November 5, 2010

Hon. Denise Moreno Ducheny, Chair
Joint Legislative Budget Committee
Room 5035, State Capitol
Sacramento, California 95814

Dear Senator Ducheny:

Chapter 20, Statutes of 2009 (ABX4 22, Evans), authorizes the Department of General Services (DGS) to (1) sell the 11 state-owned office properties shown in Figure 1 and (2) lease the buildings back from the new owners through a long-term lease. The legislation provides broad authority for DGS to determine the sale and lease terms that are "in the best interest of the state." In order to maintain oversight of the process, however, the legislation requires DGS to report on the terms and conditions of the sale-leaseback to the Legislature's fiscal committees 30 days prior to completing the transaction. Additionally, the Assembly Committee on Accountability and Administrative Review requested that DGS provide an analysis of the costs and benefits of the sale-leaseback at 20-, 30-, 40-, and 50-year intervals as part of the department's report on the terms and conditions. The Director of DGS provided these materials to you on October 11, 2010. Typically, the administration adheres to the Legislature's wishes in these types of notification periods—although it is not legally required to do so.

Figure 1

State Office Properties Authorized for Sale-Leaseback

Building	Location
Junipero Serra State Building	Los Angeles
Ronald Reagan State Building	Los Angeles
Elihu Harris Building	Oakland
California Emergency Management Agency Headquarters	Rancho Cordova
Attorney General Building	Sacramento
Capitol Area East End Complex	Sacramento
Department of Justice Building	Sacramento
Franchise Tax Board Complex	Sacramento
Public Utilities Commission Building	San Francisco
Earl Warren and Hiram Johnson Buildings (Civic Center)	San Francisco
Judge Rattigan Building	Santa Rosa

As you know, ABX4 22 was a late addition to the 2009-10 budget agreement without significant public discussion of its policy and cost implications. As a result, it made sense for the legislation to include a period for legislative notification so that the final outcome could be more closely scrutinized. Other than the notification, however, the legislation provides complete authority to the administration to determine the lease terms, select a buyer, and complete the transaction. The recently enacted 2010-11 budget agreement anticipates the revenue from the sale-leaseback. Below, we provide a summary and analysis of the proposed transaction. Some of the topics covered below respond to specific questions from legislative requests.

INTRODUCTION

A sale-leaseback is a real estate transaction in which the owner sells a property and then leases it back from the buyer. The purpose of a sale-leaseback is to free up the original owner's equity while allowing the owner to retain use of the property. The state would benefit from the sale-leaseback transaction because the one-time revenue generated from selling the buildings would be available to address the state's current budgetary shortfall. The sale proceeds would first go towards retiring the outstanding lease-revenue bonds associated with some of the buildings. After deducting a small amount for the transaction's costs, the remaining sale proceeds would be deposited in the General Fund. The *2010-11 Budget Act* assumes the sale-leaseback would generate $1.2 billion in General Fund revenue.

The sale-leaseback, however, also would result in additional costs for the state as it pays rent to the new owners. The lease costs would exceed the amount the state would pay if it maintained ownership of the properties. The major consideration, therefore, in evaluating the sale-leaseback transaction is whether the benefit of the one-time revenue from the sale of the facilities is large enough to compensate for the higher costs in subsequent years. In our previous report in April 2010—*Evaluating the Sale-Leaseback Proposal: Should the State Sell Its Office Buildings?*—we estimated that the leasing costs over a 35-year period would exceed the one-time revenue by at least $600 million in present value terms. As a result, we cautioned that the sale-leaseback was not an ideal budget solution because it would add to the state's structural deficit. The administration's selection of a buyer with defined price and lease terms allows us to revisit those projections below. In general, we reach the same conclusion that the sale-leaseback is poor fiscal policy. We have concerns with the methodology that DGS used to prepare its analysis for the Legislature, which we also discuss below.

THE TRANSACTION

Sale Price. The DGS selected the bid from California First LLC for $2.3 billion. Assuming the sale closes by the end of December 2010, we estimate one-time General Fund net revenue of $1.3 billion as shown in Figure 2—slightly more ($66 million) than assumed in the budget package. The minor increase in revenues reflects the later sales date now anticipated, resulting in the state making more debt-service payments prior to the sale than originally projected, and thus having slightly less debt to retire than initially assumed. (The state's higher debt-service payments fully offset the increased proceeds from the sale.) Although the legislation gave DGS the authority to determine most aspects of the sale and lease, it requires the sale price to be no less than market value. The sale price of $2.3 billion meets this condition by all measures of which we are aware.

Figure 2

Estimated General Fund Revenue From Proposed Sale

(In Millions)

Sale Price	$2,330
Less: Remaining Debt	-1,053
Less: Transaction Costs	-12
General Fund Revenue	**$1,266**

Lease Terms. The authorizing legislation allowed DGS to determine the lease terms for the leaseback. In bid materials, DGS requested that all bids conform to a modified gross lease structure with the following components for ten of the properties:

- ***Type of Lease.*** Under a modified gross lease, the owner would be responsible for paying most building services including building management, janitorial, maintenance, special repairs, insurance, and scheduled upgrades. The owner would pay utilities with the exception of gas and electricity costs, which the state would pay. The state also would continue to provide security at those buildings with unique security needs.
- ***Lease Term.*** The initial lease would be for 20 years. After the initial term, the state would have the option to renew the lease under the same lease conditions for six additional terms of five years each—resulting in a total lease term of potentially 50 years.
- ***Annual Rent Payments.*** Base rent payments would be set near current market rents for each property. The base rent would increase by 10 percent every five years.
- ***Operating Cost Escalator.*** On top of the base rent payments, the state would be responsible for paying annual changes in the owner's operating expenses. The operating costs would be set at a fixed amount when the buildings are purchased and adjusted each year by the change in the Consumer Price Index to reflect inflation.
- ***Property Tax Credit.*** Under the California Constitution, the state is exempt from paying property taxes on the properties it owns. Private landlords renting space to the state, however, generally are charged property taxes based on the assessed value of their properties. The base rent included in the proposed lease assumes that property taxes would be assessed on the properties and that the new owner would make those payments. In the event that the properties remain exempt from property taxes, the lease terms entitle the state to an annual credit against its rent equal to the amount built in for such taxes. In our previous analysis, we assumed property taxes would not be assessed and the resulting annual credit would reduce the state's costs. Based upon interpretations of similar situations by the Board of Equalization, it now seems likely that the properties would be subject to property taxation and the state would not receive the property tax credit.

- ***Right of First Refusal.*** If the owner receives an offer from a third party for the purchase of one or more of the properties, the state would have an opportunity to purchase the property under the same terms as the third-party offer.
- ***Repurchase.*** The proposed lease does not include any provision for the state to repurchase the property at a reduced rate or for the properties to revert to state ownership at the end of the lease.
- ***Upgrades.*** The owner would repaint all interior surfaces every five years and replace all floor coverings every ten years.
- ***Subleasing.*** The state may sublease any portion of the space.

These lease terms would apply to all of the properties with the exception of the California Emergency Management Agency Headquarters. Due to the building's specialized purpose in responding to emergencies, DGS structured the proposed lease so that the state would maintain responsibility for all building services.

Transition to Private Ownership. The department expects the transaction to be complete by the end of December 2010. The sale of the properties would remove over 7 million square feet from DGS' portfolio of managed space. In addition to staff reductions for on-site personnel such as building management and janitors, we anticipate such a portfolio reduction would also cause some restructuring within DGS' management. At this time, DGS has not provided any information on the plan for the transition from state to private ownership. Without a plan on which to base costs, our analyses of the cost of implementing the sale-leaseback assume all of the state's operating costs stop immediately upon the sale. A more realistic scenario (but harder to forecast) is that the implementation of staff reductions and internal restructuring will take some time and the state will continue to incur some operating costs after the sale. It is also likely, although we do not know the department's plans, that the state agencies occupying these facilities would continue to pay some overhead fee to DGS in addition to the rent charged by California First LLC under the sale-leaseback. Because these anticipated costs are not included in the following analyses, it is possible that the following forecasts slightly understate the state's cost of the leaseback. Given that the downsizing of DGS' portfolio and transition to private ownership will have budgetary effects, we recommend that the Legislature request details on the department's transition plan before next spring's budget hearings.

FISCAL ANALYSIS

As mentioned previously, the major fiscal consideration is whether the benefit of the one-time revenue from selling the facilities is large enough to compensate for the higher costs of leasing the facilities in the subsequent years. The department's notification letter included an analysis of the estimated cost of maintaining state ownership of the buildings—the status quo—and compared it to the cost of the sale-leaseback. Below, we assess DGS' economic analysis and then update the analysis from our earlier report.

DGS Analysis

As shown in Figure 3, DGS compared the cost of the sale-leaseback to the status quo (in nominal and present value terms) for multiple time intervals. In present value terms (that is, adjusted to account for the fact that money available at the present time is worth more than money available in the future), the department's analysis concluded that pursuing the sale-leaseback would result in $2 million of savings in the first 20 years, but that the cost of the sale-leaseback would exceed the cost of state ownership over the longer time periods. In other words, the ongoing costs of leasing the facilities eventually would exceed the one-time revenue received in 2010-11. As discussed in the nearby box, DGS asserts that the costs and savings occurring after the first 20 years are not relevant.

Figure 3

DGS Comparison of State Ownership Costs and Leaseback Costs

(In Millions)

	Years 1 to 20	Years 1 to 30	Years 1 to 40	Years 1 to 50
Nominal Comparison				
Status quo cost	$4,385	$7,936	$12,709	$16,285
Sale-leaseback costs	6,172	10,750	16,672	24,291
Net Cost (-) of Sale-Leaseback	**-$1,787**	**-$2,814**	**-$3,963**	**-$8,006**
Net Present Value Comparison				
Status quo cost	$2,202	$2,817	$3,297	$3,480
Sale-leaseback costs	2,200	3,070	3,656	4,049
Net Benefit (+)/Cost (-) of Sale-Leaseback	**$2**	**-$253**	**-$359**	**-$569**

DGS = Department of General Services.

20-Year Analysis Insufficient to Measure Effects of Sale-Leaseback

The Department of General Services (DGS) asserts that state costs and savings occurring after the initial 20-year lease term are not relevant. In our view, the department's approach misrepresents the fiscal effect of the sale-leaseback because it excludes significant state fiscal effects occurring in later years. For example, it does not account for the significant state costs in year 21 related to renewing the lease or leasing, buying, or building alternative space for these government functions. It also ignores the continuing escalation of state rent costs under the leaseback and the declining costs of state ownership as the outstanding bonds on the facilities are fully retired. Although DGS is correct that there is some uncertainty in forecasting later year costs and savings, we think that any analysis of the sale of long-term assets must consider them.

As with any forecast, DGS makes many assumptions and acknowledges the large uncertainties associated with estimating building ownership costs. Although different from some of our assumptions, we think DGS' assumptions about future growth rates for variables such as construction and utility costs are reasonable. We disagree with some of DGS' other assumptions, however, which we think overstate the potential costs and risks of the state continuing to own the buildings and make the sale-leaseback appear more favorable than it actually would be.

Estimated Renovation Costs Too High. The department's forecast assumes that under the status quo the state would conduct infrastructure studies and perform extensive renovations of the properties as they become older. While this is a reasonable assumption, the cost DGS assumes for future renovations is too high. The DGS assumes future renovations would cost $250 per square foot (adjusted for inflation over time) based upon the recent costs of renovating two other state office properties: Office Buildings 8 and 9 and the Library and Courts building. Selecting these two properties as the cost basis for future renovations represents the worst-case scenario, as these were total renovations that included almost complete demolition and replacement of existing interiors and building systems as well as exterior renovations and the abatement of hazardous materials. Additionally, the renovation of Office Buildings 8 and 9 included the addition of a new two-story reception building and childcare center that added to the square foot costs. Similarly, the Library and Courts building is a state historical landmark, and its high renovation costs reflected the state's efforts to maintain the building's historic architecture and finishes. It is possible that *some* of the buildings in the sale-leaseback portfolio could require such extensive renovations as Office Buildings 8 and 9 and the Library and Courts building. It is not reasonable, however, to assume all of the buildings would. This is particularly true given the fact that most buildings in the portfolio are newer and in better condition than Office Buildings 8 and 9 and the Library and Courts building were prior to their renovation. Based on our analysis, we estimate the average cost of future infrastructure renovations would be about one-third less than DGS' estimates.

Insurance Costs Too High. The state does not maintain insurance on buildings once the bonds used to fund construction are retired. The state's decision to self-insure reduces annual costs, but increases the financial risk of potential property damage. The department's analysis, however, assumes that the state purchases property and earthquake insurance under the status quo. The DGS asserts this is necessary to quantify the benefit of transferring this risk to the new owner. While we agree that it is important to include some calculation of risk, we think this approach somewhat overstates the cost of maintaining state ownership by creating costs that the state does not currently incur and double counting some costs that are already included elsewhere in DGS' model. For example, the state's current operating costs—on which DGS bases its operating cost forecast—already reflect the recent annual costs of any liability claims or property damage. Additionally, the state's policy not to insure its buildings is based upon the evaluation that the annual cost of insurance exceeds the potential cost of insurable property damage. For example, by self-insuring, the state avoids the overhead and profit margins built into insurance premiums. We think it is reasonable to include some cost for risk, but think DGS' assumptions overstate that cost by about 25 percent.

Reversionary Value Calculated Incorrectly. As mentioned above, the department's status quo forecast assumes that the state fully invests in the maintenance and renovation of the 11 facilities. Such an investment would extend the useful life of the facilities beyond the time periods included in the analysis. Accordingly, DGS includes a reversionary value for the properties, or an estimate of the properties' value at the end of each term. Including the reversionary value takes into account the benefit of owning the properties—for example, the value that could be derived from occupying those buildings for their remaining useful life or from selling them. We take issue, however, with the department's methodology for calculating the reversionary value. The department calculates the reversionary value of the properties at a 50-year discounted value and then applies that value to each time period. For example, at the end of the first 20 years, DGS discounts the reversionary value of the properties by 50 years rather than the appropriate 20 years. In our view, this approach makes no sense and has the effect of understating the remaining value of the buildings. The department provided no rationale for its approach.

Update of DGS Model Shows Sale-Leaseback Has Significantly Higher Cost. As described above, we have three concerns with DGS' analysis of the status quo:

- The cost of future property renovations is overstated by about 33 percent.
- The cost of insuring against property and earthquake damage is overstated by roughly 25 percent.
- The value of the properties at the end of each time interval is understated.

Figure 4 summarizes our findings after making our adjustments to DGS' calculations. Specifically, under this approach the sale-leaseback would cost the state $646 million more than the status quo over the first 20 years in present value terms. In contrast to DGS' analysis, therefore, the transaction would be a major fiscal loss even under the shortest possible timeframe. The cost of the transaction grows to $725 million over 30 years and approximately $830 million in present value terms when looking out 50 years. The estimates shown in Figure 4 assume the discount rates selected by DGS—an average of about 6 percent. (The discount rate is used to adjust future amounts to present dollars.) As we discuss later in this letter, we think 5 percent is a more appropriate discount rate for this transaction. If we modify the analysis described above to include a 5 percent discount rate, the net cost of the sale-leaseback in present value terms would range from $1 billion for 20 years to $3 billion for 50 years. (For 35 years, the time period we use in our analysis below, the net cost is about $1.4 billion.)

Figure 4

Net Present Value of Sale-Leaseback

(In Millions)

	Years 1 to 20	Years 1 to 30	Years 1 to 40	Years 1 to 50
Department of General Services (DGS) Analysis	$2	-$253	-$359	-$569
LAO Revision of DGS Analysis	-646	-725	-732	-831

LAO Fiscal Analysis

In addition to reviewing DGS' fiscal analysis of the sale-leaseback, we examined the proposed transaction using the methodology that we developed for our April report. Our approach and assumptions differ from the department's forecast in several respects. Most notably, we used 35 years for the evaluation period because it represents a reasonable remaining useful life for the buildings in the portfolio and because it is likely the state would extend its leases on these properties due to their role in providing government services, historic status, or proximity to other government facilities. In forecasting the cost of maintaining state ownership, we attempted not to understate the potential costs and risks of the state continuing to own the buildings. Although not representing the worst-case scenario, we sought to provide significant allowances for major repairs and minor renovations. Our cost estimate does not include the potential costs of major renovations, and also does not acknowledge the residual value of the buildings and land at the end of the forecast period. We assume these values would tend to offset each other. In other words, we forecast just enough funding for capital renewal to keep the buildings operational through the forecast period and then assume no residual value or useful life beyond 35 years.

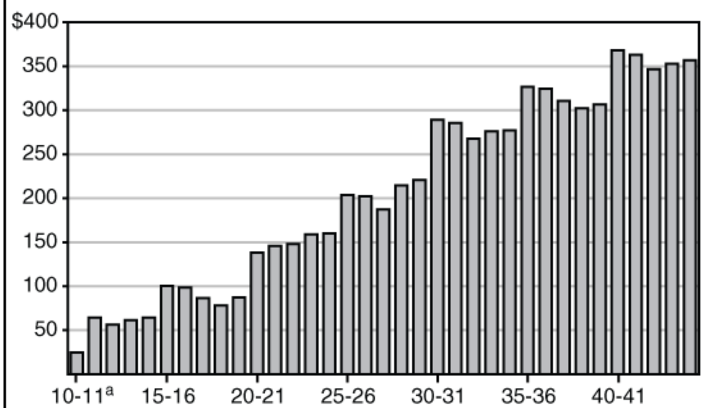
We also use a lower discount rate than DGS (5 percent rather than DGS' variable rate averaging about 6 percent). The discount rate used in a forecast is also a sensitive and critical factor that can affect the outcome. The discount rate selected should consider such factors as the anticipated inflation rate, borrowing costs, and the Legislature's valuation of the future. We typically use a lower discount rate based upon the expectation that government should not heavily discount the costs that future generations will bear. Our use of a lower discount rate places more value on costs incurred in later years, which results in higher present value costs compared to DGS' forecast.

As shown in Figure 5, the estimated difference between the cost of maintaining ownership and the cost of leasing the buildings would increase over time. In the near term, the greater cost of leasing compared to ownership would average about $54 million over the first five years. However, the estimated cost differential would increase to over $300 million annually in later years.

Figure 5

Annual Cost of Sale-Leaseback Compared To State Ownership, Nominal Dollars

(In Millions)



[a]2010-11 costs represent half of the fiscal year.

In total, as shown in Figure 6, we estimate the total cost of the sale-leaseback would be approximately $6 billion more than the cost of state ownership over the 35-year period. In present value terms, the difference is considerably less because the greatest costs occur in the latter part of the 35-year period and thus are heavily discounted. Still, in present value terms, the sale-leaseback costs are approximately $1.4 billion more than the status quo under our analysis. This increase over our earlier forecast reflects our updated assumption regarding property taxes. Specifically, we now assume that the property owners will be assessed property taxes and these costs will be passed through to the state. Although some of these additional property taxes could modestly alter the state's education costs, we did not include these effects in our analysis because we do not expect them to be significant. (While increases in property taxes paid generally offset state General Fund costs for schools, property tax increases in redevelopment areas can actually result in increased state costs due to the 2004 vehicle license fee swap.)

Figure 6

LAO Methodology: Comparison of State Ownership Costs and Leaseback Costs Over 35 Years

(In Millions)

	Nominal	Net Present Value
Status Quo	$5,617	$2,824
Sale-Leaseback	11,607	4,269
Net Cost of Sale-Leaseback	**-$5,990**	**-$1,445**

A simple way to measure the cost in present value terms is to think of the sale-leaseback as a loan with interest—the state receives cash up front through the sale with the obligation to pay it back over time through lease payments. Under such a calculation, the state's effective interest rate would be 10.2 percent. This interest rate is greater—about double—than those the state is currently paying on the buildings' outstanding lease-revenue bonds and greater than the interest rates on the state's recently issued general obligation bonds.

Summary of Fiscal Effects

In summary, over a 35-year period, both the DGS and the LAO analysis show the cost of the sale-leaseback to be about $1.4 billion (assuming a 5 percent discount rate) or about half this amount assuming a 6 percent discount rate. Considering this in terms of the state budget, the cost of the sale-leaseback is quite clear. Maintaining ownership of the buildings would lead to decreasing costs over time, but at the cost of creating a major hole in the 2010-11 budget plan. Alternatively, the rising cost of leasing the facilities would lead to an increase in the state's structural problem, but help balance the budget in the current year.

THE BIDDING AND AWARD PROCESS

The legislation exempted DGS from established state bidding and award procedures without specifying any procedures or criteria for DGS to follow in bidding and awarding the sale-leaseback. As such, DGS had significant discretion in determining the award procedures. The process started with DGS selecting the firm CB Richard Ellis (CBRE) through a competitive bidding process to serve as the broker for marketing and managing the sale-leaseback transaction. Next, DGS worked with CBRE to prepare lease terms for the leaseback part of the transaction and determine the bidding and selection process for the buyer.

As we understand it, the selection process consisted of multiple bidding rounds. At this time, DGS has not provided details on the rejected bids, but reported that the initial round resulted in 11 offers exceeding $2 billion. The DGS interviewed these final 11 bidders and invited each to submit a "best and final" offer. Unlike the competitive bidding process for the sale-leaseback broker and the typical awarding of state contracts, the sale process did not have any published criteria or scoring system for evaluating the bids, and the final award announcement did not include a ranking of each qualified bid. According to DGS, however, the final bids were evaluated based on two factors:

- ***Best and Final Price.*** According to DGS, the selected bid from California First LLC offered the highest purchase price at $2.3 billion.
- ***Certainty of Execution.*** Due to the size and complexity of the transaction, DGS wanted to ensure that buyers could meet the bid price with minimal risk. The DGS reported that evaluation criteria for this category included the bidders' diligence in reviewing the properties, financial backing, ability to remove contingencies, and ability to close the transaction quickly. Based on these criteria, California First LLC would have scored well given that it relies on 40 percent private equity and 60 percent financing from JP Morgan.

Given that DGS expected all the bids to conform to specified lease terms, it is likely that price and certainty of execution accounted for most of the variation among the bids. Other factors that could have varied include the experience and performance of the proposed property managers, the property tax implications of a private sector rather than public sector buyer, and the treatment of the properties at the end of the lease term. It is our understanding that to the extent the department considered these other factors, DGS gave them significantly less weight than price and certainty. As described earlier, such weighting was DGS' decision because the legislation provided DGS significant authority to determine the "best interests of the state" in the sale and leaseback of the properties.

Comparison of Public and Private Buyer. We have also received questions about how DGS evaluated bids from the public sector. Although the unselected bids have not been made public, our conversations with DGS and others have indicated that some public sector entities bid on the properties. While we cannot confirm the terms of those bids, we understand they included a public joint powers authority financing the purchase of the state's properties through the issuance of tax-exempt municipal bonds. Some of the advantages and disadvantages of a public bid are summarized in Figure 7. While the advantages of the public option are easier to quantify, the risk and uncertainties associated with the public option are also apparent. Based upon DGS' evaluation criteria outlined above, it is possible that concerns about completing the transaction could be a reason DGS did not choose the public option. The DGS also reported that California First LLC provided the highest price and, therefore, met both of their key criteria of price and certainty.

Figure 7

Potential Advantages and Disadvantages of Public Option[a]

Advantages	Disadvantages
• ***Property Tax.*** Public buyer probably not assessed property tax. Potential net present value savings to the state of over $700 million compared to private buyer.	• ***Less Certainty in Execution.*** Financing of properties depends upon bond market and investors. Price not guaranteed until bonds are sold.
• ***Property Reversion.*** If public bid includes reversion of properties to state at end of 50-year lease, potential net present value savings to the state of approximately $250 million to $400 million.	• ***Delay.*** Transaction would take longer to close due to preparation of bond sale documents.

[a] Based upon our understanding of submitted offers. Actual terms of those bids could be different.

Award Process Lacks Transparency. Evaluating DGS' award of the sale-leaseback purchase is difficult given the limited information the department has provided regarding the bidding process and individual bids. Overall, in contrast to DGS' usual sales and procurement procedures, it appears that the department did not use a specific (objective or subjective) point system for ranking bids based on established criteria. In addition, it appears that the department does not a have a clear process to allow unsuccessful bidders to file protests. In discussing these matters with DGS, it indicated that the special circumstances relating to this transaction made it difficult for them to follow their usual procedures. Specifically, DGS expressed concern that a selected bidder might withdraw or revise its bid during the 30-day legislative notification period if information about competing bids were to be publically available. While we acknowledge the potential risks associated with the usual procedures for governmental transparency, we find the paucity of information regarding this major state financial transaction to be troubling.

CONCLUSION

In our previous analysis, we pointed out that the sale-leaseback was poor fiscal policy and represented one imperfect option among many for balancing the state's budget. We recommended the Legislature strongly consider other alternatives to the sale-leaseback in putting together the 2010-11 budget. The inclusion of the sale-leaseback revenue as part of the 2010-11 budget package suggests that alternative solutions were less favorable or not feasible. Mainly due to changes in the interpretation of property tax assessments, our forecast of the cost of the sale-leaseback is approximately $800 million greater than our previous analysis. The Legislature may wish to consider whether this increase in costs merits changing course. If you have any questions about this analysis, please contact Mark Whitaker at (916) 319-8335.

Sincerely,

Michael Cohen
Deputy Legislative Analyst

Enclosure

cc: Members of the Joint Legislative Budget Committee
Assembly Committee on Accountability and Administrative Review