- ***Limited staff.*** The Pro-Active Management (PAM) unit of OREDs maintains that the number of leases renegotiated has been limited by the staff time available to commit to that effort. Renegotiations, officials said, vied for staff attention with other cost-saving and revenue-generating projects, such as the review of surplus property and the planning needed to make unused parcels marketable.

- ***Uncertainty resulting from consolidation projects.*** PAM officials also reported that some leases were not renegotiated because renting agencies were candidates for consolidation projects that would move them into large, usually new and state-owned facilities. In some cases, however, the agencies are not even aware they are being considered for consolidation.

All of the explanations are plausible and are supported by the evidence. But all of them could be overcome to save the State even more money. The lack of interagency cooperation is symptomatic of many of the department's efforts to manage properties more aggressively. Even if renegotiating leases would save money -- and help those tenants absorb any budget reductions required that year -- in subsequent years the budgets of those agencies would be reduced by that amount.

It is equally understandable that property managers who are already overworked would lack the time to systematically review and renegotiate every lease where the State could save money. But the department could have contracted out the task or sought the help needed to lock in savings. DGS already has a pilot project in which brokerage services are contracted out to two private firms. The project is considered a successful move toward the long-term goal of relying more on private firms to provide private-sector-like services.

That some leases were not renegotiated because the tenant agencies were candidates for consolidation also is understandable. In Sacramento, for instance, the department plans to consolidate 18 of the largest state departments into new buildings sized to accommodate their needs for 20 years. That will require "backfilling" some of the temporarily empty space in those new buildings with smaller departments. In addition, some of the 18 "anchor tenants" will be moving out of existing state-owned space. So some state agencies also will be needed to move into the more than 1 million square feet of existing state office space that will be vacated by those agencies moving into new "consolidated" facilities.[17]

Even if the department is successful over the next several years in consolidating offices, most small agencies will not move. But DGS does not know which of the more than 50 "consolidatable" small agencies will move, or the timing of those moves. As a result the vast majority of them are candidates for consolidation and "off the table" for renegotiated leases. In Sacramento -- where the State has the largest presence, the largest number of leases and the biggest plans for consolidation -- the least amount of renegotiating has been done. Of the 53 leases that were renegotiated, only six were for offices in Sacramento. Nearly all of the reworked leases were for offices, including the DGS itself, that are not expected to move.

The department attributes some of this uncertainty to its inability to direct an agency to move. Rather, it can only request a department to occupy a different space -- a structural issue addressed in Finding 3 of the report. Also, for many of these smaller departments, consolidation actually means higher rental costs, which translates into a reluctance to move. And finally DGS has not planned the details of projects that are months or years away from approval, let alone construction. The consequence of these variables, however, has been a reluctance to renegotiate leases. And despite a turnaround in some rental markets, department officials believe there are still opportunities to find savings in renegotiated leases.

Fishing For a Tenant

In some consolidation proposals planned for Sacramento, agencies will move out of older state-owned buildings into newer state-owned buildings, requiring DGS to find department to move into the old state buildings.

In the case of the planned Cal-EPA building, the State Water Resources Control Board will vacate the Paul Bonderson Building in Sacramento. In a 1993 planning document, DGS identified the California Department of Fish and Game as a good candidate to fill the water board's building.

Fish and Game is scattered throughout Sacramento in seven different leased offices with combined monthly rent of $86,446. That is in addition to the department's headquarters in the Resources Building. Moving the department to the Bonderson building would provide two consolidations for the price of one.

None of the Fish and Game's leases were renegotiated, fitting with DGS' explanation that those agencies that may move were not candidates for longer and renegotiated leases. In 1995, however, DGS officials said they did not know which agency would move into the Bonderson building, and said the Department of Fish and Game was only one of several candidates.

The Building Rental Rate: One Rent Fits All

Even the Government pays the rent. Those departments that "own" the buildings they occupy, pay the costs of that occupancy. In some cases that includes financed construction costs, as well as operational costs. Agencies that occupy privately owned lease space pay the negotiated monthly rent.

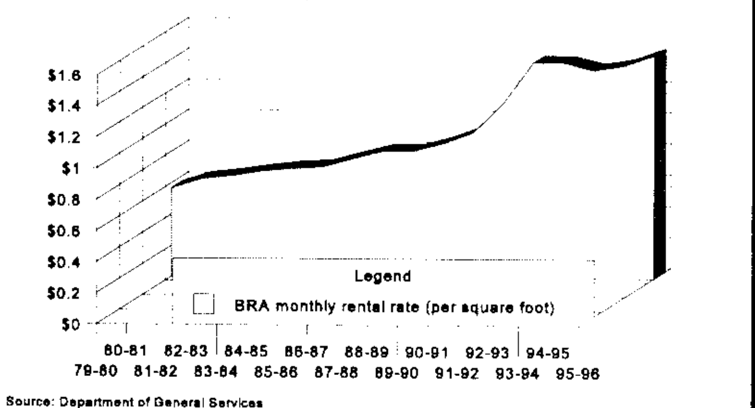
But tenants in the 44 office buildings controlled by the Department of General Services pay a uniform rate into the Building Rental Account (BRA). For the most part, tenants in modern urban high-rises pay the same as those in nearby buildings that are old, are inadequately maintained and in some cases do not meet contemporary fire or safety codes. Similarly, tenants in big cities pay the same rate as agencies in small state building in rural communities.

The building rental rate has its foundation in a 1945 law that established a revolving fund to record income and expenses resulting from the operation of buildings. The law allows for the collection of rents to cover maintenance and operational costs. And the law requires funds left in the revolving account at year's end to be transferred back to the General Fund. The Government Code and the State Administrative Manual give DGS authority to fix rental rates.[18]

For the first two decades, the Department of General Services set individual rents based on the costs of providing a particular space. By the late 1960s, however, a considerable variation had developed in the rates. That variation complicated the process of adjusting budgets when departments moved in the middle of the fiscal year. To make the bookkeeping easier, the department in 1967 established a uniform rate. A variety of property experts -- including present and former DGS officials -- now believe that the decision to establish a uniform rate has distorted the way that DGS, its clients and the Legislature make space-related decisions.

Chart 3

Rising State Rents



The uniform monthly rate charged to state agencies in DGS-controlled buildings has escalated rapidly as capital expenditures have been added.

When the Commission studied this issue in 1986, the BRA rate was 70 cents a square foot. At the time, the rate was lower than the market rate for office space in Sacramento, Los Angeles and San Francisco, where rents varied anywhere from $1.10 to $2.50 a square foot. At that time, the Commission was critical that the rental rate had not been set high enough to generate the revenue needed to properly maintain buildings, "and therefore is not a true indicator of actual costs."[19]

The Commission also was concerned about a proposal to make the Building Rental Account responsible for paying for the construction of a new Public Utilities Commission building in San Francisco. That decision would have made all DGS tenants effectively responsible for that debt by raising the monthly rate by 10 to 12 cents a square foot. In the end, the PUC picked up the costs of its building. But the Commission's concern was well-founded.

Even before the PUC building, the Building Rental Account had been looked to as a source of paying off construction-related debt.

Historically, the State paid for buildings with cash through the capital outlay process. As the State's ability to pay cash eroded, it turned to bonds. And in the 1970s, several state buildings were constructed and all or some of the bond payments were made from the Building Rental Account. Collectively, however, those charges added less than a dime to the monthly rate.[20]

In 1990, the State completed construction of the Ronald Reagan Building in downtown Los Angeles, a large and expensive building with an annual debt service and maintenance bill of $18 million -- which broke down to a monthly occupancy cost of $3.14 a square foot. After some controversy -- and with few other alternatives at the time that the 1991-92 fiscal-year budget was crafted -- the Building Rental Account was made responsible for the bond payment, which raised the monthly rate for all DGS tenants by 34 cents a square foot, increasing the rate by about one-third.

Winners and Losers

When the Building Rental Account rate is increased, those costs are essentially passed on to those agencies that rent space from the Department of General Services.

That means that some departments -- such as the judicial offices in the Ronald Reagan Building, which costs three times as much to occupy as most other state buildings -- are subsidized by other departments renting from DGS. For the subsidizing agencies to be made whole, they have to receive an increased budget appropriation equal to the additional expense. Sometimes they do; sometimes they do not.

When the rate was raised to cover the capital costs of the Ronald Reagan Building, some agencies received budget augmentations and some did not. Among the losers identified in a review by the Legislative Analyst's Office was the Department of Social Services.

The reliance on the rental account to cover construction-related debt reflects the breakdown of the capital outlay process and the difficulty some agencies have in paying the higher costs of newly constructed buildings. DGS in its 1992 strategic facilities plan, recognized the complications of capital funding through the BRA:

> *Debt financing for the construction or purchase of multi-tenant buildings or the renovation of existing state-owned buildings usually requires an increase of the BRA if the facility is to be owned by the DGS. Under current practice, inclusion of new space in the BRA affects the operating budgets of agencies statewide that occupy any DGS-owned space. This has resulted in agencies in non-major metropolitan areas occupying older state-owned facility at inflated costs. In some areas, those inflated costs may exceed lease rates for new privately owned space or may even exceed the cost of acquiring and/or building new state facilities in the area.*[21]

In fact, some departments occupying recently completed buildings have agreed to cover the costs of construction. The Franchise Tax Board has absorbed into its budget the costs of its consolidation. The recently constructed State Archives and Library and Courts annex also are single-tenant buildings being paid for out of the budgets of those departments.

Those buildings, however, are not controlled by DGS, nor are they considered "multi-tenant."

The new Attorney General's building is Sacramento represents a shift for DGS and for the Building Rental Account. While the Attorney General is the anchor tenant and is expected to some day occupy all of the building, the Sacramento mid-rise currently houses several smaller departments. The higher costs associated with occupancy are being paid for by those tenants. While that arrangement was not derived at without some consternation, the ultimate arrangement is neutral in terms of its effect on the BRA.

While the department has not crafted a financing strategy for all of the construction it has planned, the economic analyses for those projects assumes that the Building Rental Account will not be counted on to absorb construction costs. Those studies generally assume the BRA will go up 3 percent a year. At that rate, the department could barely expect to keep up with the costs of inflation, let alone make up for a backlog in maintenance projects or take on any debt. The integrity of those analyses rests in part on whether that assumption is practiced as policy.

Leaning on the Building Rental Account

When times get tough, the Building Rental Account gets tapped. For instance, the Legislature historically relied on the General Fund each year for the $7 million needed to maintain the Capitol and the nearby office space of its staff.

However, as the Legislature in the early 1990s looked for ways to trim its budget, it turned to the BRA. Beginning with the 1990-91 fiscal year, the monthly rate charged to DGS tenants was increased by 14 cents a square foot to cover the Legislature's costs -- requiring a relatively small percentage of state agencies to pick up the property costs of the Legislative Branch.

In addition, the BRA also includes $600,000 for renovating legislative offices: $300,000 for the Senate and an equal amount of the Assembly. About half of that money is used within the Capitol -- although that is only a portion of the money spent to renovate Capitol offices. The other half is used to improve the district offices of lawmakers.

Since the Ronald Reagan Building was completed, the capital costs of only one other building has been blended into the BRA rate -- the new home for the DGS Office of Buildings and Grounds, which added $700,000 a year to the account's expenditures.

Even if no other capital costs were blended into the BRA, the uniform rate distorts the actual cost of occupying space and discourages tenant agencies and DGS from making decisions based on those underlying economic conditions, or even comparing their costs to private-sector equivalents. A uniform BRA rate creates several problems:

- ***Unfair Rents.*** The State Administrative Manual (SAM) outlines a Fair Rent Policy, stating that in securing private space, DGS should secure space that provides a fair rent for the geographic area. While the regulation applies to lease space, the spirit of that policy is violated by a statewide uniform rate for DGS buildings.[22]

- ***Disadvantaged tenants.*** The Building Rental Account does not allow for individual tenant improvements to be amortized in rent, and instead DGS clients are required by the SAM to go through the capital outlay process to pay for remodels. For state agencies leasing private space, however, the SAM allows and encourages improvements to be amortized over the term of the lease, making leased space more desirable.[23]

- ***Disadvantaged DGS.*** If DGS is to evolve into a more competitive organization, it has to be able to make decisions based on costs, and its tenants will have to be able to make decisions based on market rates. Neither is compatible with a uniform rate.

The uniform rate is not established by law or the State Administrative Manual. An internal policy change could allow rents to be set reflecting actual costs or market rates. Such a system could be phased in to ease the transition.

If market-based rates were established, both DGS and its tenants could begin to resolve some of the other problems that occasionally spoil the relationship between landlord and tenant. For instance, market rates -- and flexibility in the regulations -- could allow DGS to amortize into those rates the improvements needed for an agency to reconfigure its workplace and take up less space as units downsize, are automated or allow telecommuting. A market-based approach to rents also could provide the mechanisms for more seriously dealing with a growing problem -- putting off until tomorrow maintenance projects that should have been done yesterday.

Deferred Maintenance: Leaking Equity

In recent years, the ability of DGS to complete routine maintenance projects has quickly eroded -- from a chronic, yet low-grade problem to one that threatens to undermine the department's plans for reducing property costs. The former deputy director of the Department of General Services testified:

> *The State must address the tens of millions of dollars of deferred maintenance which continue to accrue. For years, funds for deferred maintenance have been cut from the State's budget. The resulting accumulation of liabilities simply cannot continue to be ignored.*[24]

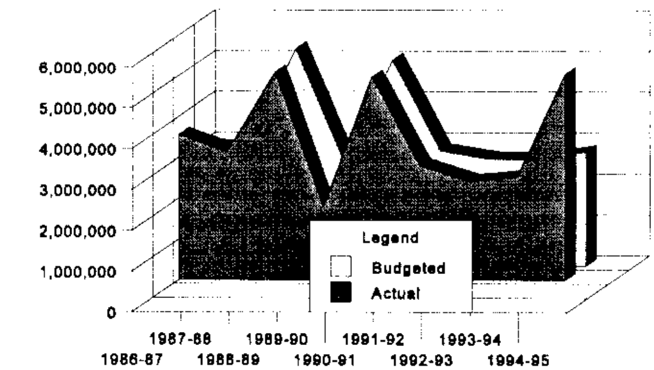
While keeping up with maintenance is a problem for many governments, the State's problem was considered small, even manageable, until the last decade -- and by some accounts, until the Ronald Reagan Building was constructed.

Routine maintenance is paid for from the Building Rental Account. Special repairs -- those needed to restore a building to its intended performance -- are paid for with annual appropriations from the General Fund. As with many expenditures, the State's ability to fund special repairs, or to allow the BRA to increase as needed, was stymied by the gradual budget squeeze that began after Proposition 13. But beginning in 1991, when the BRA was saddled with the $18 million-a-year payment on the construction bonds for the Ronald Reagan Building, the ability of DGS to pay for needed repairs out of the rent collected from its tenants was seriously eroded. Not only was that higher rent hard for many departments to accommodate, but it increased the pressure in future years to hold the rate steady, preventing DGS from gradually increasing the rate to cover routine repairs. At the same time, fiscal pressures resulted in cuts to the special repairs budgets.[25]

Since much of the BRA expenditures are relatively fixed and are necessarily immediate -- paying utility bills and janitorial salaries -- one of the only ways to keep the BRA in the black has been to defer maintenance projects. And with the General Fund appropriations for special repairs also cut, those projects began to back up, as well.

Chart 4

Erratic Special Repair Funds



Source: Department of General Services

Many repairs to DGS-controlled buildings are paid for out of the General Fund, which in recent years has been an unreliable source of funds.

Further aggravating the decision to defer maintenance was the list of projects itself, which swelled in the late 1980s and early 1990s as many of the buildings that were constructed in the 1970s -- the last state building boom -- began to show their age. On the list of projects the department has not gotten to: fixing the handicap door on the California Energy Commission building and reinforcing the air conditioners on the Water Resources Control Board building. By December 1993, the Department of General Services, responding to a budget directive, estimated that for its 44 buildings alone, it had a backlog of 445 maintenance projects with a bill exceeding $30 million. The department offered several options for raising the funds needed to fix the repairs and restore a stream of money to allow the buildings to be better maintained in the future:

- ***Redirect savings.*** DGS should retain BRA funds not spent during the fiscal year for repairs, rather than returning that money to the General Fund.

- ***Reallocate Capitol costs.*** The nearly $8 million spent annually on the Capitol and legislative offices should be pro-rated to all state agencies based on the space they occupy.

- ***Establish a minimum budget.*** Maintain a baseline special repair budget of $2.2 million.

The department believed those adjustments would provide enough revenue to eliminate the repair backlog and to allow it to reduce the rental rate, passing back to its customers the benefits of pro-rating legislative expenditures. The department also considered selling revenue bonds to pay for the projects, which would have added the costs of financing. As an alternative, it suggested raising the monthly rental rate by six cents a square foot, which would allow the projects to be completed over a 10-year period. The department's proposal was not advanced by the administration or the Legislature. Meanwhile, the department's cost estimates have grown old. The estimates are in 1993 dollars and did not allow for the extra costs likely to result from putting projects off for 10 years.

By 1993, the Department of General Services estimated that for its 44 buildings alone it had a backlog of 445 maintenance projects with a bill exceeding $30 million.

Many of these maintenance problems are a matter of public health and safety. Some of the buildings are dangerous and others do not comply with the Americans with Disabilities Act and current building codes. The Department of Food and Agriculture building in Sacramento lacks an adequate emergency stairway. DGS believes "fire and life safety" improvements are need for the Energy Commission, Bateson, Unruh and Bonderson buildings in Sacramento.[26]

In some cases, the lack of an adequate maintenance strategy has resulted in buildings becoming undesirable and prematurely obsolete. For instance, plans to construct a new state building in Long Beach are premised on the need for a building that will accommodate more agencies in less -- and safer -- space. But property officials say the need for such a facility in Long Beach was accelerated by the poor construction and maintenance of the existing building.

The fix that the State finds itself in has a number of causes: The rental rate has not been set at a price needed to maintain and renovate buildings. And difficult economic times have prompted officials to put off repairs to save money. But by not funding maintenance projects in tight years, the State borrowed from its equity -- and no one knows at what cost. While building officials assert that a $10 problem that is not fixed becomes a $20 repair, they have not estimated the higher costs resulting from deferred projects.

In some cases, state property managers concede, maintenance has been deferred on the assumption it would be cheaper to build new buildings than renovate existing buildings, and as a result long-term maintenance has been undervalued. But that strategy has fallen apart -- as the State lost its ability to pay cash for buildings, adding financing costs, and more abruptly, as the bottom has fallen out of the real estate market and leasing rates have tumbled. Now the State owns buildings that it did not maintain and cannot afford to fix. And it cannot afford to build new ones. In some places it may be able to rent for less, but state officials believe that even in the current market it is better over the long-term for the State to own its office space.

The mounting deferred maintenance problem calls into question the wisdom of the State's consolidation and construction program. The economies of ownership are based on the premise, that given the State's long-term presence, it should pay the additional early costs of ownership for the savings available in later years. But if buildings are prematurely abandoned because they are not updated to meet new building standards, or renovated to provide comfortable and safe working environments, that strategy is undermined. As the department stated in its 1992 facilities plan: "Maintenance is currently under-funded, resulting in the deterioration of state assets."[27]

The Urban Land Institute, in its review of the State's Capitol Area Plan, concluded the State needed to adopt a long-term investment perspective, which meant protecting and enhancing existing investments before spending money on new buildings. The ULI panel also urged the State to explore other management arrangements -- including privatization -- to ensure that existing facilities were kept current: "The panel recommends contracting out the building-management services for future projects and existing properties, where possible, to ensure an appropriate level of building maintenance."[28]

Deferred to Death

One of the most notorious buildings in the DGS inventory is the Junipero Serra State Building in downtown Los Angeles, more commonly known by its address, 107 South Broadway.

Health officials are concerned about asbestos, seismic safety officials are worried about its ability to withstand the Big One, and even DGS officials complain that the venting system spews out nasal-congesting air. Officials say the building's problems are a combination of bad design and bad maintenance. Over the years, repairs have not been made, systems have not been upgraded and office configurations have been poorly designed.

For several years, DGS officials internally debated the value of spending money to upgrade the building. The issue was ultimately settled when the building was used as a bargaining chip in an administration effort to save jobs in Southern California. A military installation in Long Beach needed land for housing, and the Los Angeles Unified School District had a parcel that fit that need. To facilitate a deal between the school district and the military, the State sold 107 South Broadway to the school district for $1.

Given the nature of the deal it is difficult to assess the economics. But before that opportunity, the State planned on tearing the building down and erecting an even larger structure on the extremely valuable site. The maintenance track record had contributed to the belief that the equity in the building was less than the cost of repairs.

Surplus Property: In the Eye of the Landholder

With large and diverse portfolios, many governments struggle to determine which property is no longer needed, will not be needed in the foreseeable future, and should be sold, or some other way put to a better use. Despite years of effort, the right mechanisms for making these decisions reliably have not been found.

With thousands of pieces of property in the California inventory, there is no doubt that some of the property can be used better. But identifying those lands and figuring out what to do with them has been hard. And without a comprehensive, organizationally supported effort, the State has not been able to resolve the dispute in this issue: How much land is really under-used and how could that land be put to better use to provide resources for other State functions.

The job is made difficult by the fractured property ownership that discourages a variety of systematic management decisions. And for the most part, landholding agencies have no incentive to divest themselves of property. Recent reforms have not addressed these problems.

The revenue from the sale of surplus property has been sporadic -- from a high of $13 million in 1989 to $1.67 million in 1992.

Each year, all departments are required to review their holdings and designate surplus lands. DGS presents that list to the Legislature, which can declare the land surplus.[29] Few properties move through the process, and usually the real estate transactions are linked with a broader project, such as consolidating offices. The revenue from sales in recent years has been sporadic -- from a high of $13 million in 1989 to $1.67 million in 1992.

Most agencies have little reason to divert scarce resources to this process. The Government Code specifies that with a few exceptions revenue from surplus property sales shall go to the General Fund. The code also requires proceeds from the lease of state property to be placed in the General Fund. And yet another section of the code requires that net proceeds from the sale or lease of state property must go to the General Fund.[30]

The ability of the Department of General Services to deal with under-utilized land is stymied by the reluctance of agencies to cooperate, by the fact that some property is legally off limits, by the belief that some land -- such as conservancy land -- is not intended to be put to the highest and best economic use, and by its limited authority to lease out state land without legislative approval.

In 1993, DGS reported that it had identified 125 properties that were under-used or surplus, and had a "good potential for revenue generation." The department, however, dropped its efforts on more than 70 of those properties because it felt the it lacked jurisdiction, because the "nature" of the properties limited economic potential, or that further development was not economical.

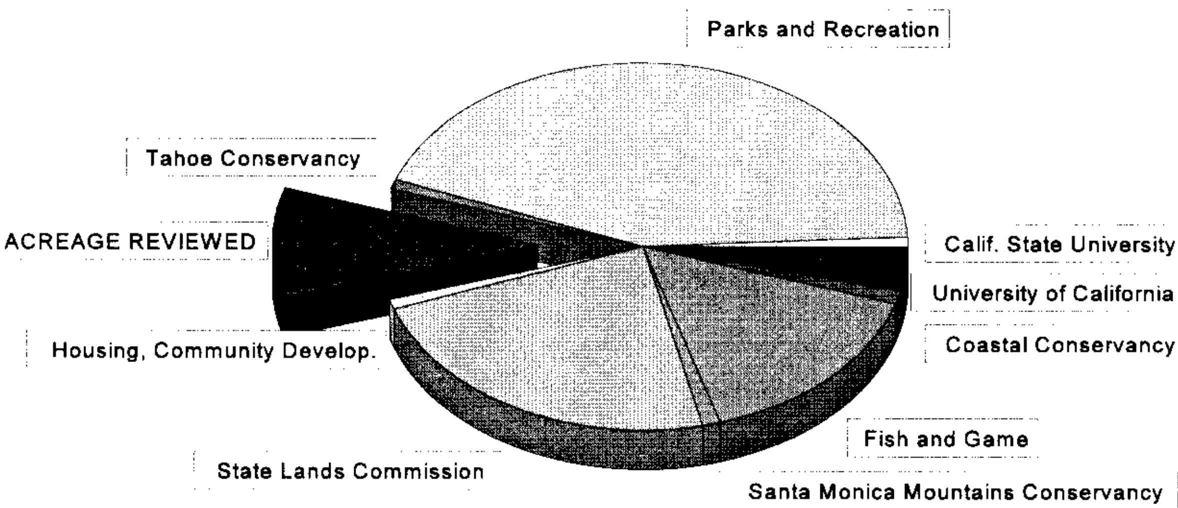
The most recent strategic effort to review property was mandated by AB 2384 (Chapter 150, Statutes of 1994), which directed DGS to review state lands and identify properties that were surplus or under-used by

January 1, 1995. The law directed DGS to sell or lease out 10 percent of the land each year until the list of properties had been exhausted.

The law was amended to specifically exclude from the review land owned by the California State University System. The department determined that since previous sections of the Government Code gave it no jurisdiction over the State Coastal Conservancy, the State Lands Commission, the Department of Transportation and the University of California, land owned by those agencies would not be reviewed.

Chart 5

Cutting a Job Down to Size



Source: Department of General Services

The review by DGS excluded nine out of 10 acres owned by the State. Some of the departments were excluded by legislation, while some were excluded because the "nature" of their mission is to preserve undeveloped land.

DGS officials then decided that land held by five other state agencies should not be reviewed because the "nature" of their programs were to provide recreational opportunities, or to preserve land for their ecological or historical value. As a result, DGS did not review lands held by the Department of Housing and Community Development, Department of Parks and Recreation, Santa Monica Mountains Conservancy, the California Tahoe Conservancy or the Department of Fish and Game (except for hatcheries and offices). Between the two lists, the department eliminated from review 2,633 of the State's 3,509 properties -- 75 percent of the properties, which accounted for 90 percent of the State's acreage.[31]

In its January 1995 report to the Legislature, DGS reported 68 properties that were not being used for any state program. It found 24 instances where a portion of a property was not being used, and 68 sites where a portion of a property was being under-used. The unused properties include: the Long Beach Marina, which is leased to the City of Long Beach; the Central Valley fish hatchery; the Crystal Creek Conservation Camp; the Cottonwood Pass Forest Fire Station, the Black Mountain Conservation Camp; two homes near Clear Lake, the Bolinger Canyon Pest Management Facility, the Columbia Armory, a maintenance yard owned by the Department of Water Resources, and 59 properties in downtown Sacramento managed by the Capitol Area Development Authority (CADA).

Some of these properties had already been declared surplus or the department owning the property intended to do so. In some of those cases, the agency refuted the finding that the property was surplus. The vast majority of the properties, however, were 59 CADA properties, mostly condominium and apartment projects in downtown Sacramento. CADA, a joint powers authority between DGS and the city of Sacramento, manages the properties in accordance with state law. The Capitol Area Plan, as originally crafted in 1960 and subsequently updated, called for buying land that will be needed for future office space, managing that land to protect the State's existing assets in downtown, and developing and managing residential and commercial properties to support a mixed-use neighborhood around the Capitol.

DGS Found Surplus in its Own Backyard

In January of 1995, the Department of General Services proposed to sell 59 state-owned parcels in downtown Sacramento. The property had been purchased to facilitate the long-term strategy of developing a government campus around the Capitol and to provide low-income housing needed to facilitate a mixed-use urban environment.

The properties, managed by the Capitol Area Development Authority, contained 428 rented residential units, 1,887 privately owned condominiums on land leased from CADA, and 20 commercial properties.

DGS sought to sell the land because the State does not receive "financial benefit" from its ownership and because the properties would not be used for state office construction in the future. But the DGS plan was opposed by CADA tenants and resisted by both the Sacramento City Council and the CADA board.

DGS maintains the law that directed it to identify surplus property also gave it authority to sell land without the Legislature's approval. The Legislative Counsel, however, opined that selling the land would require changing the Capitol Area Plan, which would require action by the Legislature.

In May 1995, the Assistant Secretary of the State and Consumers Services Agency wrote a letter to CADA saying that since the Urban Land Institute recommended developing first that land already owned by the State, selling the CADA land identified by DGS would be premature.

The DGS plan ignited a controversy that has since subsided. But the issue has not been resolved. The experience demonstrates how difficult it can be for DGS, even when it has ownership of land, to declare it surplus and use it to generate revenue. It also shows that cooperation and planning are required to determine what, when and how the State should divest itself of unneeded assets.

The 1994 surplus property law did give the DGS expanded authority to lease out land that it found to be under-used. While DGS may enter into long-term leases for those properties on its surplus list, it must still seek legislative approval for all other state properties that it wants to lease out for longer than five years.[32] Department officials hope to use that exception to show that with more authority they can complete tenant improvements or take other necessary action to lease out state property for higher rates. And while DGS only looked at those properties that it believes it was qualified to examine, the vast majority of the State's holdings were not reviewed.

Finally, just because land is not intended to be developed for urban uses does not mean that the land is fulfilling the role the Legislature or taxpayers intended. For instance, the Department of Fish and Game owns land throughout the state intended to provide wildlife habitat. The department has not done a systematic review to evaluate the effectiveness of that land. Property managers recognize that in reality some of the land the department holds may no longer provide the habitat value once thought. That land could be traded for land that could provide the desired benefit, or sold and the proceeds used to buy land that could better provide those values.[33]

Only recently, the Department of Fish and Game has been given the authority to work with the Wildlife Conservation Board to engage in land transfers to this end. Still, department officials maintain there is little incentive for field personnel to get involved in pro-active management of department facilities that could generate revenue or save money, because that money would go to the General Fund rather than to benefit their particular programs.

Familiar Problems, New Solutions

Two central dichotomies in state law and policy underlay the difficulty the State has had in attempting to be a pro-active manager of property. The first is that DGS controls a fraction of the property, but is expected to be the State's real estate authority. The second is that the department is caught between trying to be a control and provisioning agency in the mold of centralized bureaucracy, and trying to be an entrepreneurial service-oriented organization. The experience of the last five years demonstrates the persistence of these dichotomies.

These dichotomies manifest themselves in the frequent

The Coordinating Council

A central element in the State's efforts to pro-actively manage its assets was the establishment by executive order W-18-1991 of an asset management Coordinating Council. The Council was set up to provide communication between various agencies, to make property management more of a priority and to provide a venue for systemic change. In 1992, the Commission was told the council was the best solution to the structural problems because it allowed specially funded and special use lands to remain in the hands of the agencies that understood them. The Council, however, was only attended by top officials for a short time. A Council of delegates lost clout and purpose. And now the Council is dormant.

disputes between the Legislature and DGS, the consternation between DGS and its tenants or even other landholding agencies, and the lack of effort that some landholding agencies employ in putting property to its highest and best use. Not even a centralized, administrative effort -- like that embodied in the Asset Management Coordinating Council -- could overcome the institutional inertia and bureaucratic incentives to maintain the status quo.

DGS continues to have difficulty inspiring interagency cooperation -- as evidenced by efforts to renegotiate leases, identify surplus property, or plan for consolidations. It has been unable to manage property based on market-like cues, as evidenced by the uniform rental rate. And it has been unable to respond like a service-oriented agency -- to perform maintenance or provide tenant improvements.

Recommendation 1: The State should aggressively pursue more efficient and market-based management. It should infuse competition whenever possible to encourage innovation and economy. And it should more aggressively tap private-sector services to take advantage of unique opportunities.

The success of any attempts to manage property pro-actively will rest greatly on the mechanisms the State uses to pursue those goals. Pro-active management cannot be legislated, but the Legislature can provide the tools that property managers need to do a better job. Ambition also cannot be legislated, but departments and individuals can be expected to respond to economic and institutional incentives.

The Department of General Services could immediately implement this recommendation by taking the following actions:

- The department should more aggressively renegotiate leases, particularly as part of its efforts to execute some small-scale consolidation programs. The department should contract with private firms when necessary to take advantage of short-term market conditions.

- The department should expand its pilot project using private brokerage firms to more quickly gain the necessary experience needed to implement a statewide program that efficiently meets client needs while protecting taxpayers against contract abuses.

- The department should redesign the Building Rental Account to establish individual building rents that reflect the market rates of occupancy. The department and its customers should negotiate adjustments to those rates to finance deferred maintenance projects. The department and its customers also should negotiate adjustments to those rates to finance tenant improvements that might facilitate organizational restructuring. The Legislature should be billed for its space costs, or those costs should be allocated over all state agencies, not just those in DGS-owned buildings. This would be the first step toward implementing earlier Commission recommendations that buildings be appraised regularly and that facility managers calculate an annual return on investment to evaluate the performance of significant state assets.

- To the extent allowed by law, private maintenance firms should be able to compete against DGS-supplied maintenance for service contracts. The contracts should provide a level of service that minimizes long-term maintenance needs. The bidding process should be reviewed to ensure that public workers have a fair opportunity to compete for maintenance contracts, to consider the policy concerns of differing wages and to provide the State with the best possible value.

The Governor and the Legislature could further implement this recommendation by taking the following actions:

- Legislation should be enacted granting all departments the option of contracting with DGS, other government agencies or private-sector firms for meeting their space needs. DGS should have the opportunity to bid on all proposals.

- All out-sourcing contracts should be reviewed by a central authority, such as the Department of Finance. The authority's obligation would be to determine that the decision to use a private-sector provider was in the best interest of the State.

- Legislation should be passed that allows departments to redirect 20 percent of the revenue from property-related activities or savings from space-related decisions to enhance existing programs.

Inadequate Review

- *The State has developed ambitious plans for consolidating state offices, often into new state-owned buildings. But that strategy has been stalled by a variety of controversies.*

- *Changing real estate markets, the availability of funds and inadequate economic review have eroded support away from some of the consolidation projects.*

- *The projects have been shaped to a large degree by how the projects will be financed and how that financing is approved, rather than what is the best deal for the State.*

- *Many of the questionable planning assumptions and much of the controversy are the result of an informal policy for siting projects.*

Inadequate Review

Finding 2: The State's office consolidation efforts and construction projects, while subjected to much political scrutiny, lack effective economic review.

The State has long had a strategy of trying to consolidate office space -- to avoid the usually escalating costs of leasing, to accrue the equity of ownership, and to remedy the fragmentation of its agencies.

The history of the Capitol Area Plan (CAP) is testimony to the commitment that the Legislature and the State's Governors have made toward investing in public facilities and protecting that investment. The CAP recognizes the need for public agencies to be properly housed -- in ways that are accessible to the public, that encourage interaction between agencies and that foster internal effectiveness.

But implementing those policies has proven to be more difficult than crafting them. Efforts to coordinate the office space needs of the State have been troubled by an unclear process for deciding when to lease and when to own, an antiquated financing and legislative approval process, the lack of coherent siting policy, inaccurate estimates of space needs -- and overall, inadequate review of what should be built where.

The Pride of Ownership

The 1960 Capitol Area Plan, the blueprint for meeting the State's office space needs in Sacramento, specifically addressed the benefits -- both economically and in terms of effective governance -- of well-planned and consolidated space needs. The document was prepared in part because of the explosive growth in leasing in the late 1950s that proved to be an expensive way to meet office needs.

By the time the plan was updated in 1977, the State was firm in its belief that owning buildings and consolidating individual agencies was an important strategy. The 1977 revisions to the CAP set the 10-year goal of reducing the State's leases to no more than 10 percent of the space it occupied.

By 1988, when planners sat down to review the Capitol Area Plan, the share of leased space had increased from 36 percent to 48 percent, and the State's annual rent payments to private landlords had increased six-fold. Again, property managers asserted that ownership was preferred to leasing, and geared up to develop a construction and consolidation plan that would save the State money. In 1988, however, officials were careful not to set a numerical goal for limiting leases and recognized that some consolidations would necessarily involve long-term leases. But the plan continued to emphasize ownership.

From a cost standpoint, office space is a critical part of the State's property portfolio. The State occupies 11 million square feet of office space in downtown Sacramento. Of that, it leases 6.7 million square feet at a cost of $118 million a year. Outside of Sacramento, the State leases another 7.6 million square feet of space.

When the State's top property managers examined this issue in the early 1990s they concluded that if the leasing trends continued the State could be spending $250 million a year for leased space in Sacramento alone by the turn of the century.[34] Based in part on that analysis, the administration in 1993 launched a program called JOBS -- Jumpstarting Office Buildings Statewide -- to increase state ownership of buildings, to consolidate offices and to cooperate with local governments. The program was to create 50,000 private sector jobs while reducing the size of government and improving its efficiency.[35]

The program's goal was to reduce lease payments and other expenditures by up to $100 million a year -- a 25 percent reduction in annual space-related expenditures.[36]

The program began with the State being divided into six major regions, including the capital -- cities where the State has a large presence and where the largest savings could be found. Collectively, the facilities in those six regions accounted for more than 90 percent of the State's office space.

The program also envisioned small-scale consolidations in a number of other cities where the State leased dispersed office space. And finally, Department of General Services planners believed they could save money and improve public service in dozens of still smaller California cities by unifying the related state offices that the public frequently visits -- such as employment development and other social services. In the end, officials believe they could save money and make government more accessible to citizens by rearranging state offices in more than 100 California communities.

Consolidations Around the State

San Francisco. In 1993, legislation was enacted to consolidate state offices scattered over three counties into two buildings in downtown San Francisco. The project involves renovating a historic building on McAllister Street and tearing down an existing state building on Golden Gate Avenue and erecting a new one. Estimated cost: $268 million.

Oakland. The State traded the city an existing state building for a site next to City Hall. On the new site, the State will build a new office building. Estimated cost: $145 million.

Los Angeles. In 1993, legislation was enacted to restore a historic building downtown and to consolidate state workers from the suburbs into the building. Estimated cost: $62 million.

Riverside/ San Bernardino. In 1993, legislation was enacted allowing the State to work with local governments. In Riverside, the State has consolidated into an existing high-rise that the redevelopment agency acquired, renovated and is leasing to the State with a purchase option. Estimated cost $21 million. The San Bernardino project is on hold because of downsizing by Caltrans, which was to be a primary tenant. The project would vacate two existing state buildings. Estimated cost: $49 million.

Long Beach. Legislation was enacted in 1994 to build a new building. But the project has been delayed by agencies downsizing or declining to move to the new building. A smaller, leased building is being sought. The existing state building will be torn down and the property sold. The cost estimate is being revised.

San Diego. Plans call for replacement of an existing downtown building and three suburban services centers. Legislation authorizing the project is stalled. Each project is expected to cost no more than $45 million.

The project's momentum, however, stalled in 1994: Bidding procedures were challenged. Changes were made in key leadership positions. And controversy ensued in the Legislature over how the buildings were planned and how they would be financed.

The administration is working to restore the momentum. But the projects face problems that will not be resolved by changes in the leadership of either DGS or the Legislature. The Urban Land Institute (ULI), in its review of the Sacramento consolidation effort, found the goals to be laudable, but the process to be a "fiasco."

> *The implementation process for providing state office space has become bogged down in controversy and litigation. Vested interests and political factors have hampered efforts to bring to downtown Sacramento the type of space office development activity that the panel believes should logically be focused there. Ambiguous site selection criteria, failure to pre-qualify developers and unclear criteria for awarding contracts have contributed to these problems, as have a litigious development community and a highly politicized selection process.*[37]

Inadequate Review

In preparing the regional plans, the department attempted to evaluate the present and predict the future. The analyses looked at the agencies that were located in the region and how much they were expected to grow, the current economics of providing for those agencies and the future economics if no new actions were taken.

In Sacramento, it looked to find for each new building an "anchor tenant" -- a larger department or agency that could benefit organizationally and economically if it were consolidated into a single office. It then looked for smaller agencies that might be willing to share a portion of that building until the anchor tenant required all of the space that would be built for it.

In the other regions, DGS planners looked to bring together various departments that could share a common building -- bringing to bear the traditional economies of scale and enabling agencies to share conference rooms, public hearing halls and cafeterias.

Typically the analysis began with a "status quo" alternative, a scenario that assumes agencies stayed put or continued to sporadically lease as they grew. In some cases, planners concede, this was an unrealistic scenario since some agencies were in buildings scheduled to be torn down, or could be expected to move for reasons unrelated to any DGS program. The scenario also assumed that rents would increase in the future as they had in the past.

The analysis then typically examined scenarios for consolidating those agencies into leased space or into a newly constructed building, or where possible into an existing building that could be purchased by the State. In comparing the analyses, two observations can be made:

- ***The bottom line is a judgment call.*** Decision makers did not always pick the least-cost alternative. As often as not, the decision was influenced by some other policy goal, such as urban renewal.

- ***The alternatives are inflexible.*** The scenarios that are developed for comparison often do not allow for a true comparison of feasible alternatives. Assuming for instance that an entire agency must be in the same building -- rather than two buildings near each other -- can necessitate construction and rule out leasing or purchasing an existing building.

As a result of these factors, the economic analysis performed by planners is more of a litmus test -- not guiding decision makers to the cheapest alternative, but ensuring that the alternative dictated by other policy goals is cheaper than the "status quo." In this regard, the role of economic analysis in the design of the consolidation projects has not been clear.

Saving the State money is the primary reason for the consolidations, and the projects may all be defensible as cheaper than if no other effort was made to improve the State's property management. But economic considerations do not appear to have been used to help shape the alternatives. For instance, the cost of providing office space for workers was not compared to telecommuting, office sharing or other alternatives when determining the long-term space needs of an agency. The availability of existing office space was not considered in determining whether an agency requiring 800,000 square feet of space should be consolidated into one building or two.

While such considerations would have complicated the analysis, they also might have made the projects more adaptable to changes beyond the department's control -- such as persistently low rental rates or shrinking agencies.

The construction projects were planned when the real estate markets were tight and when new construction projects could provide relief from soaring rents from the first day of occupancy. Many of those projects, however, were not actually constructed until after the real estate market crashed, affordable leasing opportunities increased, and austere government budgets eroded plans for expanding government employment.

The Higher Up-Front Costs of Ownership

The Department of Justice liked the idea of occupying a new building sized to meet its headquarter needs for 20 years -- and was even willing to pay the higher initial occupancy costs.

When the project was planned, the occupancy rate was estimated at $2.30 a square foot -- far above the $1.44 a square foot DGS charged in its buildings and higher than all but the plushest offices in Sacramento.

The Department of General Services, however, had trouble finding small agencies willing to rent a portion of the building at the higher rate until that time when the Attorney General was ready to occupy the entire space. It asked the Department of Justice to defray some of those costs, but it demurred.

DGS settled the controversy by agreeing to move in its Division of State Architect. And ultimately the controversy subsided when interest rates fell on the eve of the bond sale and the final occupancy costs were set at $1.70 a square foot.

The episode exemplifies the problems DGS has had working with smaller "backfill" agencies. Even the department's economic analysis shows that while the project over time accrues considerable savings to the State, and to the Department of Justice in particular, the short-term tenants may not be in the building long enough to realize those savings.

Two of the consolidations -- in Long Beach and San Bernardino -- have been put on hold or are being redesigned because agencies downsized after the projects were conceived. The plan for downtown Los Angeles also was modified to accommodate shrinking agencies.

Some of the policy goals that influenced the decision making contained economic considerations. For instance, the decision to favor urban renewal and downtown locations, often protects other state assets and puts to better use existing freeways and other infrastructure. And the decision to renovate rather than lease, as in the case of the Los Angeles plan, offered other "urban planning benefits." In that case, the analysis showed that leasing, purchasing existing buildings or renovating and expanding the existing state building at 107 South Broadway were all significantly cheaper than the selected alternative, renovating an old department store. The analysis did show the selected alternative to be cheaper than the status quo. But without the broader social and economic considerations quantified in any way, the analysis is of limited use in making and defending decisions.

The ULI panel, while it endorsed the development of well-planned and carefully executed consolidations, also chided the department for not always following its plans, such as the decision to develop a new building for the Department of Justice before other projects ranked higher on the priority list.

> *It appears that the Department of General Services has not followed certain key elements of its own strategic facilities plan. During the study, the panel found several examples of this, such as the development of projects far down on the DGS priority list and DGS ignoring its own directive to build on state-owned land. Such actions have compromised the agency's credibility both inside and outside of state government.*[38]

These issues arise because the State lacks adequate policies or procedures in three areas: For determining when the State should lease and when it should own; for providing expedient, but effective legislative review and financial approval; and for helping determine where state buildings should be located and which agencies will occupy them.

To Lease or Own

A central tenant of the State's long-time property management strategies is also central to the latest consolidation efforts. In times of growing budgets and soaring population, the State tends to meet most of its needs through leasing -- often because it is easier, not cheaper than occupying state-owned space. During the 1980s, for instance, the State's reliance on leased space in Sacramento doubled to nearly 5 million square feet, while the costs associated with leasing increased six-fold during that time period to $65.5 million annually.[39] Outside of Sacramento, the State relies on leases for a greater percentage of its space needs.

In most markets and for most space needs, the State's property managers maintain that owning property is economical over the long-term, even if leasing rates are advantageous over the short term. By owning its own buildings, the State in some cases can avoid property taxes, insurance and the developer profits that are included in leased arrangements. The state also owns a significant amount of land in downtown Sacramento and other cities that are not being fully utilized. The factors that traditionally favor ownership, however, are being undermined by other political and fiscal concerns:

- ***A reluctance to incur more debt.*** The General Fund is strapped, voters are reluctant to approve general obligation bonds, and the State is nearing its self-imposed debt limit. While plans may show a long-term savings to the State, officials are still concerned about borrowing money for what the public may characterize as "buildings for bureaucrats."

- ***Complexities of the financing process.*** The Auditor General found that some agencies were inclined to pursue leases even when ownership would be cheaper because competition for capital outlay funds was intense and debt financing procedures were too complex.[40]

- ***Inability to maintain buildings.*** The analyses usually assume that buildings will last 50 or more years, and it is in the later years after buildings are paid off that the savings mount quickly. The plans do not make provisions for financing major repairs, even though there is evidence that some state agencies prefer to lease private space because of the State's mounting deferred maintenance problems.[41]

- ***Controversy over approval process.*** DGS has been pushing bidding, design and construction procedures that run counter to the Legislature's traditional step-by-step approval process. While design-build may be quicker, it increases anxiety in the Legislature that the State may not get its money's worth.

These institutional concerns do not include what may be the biggest issue confronting the host of recently planned consolidation efforts -- the sagging real estate market. In its 1992 strategic plan, the Department of General Services concluded: "The overbuilt and depressed real estate market in some parts of the Sacramento metropolitan area currently permits the State to lease office space more economically than it could construct and occupy state-owned space for 20 years or more."

The Auditor General in 1990 weighed these and other considerations when it reviewed the department's leasing procedures. While it agreed that the ownership is usually advantageous, it asserted that given the situational circumstances that can influence the economics, the decision to lease or own should be made on an individual basis. Should the State lease or own? The auditor concluded: "It depends."

Among the factors that it depends on, and that should be part of the policy decision makers: The ability to ensure the building will be kept in good repair; the long-term plans of an agency; the short- and long-term prognosis for the local real estate market; the cost of financing; the ability of the State to incur debt; and, the willingness to incur that debt for state office buildings. In order to better weigh these considerations, however, issues over financing, legislative review and project siting must be resolved.

Purse-String Policy Making

How the State has paid for buildings has changed over time, but the procedures for determining how and when to spend money on state facilities has not. DGS has recognized for years that a comprehensive policy needs to be developed for financing and maintaining state buildings, perhaps by directing revenue from existing facilities to future projects.[42] The director of the department told the Commission that such a plan is being prepared.[43]

The effectiveness of that policy could significantly affect both the financing costs and the political consensus for the billions of dollars in state office space that the Department of Finance estimates will be needed over the next decade.[44] The problem is not that the State lacks options, but rather that it does not have a public strategy for determining when and how those options will be exercised. Traditionally, the project approval and the appropriation processes were linked through the capital outlay procedures.

> ### *Funding Alternatives*
>
> Several mechanisms have been used to fund office building construction.
>
> - **Capital Outlay.** In previous decades the State paid for most of its projects the old-fashioned way -- with cash.
> - **General Obligation Bonds.** As cash grew scarce, more capital projects were funded with low- interest and tax-exempt bonds approved by voters.
> - **Revenue Bonds.** As voters became leery of approving more debt, the State has turned toward revenue bonds, which are more expensive, but do not require voter approval.
> - **Lease-Purchase.** Partly to accelerate the approval process, property officials have increasingly looked to one of three different types lease-purchase agreements :
>   1. Leases with purchase options.
>   2. Lease purchases amortized from private or public entities.
>   3. Lease purchases with tax-exempt debt.

Capital Outlay is a budget-based process that requires projects to receive a series of sequential legislative approvals, with funding attached to each step, such as conceptual design, detailed engineering, environmental review, land acquisition and construction. The process provides multiple legislative reviews and integrates capital expenditures with other budgetary decisions.

The capital outlay process was established when the State paid cash for its buildings, and so could literally afford to approve projects in stages. When the State is borrowing funds for construction, time is literally money, and bondholders do not like procedures that allow projects to be delayed or even canceled in midstream.

As a result, the traditional review procedures do not match the contemporary funding mechanisms. And in order to make those funding mechanisms work, project proponents have sought ways around the traditional review process. For instance, DGS officials have found that with lease-purchase agreements, they can avoid multiple legislative approvals in exchange for a single review of the financing arrangement.

In the end, selecting a financing mechanism may be influenced by the required approval procedures as much or more than whether that financing plan is the best deal for the State.

The Urban Land Institute concluded that a resolution to this problem would require a new process, and more:

> *The procurement policies and regulations for the development of owned facilities must be reviewed and in all likelihood reformulated to expedite the process. Also DGS must develop the credibility necessary to avoid the long time it takes to get multiple legislative approvals for single projects. The lag time of several years inherent in carrying through such a process usually results in the program being outdated by the time the project is completed.*[45]

In considering a policy for financing office projects, at least three issues need attention:

- ***Priority for borrowing.*** To the extent that office constructions are going to be financed by state debt -- and the Department of Finance estimates that more than $1 billion worth of construction will be financed that way over the next decade -- those decisions must be made in the context of the State's other capital needs. Policy makers should give consideration to the fact that these projects are expected to directly save the State money; however, they should still be considered in the context of capital outlay projects such as schools, universities, and prisons.

- ***Funding studies and planning.*** Facility planners have had to scramble to find the funds to complete the initial study phase of projects -- tapping earthquake repair bonds, the Pool Investment Board fund and department support budgets. Using a modified capital outlay-like process could not only provide a mechanism for financing the planning stages of a project, but also provide a mechanism for early legislative approval.

- ***Appropriate legislative review.*** The Legislature is the main venue for deriving State policy and for determining direct state appropriations. The current procedures do not provide the Legislature the opportunity to adequately review projects for consistency with state policies and funding priorities.

- ***Quick review time.*** While the Legislature should retain an active role in setting policy and determining appropriations, it should respond to the need of property officials to receive expedient consideration of proposals in order to protect financing and other options.

DGS is preparing a plan intended to give lawmakers and other decision makers a more complete view of the department's office building construction program, including plans to complete special repairs, seismic upgrades and toxic clean-up. The plan also will describe the long-term capital need of the department's construction program.[46]

That plan could be the first step in developing a strategy for determining how state office buildings will be financed, and how the Legislature will review the projects and approve of the financing. Such a strategy is particularly important if structural reforms are not made to the State's real property management organization.

Who Should be Where

One of the first issues that projects face is that of location, and some projects have been bogged down in controversy from that point on. In virtually all cases, broad economic and social factors that are difficult to quantify have guided decision makers. Whether those decisions have been controversial or not, they would best be made within the guidelines of a formal state policy.

The controversy over the proposed headquarters for the California Environmental Protection Agency has become a notorious example of this problem. The Department of General Services in September 1993 solicited bids for developers to present both a site and a building to house a consolidated Environmental Protection Agency. DGS received 15 bids for a variety of sites, designs and prices. The department then ranked the proposals, and selected a winner. Several of the unsuccessful bidders challenged the process the department used. The department re-scored the proposals and came to the same conclusion on which of the bidders should be awarded the project.

A central element of controversy was whether the State was obligated to take the lowest-priced bidder, or whether DGS could develop a process that determined which proposal would give the State the best value. While the law is very clear that the State should select the lowest bidder, there are inferences elsewhere in the codes and regulations that the State should seek best value. In addition, DGS officials maintained that the cost of a project alone does not account for all of the associated economics, such as the best use of existing infrastructure.

At the heart of the Cal-EPA controversy, however, was the issue of where the State should build -- in central business districts, or in suburban areas where land is cheaper and construction costs can often be less. The Urban Land Institute panel reviewed the issue and made two recommendations: The State should separate the site selection process from the design and construction competition in order to prevent such controversies from recurring. And the State should build downtown unless the project requires large horizontal spaces that downtown sites cannot provide. The panel pointed out that "while the initial capital cost of downtown space is somewhat higher than in the suburbs, the overall long-term cost to the State and the economy may be lower."

Existing laws and policies imply that DGS should consider social goals and economic factors beyond the construction costs of individual buildings. The State Administrative Manual states that the location of new buildings should be made after considering the administration's policies on social and economic impacts and requires that access to public transportation be considered.[47]

DGS also maintains that new buildings in downtown areas often protect the State's existing investments. That was the explicit rationale behind the Capitol Area Plan. DGS also cited that reasoning when it limited its search for a new facility in Los Angeles: "The State has the opportunity to use the consolidation process to revitalize downtown Los Angeles and, at the same time, to enhance the environment surrounding the Ronald Reagan State Building and the investment in that facility."[48] As a result of that decision, the option of leasing space was discounted because the department said it could not find appropriate space close enough to the Ronald Reagan Building.

Other governments have explicit policies to guide the siting of public facilities. The federal government established a policy in 1978 that specifically directed government agencies to give central business districts first consideration when new buildings are sited.[49]

Similarly, in June 1994, the governor of Oregon signed an executive order giving explicit instructions on how state buildings should be sited. The order gave preference to central business districts, areas where public transportation could be used by employees and the public, and where the revenue spent by employees could encourage goals of developing mixed-use downtowns.[50]

The Oregon order directs decision makers to consider the value of being in downtown areas when adhering to the state law requiring state officials to make such decisions in "the most cost-effective manner feasible." And the order directs other state agencies to cooperate with the state's Department of Administrative

Federal Siting Policy: Central Cities First

In 1978, President Jimmy Carter issued an executive order specifically stating that federal construction projects should be sited and designed in ways that "strengthen" the nation's cities by giving first consideration to central business districts.

The executive order has been sustained by three succeeding administrations, and has been used as a model by state and other governments seeking to use their own investments to support urban renewal policies. The order states:

> *Federal facilities and Federal use of space in urban areas shall serve to strengthen the Nation's cities and to make them attractive places to live and work. Such Federal space shall conserve existing urban resources and encourage the development and redevelopment of cities.*

The order instructs federal planners to consider the availability of low-income housing for federal employees, the proximity to public transportation, the need to improve employment opportunities in certain areas and to minimize the environmental impacts on others.

Services, and to get the department's approval before locating outside of a central business district.

California has grappled with these problems on a more case-by-case basis, and as a result individual projects at times have to resolve the controversy that springs from informal and inconsistent policies.

Planning for the Future: No Time in the Present

Historically, the State has underestimated its space needs. The 1977 update of the Capitol Area Plan said the State's office demand in the downtown area would be 6.2 million square feet by the year 2000. In 1993, the state owned 5 million square feet in Sacramento and leased 6.7 million more square feet.[51]

While pro-active management has always required planning, changes in government, organizational structures, technology and social trends are making sophisticated planning an essential precursor to successful property management. The State's property managers are aware of these trends and the need to do this planning, but it has not yet permeated the State's strategy in ways needed to save money and make organizations more efficient.

For instance, in 1992 DGS released a strategic plan for meeting the office space needs of the 111 state agencies in the capital over the next 20 years. That plan estimated that the personnel of those agencies would grow by 54 percent, creating a need for an additional 8.3 million square feet of office space.

Those trends were based on the assumption that state employment would match population increases. That assumption goes against the gradual decline in state employment in relationship to the population. It also goes against the widely held view that governmental organizations will have to become more efficient, particularly by reducing personnel. The analysis also did not fully recognize the efficiencies available through telecommuting and physical changes in workplace design.

By July 1993, DGS began to realize the magnitude of these trends: "It is difficult to project how the State's current fiscal condition will impact long range office space requirements. Any additional office space demand will create serious cost implications for the State."[52] And more recently, department officials have said they believe that modern office designs and electronic offices can reduce space needs by 50 percent.[53]

The Urban Land Institute, in its review of the State's building programs, concluded likewise:

> *At this time, the State should develop office space for only its most pressing needs, perhaps as much as 1 million to 2 million square feet. It should not proceed further without thoroughly*

> *studying the potential impact of high technology and telecommunications on the State's long-term office requirements. The state cannot be immune from the downsizing of office space that is occurring throughout the private sector. ...*
>
> *The panel believes there is a need for an independent and objective department-by-department analysis of the amount of space each agency needs, the most appropriate type of office space and the best location for it. Furthermore, the State should generally rethink its space allocation standards and adopt standards that reflect more current criteria.*[54]

ULI said an apparent lack of consensus among state agencies about their space needs and how they should be addressed is making long-range space planning difficult. It recommended that agencies coordinate their space planning and craft a single policy incorporating contemporary standards and the impact of technology and telecommunications.

Recommendation 2: The State should establish a streamlined, yet rigorous, process for independently analyzing and winning legislative approval of large projects.

The process needs to reaffirm the Legislature's role of setting policy and funding priorities for construction of state facilities, while recognizing needs of property managers for expeditious review and approval. An effective process also would require clear strategies for siting, awarding design and construction bids and financing such projects.

The Governor and the Legislature could implement this recommendation in the short term by taking the following actions:

- Consolidation plans should be financially fashioned and physically sized after a review of both leasing and purchase options of existing structures are explored, as well as the program needs of prospective tenants and non-building alternatives for meeting those needs.

- The department should more aggressively assist departments to reassess their long-term space needs and explore alternatives for satisfying those needs, including telecommuting and space sharing.

- The Department of General Services should have the agreement of all tenant agencies needed to fill a new building before construction begins. Tenant agencies should agree to pay rent equal to the actual costs of occupying the new structure, including a long-term maintenance plan. (If a statewide interest exists in providing additional public spaces or architectural stature, an appropriation from the state capital outlay budget could be used to augment tenant contributions.)

- Legislation should be enacted clearly establishing a state policy of how and where state buildings will be constructed, the procedures for setting qualifications and awarding bids, and designating the appropriate point for legislative approval for all large projects and under various financing scenarios.

- The Legislature should create a standing joint committee to review and approve large construction projects and long-term leases. The committee and its staff would have the opportunity to gain a greater expertise in order to provide thoughtful review, while providing the new department with the opportunity to gain trust with the Legislature. Upon approval by the committee, the full Legislature would have 45 days to act on the proposal.

- The Department of General Services should adopt internal procedures for reviewing the rationales for a project prior to the commencement of construction to ensure that assumptions used in the planning process are still valid.

Structural Woes

- *The internal structure of DGS makes it difficult to pro-actively determine when the State should lease or own, or who will oversee new construction projects.*
- *Changes in how construction projects are financed have aggravated the relationship between DGS and the Legislature.*
- *DGS has struggled to be both a service-oriented organization and a control organization. That confusion has further muddied the relationship between the department and its clients, who must do business with DGS, but do not have to accept all of the department's decisions.*
- *Structural reforms enacted elsewhere has given property management agencies more independence and authority, while increasing the accountability. In some places, restructured agencies are required to compete with the private sector to provide services to government clients.*

Structural Woes

Finding 3: The State's major property management problems will be difficult, if not impossible, to resolve without significant organizational restructuring.

More than five years of effort on the part of the Executive Branch to reform property management practices without changing the organizational structure has failed to show substantive improvements. While managers have recognized these problems, their strategy has been to correct the State's administrative deficiencies first and to worry about organizational deficiencies later.

At best, the structural problems have made it hard for the State to be a pro-active manager by posing an institutional resistance to change. At worst, the experience of recent years has shown that overall improvements will not be made until the State makes structural changes in real property management.

In other jurisdictions, structural changes have been seen as a means to an end -- an attempt to create a system that would lead to efficiency rather than trying to dictate efficiency. Those reforms have looked at using competition and linking authority with responsibility to make property management organizations -- and their customers -- more efficient decision makers.

Defining Structural Problems

The structural problems facing the Department of General Services can be broken down into problems internal to the department, problems between the department and the Legislature and problems between the department and its clients.

Some of these problems are exemplified in the controversies that have resulted from the State's efforts to be pro-active, and particularly those surrounding the department's efforts to consolidate state offices into newly constructed buildings. These problems, however, exist in day-to-day transactions, as well as in mammoth projects.

Resolving these structural woes is an essential precursor to improving the State's management of real property, from both a fiscal standpoint, and in terms of improving the performance of public agencies that directly serve the public.

Problems Internal to DGS

The Department of General Services has separate leasing, planning and construction, and maintenance offices. Those internal divisions often leave no one person or even one office accountable for the success or failure of new projects, or the ability to successfully adjust property management strategies to take advantage of marketplace trends.

The Real Estate and Building Division within DGS is headed up by a chief deputy director. Under that deputy director, four offices perform the state's property management duties:

- ***Office of Real Estate and Design Services.*** OREDS has three branches -- leasing and design, real estate services and program management, and support services. The leasing and design unit determines the present and future space needs of state agencies and tries to provide state agencies with economical office quarters that conform to state standards. The office does space planning, design, layout, negotiation and consummation of leases. The real estate section helps landholding agencies make the best real estate decisions. It appraises properties, manages the inventory and disposes of surplus property. Support services manages state properties that are leased out.

- ***Office of Project Development and Management.*** OPDM is responsible for planning the development of state office facilities, forecasting future space requirements for agencies, and initiating the first steps toward constructing, financing and purchasing state buildings.

- ***Office of Buildings and Grounds.*** OBG is responsible for day-to-day maintenance and routine repairs of buildings controlled by DGS and the state Capitol. It also is responsible for special repairs to buildings up to $250,000 in value.

- ***Office of Energy Assessments.*** Funded primarily by voter-approved bonds, this office oversees a variety of efforts to make state facilities more energy efficient.

Separate from the Real Estate and Building Division, the Department of General Services also houses the Division of the State Architect. The State Architect has offices of Design Services, Construction Services and Regulatory Services. The three offices are responsible for the design of new projects and improvements, inspection of new construction and inspection of plans for state buildings and public schools.

In 1986, DGS attempted to reorganize the responsibilities related to managing state building projects. The long-range planning and environmental review duties of the then-Office of Facilities Planning and Development were merged with the project management activities of the then-Office of State Architect to form the Office of Project Development and Management. The goal of the reorganization was to eventually shift all of the shared activities to the Office of Project Development and Management. However, that shift has only partially been accomplished and both the State Architect and OPDM continue to share responsibilities in the capital outlay program.[55]

While there is "conspicuous overlap" between the State Architect and the Real Estate and Building Division, the organizational structure of the Real Estate and Buildings Division alone causes confusion among the department's customers and the Legislature.[56]

DGS officials concede that in some respects the offices within the division operate as separate "fiefdoms," even though the tasks of planning, designing, constructing and maintaining facilities require integration to be successful. Among the areas of confusion:

- ***Construction management.*** In some recent cases, new construction projects have not been managed by the office of Project Development and Management (which shares construction responsibilities with the State Architect). Rather the project was managed by OREDS -- which specializes in space planning and leasing -- because the projects were financed through lease-purchase agreements rather than with capital outlay funds. For example, OREDS managed construction of the new Department of Justice building in Sacramento because it was financed through a lease purchase agreement. It also oversaw construction of the Board of Equalization high-rise because it was developed under a lease with an option to buy that the State later exercised.

- ***Private lease or state tenant.*** In some cases, whether a customer is housed in lease space or in state-owned space -- or would be even better off in a newly constructed building -- may have more to do with the DGS office receiving the request for help, than a decision based on a coordinated alternatives analysis.[57]

- ***New construction, old repairs.*** The department's ability to maintain existing state buildings has been eroding even as the department tapped revenue bonds to pay for new buildings. Only recently have department officials made a strong link between maintaining old buildings and constructing new ones.

Some of the organizational problems would not be solved merely by tearing down walls within the Real Estate and Buildings Division. Some of the problems are the result of not having the authority to do the task at hand. In 1990, the Auditor General looked at the department's office space planning process and concluded that OPDM had limited resources to maintain the Capital Area Plan for office space in Sacramento and virtually no authority to implement the plan. The auditor concluded that "control over the capital acquisition process is dispersed and ill-defined."[58]

The auditor concluded that the OPDM went about its business and conducted its analyses based on "sound professional practices and criteria." But OPDM, and the department in general, do not have the legal authority to translate that professional approach into the marketplace decisions needed to bring state policy to fruition. The auditor noted that a bolstered OPDM would be a difficult venue for making those decisions because it is not insulated from political pressures. And the auditor attributed part of the problem to the lack of a comprehensive capital outlay process.

The auditor also recognized, however, that some of the problems resulted from the department's internal structure. For instance, the question of how a customer's space needs were met was not always determined by thorough comparison of the alternatives:

> *The determination of where a given department should be located depends on whether the requesting agency wants to build or lease, and where the space is needed. If the requesting agency wants to construct a state-owned building, OPDM works with the agency to land the location. If the requesting agency wants to lease, then OREDS is responsible. The Department of General Services does not make an independent decision on which agencies should move or where they should go.... The decision rests on the judgment of the planner, and the client agency must*

agree. It appears to consultants that outside political pressure is one of the most important factors in determining the final choice.[59]

Others have examined the department and concluded that DGS could get over some of these hurdles if it relied more on private-sector firms to accomplish tasks, and where necessary to provide the multi-discipline approach needed to efficiently meet a customer's needs. The Urban Land Institute, for instance, said the department should enter into more partnerships with private-sector firms to accomplish such functions as leasing and project development. The ULI panel said the department's pilot project to use commercial brokers in Southern California was a tentative step in that direction, and urged the department to use commercial brokerages in implementing the consolidation process.

DGS and the Legislature

The tense relationship between DGS and the Legislature has become a significant impediment to implementing the department's long-term plans. The lack of trust between the two makes it hard to resolve large and small issues. While this schism has existed for some time, controversy over the department's consolidation and construction program has made it worse.

The process for deciding what gets built where, and who will pay for it, goes to the heart of both public policy making and professional property management planning. As described in Finding 2, these decisions were historically made through the capital outlay process, in which the Legislature took an active role in reviewing projects at critical junctures and appropriating funds for the next step in development. While the process required multiple approvals, it provided cash from the General Fund for development projects. And without interest to pay or bond holders to satisfy, time was not of the essence.

While the State still has a capital outlay process, much of the funding is now done with bonds. And the Department of General Services -- attempting to hold down costs by accelerating the planning and construction process and by relying more on the private sector to design and build projects -- has avoided capital outlay procedures.

In fact, from the department's standpoint, one benefit of lease-purchase agreements is that the department must only seek the Legislature's approval once. And in many cases that approval is sought after all of the politically volatile issues have been settled.

More recent construction projects also have moved to the Legislature in the form of a single authorizing bill, often carried by the lawmaker in whose district the building would be constructed.[60] Among the criticisms of this process:

- ***Political influence.*** The fate of a project contained in a single bill is more likely to be determined by political issues unrelated to the merits of a project than a project making its way through the capital outlay process.

- ***No fiscal context.*** When considering projects as separate bills, legislators do not have the opportunity to consider that expenditure or commitment of state debt in the context of all of the State's capital outlay needs.

- ***Late involvement.*** Legislators are often asked to approve of a project after millions of dollars have been spent on it, or are essentially committed, and after design elements have been finalized, and their only choice is to approve the project or reject it.

The former director of the Office of Asset Management said one reason for the tension between the Legislature and the State's professional property managers is that both policy formation and policy implementation require judgment calls. Those decisions are made with imperfect foresight and judged with the clarity of hindsight:

> *It is true that real estate data, and its related financial information is capable of being objectively measured. Nevertheless, management decisions involving real estate are, by their very nature, essentially subjective. Many correct approaches, or solutions usually exist to any particular real estate situation.*
>
> *When subjective issues related to real estate management are placed it the arena of a democratic process for resolution, we unfortunately often get bogged down in debate over which of the correct solutions will be pursued. Problem resolution occurs on the basis of the subjective choice of alternatives, rather than who possesses the institutional and managerial responsibility and authority to make the decision and to be held responsible for its implementation. As a secondary consequence of this fact, and the length of time often required to implement capital project, decisions believed to be final are often revisited with changes in political balance, further jeopardizing consistent and intelligent results.*[61]

The evolution away from the capital outlay process and toward a project-by-project bill has further strained the relationship. For instance, in late 1994, six of the department's seven proposed buildings failed to receive authorization. Among the Assembly's concerns was the fact that financing was not included in the cost estimates of the project. DGS maintains that financing costs can not be fixed until the last minute because of interest rate fluctuations. But with only one chance to approve projects that are done through bill form rather than capital outlay, legislators complain that they are essentially being asked to write a blank check.

DGS and the Departments it Serves

Externally, DGS suffers from the reputation of a monopoly that does not provide its customers any of the reliability and stability that monopolies are expected to provide. Few agencies want to subject themselves to DGS control, and those with political clout successfully avoid it by legislatively acquiring duplicative authority. But while agencies may escape DGS, that does not mean they have the expertise or the incentives to manage their own property better.

Part of the dilemma results from the department's ambiguous authority. While the State Administrative Manual states that the department is to "assign" space, neither DGS nor its client agencies believe that means the department can tell an agency that it must move from one office to another -- or even that it must accept a DGS assignment when it is looking for space. The department cites that legal weakness as a reason why it cannot always ensure that the most cost-effective property decision is made.

"Agency after agency complained that DGS is unresponsive to its needs, inflexible in responding to departmental requests and generally a hindrance to meeting facility needs."

-- Urban Land Institute

The customers have a different perspective. The Urban Land Institute noted that the sour relationship between DGS and its clients could have significant consequences for the department's long-term goals:

> *DGS is held in low esteem with respect to its real estate operations in Sacramento. Agency after agency complained that DGS is unresponsive to its needs, inflexible in responding to departmental requests and generally a hindrance to meeting facility needs in a timely fashion and managing state-owned properties. Although DGS has highly competent staff, the panel believes that they need focus and a new vision of their mission.*

Elsewhere in its report, ULI concluded:

> *The panel found that there is a sense among DGS's various constituencies that it is staffed by good people hobbled by a poor system. The system is seen as unduly 'political' and subject to rigid rules where customer satisfaction and making a good deal are relatively low priorities. Real estate has become an end in itself rather than an instrument to support state agencies in the delivery of public services.*[62]

The Commission found evidence of that sentiment during its recent review of the State's performance-based budgeting pilot projects. A common request by the departments participating in the experiment was relief from the requirement that they use DGS to fulfill their space needs. The Department of Parks and Recreation, the Department of Consumer Affairs and the California Conservation Corps all thought that they could increase their performance by having the option of when to use DGS-provided services.

Designing Structural Reforms

The Department of General Services has tried unsuccessfully to rearrange itself internally, and DGS officials have unsuccessfully sought from the Legislature the authority that it thinks it lacks. In other instances, it has struggled to adapt -- to be a service-oriented agency, to utilize design-build construction strategies and to seek legislative approvals with individual bills. While successes can be cited in each of these areas, experts who have reviewed DGS, the Legislature, their customers, and even the department itself have serious reservations about this situational evolution.

In November of 1994, the Real Estate and Buildings Division published a proposal for structural changes to reform how the department makes decisions and the tools it uses to implement those decisions -- from civil service rules to bidding procedures.

> *Many of these problems are found in other real estate organizations and may be endemic of the industry. However, even the most difficult are not beyond solution. In fact, many organizations both within government and in the private business world, have recently restructured and refocused their real estate organizations to address exactly these issues. It will not be difficult to find examples from which California can borrow.*[63]

The document recommended as the best solution the establishment of a quasi-public corporation that could be responsible for making virtually all property-related decisions. As a short-term and politically easier alternative, the report recommended revamping the Real Estate and Building Division to create a more cohesive and potentially responsive organization.

The report called for unifying the planning within the department and unifying the construction management within the department -- both of which are now bifurcated. It called for the creation of three portfolio managers to oversee activities in Sacramento, Northern California and Southern California. And the plan called for a task force of personnel, finance and property officials to develop the details of the reorganization.

The most often used model for a quasi-public corporation is the British Columbia Buildings Corporation (BCBC). Based in Victoria, the corporation was established 17 years ago to replace a failing bureaucracy. It has a portfolio of 3,500 buildings, about half of them leased. It is totally revenue dependent, reported a return on investment in 1994 of 10.3 percent, and makes a substantial contribution to the public treasury annually. An independent study in 1994 showed that it was providing facilities for between 9 and 16 percent below market.[64]

In addition to the economic advantages, the corporation has separated the business of property from the business of politics. Corporate officials said they rely -- even insist -- on lawmakers setting public policies that form a framework for property decisions, and specific policies for high profile or potentially controversial projects. But once the policies are established, the corporation is free to use the tools of the business world to meet the space needs while complying with those policies.

The British Columbia Buildings Corporation had a return on investment in 1994 of 10.3 percent, makes a substantial payment to the provincial treasury annually, and provides facilities at between 9 and 16 percent below market.

The BCBC is criticized by some reformers for maintaining its monopoly. Traditionally, the corporation's provincial clients have had no choice but to use BCBC services. The corporation, however, has won competitive bids to provide services to local and other governments and to non-profit agencies. The corporation also will have to compete for the business of the provincial health ministry as that agency decentralizes its operations.

Among other lessons, the BCBC model exemplifies, perhaps to an extreme, the often prescribed reform of providing managers more autonomy in exchange for more accountability.[65] The path that British Columbia took to reform also displays four characteristics that the federal General Accounting Office has found to be common among successful public and private reorganizations: a holistic approach, tailored changes, management commitment and flexible organization. The GAO said significant change was not derived through hesitancy:

> *Successful, sustained changes were rarely brought about in piecemeal fashion. Rather, they were planned and implemented as holistic and mutually supporting efforts, directed at long-term organizational objectives.*[66]

Increasingly, however, reformers believe that in addition to establishing accountability and making holistic changes, organizational structures must be infused with competition in order to become efficient. Specifically, in the case of DGS, the Urban Land Institute laid part of the blame at the department's lock on its customers.

> *The panel believes that the source of the State's problems in this regard is that there should not be the current real estate and real estate services monopoly that DGS enjoys, since public monopolies do not work any better than private ones and tend to become rule-bound. The way to energize the system would be*

> *to break up the monopoly, allowing agencies to choose commercial sources for real estate services and DGS would become a discretionary source along with other competitive enterprises.*[67]

Recommendation 3: The State should unify its management of developed property. The unified entity should be independent yet accountable. It must be free to use market mechanisms and business practices and free from day-to-day political influence.

At a minimum the State must tear down the walls within the real estate arm of the Department of General Services so that it can more efficiently plan for and deliver property services. But the potential for reform is far greater, and the State should seize the opportunity to create a new organization that can profitably manage its multi-billion-dollar property portfolio.

The Governor and the Legislature could implement this recommendation in the short term by taking the following actions:

- Legislation should be enacted creating a Department of Real Property Services separate from the Department of General Services. Planning, construction, leasing and maintenance should be unified to make more coordinated decisions about how to meet space needs of customer agencies, how to manage existing structures and how to blend technology, space design and management techniques to reduce space needs.

- The legislation should provide that employees of the new department will have a separate bargaining unit and the initial contract should include greater flexibility for offering merit-based compensation, broad classifications and expedited disciplinary appeals.

The Governor and the Legislature could implement this recommendation over the long term by taking the following actions:

- Legislation should be enacted creating a public corporation similar to the British Columbia Buildings Corp. The corporation should be financially independent and fee-based. It should be governed by a board appointed by the Governor and Legislature and could include constitutional officers, including the Controller and Treasurer. Its independence would allow it to make business-oriented decisions and to respond to market and technological changes to better serve customers. The corporation could be expected to provide services efficiently through economy of scale and access to public financing tools. While revenues could be reinvested in corporate programs, profits would be turned over to the General Fund.

- The corporation should be free to hire employees outside of the civil service system, and to enter into contracts with the private sector without approval from control agencies, including the State Personnel Board and the Department of General Services.

- The corporation should purchase from the State all developed office space. After a period of organizational development, the corporation would have to compete for the services of all customer agencies. At that time, departments would be free to turn to the private sector, other government agencies, or to the corporation to satisfy their space needs. This would provide the corporation with the time to organize, while ultimately providing the competition necessary to achieve even greater efficiencies than a unified monopoly can provide.

- The corporation should be granted the authority to decide building location, design and financing. Before the client agency could enter into an agreement with the corporation, however, it must prove that it has the funds to pay for any additional facility-related costs.

- The corporation should be directed to site buildings in compliance with the State's siting policy, while granting the corporation the authority to size and specify buildings to meet a client agency's needs and budget.

- The legislation should grant the corporation the authority to float revenue bonds and to tap private financing sources in order to provide the organization as much flexibility as possible.

Conclusion

Conclusion

Reformers must always swim against the institutional tide, and that has been the challenge of those who have tried in recent years to pro-actively manage the State's real property assets.

By consolidating offices and building new structures, the Department of General Services (DGS) has strived to save money and provide better facilities. But the strategy has been frustrated by a variety of inconsistent policies and unclear priorities. Similar frustrations have stymied efforts to coordinate the property-related strategies of dozens of other landholding state agencies.

Measures could be taken to ease these problems: The State could craft clear policies on where state facilities will be sited, how they will be financed and at what stage they will be approved by the Legislature. DGS could reform its rental rates to reflect the market and include the costs of providing long-term maintenance and completing tenant improvements.

But none of those changes would result in a property management system that actively encourages innovation and efficiency. The means to that end is structural reform and an increasing reliance on the incentives and competition that drive many organizations toward excellence.

Structural reforms come in two varieties: renovation and reconstruction. California can renovate its property management system by creating a separate and unified department -- for pioneering new office space management techniques, for assessing facility needs and overseeing their development. The State can reconstruct its property management system by establishing a quasi-public corporation -- separating the business of politics from the business of property, and creating an organization with private-sector tools that could be held accountable for managing public resources.

In either case, the new structure should provide for competition -- between agencies and with private-sector firms -- to foster economy and change. And all state agencies -- those who hold property and those who rely on others to meet their needs -- should be given a greater reason to constantly re-examine their property-related decisions by granting them the ability to redirect savings and revenue to other program needs.

Without such reforms, the State can expect more of the same: Recurring proposals for better management, followed by controversy.

With such reforms, the State could expect its real property assets to be better managed to save money and even generate revenue. More importantly, the State could expect its more than 100 different departments to give greater consideration to the size, shape and location of their facilities in order to make themselves internally efficient and publicly accessible.

Appendix

APPENDIX

Witnesses Appearing at
Little Hoover Commission
Real Property Management
Public Hearing

August 30, 1995
Sacramento

Peter Stamison
Director
Department of General Services

John Salmon
Former Director
Office of Asset Management

Daniel Rosenfeld
Deputy General Services Director
City of Los Angeles

John Bidlake
Vice President of Client and Planning Services
British Columbia Buildings Corp.

Al Kemp
Vice President of Project Development, Construction, and Leasing
British Columbia Buildings Corp.

Patrick Keogh
consultant,
former program manager
U.S. General Services Administration

Winston Folkers
Urban Land Institute

Peter McCuen
General Partner
McCuen Properties

Andrea Rosen
Sacramento Old City Association

Ralph Megna
Development Director
City of Riverside

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LITTLE HOOVER COMMISSION FACT SHEET

The Little Hoover Commission, formally known as the Milton Marks "Little Hoover" Commission on California State Government Organization and Economy, is an independent state oversight agency that was created in 1962. The Commission's mission is to investigate state government operations and -- through reports, and recommendations and legislative proposals -- promote efficiency, economy and improved service.

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