REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

REVIEW OF THE STATE'S LEASE-PURCHASE OF THE FRANCHISE TAX BOARD BUILDING

P-344.1

FEBRUARY 1984

REPORT BY THE

OFFICE OF THE AUDITOR GENERAL

TO THE

JOINT LEGISLATIVE AUDIT COMMITTEE

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LEASE-PURCHASE OF THE
FRANCHISE TAX BOARD BUILDING

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P-344.1

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the Department of General Services' lease-purchase of the Franchise Tax Board building. Although the department bid the lease-purchase in accordance with the California Government Code, the department did not provide bidders with complete information on which to base its bids. Because the department did not provide complete information in the form of final drawings or a final Environmental Impact Report, the department has had difficulty in monitoring the developer's work, and completion of the preconstruction phase of the building has been delayed.

Respectfully submitted,

Thomas W. Hayes

THOMAS W. HAYES
Auditor General

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SUMMARY

The Department of General Services (department) competitively bid the lease-purchase of the Franchise Tax Board (FTB) building in accordance with the California Government Code and determined that the costs to lease-purchase the FTB building were acceptable. However, the department did not provide bidders with complete environmental impact information and final design drawings on which to base their bids. As a result of the department's not providing complete information, the winning bid may contain an undetermined amount for mitigation costs that the department subsequently declared unnecessary, and unresolved issues regarding building design and location have developed. In addition, preconstruction work on the FTB building has been delayed for over three months. Furthermore, the department must spend additional time to ensure that the developer is conforming to the State's lease requirements and is experiencing difficulty monitoring the preconstruction phase of the FTB building.

Competitive Bidding

In compliance with state law, the department used a competitive bidding process to select the lowest bidder that would supply a site and construct the FTB building. To secure a site and competitive bids, the department took the following steps: selected an area for the site, advertised for sites based on requirements for acreage and public transit service, evaluated the sites, requested bids, and chose the lowest bidder. As a result, the department complied with the State's legal requirements for competitive bidding.

The department did not, however, provide bidders with a final Environmental Impact Report (EIR) that identified negative effects on the environment resulting from constructing the FTB building and the developer's costs for mitigating those effects during the term of the lease. In a draft EIR supplied to bidders, the department identified FTB employee commuting as a possible negative effect on the environment. The department required bidders to demonstrate in their bids that public transit would be provided to the building site. The Sacramento Regional Transit District estimated that providing bus service to the property of the winning bidder would cost approximately $9 million. After the bids were opened, however, the department declared the transit costs unnecessary. Because costs for mitigating environmental effects were not specifically identified in the bids, it is impossible for the State to determine the portion of estimated public transit costs that the winning bid may have included. In addition, because the department provided incomplete environmental impact information, one unsuccessful bidder brought suit against the State, delaying awarding of the contract nearly four months until the suit was withdrawn.

Lease-Purchase Costs

The State is paying approximately $42 million to lease-purchase the FTB building, including the cost of land, construction, and financing. The cost of land is $6.2 million for 44.7 acres, or $3.20 per square foot. According to a department survey of private real estate transactions, this cost for land is comparable to costs of similar parcels in Sacramento.

In addition, construction costs in the winning bid are similar to department estimates for constructing the FTB building. The department estimated that the costs of land and construction of an 800,000 square-foot building financed by capital outlay funds would be $56.4 million. The department's estimate for lease-purchasing the land and construction of a 465,000 square-foot building for the FTB was $36.9 million. The low bid chosen by the department allocated approximately $30 million for the cost of land and construction.

Finally, the department financed the building at a maximum 9 percent interest rate, which was identical to the rates on two state bonds issued at approximately the same time that the certificates of participation were issued. Other financing charges, such as the underwriter's discount, are comparable to charges paid by other state agencies.

Monitoring the Preconstruction Phase

The department is experiencing difficulty in monitoring the preconstruction phase of the FTB building. Because the department was not required to comply with the portion of the State Contract Act dealing with plans and specifications when it lease-purchased the FTB building, the department did not provide the developer with final design drawings to use in constructing the building.

As a result, the department must devote more staff time than normally required to determine that the developer is conforming to the State's lease requirements. Furthermore, major unresolved issues have developed, one of which requires arbitration, and preconstruction work has been delayed for over three months.

INTRODUCTION

The Department of General Services (department) is responsible for determining future space requirements of state agencies, allocating and managing space in state-owned and state-leased buildings, and negotiating state leases. The department also oversees construction of state buildings financed by capital outlay funds and evaluates and develops alternative financing, such as long-term lease-purchasing, for proposed state buildings when capital outlay funds are not used.

Construction Using Capital Outlay Funds

State buildings are financed and constructed primarily in the following manner. The Legislature appropriates capital outlay funds during the annual budget process. The funding process for a specific building may take from two to three years because the Legislature typically appropriates funds in stages. For example, state agencies may receive successive legislative appropriations first to acquire a site, then to have the department's Office of the State Architect prepare final drawings, and, finally, to construct the building.

In addition to legislative approval, most state buildings must be constructed in compliance with the State Contract Act contained in Section 10100 *et seq*. of the Public Contract Code. The State Contract Act is a comprehensive statute that establishes the State's authority over all aspects of construction on state buildings. The act specifies the department's monitoring of each aspect of building construction and specifies the department's remedies in the event of bidder complaints or a contractor's failure to perform required work.

Lease-Purchasing As Alternative Financing

Since March 1983, the department has used lease-purchasing as a method of financing the construction of state office buildings. Lease-purchases are an alternative to appropriating capital outlay funds or selling state bonds to finance construction. In lease-purchasing, the State makes annual rental payments to a developer who finances and constructs a building for the State. The developer raises the initial capital necessary to purchase the land and finance construction of a building by selling certificates of participation to private investors. These certificates, which are tax-exempt, represent a certificate owner's share in the annual rental payments to be made by the State. At the end of the lease term, the State acquires ownership of the land and building.

Recent law establishes how the department may use its lease-purchasing authority. Section 14669 of the California Government Code (Chapter 919, Statutes of 1981) permits the department's director to lease-purchase a building or building space if the director deems leasing to be in the best interests of the State. Prior to 1983, the law required the director only to notify the Legislature before executing a lease-purchase agreement. In 1983, the Legislature amended the law to require the director to obtain legislative approval for a lease-purchase and for a lease with option to purchase when the option price for office space exceeds $2 million. Section 14669 of the California Government Code requires the department to follow particular bidding procedures, but it does not specify the contractor's duties or the department's responsibilities for providing final drawings and monitoring building construction, as does the State Contract Act.

First Use of Lease-
<u>Purchase Authority</u>

The department's first use of its lease-purchase authority was to finance construction of new facilities for the Franchise Tax Board (FTB). In separate studies, in 1979 and in 1981, the department determined that the FTB would need to substantially increase its existing office space by 1991 and that this could be best accomplished at a new location. At present, the FTB leases two buildings for a total of 378,600 square feet at the Aerojet Center in eastern Sacramento County, at an annual cost of $1.1 million. This lease expires in July 1986. In addition, the FTB leases approximately 114,000 square feet at other locations for a total of almost 500,000 square feet of current leased space. In 1979, the department determined that the FTB would need approximately 727,000 square feet by 1991. This forecast was based on an expected increase in the number of state tax returns processed by the FTB.

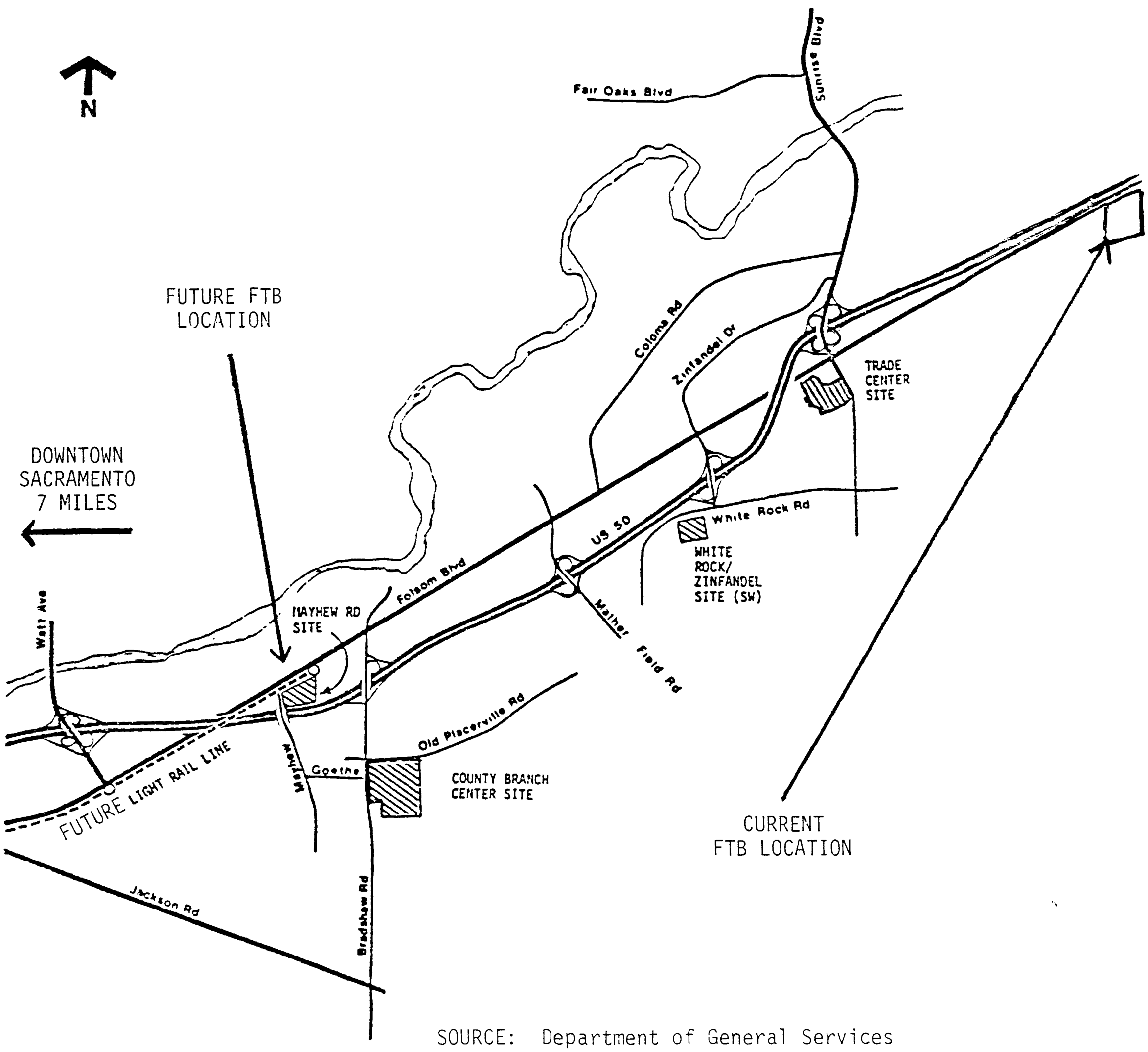
To secure the additional space, the department recommended that the FTB attempt to purchase and renovate the leased Aerojet facilities and to acquire surplus federal property owned by the United States Air Force at the Aerojet site. Between 1979 and 1981, the department attempted to acquire the surplus property, but in 1981 the Air Force decided not to sell its property to the State. In addition, a consulting firm hired by the department concluded in 1981 that the property that the FTB was leasing at the Aerojet Center--property that the State had an option to purchase--would not be sufficient to meet future space needs of the FTB.

In March 1983, the department entered into a lease-purchase agreement with a developer to finance construction of a building for the FTB. Construction of the FTB building is scheduled to begin not later than April 1, 1984, and is to be completed by January 1986. This building will provide the FTB with about 466,000 square feet, which represents the first of two phases of constructing a planned 800,000 square-foot facility. The second construction phase will require legislative approval.

The financial underwriters hired by the developer issued approximately $42 million in certificates of participation to pay for purchase of the land, construction of the building, and financing charges. These certificates of participation will yield from 6 to 9 percent interest, depending on their date of maturity. The $42 million represents the initial cost of the FTB building. The State will pay annual rent on the FTB building of about $4 million for 19 years, beginning in 1986. This rent includes the cost of financing the building over the full lease term.

In addition to the $4 million in annual rent, the department estimates that the State will spend an additional $1.8 million annually for building maintenance, utility charges, insurance, and taxes. The State may purchase the building in 1986, when it first occupies the building, and in each succeeding year, if the Legislature appropriates funds for the purchase. At the time of purchase, the State will acquire title to the building and land. If the State does not purchase the building until the end of the lease term in 2005, it will have paid approximately $86 million for the FTB building. The locations of the current and future FTB buildings and other sites that were bid are shown on the next page.

LOCATION OF THE CURRENT AND FUTURE FRANCHISE TAX BOARD OPERATIONS AND OTHER SITES THAT WERE COMPETITIVELY BID



SOURCE: Department of General Services

Future Lease-Purchases

The State may use lease-purchasing more extensively to fund construction of state prisons, state college facilities, and other state office buildings. Section 15820 et seq. of the California Government Code (Chapter 1268, Statutes of 1983), permits the State Public Works Board to use lease-purchasing to construct, renovate, or equip the University of California, the California State University, and California's community colleges with "vital, high technology facilities." Section 7009 of the Penal Code (Chapter 958, Statutes of 1983), authorizes the Department of Corrections and the Legislative Analyst to report on the feasibility of using lease-purchasing to construct state prisons. In addition, over 15 planned state buildings have not been funded and the department could choose to construct the buildings using lease-purchasing. However, unlike the lease-purchase of the FTB building, these future lease-purchases will be subject to legislative approval, as required by the 1983 amendment (Chapter 323, Statutes of 1983) to Section 14669 of the California Government Code.

SCOPE AND METHODOLOGY

We reviewed the Department of General Services' lease-purchase of the Franchise Tax Board building. The objectives of the audit were to (1) identify the legal authority of the department to lease-purchase, (2) to determine if the department had complied with state law and state administrative guidelines in lease-purchasing the FTB building, and

(3) to ascertain whether the lease-purchase agreement that the department entered into was in the best interests of the State.

We examined the records and interviewed the staff at the department's Office of Space Management and the Office of Facilities Planning and Development. These two offices have primary responsibility for lease management and involvement in the FTB lease-purchase. In addition, we interviewed officials of the Franchise Tax Board, the Department of Transportation, the Department of Health Services, the Office of the State Treasurer, and the Department of General Services' Office of the State Architect.

Our review included an examination of the department's policies and procedures, lease documents, correspondence, cost estimates, and drawings and reports submitted by the developer of the FTB building. In addition, we compared the FTB lease-purchase with a sample of other department leases.

ANALYSIS

I

BIDDING FOR THE FRANCHISE TAX BOARD BUILDING

The Department of General Services complied with state law governing lease-purchases in using a competitive bid process to secure a site and a developer to construct the Franchise Tax Board building. In securing competitive bids, the department selected an area for the FTB site, advertised for sites, conducted bidding, and chose the lowest bidder. However, the department did not provide bidders complete information on which to base their bid, as state law requires. The department did not provide a final Environmental Impact Report that identified negative effects on the environment resulting from constructing the building and the developer's costs to mitigate or correct those effects. As a result of incomplete information, one bidder sued the State, delaying acceptance of the low bid. Furthermore, after the bids had been opened, the department declared that certain mitigation costs were unnecessary. Because bidders were not required to specify such costs in their bids, the State cannot identify the amount of unnecessary mitigation costs included in the winning bid.

The Department Used a Competitive Bid Process

Section 14669 of the California Government Code requires the department to competitively bid the lease-purchase of buildings or equipment. The department must advertise for sites, obtain written bids, and select the lowest responsible bidder by publicly opening bids.

As part of its bid process for the FTB building, the department also required that the bidding meet requirements of the public transit law contained in Section 15808.1 of the California Government Code (Chapter 1358, Statutes of 1982). The department believed that the State's contract would be signed in 1983, after the law was in effect. Public transit law requires that a building leased by a state agency that employs more than 200 people be located within a public transit corridor. Because the FTB would have more than 200 employees in its new building, the public transit requirements would apply. Under Chapter 485, Statutes of 1981, a "public transit corridor" is an area within one-quarter mile of a transportation route that provides, or will provide, a specified level of service.

In July 1982, the department advertised in a Sacramento newspaper for 50 acres of land in eastern Sacramento County, within one-quarter of a mile on either side of Highway 50 (see map on page 6). The department had determined that this area was within a public transit corridor and the preferred location for the FTB. According to the department, sites in other parts of the county had major disadvantages, such as increasing the commute distance for FTB employees and being farther from the future location of Sacramento's light rail transportation system.

From responses to the department's advertisement, the department selected five sites from the Highway 50 area as eligible to be bid and required that bidders submit written bids documenting site ownership or control. Bidders were to use either lease-purchase financing or conventional financing, that is, a bank loan with installment payments. One owner did not submit a written bid. The remaining four owners submitted five written bids in response to the department's bid proposal. One owner submitted two bids. In all cases, the department required the developer to demonstrate that the Sacramento Regional Transit District would provide service to the sites without cost to the State and in compliance with public transit law.

The department publicly opened bids on November 30, 1982. Four bidders proposed to construct the FTB building through lease-purchase financing. One bidder proposed to construct the building with bank financing. The Cook Company, a Sacramento real estate firm, submitted the low bid using lease-purchase financing for construction of the FTB building on a 44.7-acre site at the southeast corner of Mayhew Road and Folsom Boulevard. This site is served by the Sacramento Regional Transit District, will be a future terminus of the Sacramento light rail system, and meets public transit corridor requirements.

Because one bidder protested the bidding results and filed a lawsuit, the department could not immediately award the low bid and the Cook Company could not promptly have underwriters prepare the financing arrangements for the building. On March 30, 1983, after the lawsuit was withdrawn and the department could award the low bid, the State entered into a lease-purchase agreement with the Cook Company as developer for construction of the FTB facility.

The Department Did Not Provide Bidders with a Final Environmental Impact Report

State law and the California Administrative Code require that an Environmental Impact Report provide complete information on the extent of the negative effect on the environment that will result from a construction project and what mitigation or correction of these negative effects the State will require. Usually, the department provides bidders with a final EIR when requesting bids to construct a state building. The California Environmental Quality Act requires that when the department is responsible for constructing a building that is not exempt from the act, the department must supply either a final EIR or document that there are no negative effects from construction and thus no need for an EIR.

For the FTB building, the department indicated there might be negative effects; consequently, state law required the department to furnish a final EIR. However, department officials state that they lacked time to produce a final EIR by October 1982, when bidders received bid proposal information. The department did not produce its final EIR until December 17, 1982, two weeks after it publicly opened bids.

Instead of furnishing bidders with a final EIR, the department provided bidders with a draft EIR. In addition, the department informed bidders that they must demonstrate that mitigation of harmful effects on the environment could be provided for their site, and that the winning bidder would be required to meet the full cost of mitigating the effects. The department did not require bidders to identify the specific amounts of mitigation costs that they included in their bids. One possible negative effect on the environment that the department identified was the effect of employee commuting to the FTB building. The department asked bidders to obtain estimates from the Sacramento Regional Transit District on the probable costs of providing transit service to their sites during the term of the lease. According to department staff, bidders had to estimate what portion of these transit costs the department might decide to include in its final EIR and, therefore, what transit costs to include in their bid. The lawsuit filed by one of the losing bidders charged that without a final EIR, it was impossible for a bidder to know how many dollars should be included in the bid to pay the costs of providing public transit service to a site.

The Sacramento Regional Transit District supplied estimates of transit costs to bidders. For example, the district notified the Cook Company that the cost of providing bus service to the Cook site for 20 years would be approximately $9 million. Two weeks after bidding closed on November 30, 1983, the department rejected the Sacramento Regional Transit District's estimate of the cost of transit service to the sites. According to the department, Regional Transit would not need additional buses to provide service to the sites, in part, because Sacramento's planned light rail transportation would reduce requirements for bus service. Thus, the Cook Company would not need to pay the nearly $9 million in estimated transit bus service to its site. However, since department bid practices did not require bidders to identify mitigation costs as a specific bid item, it is impossible to determine whether the Cook Company included some or all of these estimated transit costs in its bid.

II

COSTS OF LEASE-PURCHASING

The State Administrative Manual, as well as department policy, direct the Department of General Services to obtain the lowest costs when constructing state buildings. In view of the cost of other alternatives, the department determined that the costs of lease-purchasing the Franchise Tax Board building were acceptable. The department found that the costs for the FTB building are comparable to costs of land in other parts of Sacramento, to department estimates of the cost of constructing the FTB building, and to costs paid by other state agencies for financing state buildings.

Allocation of Lease-Purchase Costs

To finance the FTB building, the developer sold $42,055,000 of certificates of participation, using the services of financial underwriters. According to the underwriters responsible for marketing the certificates, proceeds from this sale will be allocated to cover costs of the land, construction, and financing. The table on the following page shows the allocation of these costs.

INITIAL COSTS OF THE FRANCHISE TAX BOARD BUILDING

Land	$ 6,233,913
Construction	23,129,342
Financing:	
Capitalized Interest	10,139,927
Reserve Fund	4,518,050
Bond Insurance	767,230
Underwriters' Discount	1,261,650
Other Costs	325,000 *
Subtotal	46,375,112
Less Reinvestment Earnings	(4,320,112)**
Total Costs	$42,055,000

*Costs include payment for fees to the lessor ($100,000), bank trustee ($62,000), legal counsel ($60,000), title insurance company ($55,000), and other miscellaneous costs ($48,000).

**These earnings are estimated by the underwriters and result from the investment of the Reserve Fund and two other funds by the bank that serves as trustee for the owners of certificates of participation.

Cost of Land

Both the State Administrative Manual and department policy require the department to obtain the lowest costs when constructing state buildings. As the table indicates, the cost of the 44.7-acre site for the FTB building was $6.2 million, or $3.20 per square foot. A department survey of private real estate transactions determined that this cost was comparable to prices for land in other areas of Sacramento. For example, the department found that the price of 40-acre and larger parcels that are zoned for office use ranged from $2.50 to $3.00 per square foot in West Sacramento. The department determined that such parcels in the South Natomas area in northern Sacramento County would cost the State from $12 to $14 per square foot because of the added cost of correcting adverse environmental effects, such as a lack of nearby public transit service. Further, the department concluded that although there were cheaper parcels in other parts of Sacramento, these sites lacked drainage, nearby public transit service, or would have required that the State pay higher utility rates than at the selected site.

The developer purchased most of the land for the FTB site from the State Department of Transportation (Caltrans). In October 1982, the Cook Company acquired an option to purchase 35.35 acres of surplus highway land from Caltrans. The company needed this option to demonstrate to the department that it had the legal right to sell the property to the State if it were the successful bidder on the FTB building. The Cook Company, which owned acreage adjacent to the Caltrans land, was eligible to buy the Caltrans land with approval of the California Transportation Commission. The Cook Company used this option to bid on the FTB building and in March 1983 acquired the 35.35 acres from Caltrans for approximately $4.7 million, or $3.00 per square foot.

Cost of Construction

Total construction costs for the FTB building, not including long-term interest costs, are comparable to department estimates of the cost of construction. As the table shows, approximately $30 million of the $42 million in certificates of participation issued to finance this building will pay for the cost of land and construction. This amount is considerably lower than department estimates. In September 1982, the department asked its Office of the State Architect (OSA) to estimate the cost of land and construction of an 800,000 square-foot building for the FTB. The OSA estimated the cost of land and the building, financed by capital outlay funds, at $56.4 million. In February 1983, the OSA estimated that the cost of land and construction of a 465,000 square-foot building using lease-purchase financing would be $36.9 million.

In calculating its February 1983 cost estimate, the OSA determined that the project should be designed to cost less than most new state office buildings. Furthermore, the OSA assumed that a developer could construct a lease-purchase building in less time than a building financed by legislative appropriations. Thus, the developer could reduce the impact of inflation on construction costs. The OSA also determined that a lease-purchase project based on general design specifications allows the contractor to determine its most cost-effective methods of construction and allows greater flexibility in the purchase of materials. As a result, the contractor has more freedom, which lowers costs, but the State has less control over construction.

Cost of Financing

Capitalized Interest and Interest Costs

The $10,139,927 in capitalized interest shown in the table reflects proceeds from the sale of the certificates that will be used to pay the accrued interest during the construction period from 1983 to 1986. The department has only limited control over costs of financing. For the FTB building, the department encouraged bidders to bid the lowest interest rate by agreeing to adjust the interest rate following bidding. This adjustment meant that bidders would not be penalized for market variations between the close of bidding and the sale of the certificates of participation. If interest rates increased by the time the certificates were issued, the department would allow the winning bidder to use the higher rate to calculate the State's rent payment. Similarly, this rate adjustment option would allow the department to decrease the payments if interest rates declined.

In November 1982, when the department received bids for the FTB building, the Cook Company used an interest rate of 10.19 percent to calculate its bid. By March 1983, when the department signed the lease-purchase agreement with the Cook Company and the certificates of participation were issued, the interest rate for similar securities had dropped to approximately 9 percent.

The 9 percent maximum interest rate paid by the State to finance the FTB building compares favorably with interest rates paid by the State for the sale of revenue and general obligation bonds. We reviewed two different state bonds issued in April 1983, at approximately the same time underwriters issued the FTB certificates of participation. The interest rate of the bonds issued by the State was also a maximum of 9 percent.

Reserve Fund and Bond Insurance

A reserve fund and bond insurance serve as inducements to potential investors and as additional security to owners of certificates of participation. For the FTB lease-purchase, the reserve fund of $4.5 million provides for prompt payment to the certificate owners if the State defaults or fails to pay the annual rent. Under the lease agreement, if the State is late in paying its rent, the reserve fund provides payment. Bond insurance, on the other hand, guarantees payment of the entire investment (both principal and interest) to certificate owners for the life of the certificates.

In addition to protecting investors, the reserve fund and the bond insurance also benefit the State. Because interest rates depend, to some extent, on how much risk the market associates with an investment, a higher rating (AA or AAA) for bonds or certificates of participation can reduce the interest rate by several percentage points. According to the financial underwriters of the FTB building, the presence of a reserve fund and the bond insurance enabled the underwriters to obtain a Standard and Poor's rating of AAA for the certificates. Without the reserve fund and the bond insurance, the underwriters would have been able to secure only an A rating. Furthermore, the reserve fund earns interest, called reinvestment earnings, which further lowers the effective interest rate for financing the FTB building and reduces the interest expense to the State.

Underwriters' Discount

The cost of financing the FTB building also includes the fees paid to the underwriter who markets the certificates of participation. According to staff at the Office of the State Treasurer, which has primary responsibility for state lending, there is no standard range of fees that state agencies are required to pay underwriters. However, state agencies are expected to use judgment to minimize these costs. Usually, underwriters are chosen and paid by the Office of the State Treasurer. According to staff at that office and a recent legislative study, underwriter discounts may range from 1.8 to 3 percent of the dollar amount issued. Three percent of the total costs, shown in the table, or $1,261,650, was paid to the underwriters of the FTB building.

III

MONITORING THE PRECONSTRUCTION PHASE

Although the Department of General Services has reviewed the drawings and reports submitted by the developer for the Franchise Tax Board building, it is experiencing difficulty in monitoring the building's preconstruction phase. State law governing lease-purchasing did not require the department to provide the developer with final design drawings prior to bidding. Consequently, department staff must spend additional time reviewing the developer's work to ensure that the developer has conformed to the State's lease requirements. As a result of the department not providing complete specifications, unresolved issues regarding building design and location have developed and the preconstruction phase has been delayed for over three months. Furthermore, the department is experiencing difficulty monitoring the preconstruction work.

The State Contract Act Requires Complete Specifications

Section 10120 of the State Contract Act requires the department to provide full, complete, and accurate plans and specifications that enable a builder to construct a state building. For almost all state building construction, the department has interpreted this requirement to mean that it must provide final design drawings prior to bidding construction of a building. Further, department officials state that these final drawings provide the department with an effective means of verifying that a developer is conforming to the State's lease requirements. These drawings also minimize the amount of time and effort that department staff must devote to monitoring state construction projects. According to department officials, the department has provided final drawings on all state office buildings constructed with capital outlay funds since 1978. Consequently, the architects and contractors for these buildings had well-defined tasks and the department could effectively review construction work.

However, lease-purchase law contained in Section 14669 of the California Government Code does not require the department to comply with Section 10120 of the State Contract Act. Thus, the department did not provide final design drawings to bidders on the FTB building. Department officials told us that the department lacked any legislative appropriation in its 1982 budget to fund the preparation of final drawings. Therefore, the department required the developer to supply all architectural drawings as a condition of the FTB lease agreement and to base these drawings on the general instructions, or design specifications, that the Office of the State Architect prepared for bidders.

Inadequate Drawings Require Arbitration

Since July 1982, the department has been reviewing the developer's work based on the State's lease requirements. Because the State did not provide final design drawings, the department and the developer have had extended discussions over a five-month period to resolve major issues of the building design and the location of the building on the site. Most recently, the department decided to submit one major unresolved issue to binding arbitration.

The department has used its design specifications to review and reject some of the developer's drawings and reports. On June 30, 1983, the developer first submitted preliminary drawings and a design for the building's interior. Although the department accepted the interior design, the department determined that the preliminary drawings did not substantially conform to the lease requirements and rejected them. Further, the department identified 43 design deficiencies that the developer had to correct. For example, the department found that the number and arrangement of parking spaces did not conform to the lease requirements.

On August 15, 1983, the developer resubmitted the preliminary drawings for the department's second review. The department determined that 13 of the 43 deficiencies had been corrected, but found that key issues related to the building site, building design, and energy requirements remained uncorrected. The department also stated that the developer still had not provided all land specified in the lease. Specifically, the department claimed that the developer provided at least 8,000 to 10,000 square feet less than the 334,500 square feet required for the second phase of the 800,000 square foot FTB project.

In September 1983, the developer responded to the department's review for a third time. The developer stated that the firm believed some issues were not appropriate to the preliminary drawing phase and could be addressed later. The developer also stated that construction work had been delayed largely because of the department's inability to adequately interpret ambiguities in its own design specifications. Further, lawyers for the developer indicated they had advised their client to seek arbitration based on a provision of the lease to recover the costs of the State's alleged delay. Subsequently, the department approved the developer's preliminary drawings with stipulations that some design issues will need to be reconsidered at a later date. Thus, the developer could submit the next phase of drawings and reports to the department.

The developer and the department could not agree on the size of the site. The department contends that the developer must provide additional land to comply with the terms of the lease. Based on the department's lease requirements, disagreements can be resolved by binding arbitration. In December 1983, the department and the developer agreed to use arbitration to resolve the issue and to hire a retired judge to arbitrate the dispute.

Disagreements between the department and the developer have resulted in over three months' delay in the developer's preconstruction work and may result in further delays. The developer has asked the State for an extension of both the April 1, 1984, construction commencement date and the January 1, 1986, construction completion date.

IV

CONCLUSION AND RECOMMENDATIONS

The Department of General Services complied with the California Government Code in selecting the lowest bidder to construct the Franchise Tax Board building and met legal requirements in advertising for a site and obtaining written bids. However, the department did not supply bidders with a final Environmental Impact Report, which the department usually provides when bidding the construction of state buildings. As a result, one bidder brought suit against the State. Moreover, the successful bid may include unidentified mitigation costs that the department subsequently declared unnecessary.

The department determined that costs associated with the FTB building are comparable with the cost of land in other areas of Sacramento, with department estimates for constructing the building, and with the experience of other state agencies in financing state projects.

The department is experiencing difficulty in monitoring construction of the FTB building. Because the department was not required to comply with the portion of the State Contract Act dealing with plans and specifications, it did not provide complete specifications before soliciting bids for the FTB building. As a result, unresolved issues regarding building design and location have developed and construction has been delayed. Furthermore, department staff must spend additional time to ensure that the developer is conforming to the State's lease requirements, and staff are having difficulty monitoring the preconstruction phase.

Recommendations

To ensure that the State pays the lowest costs for lease-purchases, the Department of General Services should provide bidders with complete bidding information, including a final Environmental Impact Report. In addition, the department should require bidders to identify in their bids specific amounts for mitigation costs.

To ensure that the State can more effectively monitor the construction of state office buildings when it bids future lease-purchases, the department should provide bidders with final drawings in compliance with the provision of the State Contract Act that requires complete plans and specifications.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

THOMAS W. HAYES
Auditor General

Date: February 8, 1984

Staff: Robert E. Christophel, Audit Manager
Steven M. Hendrickson
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GEORGE DEUKMEJIAN, GOVERNOR

State and Consumer Services Agency

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February 1, 1984

Mr. Thomas W. Hayes
Auditor General
660 J Street, Suite 300
Sacramento, California 95814

Re: P-344.1

Dear Mr. Hayes:

The Department of General Services has reviewed the draft copy of your report entitled "Review of the State's Lease-Purchase of the Franchise Tax Board Building." I appreciate the opportunity to respond to the report and to provide additional clarifying comments.

The Department agrees with the conclusion and recommendations presented on Pages 29 and 30 of the report. It is true that a complete Environmental Impact Report (EIR) was not supplied to the bidders. The recommendation that a final EIR be provided is valid, and has been adopted. I would like to note, however, that staff from the Department's Office of Facilities Planning and Development did meet on a regular basis with representatives of owners of all acceptable sites to discuss all requirements as they were developed. Thus, I am confident that the Department proceeded in a positive and responsible manner. Although a final EIR was not provided, all potential bidders were aware of every requirement that would have been in a final report.

The recommendation that the Department provide bidders with final drawings when it bids future lease-purchases is also valid. New departmental policy to resolve the working drawing issue has been adopted. In the future, capital outlay funding at least through completed work drawings will be requested regardless of the method of construction financing.

As a final note, the Department has informed me that despite the funding and time restrictions that were faced, the project is on schedule. Construction is slated to begin on April 1, 1984, with occupancy planned for January, 1986.

Again, I appreciate being able to comment on the draft of your report. If there is any further clarification or information needed, please contact me at 445-1935.

Sincerely,

A. A. PIERCE
Undersecretary

AAP:jk

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps