CALIFORNIA STATE AUDITOR

Metropolitan Transportation Commission

The Use of Toll Revenues to Purchase a New Headquarters Building Is Likely Legal, but the Transaction Exposes Toll Payers to Undisclosed Financial Risk

August 2012 Report 2011-127

Independent NONPARTISAN TRANSPARENT Accountability

The first five copies of each California State Auditor report are free. Additional copies are $3 each, payable by check or money order. You can obtain reports by contacting the Bureau of State Audits at the following address:

California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, California 95814
916.445.0255 or TTY 916.445.0033

OR

This report is also available on the World Wide Web http://www.auditor.ca.gov

The California State Auditor is pleased to announce the availability of an on-line subscription service. For information on how to subscribe, please contact the Information Technology Unit at 916.445.0255, ext. 456, or visit our Web site at www.auditor.ca.gov.

Alternate format reports available upon request.

For questions regarding the contents of this report,
please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

Elaine M. Howle
State Auditor

Doug Cordiner
Chief Deputy

CALIFORNIA STATE AUDITOR
Bureau of State Audits

555 Capitol Mall, Suite 300 Sacramento, CA 95814 916.445.0255 916.327.0019 fax www.auditor.ca.gov

August 28, 2012 2011-127

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning the acquisition of a new headquarters building for the Metropolitan Transportation Commission (transportation commission) and the Bay Area Toll Authority (toll authority). The audit also examined the toll authority's administration of toll bridge revenues, particularly the use of toll revenues for acquiring the headquarters building.

This report concludes that the decision the board governing the toll authority made to use toll revenues to fund the acquisition of a new headquarters building likely was legally permissible. However, a court would ultimately decide the legality of the purchase. Further, during the decision-making process the transportation commission and the toll authority could have done more to clearly articulate to both their shared governing board and the public the financial risks associated with purchasing the building. Specifically, the transportation commission's presentation to the board in September 2011 stated that toll payers are protected because the cash flows from the building would repay contributed toll revenues. However, in its projection the transportation commission did not discount the value of future cash flows to today's dollars. We converted the cash-flow projection and determined that, in the most conservative combination of rental and occupancy rates, cash flows would fall short of repaying contributed toll revenues by $30 million. We also noted that the financial risk of being unable to repay all of the toll revenues significantly increased in May 2012 when the Bay Area Headquarters Authority announced plans to convert 101,000 square feet of the building into an atrium and building support space that will reduce rentable space available to generate income. According to the current occupancy plan, unless the three most optimistic combinations of rental and occupancy rates are used, cash flows will fall short of repaying contributed toll revenues by a range of $1.5 million to $53.7 million over 30 years.

The transportation commission developed property search criteria and followed a reasonable process for evaluating potential properties, but at 350,000 square feet, the specified criteria for the overall building size was roughly twice the amount originally shared with its governing board. Moreover, it is not clear to us what the transportation commission's motivation was in setting the search criteria for the building's size—planning for growth or generating income. Notwithstanding the building's size, the governing board was well informed about the transaction and was responsive to public comment. Moreover, the Bay Area Air Quality Management District (air district) has signed a lease for space in the headquarters building with an option to buy. The transportation commission, toll authority, and the air district plan to move in to the headquarters building in fall 2013. Meanwhile, the transportation commission and the air district still need to resolve their options for disposing of their current headquarters buildings.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
State Auditor

Contents

Summary

Results in Brief

In October 2011 the Bay Area Headquarters Authority (headquarters authority)—an entity created by the Metropolitan Transportation Commission (transportation commission) and the Bay Area Toll Authority (toll authority)—purchased a building located at 390 Main Street in downtown San Francisco, using revenues from seven state‑owned toll bridges in the San Francisco Bay Area (Bay Area). The building purchase was the culmination of nearly two years of planning among the transportation commission, the toll authority, the Bay Area Air Quality Management District (air district), and the Association of Bay Area Governments (association) to colocate, and the site is intended to serve as their regional headquarters. The transportation commission and toll authority share the same governing board (board), which has authorized the toll authority to contribute more than $167 million in toll revenues toward the estimated $180 million cost to purchase, renovate, and prepare the building for occupancy by fall 2013.

The board's September 2011 decision to authorize the purchase of a new headquarters building has been controversial. At a board meeting in September 2011, members of the public questioned why public toll revenues were being used to purchase a building that is larger than the amount of office space the colocating agencies need, effectively causing the toll authority, using public toll revenues, to enter the real estate business and become a commercial landlord. Others have questioned whether it was even permissible for the toll authority to use toll revenues for this purpose.

Although a court would ultimately decide the legality of the purchase, our legal counsel advised that the board's decision to use toll revenues to acquire a new headquarters building likely was legally permissible. State law expressly authorizes the toll authority to pay its direct and administrative costs from gross annual bridge revenues and to contribute funding to the transportation commission. Therefore, our legal counsel advised that a court would likely conclude that costs to plan for, acquire, and develop facilities and office space for the toll authority and transportation commission and its staff are direct costs that can be paid from gross annual bridge revenues. Our legal counsel also advised that a court would likely conclude that the sole fact that the building exceeds the needs of the toll authority and transportation commission would not adversely affect that authority, because a court would defer to reasonable decisions made by the board, and our legal counsel believes a court would likely find that the board's decision was reasonable. Ultimately, we note that under state law, the toll

Audit Highlights . . .

Our audit of the Bay Area Headquarters Authority's acquisition of a new regional headquarters and the Bay Area Toll Authority's (toll authority) administration and use of toll bridge revenues, revealed the following:

- ***Using toll revenues to acquire a new headquarters building likely was legally permissible.***
- ***The Metropolitan Transportation Commission (transportation commission) and the toll authority could have done more to clearly articulate to both their board and the public the financial risks.***
  - ***In today's dollars, the transportation commission's expected cash flows would fall short of repaying contributed toll revenues by roughly $30 million.***
- ***The financial risk of repaying toll funds increased following plans in May 2012 to reduce the building's rentable space.***
- ***The transportation commission and the Bay Area Air Quality Management District (air district) had valid reasons for wanting to leave their current facilities.***
  - ***The transportation commission stated that it wanted to ensure sufficient room for growth over the long term.***
  - ***The air district faced spending between $12 million and $30 million to fix its aging building.***
- ***The specified criterion for overall building size, at 350,000 square feet, was roughly twice the amount originally shared with the board.***
  - ***The transportation commission's space needs were based on anticipated future responsibilities the specifics of which are unknown.***

authority may do all that is necessary or convenient to exercise its powers, including, but not limited to, the acquisition, management, and operation of any public facility or improvements.

During the decision-making process, the transportation commission and the toll authority could have done more to clearly articulate to both their board and the public the financial risks associated with purchasing the building. The transportation commission's presentation to the board in September 2011 stated that toll payers were protected because the projected net income, or cash flows, from the building would offset contributed toll revenues. However, in its projection the transportation commission did not discount the value of the future cash flows from the rental income, thus preventing a comparison of the expected toll fund contributions to the building's expected income in today's dollars. We converted the transportation commission's cash-flow projection based on its September 2011 space plan to today's dollars and determined that, in the most conservative combination of rental and occupancy rates, cash flows would fall short of repaying contributed toll revenues by a total of roughly $30 million. The income the building generates is largely dependent on the rental and occupancy rates that can be achieved. The future values of these rates are uncertain, and thus there is uncertainty as to whether and when toll revenues will be repaid.

We also note that the financial risk of being unable to repay all of the toll revenues significantly increased following the board's September 2011 decision to acquire the building. In May 2012 the headquarters authority announced plans to convert 101,000 square feet of space in the new headquarters into an atrium and building support space that will reduce the rentable space available to generate income. According to the current occupancy plan, unless the three most optimistic combinations of rental and occupancy rates are used, cash flows will fall short of repaying contributed toll revenues by a range of $1.5 million to $53.7 million over 30 years.

We found that the transportation commission and the air district had valid reasons for wanting to leave their current facilities. Both identified limitations with their current facilities, and both identified the potential benefits of easier cross-agency collaboration by sharing a new headquarters building. The transportation commission determined that it needed more space to accommodate its staff count as well as for conference rooms, storage space, and other support functions. The air district's justification for moving is largely based on the cost of improving its current headquarters. In recent years consultants have concluded that the air district faced spending between $12 million and $30 million to replace key components of its aging building. In January 2010 the transportation commission, the air district, and the association began to explore the potential benefits of colocating into a single headquarters facility.

The transportation commission developed property search criteria and followed a reasonable process for evaluating potential properties based on these criteria. However, the specified criterion for overall building size, at 350,000 square feet, was roughly twice the amount originally shared with the board in November 2010. Moreover, it is not clear to us what the transportation commission's motivation was in setting this search criterion for the building's size. According to the transportation commission's executive director, he wanted to ensure that the new headquarters building has sufficient room for growth over the long term, and he also stated that income generation was not a factor when deciding on the amount of needed space. The transportation commission's chief financial officer further explained that the projected space needs were finalized in undocumented internal discussions about anticipated future projects that would affect the need for more work space. However, when asked about these projects, the chief financial officer explained it was a guess based on assumptions regarding the transportation commission's future responsibilities, the specifics of which are yet to be determined.

Once the search criteria were finalized, the transportation commission's broker solicited property proposals and made recommendations to the transportation commission regarding which proposals warranted further consideration. The transportation commission and its broker identified five finalist properties and ultimately selected the property at 390 Main Street in San Francisco, since the others had certain flaws and the 390 Main Street property had the lowest price per square foot. Since price per square foot was a key consideration in the selection process, we reviewed the five finalist property proposals and found that the price information submitted to the board for decision making was consistently developed by the transportation commission's broker.

Finally, the air district has signed a 30-year lease agreement with the headquarters authority to acquire approximately 62,500 square feet of work space in the new headquarters building. The lease agreement provides the air district with an opportunity to purchase its share of the building at any time over this 30-year period. The association and the San Francisco Bay Area Conservation and Development Commission have also demonstrated interest in relocating to the new building, having participated in space-planning meetings as recently as April 2012, but they have not executed leases. In the summer of 2012, both the transportation commission and the air district plan to begin assessing their options for disposing of their current headquarters buildings.

Recommendation

If the Legislature believes state law provides the toll authority with too much discretion over its use of toll revenues, it should consider amending state law to more narrowly define how toll revenues that are not immediately needed for bridge maintenance or debt service may be spent or invested. For example, the Legislature might consider imposing specific limitations or prohibitions on the use of toll revenues to acquire real estate for administrative or investment purposes.

Agency Comments

The transportation commission agreed with certain conclusions in our report and disagreed with others, including the report's recommendations. Specifically, the transportation commission stated that it was pleased with the report's conclusion that a court would likely find its board's decision to purchase a new building with toll revenue was within its legal authority. The transportation commission was also pleased that our report found that its board was generally informed throughout the property search and selection process. However, the transportation commission disagreed with our report's net present value (NPV) analysis. In its view, the report's NPV analysis was incomplete because it did not include the building's residual value. Finally, the transportation commission expressed that it did not believe the recommendations to the Legislature were supported by the audit's findings.

The air district stated that it reviewed the portions of the report it was provided and did not have substantive comments.

Introduction

Background

In October 2011 the Bay Area Headquarters Authority (headquarters authority)—a joint powers authority created by the Metropolitan Transportation Commission (transportation commission) and the Bay Area Toll Authority (toll authority)—purchased a building with revenues from seven state-owned toll bridges in the San Francisco Bay Area (Bay Area). The building purchase was the culmination of nearly two years of planning among the transportation commission, the toll authority, the Bay Area Air Quality Management District (air district), and the Association of Bay Area Governments (association) to colocate, and the building is intended to serve as their regional headquarters. The transportation commission and toll authority share the same governing board (board), which has authorized the toll authority to contribute more than $167 million in toll revenues toward the estimated $180 million cost to purchase, renovate, and prepare the building for occupancy by fall 2013. Figure 1 on page 8 provides the timeline of significant decisions and events leading up to the purchase of the building, a property located at 390 Main Street in San Francisco.

The Transportation Commission's Role and Responsibilities

The transportation commission is the comprehensive transportation planning agency for the Bay Area. It is responsible for developing and updating the regional transportation plan, a comprehensive blueprint for mass transit, the state and federal highway systems, and the transbay bridges. In addition, the transportation commission is required to work collaboratively with other regional agencies on Bay Area land use, transportation, and air quality issues.[1] A 19-member board appointed by various state, local, and federal officials governs the transportation commission. At its headquarters in Oakland, California, an executive director, two deputy directors, a chief financial officer, and a general counsel make up the transportation commission's key executive management who carry out the day-to-day administration of the transportation commission and the management of its employees.

1 The requirement for cross-agency collaboration is contained in California Government Code, sections 66536 through 66536.2, which establish the air district and the San Francisco Bay Conservation and Development Commission as members of the Joint Policy Committee that was previously established by the transportation commission and the association. The Joint Policy Committee is responsible for coordinating the development and drafting of major planning documents by its member agencies, such as regional plans for transportation, housing, and air quality.

The Toll Authority's Role and Responsibilities

The toll authority manages and administers toll revenues from seven state-owned toll bridges in the Bay Area; the text box lists these bridges. Although state law established the toll authority as a legal entity separate from the transportation commission, it also requires that the two be governed by the same board. Moreover, the toll authority is part of the transportation commission's operations and is administered by the transportation commission's key executive management.[2] During May 2012 the transportation commission and the toll authority collectively had approximately 177 authorized positions; however, according to the director of administrative and technology services, with interns and temporary staff, the head count exceeds 230. The toll authority is located with the transportation commission's offices in Oakland, California.

The San Francisco Bay Area's Seven State-Owned Toll Bridges

According to state law, the Bay Area Toll Authority uses toll revenue collected from the following state-owned bridges:

- Antioch Bridge
- Benicia-Martinez Bridge
- Carquinez Bridges
- Dumbarton Bridge
- Richmond–San Rafael Bridge
- San Mateo–Hayward Bridge
- San Francisco–Oakland Bay Bridge

Source: California Streets and Highways Code.

State law requires that tolls collected from state-owned bridges be used for specific purposes, such as to pay the costs for bridge construction, maintenance, and seismic retrofit projects. Furthermore, state law authorizes the toll authority to issue bonds—to be repaid with toll revenues—for these purposes. As noted in the transportation commission's financial statements, for the fiscal year ending June 30, 2011, the toll authority had approximately $7.9 billion in revenue bonds outstanding and had collected more than $597 million in bridge tolls.

The toll authority increased bridge toll rates effective July 1, 2010. The text box describes some of the purposes for which the toll authority may increase toll rates. The reasons the toll authority cited for the most recent toll rate increase were to cope with declining traffic volumes and higher-than-projected debt and operating costs. The toll authority did not cite its plans to fund the purchase of a new headquarters building as justification for its toll increase. In fact, the July 2010 increase was studied, proposed, and approved before October 2010, when a consultant to the transportation commission recommended that it colocate with other public agencies. Our review of the toll authority's accounting structure, and discussions with its deputy financial officer, indicate that toll revenues resulting from the 2010 increase are consolidated with other toll revenues.

[2] Throughout this report we use the term *transportation commission* to include both the transportation commission and the toll authority, unless otherwise specified.

As a result, our audit could not assess whether the toll revenues generated specifically from this increase were used to purchase the new headquarters building.

Allowable Reasons for Increasing the Bridge Toll Rates

According to state law, the Bay Area Toll Authority may increase bridge toll rates to provide funding for reasons including:

- To plan, design, construct, operate, maintain, repair, replace, rehabilitate, and seismically retrofit the seven state-owned toll bridges.
- To meet the requirements of voter-approved regional measures.
- To meet obligations and covenants under any bond resolution or indenture for bonds it issued.

Source: California Streets and Highways Code.

The Purpose of the Headquarters Authority

The headquarters authority is a joint powers authority created in September 2011 to plan, acquire, and develop office space for the transportation commission and the toll authority. State law expressly authorizes two or more public agencies to jointly exercise any power common to them by forming a joint powers authority. As a separate legal entity, the headquarters authority is authorized to enter into contracts, hire employees, incur debts, and sue and be sued in its own name.

In October 2011 the headquarters authority purchased a building located at 390 Main Street in San Francisco. According to the transportation commission's general counsel—who also serves as the headquarters authority's general counsel—a primary advantage to forming the headquarters authority is that it protects the assets and revenues of the transportation commission and the toll authority from building-related liabilities. In addition, the general counsel stated that the California Government Code includes well-developed and detailed operating rules for entities such as the headquarters authority. The code also includes helpful provisions regarding governance and auditing.

The Timeline Leading to the Purchase of a Regional Headquarters Building

The transportation commission, the air district, and the association spent nearly two years planning their colocation into a regional headquarters building. As was noted previously, the transportation commission must collaborate with other regional agencies, including the air district and the association. The air district serves as the Bay Area's regional air pollution control agency and is governed by a 22-member board of directors consisting of members appointed from each of the Bay Area counties. It is headquartered in San Francisco. The association is the regional planning agency that provides and coordinates programs to address the Bay Area's economic, social, and environmental challenges. It is currently located in Oakland in the same building as the transportation commission. In January 2010 the three agencies began to collectively explore their options for relocating together to a new headquarters building. Figure 1 provides the timeline leading up to the purchase of the regional headquarters building and describes how the air district and association participated in the property search process.

Figure 1
Regional Headquarters Building Purchase Timeline

PHASE I
Strategizing and Planning

January 2010
The Metropolitan Transportation Commission (transportation commission), the Bay Area Air Quality Management District (air district), and the Association of Bay Area Governments (association) execute a cooperative agreement to investigate options for colocating in a regional government facility.

June 2010
The air district enters into an agreement with a commercial real estate firm to develop a real estate headquarters strategy that best aligns with the needs of the transportation commission, the air district, and the association.

October 2010
The real estate firm presents its findings in a strategic facility plan (plan) to a joint agency ad hoc committee; the real estate firm concludes that the transportation commission, the air district, and the association should consolidate into a single facility in either Oakland or San Francisco. The plan summarizes criteria the entities thought important in a headquarters building.

November 2010
The transportation commission's governing board votes unanimously to proceed with the next phase of the plan to identify specific properties in Oakland and San Francisco. Subject to the boards for the air district and the association also agreeing to proceed, the transportation commission is directed to issue a request for proposals for brokerage services.

PHASE II
Searching for Regional Headquarters Locations

February 2011
The transportation commission takes the lead in searching for new regional headquarters and enters into an agreement for real estate brokerage services.

March 2011
The real estate broker issues a request for proposals for properties that meet specified criteria.

April 2011
The real estate broker receives proposals for 12 potential properties and assesses each proposal based on the property criteria.

May 2011
- The real estate broker develops a short list of five properties and presents the list to each agency's governing board.
- The transportation commission's governing board votes to proceed with real estate negotiations with the owners of the five properties.

PHASE III
Purchasing a Regional Headquarters Building

July 2011
- Outside counsel provides the transportation commission and the Bay Area Toll Authority (toll authority) with a legal opinion that a court would hold that using toll bridge revenues to purchase a building is permitted by California law.
- The governing board for the transportation commission votes to proceed with purchasing a building located at 390 Main Street, San Francisco.
- The governing board for the air district votes in favor of participating in the new regional headquarters, subject to certain terms, and instructs its staff to develop the necessary agreements.
- The association declines to support moving to San Francisco with the transportation commission so as to allow additional time for review.

August 2011
After public opposition to the move from Oakland, the governing board for the transportation commission rescinds its vote to proceed with purchasing 390 Main Street and appoints an ad hoc committee to review the legal and financial issues related to the purchase.

September 2011
- The ad hoc committee completes its review and reports to the transportation commission's governing board that the process leading to the selection of 390 Main Street was fair, transparent, and proper.
- The governing board for the transportation commission votes to proceed with purchasing the building at 390 Main Street, San Francisco.
- The transportation commission and the toll authority form a joint powers authority—the Bay Area Headquarters Authority (headquarters authority)—to plan, acquire, and develop office space facilities.

October 2011
The headquarters authority purchases 390 Main Street, San Francisco, using toll bridge revenues from the toll authority.

PHASE IV
Rehabilitating and Moving Into the Regional Headquarters Building, and Planning for the Disposal of Current Headquarters Buildings

May 2012
The headquarters authority announced plans to convert 101,000 square feet in the new building to an atrium and building support space, thereby reducing rentable space.

September 2012
The air district will award a contract to a real estate brokerage firm to assist it with the sale or lease of its current San Francisco headquarters building.

September Through December 2012
The headquarters authority will issue a request for proposals, which will include brokerage services for the sale or lease of the transportation commission's headquarters building in Oakland.

By Fall 2013
The transportation commission and the air district intend to move into the regional headquarters building.

Sources: California State Auditor's analysis of documents the transportation commission and the air district provided.

Scope and Methodology

The Joint Legislative Audit Committee (audit committee) directed the California State Auditor to perform an audit of the headquarters authority's acquisition of new regional headquarters and the toll authority's administration of toll bridge revenues, particularly the use of toll revenues for acquiring the regional headquarters. The audit analysis the audit committee approved contained nine separate objectives. We list the objectives and the methods we used to address them in Table 1.

Table 1
Audit Objectives and the Methods Used to Address Them

	AUDIT OBJECTIVE	METHOD
1	Review and evaluate the laws, rules, and regulations significant to the audit objectives.	Reviewed relevant laws, regulations, and other background materials.
2	Review and assess the space needs assessment of the agencies involved to determine the extent to which the space in the new building meets or exceeds their respective space requirements. In addition: • Determine whether the Metropolitan Transportation Commission (transportation commission) and the Bay Area Toll Authority (toll authority) considered other alternatives to acquiring a new office building. • Review the transportation commission's and the Bay Area Air Quality Management District's (air district) justification for vacating their buildings and relocating to the new building. • Identify the plans for disposing of existing buildings owned by the agencies involved, including the transportation commission, the toll authority, and the air district.	• Interviewed key officials to determine the agencies' justification for vacating their current headquarters buildings, their anticipated growth projections, and their plans for disposing of those buildings. • Reviewed a consultant's report on the agencies' options for colocating, which summarizes the agencies' options for leasing space, purchasing property, and renovating their current buildings. • Reviewed the transportation commission's materials related to its analysis of the growth rate of its staff.
3	Identify the funding sources for the purchase of the new building.	• Interviewed key officials. • Reviewed the toll authority's accounting records to confirm the funding source for purchasing the regional headquarters building. • Reviewed the building purchase agreement.
4	Review and assess any transportation commission and toll authority policies, procedures, and internal controls to determine if there is adequate separation between the two to ensure that decisions regarding the use of toll revenue are in the best interest of the toll payers.	• Interviewed key officials. • Reviewed pertinent laws regarding the roles and responsibilities of the transportation commission and the toll authority, and laws regarding appropriate use of toll revenues. We also reviewed relevant legislative analyses concerning the separation of the transportation commission and the toll authority.

continued on next page . . .

	AUDIT OBJECTIVE	METHOD
5	Determine the appropriateness of the use of toll bridge funds to acquire a headquarters building. Specifically: • Determine whether it is permissible to use toll revenues, including those from the 2010 increase, to acquire an office building. • Determine if there are any prohibitions against the toll authority using toll revenues to acquire a headquarters office building that exceeds its space needs to such an extent that there is room to lease space to other public entities.	• Reviewed relevant statutes regarding the authority of the transportation commission, the toll authority, and a joint powers authority. • Reviewed relevant court decisions and legal opinions.
6	Review and assess the cost-benefit analysis related to the acquisition of the new headquarters building to determine if it was reasonable, was supported, and considered alternatives to purchasing a building. Identify the financial risks, if any, that the transportation commission and the toll authority assumed by acquiring a new office building.	• Interviewed a key official to understand the process the transportation commission and its real estate broker followed to solicit and review properties. • Reviewed the proposals the transportation commission received related to potential properties and the summary materials the real estate broker prepared. • Reviewed board meeting agendas, minutes, and materials of the governing board for the transportation commission related to the property selection.
7	Examine the structure of the transaction to acquire the new building and determine if it has any unique features and whether the public interest is protected.	• Interviewed a key official. • Considered the transportation commission's financial model and its key assumptions about which entities would contribute funds to reimburse the toll authority. • Reviewed the opinions of the value of the property that the real estate broker, the independent consultant, and the property appraisers prepared. • Analyzed the net present value of the cash flows from the property the transportation commission assumed over a 30-year period.
8	Identify whether any of the proposed public agency tenants are taking an equity position in the building. If so, determine the source of revenue and if the tenants are paying for tenant improvements.	• Interviewed key officials. • Reviewed the minutes and related materials from meetings of the governing boards for the transportation commission and the air district and other related documents.
9	Review and assess any other issues that are significant to the acquisition of the new headquarters building.	We did not identify any other significant issues concerning the purchase of the building.

Sources: The California State Auditor's analysis of Joint Legislative Audit Committee audit request number 2011-127, and information and documentation identified in the table column titled *Method*.

Audit Results

The Bay Area Headquarters Authority's Use of Toll Revenues to Purchase a Regional Headquarters Building Likely Is Legally Permissible

In October 2011 the Bay Area Headquarters Authority (headquarters authority)—a joint powers authority created by the Metropolitan Transportation Commission (transportation commission) and the Bay Area Toll Authority (toll authority)—purchased a building, using $93 million in toll bridge revenues. The building will serve as the regional headquarters for these and potentially other entities. Located at 390 Main Street in San Francisco, the building is more than 497,000 square feet and, at the time it was purchased, exceeded the combined space needs of the entities seeking to colocate—the transportation commission, the Bay Area Air Quality Management District, and the Association of Bay Area Governments—by more than 263,000 square feet.[3] As a result, a significant portion of the building will be rented out. Appendix A details two potential occupancy plans for the regional headquarters building as of September 2011 and May 2012. A comparable version of each plan was presented at meetings of the respective governing board (board) for the transportation commission and the headquarters authority.

The toll authority's decision to contribute toll revenues to acquire a larger-than-necessary building has been controversial and was the subject of public debate at board meetings of the transportation commission and toll authority. At a board meeting less than one month before the building was acquired, members of the public as well as staff for certain members of the Legislature, questioned the appropriateness of using public funds to essentially enter the commercial real estate business. Legislative staff for various state senators urged the transportation commission and toll authority to await the completion of this audit before purchasing the building with toll bridge revenues.

Our review found that, if challenged, a court would likely find that the toll authority's decision to contribute toll bridge revenues to purchase 390 Main Street was within its legal authority. Our legal counsel has advised that state law expressly authorizes the toll authority to do all acts necessary or convenient for the exercise of its powers, including, but not limited to, acquiring, constructing, managing, maintaining, leasing, or operating any public facility or improvement. Similarly, state law authorizes the transportation

3 Throughout this report we use the term *transportation commission* to include both the transportation commission and the toll authority unless otherwise specified.

commission to do any and all things necessary to carry out its statutory purposes. California Streets and Highways Code, Section 30958, expressly authorizes the toll authority to pay its direct and administrative costs from gross annual bridge revenues. In addition, Streets and Highways Code, Section 30959, authorizes the toll authority to contribute funding to the transportation commission in furtherance of the exercise of the toll authority's powers, and on a reimbursement-for-cost basis for transportation commission activities that are not in furtherance of the exercise of the toll authority's powers. Even though the phrases *gross annual bridge revenues* and *direct costs* are not expressly defined in state law, courts interpret statutes according to their plain meaning. Therefore, our legal counsel advised that it is likely that a court would conclude that costs to plan for, acquire, and develop facilities and office space for the toll authority and its staff are direct costs that may be paid from gross annual bridge revenues. We would also expect a court to conclude that the toll authority may contribute toll revenues to the transportation commission to acquire facilities and office space as authorized by Streets and Highways Code, Section 30959.

***A court would defer to a determination by the board of the toll authority and the transportation commission that acquiring a headquarters building was both necessary and convenient to carry out their purposes as long as that determination was reasonable rather than "arbitrary, capricious, or lacking evidentiary support*."**

Further, our legal counsel advised that a court would likely hold that the fact that the acquired building exceeds the transportation commission's and toll authority's current space needs does not limit their board's authority to use toll revenues for the purchase. According to our legal counsel, a court would defer to a determination by the board of the toll authority and the transportation commission that acquiring such a building was both necessary and convenient to carry out their purposes as long as that determination was reasonable rather than "arbitrary, capricious, or lacking evidentiary support."

In May 2012, the California Legislative Counsel Bureau issued an opinion (legislative counsel opinion) that concluded that the toll authority could use toll revenues to purchase a building. The opinion also concluded, however, that a court could determine that using toll revenues to acquire the building exceeded the toll authority's statutory powers because the facility substantially exceeds the administrative office needs of toll bridge project and program administration and the Legislature has not authorized the use of toll bridge revenues for the objective of creating a regional governance colocation facility. Before reaching this conclusion, however, the legislative counsel opinion noted that a court considering the issue would take into account all relevant facts regarding the purposes underlying the building purchase, and would give deference to reasonable determinations made by the headquarters authority regarding the purchase. Applying the standard of whether the decision the board governing the toll authority and transportation commission made to purchase the building was reasonable rather than arbitrary, capricious, or lacking in evidentiary support, our legal counsel advised that after considering the facts a court would most likely defer to the determination by the toll authority's and the transportation commission's board that acquiring such a building was necessary and convenient to carry out its purposes because the determination was reasonable.

As described in other parts of this report, the toll authority and the transportation commission sought the advice of outside legal counsel and real estate consultants and evaluated against established criteria a variety of properties of different sizes in San Francisco and Oakland before deciding to purchase the building at 390 Main Street in San Francisco. Moreover, the financial model the toll authority and the transportation commission used to advise the governing board in September 2011 showed that, over 30 years, all revenues used to purchase and renovate the building would be recouped and the building would generate an additional $40 million in revenue, all of which would be returned to the toll authority under the joint powers agreement. Based on these facts, our legal counsel advised that a court would likely hold that the board of the toll authority and the transportation commission made a reasonable determination that acquiring the building was necessary and convenient for carrying out their statutory purposes, and that it was permissible to use toll revenues to acquire the building even though the building exceeds the space needs of the toll authority and the transportation commission to such an extent that there is room to lease space to other entities.

Although our report concludes that it likely was legally permissible for the toll authority to use toll revenues to purchase a headquarters building, the lack of a clear distinction between the toll authority and the transportation commission may have caused some to question whether adequate separation between them existed during the process of deciding to purchase a new headquarters building. State law requires that the toll authority be a separate entity from the transportation commission but that both entities report to the same governing board. The law creating the toll authority was amended in 2003 (Senate Bill 916 (SB 916); Chapter 715, Statutes of 2003) and clarified that the toll authority and the transportation commission would report to the same board, but that the toll authority would be a separate entity. When the Legislature considered SB 916, committee analyses stated that the bill would establish the toll authority in its own right, with standard public agency powers and duties. Legislative analyses also stated the intent to move away from the toll authority, "existing as a form of the transportation commission with the same membership for the two bodies."

State law requires that the toll authority be a separate entity from the transportation commission but that both entities report to the same governing board.

The organizational structures of both entities are such that the toll authority's key management is not clearly distinct from the transportation commission's staff.

Despite the provisions of SB 916, it is clear that the toll authority is part of the transportation commission's business operations. During our review we noted that the organizational structures of both entities are such that the toll authority's key management is not clearly distinct from the transportation commission's staff. For example, both entities share the same chief executive officer, the same chief financial officer, and the same general counsel. Furthermore, the financial activities of the toll authority are blended with and are included in the transportation commission's audited financial statements. Nevertheless, the following controls are in place to help ensure adequate separation between the two entities regarding decisions about spending toll revenues: (1) state law defines the appropriate use of toll revenues and (2) the toll authority's governing board approves in a public forum the specific projects and activities that may be funded with toll revenues. In our opinion, these controls seem reasonable.

The Transportation Commission Could Have Disclosed More About the Financial Risk Associated With Purchasing a New Headquarters Building

When the board was deciding whether to purchase a headquarters building in San Francisco, a key selling point the transportation commission raised was that toll payers would be protected under the deal. Specifically, in August 2011, the transportation commission stated that using the toll authority's various cash reserves and contingency funds would allow it to "put a portion of these funds to work" and potentially cover its costs in return. In September 2011 the transportation commission provided its board and the public with a projection of revenues and expenses for the building over a 30-year period showing that contributed toll revenues would be fully repaid. In fact, the September 2011 slide presentation showed a "net after building investment"—or profit—of $40 million.

However, our review and analysis of the transportation commission's 30-year projection showed that, when converted to today's dollars, the expected income will fall short of repaying contributed toll revenues by roughly $30 million. The main cause of the difference is that the transportation commission's presentation to its board did not discount the income projections so as to express them in today's dollars, a concept that we discuss in more detail later. Our analysis also showed that under conditions more favorable than those the transportation commission assumed, such as higher rent per square foot and/or higher occupancy rates, toll payers might experience faster payback periods and larger returns on the contributed toll revenues. However, given the potential for not repaying toll payers as measured in today's dollars, we would have expected the transportation commission to disclose these potential outcomes to the board and the public so that they could have been more informed about the risks before deciding to purchase the property.

Despite limitations in the transportation commission's presentation to its board, the financial model it developed to project revenues and expenses over a 30-year period is conservative when compared to information it obtained from its various advisers. As one might expect, the transportation commission's projection to repay contributed toll revenues is dependent on how much toll revenue is provided and how much rental income can be earned, given factors such as the expected market rent and level of occupancy. The text box shows key assumptions used in the transportation commission's 30-year financial model. In September 2011 the transportation commission assumed that the total cost to acquire and improve the new headquarters building would be $180 million and the net toll revenue contribution would be $122 million after other contributions were received, including those from the air district and the transportation commission. The projected net income of $162 million over 30 years is based on market rent of $32.40 per square foot—which increases by $1 each year in the model—for an assumed 309,000 rentable square feet and an assumed occupancy rate of 70 percent.

Bay Area Toll Authority's Estimated Net Income From the Regional Headquarters Building as of September 2011

	DOLLARS IN MILLIONS
Purchase price and renovations	($180)
Bay Area Air Quality Management District contribution	24
Metropolitan Transportation Commission contribution	19
Commercial tenant improvement costs recouped from leases	15
Net Bay Area Toll Authority (toll authority) contribution	**($122)***
Net income to the toll authority over 30 years	**$162**
Profit to the toll authority	**$40**

Commercial rental rate	$32.40 per square foot
Occupancy rate	70 percent

Source: The toll authority's financial presentation to its governing board at a September 2011 meeting.

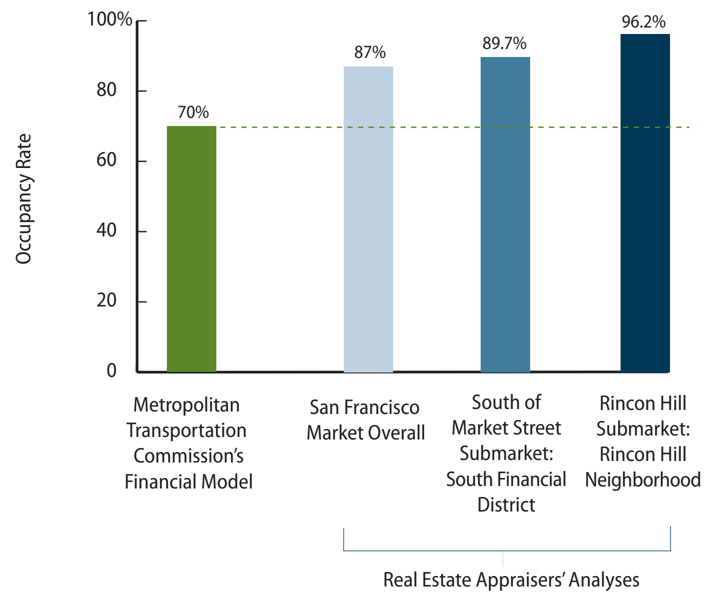
* Although the toll authority was authorized by its governing board to contribute roughly $167 million in toll funds, this financial presentation reflects that only $122 million would be needed after factoring in other estimated contributions.

We found that the transportation commission's rental rate and vacancy rate assumptions were on the conservative side for commercial office space in San Francisco. Specifically, we compared the initial rental rate of $32.40 per square foot that the transportation commission used in its model to the projected rental rate information the transportation commission received from its real estate broker, consultant, and property appraisers. Each developed its own rental revenue projections for 390 Main Street, using annual lease rates of between $31 and $42 per square foot. The transportation commission's beginning rate of $32.40 per square foot is on the lower end of this range. As shown in Figure 2 on the following page, the transportation commission's assumed occupancy rate of 70 percent is also much lower than the overall citywide occupancy rate and the occupancy rates in the areas surrounding the 390 Main Street property, per analyses performed by two independent appraisers.

The transportation commission's projection of future expenses also appears to be either consistent with or more conservative than information provided by its appraisers and investment consultant.

In its 30-year model, expenses averaged roughly $9.7 million annually. This amount is higher than the expected $4 million to $7 million in expenses projected by its investment consultant and two of its appraisers. Finally, the transportation commission's expectation of the cost to improve the San Francisco property was more than the amounts shown by its investment consultant and two appraisers in their analyses.

Figure 2
Market Occupancy Rates for the Second Quarter of 2011 Compared With the Rate the Metropolitan Transportation Commission Used in Its Model



Sources: The Metropolitan Transportation Commission's independent property appraisals dated September 2011 and its financial model.

Using the transportation commission's 30-year financial model, we analyzed whether toll payers could expect to be fully repaid for their contribution of toll revenues. To perform such an analysis, we calculated the net present value (NPV) of the building's projected cash flows over a 30-year period. The NPV approach compares the amount of net income the building generates over time (cash inflow) to the amount of cash outflow—in this case, contributed toll revenues. To arrive at the cash inflow, we discounted the net income so as to convert the cash inflows to today's dollars to take into account a 30-year time span. To arrive at the cash outflow, we updated the transportation commission's financial model to reflect the building's actual purchase price of $93 million and assumed that the costs to improve the building and the expected contributions from the air district and the transportation commission were timely and accurate. As a result, the total amount to be repaid to the toll authority is approximately $109 million, instead of the $122 million shown in the text box on page 15.

A financial analysis such as an NPV calculation is a function of various assumptions. One key assumption is the interest rate used to account for the time value of money. In our NPV analysis, we used an interest rate of 4.3 percent. In fiscal year 2010–11, a significant source of the toll authority's cash came from issuing bonds to be repaid with toll revenues (toll-revenue bonds). As of June 30, 2011, the toll authority had nearly $7.9 billion in outstanding toll-revenue bonds and total assets of $4.4 billion.[4] We believe our decision to use 4.3 percent is reasonable because it approximates the toll authority's cost of capital, based on information contained in its audited financial statements. In our opinion, applying the same interest rate benchmark in our NPV analysis as bondholders use when they loan money to the toll authority is an appropriate way to assess the likelihood of whether the public's toll funds will be repaid.

In its financial model the transportation commission made two key assumptions that present risk. The first assumption—which we also used in our NPV analysis—is that the Bay Area Air Quality Management District (air district) would contribute $24 million at the beginning of the project to purchase one floor of the new headquarters building. There is risk in this assumption because it is not certain if or when the air district will purchase the space. The agreement the air district and the headquarters authority executed in April 2012 is a 30-year lease with an option to buy at any time during the agreement. We discuss the air district's plans in greater detail later in this report. The second assumption involving risk is that the transportation commission would contribute $19 million in today's dollars, based on its assignment of future rental income from leasing its current Oakland headquarters for roughly 30 years. Whether this is a reasonable assumption is uncertain; as we discuss later in the report, the transportation commission has yet to focus any significant effort on developing a disposition strategy for its Oakland headquarters. If either assumption proves to be wrong, it would affect the calculation of the toll authority's net contribution and could extend the toll revenue payback period.

Finally, the transportation commission's financial model focused on the net income from the building's operations over 30 years. We intentionally focused our NPV calculation on assessing whether the present value of cash inflows generated from the building's rental

4 The transportation commission's and the toll authority's financial statements show liabilities exceeding assets because the toll bridges are not an asset of either entity. Instead, the toll bridges are owned by the State.

income would be sufficient to repay the toll authority. Our focus on cash inflows to repay the toll authority is the same focus the transportation commission and headquarters authority, respectively, used in their September 2011 and May 2012 public presentations. However, we took the additional step of converting the projected cash flows from the new headquarters building to the equivalent in today's dollars to determine, where applicable, the number of years needed to repay the estimated net contributed toll revenues of $109 million.

Table 2 provides a grid of different NPV results and the expected payback period using only cash flows from rental income. The table is based on the transportation commission's financial model as of September 2011 and our varying assumptions regarding rental and occupancy rates. Green values represent instances in which the NPV is positive—and thus cash flows converted to today's dollars will cover the contributed toll revenues in 30 years' time—whereas red values indicate conditions under which cash flows will not cover the contributed toll revenues. As the table demonstrates, the question of whether toll payers will be repaid depends, in part, on the occupancy and rental rates that can be attained. Under the transportation commission's financial model and conservative assumptions of an initial rental rate of $32.40 per square foot and an occupancy rate of 70 percent, the building will not generate adequate cash flows when converted to today's dollars to repay contributed toll revenues within a 30-year period. In fact, those assumptions result in the cash flows from the building falling short by more than $30.2 million. However, in many alternative scenarios with higher rental and/or occupancy rates, toll revenues will be repaid. Specifically, by charging a rental rate of $38.40 per square foot and achieving an 80 percent occupancy rate, the toll authority would realize $12.7 million in excess cash flows—discounted in today's dollars—allowing it to repay contributed toll revenues within 26 years. Similarly, if the headquarters authority were to achieve an occupancy rate of 85 percent at a starting rent of $38.40 per square foot, the toll authority would earn $23.5 million in excess cash flows over the 30-year period, and would repay contributed toll revenues within 24 years.

Under the transportation commission's financial model and its conservative assumptions about rents and occupancy, the building will not generate adequate cash flows when converted to today's dollars to repay contributed toll revenues within a 30-year period.

The transportation commission's ability to repay toll revenues stems in part from the fact that its September 2011 financial model earmarked a significant portion of the building's space—approximately 309,000 square feet—as producing income from market rents. Our review found that this amount of square footage seems reasonable because it materially reconciles with the square footage shown in Table A.1 in Appendix A for the entities projected to pay market rent and the space to be leased at market rents. This table is a schematic of how the transportation commission envisioned the building's occupancy plan as of September 2011. However, the table does not reflect rents to be paid, and it cannot be used to derive the amount of space designated for market rents as used in the financial model. Moreover, the dollar amounts in Table 2 cannot be directly derived from the square footage in Table A.1 because of the assumptions and formulas applied in the transportation commission's financial model.

Finally, the amounts shown in Table 2 do not consider the potential value of the new headquarters building if it was sold. For example, the headquarters authority could sell the entire building, or a portion of the building, as a means to raise additional funds to potentially make up the shortfalls highlighted in Table 2. We chose not to consider such a sale in Table 2 because the transportation commission focused its analysis on cash flows from rental income and did not mention to its board any plans to sell the building in the future. Further, the amount of space that could be sold is highly uncertain, given the headquarters authority's drastic changes in May 2012 to the building's proposed layout, as discussed later in this section and shown in Table A.2 in Appendix A. Nevertheless, we acknowledge that the building is an asset that could be sold, if necessary, as a means to return additional funds to the toll authority.

Table 2
Net Present Value of Cash Flows From Rental Income and Resulting Payback Period With Varying Rental and Occupancy Rates Over a 30-Year Period With 309,000 Square Feet at Market Rent
(Dollars in Thousands)

ANNUAL OCCUPANCY RATE*	ANNUAL COMMERCIAL OFFICE RENT (PER SQUARE FOOT)†				
	$32.40	$35.40	$38.40	$41.40	$44.40
70%	$(30,288)	$(19,561)	$(8,834)	$1,893 30 years	$12,620 26 years
80	(11,285)	726 30 years	12,737 26 years	24,748 23 years	36,759 21 years
85	(1,784)	10,869 27 years	23,522 24 years	36,175 21 years	48,828 19 years
87	2,017 30 years	14,926 26 years	27,836 23 years	40,746 20 years	53,656 19 years

Source: California State Auditor's net present value analysis based on the Metropolitan Transportation Commission's (transportation commission) September 2011 cash-flow model for 390 Main Street located in San Francisco.

Note: We applied the following definitions to the table:

Net present value: Using the rental and occupancy rates indicated for each box, the amount of net cash flows generated over 30 years by the regional headquarters building, discounted at a rate of 4.3 percent to account for the time value of money.

Red values: Rental and occupancy rates for which the net present value of the cash flows from the regional headquarters building will not repay the Bay Area Toll Authority's (toll authority) expected contribution of $109 million within 30 years.

Green values: Rental and occupancy rates for which the net present value of the cash flows from the regional headquarters building will repay the toll authority's contribution. The payback period in terms of years is also noted.

Payback: The number of years, based on the net present value of the cash flows, needed to repay the toll authority's expected contribution of $109 million.

* We varied the annual occupancy rate between the transportation commission's 70 percent and the 87 percent occupancy rate for the San Francisco market overall as shown in Figure 2 on page 16. The occupancy rate does not pertain to the building as a whole, but rather to a certain amount of space designated to generate market rent.

† The rental rates shown are the beginning values used in the transportation commission's financial model. The model increases these rates by $1 per year over 30 years.

Given the potential that the building's cash flows as measured in today's dollars might not cover contributed toll revenues, we would have expected the transportation commission to have provided the board and the public with information similar to the data shown in Table 2. During our review of the transportation commission's financial model, we noted that its chief financial officer calculated his own NPV amount but did not share the results with the board. The chief financial officer's NPV calculation used a 3 percent discount rate to determine that the building's future income was worth $93 million in today's dollars. When compared to the $122 million in expected net toll fund contributions to purchase and improve the building—as shown in the text box on page 15—the chief financial officer's NPV calculation shows that the cash flow over a 30-year period, converted to today's dollars, would be $29 million short of repaying contributed toll revenues.

The chief financial officer's NPV calculation shows that the cash flow over a 30-year period, converted to today's dollars, would be $29 million short of repaying contributed toll revenues.

When asked why he chose not to share his NPV analysis with the board to demonstrate the range of possible outcomes from purchasing the building and renting available space, the chief financial officer indicated that he did not believe it was necessary or appropriate to share this information with the board because an NPV analysis would assume a return on investment, whereas he wanted the board to focus on the building's value in terms of price per square foot and its value to the transportation commission and the other agencies. The chief financial officer further stated that the transportation commission's model was intended to demonstrate that the toll authority could afford the building and that its purchase would not result in a loss but rather an economic net zero to the transportation commission over the course of 30 years. However, we believe the transportation commission's claim that expected rental income will cover the contributed toll funds is based on an incomplete analysis that should have discounted the building's future cash flows, since the value of those amounts are worth less in today's dollars.

Finally, according to the chief financial officer, presenting the purchase in terms of profit and loss would require many projections and would represent a commitment to a certain return, when that was not the purpose of the project. The toll authority, according to the chief financial officer, considered the acquisition an investment in the organization and region. He asserted that by purchasing a building large enough to house all of the regional agencies, the toll authority would create an investment in regional planning and coordination as well as a direct investment in the future of the transportation commission and the toll authority, in much the same way that one would invest in a house without expecting a return.

Recent plans the headquarters authority made public suggest a further increase in the risk, beyond what is shown in Table 2, that toll revenues will not be repaid with cash flows from the building's rental income over 30 years. In May 2012 the headquarters authority held a public meeting at which it presented a revised occupancy plan for its new headquarters building. In the revised plan, shown in Table A.2 in Appendix A, the headquarters authority converts roughly 101,000 square feet of building space to an atrium and to building support space, such as closets for electrical and telephone equipment. To determine the effect of this proposed reduction in rentable space on the ability to pay back the contributed toll revenues, we obtained the transportation commission's revised financial model and updated our NPV analysis of the building's cash flows and our calculation of the payback periods. Table 3 shows the results of our analysis.

Table 3
Net Present Value of Cash Flows From Rental Income and Resulting Payback Period With Varying Rental and Occupancy Rates Over a 30-Year Period With 241,000 Square Feet at Market Rent
(Dollars in Thousands)

ANNUAL OCCUPANCY RATE*	ANNUAL COMMERCIAL OFFICE RENT (PER SQUARE FOOT) †				
	$32.40	$35.40	$38.40	$41.40	$44.40
70%	$(53,699)	$(45,262)	$(36,826)	$(28,390)	$(19,953)
80	(39,128)	(29,710)	(20,292)	(10,874)	(1,455)
85	(31,843)	(21,934)	(12,025)	(2,116)	7,794 28 years
87	(28,929)	(18,823)	(8,718)	1,388 30 years	11,493 27 years

Source: California State Auditor's net present value analysis based on a revised 390 Main Street, San Francisco, cash-flow model as reported by the Bay Area Headquarters Authority on May 23, 2012.

Note: We applied the following definitions to the table:

Net present value: Using the rental and occupancy rates indicated for each box, the amount of net cash flows generated over 30 years by the regional headquarters building, discounted at a rate of 4.3 percent to account for the time value of money.

Red values: Rental and occupancy rates for which the net present value of the cash flows from the regional headquarters building will not repay the Bay Area Toll Authority's (toll authority) expected contribution of $112 million within 30 years.

Green values: Rental and occupancy rates for which the net present value of the cash flows from the regional headquarters building will repay the toll authority's contribution within 30 years. The payback period in terms of years is also noted.

Payback: The number of years, based on the net present value of the cash flows, needed to repay the toll authority's expected contribution of $112 million.

* We varied the annual occupancy rate between the Metropolitan Transportation Commission's (transportation commission) 70 percent and the 87 percent occupancy rate for the San Francisco market overall as shown in Figure 2 on page 16. The occupancy rate does not pertain to the building as a whole, but rather to a certain amount of space designated to generate market rent.

† The rental rates shown are the beginning values used in the transportation commission's financial model. The model increases these rates by $1 per year over 30 years.

The revised financial model reflects that the toll authority's expected contribution would increase from $109 million to $112 million. The $3 million increase is a result of less space in the building generating rental income and thus, less income available to pay for certain expenses. The assumed amount of space earmarked for market rent in the revised financial model is roughly 241,000 square feet. This amount seems reasonable because it materially reconciles with the square footage shown in Table A.2 for entities projected to pay market rent and the spaces to be leased at market rents. However, Table A.2 alone cannot be used to derive the market rent square footage or the amounts presented in Table 3. As can be seen in Table 3, many of the scenarios now project that after converting cash flows over 30 years to today's dollars, the building's rental income will not cover contributed toll revenues. Similar to our comments regarding Table 2, our NPV analysis did not consider the value of the building if sold as a means to ensure that contributed toll revenues are ultimately repaid.

The Transportation Commission and the Air District Faced Challenges With Their Current Headquarters Facilities, Which Led Them to Explore Opportunities to Share a Common Building

The transportation commission's challenge with its current space was that it did not provide room for additional growth.

Although both the transportation commission and the air district acted on the advice of the consultant they jointly hired in June 2010, both had also previously evaluated their separate needs to varying degrees. The transportation commission's challenge with its current space was that it did not provide room for additional growth. In fact, the transportation commission began developing strategies for securing additional space as early as February 2001, when it hired an architect to, among other things, develop a five-year office space plan. To accommodate growth through 2005, and to allow for a less compressed work environment, the architect determined that the transportation commission needed a building with roughly 68,000 square feet. In 2005 the transportation commission bought an ownership interest in the second floor of its Oakland building, which allowed an expansion so that it could house the staff in its satellite office in the Oakland building.[5] More recently, the transportation commission obtained a space needs assessment in July 2011 from its real estate broker's subcontractor, who concluded that the transportation commission needed more than 69,000 square feet of space to accommodate its staff, interns, and temporary employees and to address its needs for additional conference rooms, storage space, and areas for other support functions. The transportation commission currently occupies approximately 48,000 square feet of work space, primarily on the second and third floors of its current headquarters building in Oakland, which does not include the space on the first floor for the public board meeting room, cafeteria, and library.

5 The transportation commission is a part owner of its Oakland headquarters building under a joint-ownership agreement it executed in 1984 with the Association of Bay Area Governments and the Bay Area Rapid Transit District.

The air district also began identifying its own needs prior to hiring a consultant jointly with the transportation commission. In October 2009 the air district's facility consultant issued its preliminary findings indicating that the air district's building in San Francisco required roughly $12.8 million in maintenance and repairs. Key components of these estimated costs included $2.5 million for a new heating and ventilation system and $4.5 million for a fire sprinkler system. According to the facility consultant, the approximately 84,500-square-foot building actually consists of two structures with an adjoining structural wall, and the building's structural challenges were exacerbated by the gradual addition of walls and partitions over time, resulting in many mazelike and dark areas.

Observing that the air district had been working with a facility consultant, the transportation commission's executive director in September 2009 informed the board that the transportation commission would work with the air district to assess the option of colocating. The executive director saw this assessment as an opportunity to begin a process of analyzing and developing options to meet the transportation commission's future growth needs, since no more space was available in the Oakland headquarters unless other entities vacated. As a result, in January 2010, the transportation commission entered into a cooperative agreement with the air district and the Association of Bay Area Governments (association) to collectively investigate their options for colocating in a regional facility, with the air district serving as the lead agency. In late June 2010 the air district entered into a contract with a real estate broker to explore alternative headquarters solutions and develop a real estate strategy that best aligned with the business and financial objectives of the air district, the transportation commission, and the association.

The real estate broker issued the results of its review in October 2010. In its report, the broker found that the transportation commission's building in Oakland would require minimal renovations; however, it found that the building lacked space for growth. The broker's review of the air district's building found problems similar to those the facility consultant had identified. In particular, the real estate broker estimated that the air district faced more than $30 million in renovation and other costs over the next 10 years should it remain in its San Francisco building. According to the broker, the cost to renovate the building would be equivalent to buying a newer facility in move-in condition. Overall, the real estate broker recommended that the transportation commission, air district, and association consolidate into a single building, and that either San Francisco or Oakland was an appropriate location

Consolidated Space Requirements as Presented to the Metropolitan Transportation Commission's Board

- 150,000 to 200,000 square feet, contiguous space
- Public meeting space
- Proximity to Bay Area Rapid Transit and other transit for employees, board members, and the public
- Energy-efficient building—Leadership in Energy and Evironmental Design certified
- Seismically retrofitted building
- Availability of parking for agency fleet cars, board meetings, and employees
- Secured server room capacity for an Advanced Toll Collection and Accounting System computer system
- Emergency operations center capacity
- Purchase option preferred

Source: Metropolitan Transportation Commission's board presentation dated November 17, 2010.

for consolidation. The text box lists the consolidated space requirements as presented to the transportation commission's board, some of which became criteria for selecting a headquarters building.

Although the Transportation Commission's Reasons for Needing a Building of at Least 350,000 Square Feet Are Unclear, It Followed a Reasonable Process to Evaluate Properties Against Its Search Criteria

The transportation commission's executive management finalized the property search criteria following the board's vote to approve a search for potential locations for a joint headquarters facility. The property criteria included space requirements that the building be at least 350,000 square feet, of which 150,000 to 200,000 square feet must be contiguous to accommodate the needs of public agencies. This contiguous space requirement is consistent with the results of the broker's November 2010 presentation to the board regarding the space needs of the transportation commission, toll authority, association, and air district. However, the specified overall building size was roughly twice the amount shared with the board in November 2010. When we asked the transportation commission's executive director why he approved the 350,000-square-foot space requirement in the request for proposals (RFP), he stated that he wanted to ensure that the new headquarters building would have sufficient room for growth over the long term—20 years or more—and that income generation did not factor into the determination of needed space at the time. However, the executive director stated that income generation was considered when evaluating the final real estate options and determining which option made the most economic sense. According to the executive director, the transportation commission did not have to consider economics but did so to provide an added benefit, a means of returning capital to the toll authority.

Given these statements, it is not clear to us what the transportation commission's motivation was—growth or income—in setting the criteria for the building's size. The chief financial officer explained that the transportation commission's projected space needs were finalized by its executive management in undocumented internal discussions about projects that would affect the need for additional work space. When asked about these anticipated projects and how they informed the transportation commission's expectations regarding its future space needs, the chief financial officer acknowledged that there is no evidence or documentation to substantiate the amount of space the transportation commission reserved in the new building. Rather, according to the chief financial officer, the transportation commission's space estimates were based on management's best guess of its future responsibilities, the specifics of which have not yet been determined. In an undated slide presentation the chief financial officer provided to us, the project's goal was stated as being to obtain a building that the transportation commission can grow into while maximizing protection of the toll fund investment. The presentation focused on strategies to minimize investment risk—such as following a competitive procurement process—and to maximize the protection of the toll investment through the formation of the headquarters authority. The chief financial officer's presentation also stated that the process was designed to ensure that the toll authority gets its money back and has the opportunity to earn a return on its investment.

Ultimately, the transportation commission's executive director explained, the need to accommodate future growth was the key motivation for moving. He indicated that the toll authority and transportation commission have more than doubled in size in the past 20 years and have outgrown the current facility. According to the executive director, given this history, purchasing a building with only 150,000 to 200,000 square feet today would in short order leave the colocating agencies in the identical position that they are in today. The executive director further explained that prudence dictated considering a larger space, the need for which can be attributed to his agency's strong performance. In the simplest terms, according to the executive director, when you are good at something you get more work, and it would not be prudent to believe that the trend of being given additional responsibilities by the Legislature would stop as of 2011. In setting the building's size, the executive director explained that he wanted to include a margin of safety for unknowns and room to accommodate the colocating agencies' future growth needs.

However, despite the executive director's assertions about the need to accommodate anticipated growth, we question his explanation, given that his staff have been unable to provide specifics on their increased responsibilities and how such responsibilities could reasonably translate into the possibility that public agencies will eventually displace non-public agency tenants in the new building. Further, we note that the financial model for the building that his staff developed in September 2011—the same financial model used to tell the board and public that toll funds would be repaid—does not show the transportation commission occupying progressively more space over the 30-year period.

Despite the executive director's assertions about the need to accommodate anticipated growth, we question his explanation, given that his staff have been unable to provide specifics on their increased responsibilities.

In March 2011 the transportation commission's broker began soliciting proposals, using the search criteria that had been established, and in May 2011 it presented its recommendations for five finalist properties. Our review of the broker and transportation commission's evaluation of the five finalist properties found that the process followed was reasonable, notwithstanding how the criteria for the building's size was established. For example, we determined that the real estate broker consistently evaluated the five properties against the established criteria. In addition, the real estate broker's method for deriving a price per square foot was reasonably consistent for each of the five finalists. The real estate broker generally derived the price per square foot based on the purchase price each seller offered and the broker's estimates of additional costs, such as the cost to renovate the space for public agencies and to lease excess space to third parties. The broker's estimates of the total occupancy cost and corresponding price per square foot are reflected in Table 4.

Table 4
Summary of the Cost and Price per Square Foot of Five Proposed Regional Headquarters

FACTORS USED IN COMPUTING PRICE PER SQUARE FOOT	PROPERTY ADDRESS: 390 MAIN STREET, SAN FRANCISCO	875 STEVENSON STREET, SAN FRANCISCO	1945 BROADWAY, OAKLAND	1221 BROADWAY, OAKLAND	1100 BROADWAY, OAKLAND
Total cost to occupy property*	$148,332,669	$105,470,686	$113,305,535	Not provided/unknown†	$164,177,401
Total rentable square footage	497,204	334,122	360,440	504,855	318,397
Price per square foot‡	$298	$316	$314	Not provided/unknown†	$516

Sources: Initial and revised proposals submitted in response to the real estate broker's request for proposals (RFP) and the real estate broker's financial analysis of each property.

* The real estate broker used the purchase price offered by the property owner, along with other costs associated with renovating the property and leasing excess space, to determine the total cost to occupy the property.

† Not provided: This property proposal did not contain the information specified in the RFP. As a result, the real estate broker could not fully evaluate the property.

‡ The price per square foot is the total cost to occupy the property divided by total rentable square feet.

According to the transportation commission's chief financial officer, price per square foot was a key measure the real estate broker and the transportation commission used to compare the five properties. Appendix B lists the criteria the real estate broker used to evaluate the five finalists and shows how each property compared to those criteria. Through their analysis, the real estate broker and the transportation commission identified issues with four of the proposed properties that eliminated those properties from further consideration. Two properties were eliminated based on their size and cost. Specifically, the transportation commission and its broker determined that there would not be enough space in the building at 875 Stevenson Street, San Francisco, to lease at market rates in order to subsidize the building's costs. Similarly, an analysis of the 1100 Broadway, Oakland, property revealed that its size and the costs to construct the building might exceed what could be recouped through market-rate leases. In addition, the proposal for 1100 Broadway stated that delivery of the building would take place in 30 months, which exceeded the 24-month time-to-occupy requirement specified in the RFP. The third property, 1945 Broadway, Oakland, was also eliminated because of concerns with the time frame within which the space would be available. The property required extensive renovation, and the real estate broker indicated that it would not be ready to occupy within the required 24-month time frame. Finally, the building at 1221 Broadway, Oakland, was eliminated because the owners were offering only a long-term lease and did not want to sell the property.

The Transportation Commission's Board Was Generally Informed Throughout the Property Selection Process

Although it should have disclosed more about the financial risks of purchasing the building and should have had better evidence to substantiate its space needs, the transportation commission provided its board with materials that informed the board's decision to select the new headquarters building. For example, at the November 2010 board meeting, the transportation commission described the process it planned to follow, which included hiring a real estate broker, issuing an RFP, and presenting the results of this work to the board the following spring. However, as noted on page 24, the board was unaware that the search would focus on buildings with at least 350,000 square feet.

The transportation commission's broker received proposals for 12 properties and determined that five substantially met the search criteria. In a May 2011 meeting, the transportation commission's broker provided a presentation to the board in closed session, discussing the findings and recommendations for properties warranting further consideration. Following this presentation, the board voted unanimously to authorize staff to proceed with real estate negotiations for five properties. After identifying flaws with four of the properties, the transportation commission's executive director recommended to the board that 390 Main Street be purchased. At the July 2011 board meeting, during a closed session, the transportation commission presented the board with a number of key items for the one remaining property—390 Main Street—including the costs to renovate the property, the anticipated source of funds, and the potential income the property might generate. Finally, in a September 2011 public presentation to the board, the transportation commission informed board members that the toll authority's anticipated net contribution of $122 million to purchase the building at 390 Main Street would be repaid with $162 million over 30 years, based on the anticipated net income generated from leasing the excess space. From materials presented to the board between May and September 2011, it is clear that the board was aware that the 390 Main Street building exceeded the transportation commission's current space needs and represented a purchase that offered both the flexibility to accommodate future growth and the potential to generate sufficient rental income to fully repay contributed toll revenues. Following comments from the public and the board questioning the size and location of the new headquarters building, the board voted in September 2011 to proceed with acquiring 390 Main Street.

The Transportation Commission and Its Board Were Responsive to Public Criticism About Plans for Regional Headquarters in San Francisco

The transportation commission and its board afforded the public an opportunity to comment on the acquisition of a regional headquarters building located in San Francisco and took steps to respond to the comments. In August 2011 the transportation commission's board held a meeting in response to a letter from the city of Oakland alleging an open-meeting violation that occurred at the July 2011 meeting when the board voted in closed session to open escrow to purchase 390 Main Street. Board minutes for the August 2011 meeting indicate that numerous individuals, including staff representing members of the Legislature and the city of Oakland, expressed concerns about the board's previous decision to move to San Francisco. The comments generally expressed support for a proposal to construct a new building in Oakland but also raised concerns regarding transit accessibility at the San Francisco building and the transportation commission's authority to enter into the real estate business. In reaction to the public's concerns, the board voted to rescind the action it took in July approving opening escrow to purchase the regional headquarters building. The board also created an ad hoc committee to study the legal and financial issues surrounding the regional headquarters selection process and directed it to report back with a recommendation for action by mid-October 2011.

In reaction to the public's concerns, the board voted to rescind the action it took in July 2011 approving opening escrow to purchase the regional headquarters.

The ad hoc committee—made up of the board's chair and vice chair and four other board members—met at least twice with the transportation commission's staff to review the due diligence material that was developed supporting the decision to purchase 390 Main Street. In particular, the ad hoc committee reviewed the process for soliciting property proposals, considered a legal opinion sought from outside counsel that concluded that using toll revenues to purchase the building would be permitted under

California law, and was briefed on the total budget for the targeted property and the building's expected net operating income over a 30-year period, based on the transportation commission's financial model, discussed previously. The ad hoc committee was also provided with two independent appraisals of 390 Main Street, showing "as-is" purchase values of $80 million and $111 million.

The ad hoc committee members also reviewed a comparison of the total cost of acquiring and improving 390 Main Street versus an alternative property in Oakland at 1100 Broadway. The ad hoc committee considered the fact that the property owners for 1100 Broadway had reduced the price from the initial proposed price of $152.6 million to $118.6 million to build a 20-story building with 318,400 rentable square feet. Most of this reduction, roughly $24.6 million, was based on the assumption that the transportation commission and toll authority would finance the developer's construction of the building. However, the transportation commission's chief financial officer indicated that the transportation commission would not have financed the construction of 1100 Broadway because the additional financial risk of doing so was not warranted, given that it had readily available properties that it had previously determined to be of better value. The price per square foot based on the reduced price amounted to roughly $373, according to the property's owner, and did not include other expected costs such as tenant improvements as calculated by the real estate broker and reflected in Table 4 on page 26.[6]

In contrast to 1100 Broadway, the ad hoc committee saw that the total cost to acquire 390 Main Street—including the purchase price and building and tenant improvements—was roughly $180 million. With the seller of 390 Main Street indicating that the building had 497,000 rentable square feet, the total cost to acquire 390 Main Street was $362 per square foot, or $11 less per square foot than 1100 Broadway's revised purchase price of $373 per square foot, which excluded needed improvements. Ultimately, the transportation commission showed the ad hoc committee that when needed improvements and financing were factored in, the total cost of 1100 Broadway would likely be $562 per square foot.

In September 2011 the ad hoc committee reported to the board that the real estate search process was thorough, fair, and transparent to all bidders, and resulted properly in the recommendation to purchase the property located at 390 Main Street. The ad hoc committee recommended that the board authorize the purchase of the San Francisco property, which it did later that month.

The ad hoc committee reported to the board that the real estate search process was thorough, fair, and transparent to all bidders, and resulted properly in the recommendation to purchase the 390 Main Street property.

6 The developer's proposal for 1100 Broadway specified that it would deliver the building in a core and shell condition, indicating that the build-out of tenant improvements was not included.

Lease Terms From the Agreement Between the Bay Area Air Quality Management District and the Bay Area Headquarters Authority for Office Space

The agreement provides for a 30-year lease for office space. The terms include:

- The Bay Area Air Quality Management District (air district) will obtain 62,500 square feet of office and laboratory space.
- The air district will pay a base rental rate of $1.9 million annually for the first 10 years; the base rent will be adjusted beginning in year 11 based on 90 percent of the current market rate. Annual rent will then be adjusted every five years thereafter.
- The air district will pay additional rent based on the proportionate share of the common area and joint space amenities, including meeting rooms and a library.
- The Bay Area Headquarters Authority will pay utility costs and provide the tenant improvements, including office furniture.

Source: 390 Main Street Office Lease, Bay Area Headquarters Authority as Landlord, and Bay Area Air Quality Management District as Tenant, effective April 19, 2012.

The Headquarters Authority Has Confirmed the Air District as a Tenant and Has Had Discussions With Two Other Agencies

In April 2012 the headquarters authority executed a lease agreement with the air district for office space at 390 Main Street. The text box summarizes only the lease terms of that agreement. Moreover, the air district has expressed its intention to purchase the space it will occupy in the regional headquarters, and the lease terms account for this possible purchase. The lease agreement includes an option for the air district to purchase its space at any time during its 30-year lease, but if it purchases the space within 10 years of occupancy it will be guaranteed a fixed price not to exceed $385 per square foot, or roughly $24 million. During its November 2011 board meeting, the air district's executive management expressed an interest in issuing bonds to finance its office space purchase, indicating that the toll authority would buy these bonds. The transportation commission's chief financial officer stated that he is aware of the air district's financing plans, but the toll authority's participation would depend on the final structure of the financing plan, including the interest rate and other factors. The air district's general counsel confirmed in April 2012 that the financing details are not final and there is no date by which he expects that work to be complete.

In addition, two other public agencies appear interested in obtaining office space in 390 Main Street. Specifically, the headquarters authority is in discussions with representatives for the San Francisco Bay Area Conservation and Development Commission (BCDC) to lease approximately 17,000 square feet of office space.[7] Further, according to counsel for the association, the association has approached the headquarters authority to discuss possibly relocating to 390 Main Street. In fact, both the BCDC and the association are currently participating in space-planning activities for 390 Main Street with the headquarters authority, meeting as recently as April 2012. According to a status report that the headquarters authority's deputy executive director provided the board in June 2012, the association will make its decision following a subcommittee report in September 2012. Finally, according to

[7] Following the conclusion of our audit fieldwork the headquarter's authority informed its board in July 2012 that it was removing BCDC from its planning process since the governor's office denied BCDC's request to relocate.

the transportation commission's director of administration, the transportation commission is in active discussions with two of its customer service contractors about relocating their nearly 200 employees into approximately 62,300 square feet in the regional headquarters building sometime in 2013 and 2014.

The Transportation Commission and the Air District Have Yet to Decide What to Do With Their Existing Buildings

In the fall of 2013 the transportation commission intends to move to the regional headquarters building and vacate its current site in Oakland. Therefore, the transportation commission is faced with a decision about whether to sell or lease the space it occupies in its current Oakland headquarters building. The transportation commission's options for selling or leasing its current space are influenced by ownership of that building. The transportation commission is a part owner of its Oakland headquarters under a joint-ownership agreement it executed in 1984 with the Bay Area Rapid Transit District (BART) and the association. The joint-ownership agreement specifies that BART and the association have the right of first refusal to buy the space the transportation commission owns. However, according to the chief financial officer, should BART and the association decline to exercise their right, the transportation commission will likely retain ownership and lease the space to a tenant. At the June 2012 headquarters authority board meeting, staff briefed the board that an RFP would be issued and would include optional services for assisting with disposing of the Oakland headquarters building. The headquarters authority expects to issue the RFP in September 2012 and to seek board approval in December 2012.

The transportation commission is faced with a decision about whether to sell or lease the space it occupies in its current Oakland headquarters building.

Like the transportation commission, the air district must make decisions about the building it currently owns and occupies in San Francisco. In April 2012 the air district issued an RFP for a commercial real estate brokerage firm to assist it in selling or leasing its San Francisco headquarters; the air district amended the RFP in May to reflect that it will award a contract in mid-September 2012. The amended RFP states that the air district expects to begin work with the real estate broker in the summer of 2012 and to complete work in about July 2013, to correspond with the planned move to the regional headquarters building. Although the analysis is almost two years old, in October 2010 the real estate broker guiding the transportation commission and air district through their regional headquarters planning process at that time concluded that, given the air district building's age and condition, the "as-is" sales price is estimated to be $4 million. However, the current RFP states that the selected real estate broker will research the potential market, determine an appropriate sales price or rent, develop appropriate disclosures, and develop and implement market strategies that will produce the highest and most certain financial return to the air district.

Recommendations

If the Legislature believes state law provides the toll authority with too much discretion over its use of toll revenues, it should consider amending state law to more narrowly define how toll revenues that are not immediately needed for bridge maintenance or debt service may be spent or invested. For example, the Legislature might consider imposing specific limitations or prohibitions on the use of toll revenues to acquire real estate for administrative or investment purposes.

If the Legislature desires greater separation between the transportation commission and the toll authority, it should consider amending state law to require that each entity have its own key executive management staff, such as its own chief executive officer, chief financial officer, and general counsel.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
State Auditor

Date: August 28, 2012

Staff: Grant Parks, Audit Principal
Sharon L. Fuller, CPA
Ralph M. Flynn, JD
Erin Satterwhite, MBA
Maya Wallace, MPPA

Legal Counsel: Scott A. Baxter, JD

For questions regarding the contents of this report, please contact
Margarita Fernández, Chief of Public Affairs, at 916.445.0255

Appendix A

POTENTIAL OCCUPANCY PLANS FOR THE REGIONAL HEADQUARTERS

The Bay Area Headquarters Authority (headquarters authority)—an entity created by the Metropolitan Transportation Commission (transportation commission) and the Bay Area Toll Authority (toll authority)—purchased a property located at 390 Main Street in San Francisco. The building will serve as a headquarters for these and possibly other public entities. Table A.1 demonstrates, as of September 2011, the plan for the potential occupancy of the regional headquarters building; the transportation commission presented a comparable schematic to its board.

Table A.1
Potential Occupancy Plan for the Regional Headquarters Building as of September 2011

FLOOR	OCCUPANCY				RENTABLE SQUARE FEET (sq. ft.)
8	Metropolitan Transportation Commission (transportation commission) and Bay Area Toll Authority (toll authority)				62,500
7	Bay Area Air Quality Management District				62,500
6	Support space* 26,400 sq. ft.	Association of Bay Area Governments 17,000 sq. ft.	San Francisco Bay Conservation and Development Commission (BCDC) 19,000 sq. ft.‡		62,400
5	Transportation Commission and Toll Authority customer service (over time)†				62,300
4	Tenant to be determined	Tenant to be determined	Tenant to be determined		62,100
3	Tenant to be determined	Tenant to be determined	Tenant to be determined		62,000
2	Tenant to be determined	Tenant to be determined	Tenant to be determined		57,800
1	Lobby and Cafeteria 10,000 sq. ft.	Auditorium 26,700 sq. ft.	Air Lab 2,500 sq. ft.	Garage 26,700 sq. ft.	65,900

Gross square feet	**497,500 sq. ft.**	**100%**
Space identified for the colocating agencies	197,600 sq. ft.	40%
Space identified for one public entity, certain customer service vendors,† and other tenants to be determined	263,200 sq. ft.	53%
Non-work space	36,700 sq. ft.	7%

Source: California State Auditor's (state auditor) analysis based on material presented to the governing board for the transportation commission and toll authority, September 28, 2011.

Note: To correct for minor math errors in the transportation commission's September 28, 2011, presentation, the state auditor adjusted certain square footage amounts. We also present colocating agency space versus other tenant space, excluding the lobby, cafeteria, and garage spaces from these amounts.

* According to the chief financial officer, the transportation commission and toll authority intend to allocate work space for administrative services, such as printing, information technology, graphics, purchasing, and receiving, which would potentially benefit multiple public agencies.

† The transportation commission and toll authority intend for vendors who provide customer support services, such as staffing for customer call centers, to occupy space in the building in the future, possibly in 2013 and 2014.

‡ Following the conclusion of our audit fieldwork the headquarter's authority informed its board in July 2012 that it was removing BCDC from its planning process since the governor's office denied BCDC's request to relocate.

Table A.1 is divided primarily between space for the colocating agencies and space available for other tenants. The colocating agency space identifies the space the transportation commission, the toll authority, the Bay Area Air Quality Management District (air district), and the Association of Bay Area Governments (association) might occupy, including shared space for agency support and an auditorium. The occupancy plan also reflects space for the San Francisco Bay Conservation and Development Commission (BCDC). However, we have not included BCDC as a colocating agency because it was not a formal part of the various phases that led up to the headquarters building purchase. Figure 1 on page 8 provides a timeline of these phases. Although the association and BCDC are currently participating in space-planning activities for the building, neither has executed a lease or purchase agreement to secure their space.[8] As shown in Table A.1, the space designated for the colocating agencies accounts for nearly 198,000 square feet, with just over 263,000 planned for other tenants.

The headquarters authority made public a revised proposed occupancy plan for 390 Main Street on May 23, 2012, reflecting a substantially reduced amount of leasable floor space. As shown in Table A.2, the revised plan designates 101,000 square feet, or 20 percent of the building's gross square footage, for building core and support—representing a planned seven-story atrium and building support space such as electrical and telephone closets. This space is unleasable. The May 2012 schematic provided far less detail than the September 2011 schematic concerning agency and tenant placement. However, the colocating agencies were designated a total of 187,000 square feet, including an air lab, an auditorium, a conference center, and a library—or roughly 10,600 square feet less than was designated in the September 2011 occupancy plan. Notes on the plan also indicate that space is designated for the association and the BCDC.

8 Following the conclusion of our audit fieldwork the headquarter's authority informed its board in July 2012 that it was removing BCDC from its planning process since the governor's office denied BCDC's request to relocate.

Table A.2
Proposed Occupancy Plan for the Regional Headquarters Building as of May 2012

FLOOR	BUILDING CORE SQUARE FEET (sq. ft.)	OCCUPANCY	RENTABLE SQUARE FEET (sq. ft.)
8	11,000	**Agency space** 53,000 sq. ft.	53,000
7	11,000	**Agency space** 53,000 sq. ft.	53,000
6	11,000	**Agency space** 53,000 sq. ft.	53,000
5	11,000	**Tenant to be determined** 53,000 sq. ft.	53,000
4	11,000	**Tenant to be determined** 17,000 sq. ft.; **Tenant to be determined** 36,000 sq. ft.	53,000
3	11,000	**Tenant to be determined** 44,000 sq. ft.; **Boardroom/ auditorium** 9,000 sq. ft. (floors 3 and 2)	48,500
2	11,000	**Building support** 6,000 sq. ft.; **Parking and bike lockers** 22,000 sq. ft.; **Tenant to be determined** 11,000 sq. ft.; **Library showcase** 5,000 sq. ft.	42,500
1	6,000	**Building support** 12,000 sq. ft.; **Parking** 18,000 sq. ft.; **Air lab** 5,000 sq. ft.; **Tenant to be determined** 12,000 sq. ft.; **Lobby** 2,000 sq. ft.; **Conference center** 9,000 sq. ft.	46,000

Gross square feet	503,000 sq. ft.	100%
Space identified for the colocating agencies	187,000 sq. ft.	37%
Space for tenants to be determined	173,000 sq. ft.	35%
Building core and support space	101,000 sq. ft.	20%
Non-work space	42,000 sq. ft.	8%

Source: California State Auditor's analysis based on material presented on May 23, 2012, to the governing board for the Bay Area Headquarters Authority.

Blank page inserted for reproduction purposes only.

Appendix B

COMPARISON OF THE FIVE PROPOSED REGIONAL HEADQUARTERS PROPERTIES AGAINST VARIOUS CRITERIA

The Metropolitan Transportation Commission (transportation commission) and the Bay Area Air Quality Management District established requirements for their regional headquarters. The property criteria were reflected in the request for proposals the transportation commission's real estate broker issued in March 2011 to solicit potential properties. Table B on the following page summarizes the criteria and reflects whether each of the five proposed properties met the criteria, based on the information collected by the broker. These are the five short-list properties the transportation commission and its real estate broker initially determined were viable options.

Table B
Comparison of Five Proposed Regional Headquarters Properties to Various Criteria

	PROPERTY ADDRESS				
	390 MAIN STREET, SAN FRANCISCO	875 STEVENSON STREET, SAN FRANCISCO	1945 BROADWAY, OAKLAND	1221 BROADWAY, OAKLAND	1100 BROADWAY, OAKLAND
Property Criteria					
Project size (minimum 350,000 rentable square feet)	✓	✕	✓	✓	✕
Contiguous availability (150,000 to 200,000 usable square feet)	✓	✕	✓	✓	✓
Occupancy timing (available within 24 months)	✓	✓	✕	✓	✕
Located within city of Oakland or San Francisco	✓	✓	✓	✓	✓
Located within 0.5 mile of nearest Bay Area Rapid Transit Station and other forms of mass transit	✓	✓	✓	✓	✓
Public meeting space	✓	✓	✓	✓	✓
Code compliance: seismic*	✓	✓	✓	Not provided/ unknown†	✓
Code compliance: Americans with Disability Act*	✓	✓	✓	Not provided/ unknown†	✓
Code compliance: other* ‡	✓	✓	✓	Not provided/ unknown†	✓
Leadership in Energy and Environmental Design certified or able to obtain certification	✓	✓	✓	✓	✓
Purchase option§	✓	✓	✓	✕	✓
Other Evaluation Criteria					
Parking available	✓	✓	✓	✕	✓
Ability to house small air-testing lab with dock/ delivery access	✓	✓	✓	Not provided/ unknown†	✓

Sources: Initial and revised proposals submitted in response to the real estate broker's request for proposals (RFP) and the real estate broker's financial analyses of each property.

✓ = The proposed regional headquarters property meets the criteria.

✕ = The proposed regional headquarters property does not meet the criteria.

* The RFP indicated that the property must meet or be able to meet seismic, Americans with Disabilities Act, and other code compliance requirements without extraordinary cost.

† Not provided: This property proposal did not contain the information specified in the RFP. As a result, the real estate broker could not fully evaluate the property.

‡ The seller's proposal addressed other code compliance requirements applicable to the property, such as that the 875 Stevenson property is required to comply with hazardous materials codes.

§ The RFP specified that each property must be available for immediate purchase or offered as a short-term lease with a fixed purchase option.

(Agency comments provided as text only.)

July 30, 2012

Metropolitan Transportation Commission/Bay Area Toll Authority
101 Eighth Street
Oakland, California 94607-4700

Ms. Elaine M. Howle*
California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Re: Draft Audit Report 2011-127

Dear Ms. Howle:

Enclosed please find the Metropolitan Transportation Commission/Bay Area Toll Authority response to your draft audit report, sent to Steve Heminger by letter with enclosure, dated July 24, 2012.

Very truly yours,

(Signed by: Adrienne D. Weil)

Adrienne D. Weil
General Counsel

* California State Auditor's comments begin on page 43.

(Agency comments provided as text only.)

July 30, 2012

Metropolitan Transportation Commission/Bay Area Toll Authority
101 Eighth Street
Oakland, California 94607-4700

Ms. Elaine M. Howle
California State Auditor
Bureau of State Audits
555 Capitol Mall, Suite 300
Sacramento, CA 95814

Dear Ms. Howle:

Thank you for the opportunity to review and comment on the draft report prepared by the Bureau of State Audits (BSA) regarding the acquisition of 390 Main Street in San Francisco as a headquarters facility to provide more integrated and efficient regional planning for the Bay Area. The Bay Area Toll Authority and Metropolitan Transportation Commission (BATA/MTC) appreciate your staff's extensive and thorough review of a long, complex and multifactored real estate process. We agree with the BSA on the importance of transparency, responsiveness and disclosure in conducting the public's business.

We are very pleased the BSA validated most of our work and found that a court "would likely find [BATA's] decision to contribute toll bridge revenues to purchase 390 Main Street was within its legal authority." We also appreciated your findings that our board was generally informed throughout the property selection process, and that we were responsive to public criticism when it surfaced.

1 We respectfully disagree with the BSA's presentation and analysis of net present value. We note that we did not buy the building as an investment. We bought it as a long-term home to co-locate BATA/MTC and other related regional agencies. We therefore evaluated it as one would evaluate the purchase of a home:
2 as the least cost per square foot option. The building has excess space to start, but we expect growth over the next thirty years. It would have been imprudent to buy a building without extra space. The reason for the nominal value analysis presented to our boards was not to show a return on investment, per se, but to show a mitigation in the cost of the extra space until it would ultimately be filled by agency operations.

We appreciate the BSA noting in its draft report that its present value analysis "does not consider the potential value of the new headquarters building if it was sold." We believe that your evaluation should have
3 considered some residual value (whether of the building, the land underneath it, or both) to be a complete present value analysis. Had the BSA done so, all recovery scenarios except one would be positive. Although the BSA did not include any asset value, we note that the midpoint scenario in Table 3 (80% building occupancy with a rental rate of $38.40/square foot) results in an 82% "return" to BATA plus ownership of the land and the building asset. Such a result is well within BATA's risk parameters.

4 Finally, we believe the two recommendations in the draft report are not supported by the findings of the audit which determined the transaction likely to be legal and that MTC and BATA have reasonable internal controls in place to protect the fiduciary interests of both bodies, even though they are served by a common staff and board. Clearly, it is a policy matter for the Legislature to consider whether any alterations to the BATA enabling statute are warranted by changing circumstances. We would emphasize, however, that

Ms. Elaine M. Howle
July 30, 2012
Page 2

the Legislature has one critical restriction placed on its ability to enact such changes: the statutory pledge, also included in BATA's bond indentures, not to impair BATA's contract with the bondholders while any bonds are outstanding (see Streets and Highways Code Section 30963). Any changes to BATA's authority over toll revenues cannot impair any of BATA's agreements with bondholders and with any parties to contracts made with BATA, until the principal and interest on all BATA bonds are fully paid and all contracts fully discharged.

We believe that BATA's current governance and administrative structure has served both the state and the region well. We are proud of our record of achieving one of the lowest overall costs of debt in the country and one of the highest credit ratings among transportation revenue bond issuers in the nation. Since BATA was established in 1998, we have overseen completion of the $2.4 billion voter-approved Regional Measure (RM) 1 program, allocation of more than 80% of RM 2 funds out of a total amount of $1.5 billion, and completion of the $9.1 billion seismic retrofit program forecast for 2013 within the same budget approved by the Legislature in 2005, as amended by the addition of the Dumbarton and Antioch bridge projects in 2009. In total, BATA and its project partners have delivered nearly $13 billion of transportation improvements to Bay Area toll payers in little over a decade.

In closing, I would like to acknowledge the enormous amount of time and resources both the BSA and BATA/MTC expended in the course of completing this audit. We greatly appreciate the professionalism and courtesy BSA management and staff accorded us, and hope they found us to provide the same in return.

Sincerely,

(Signed by: Adrienne J. Tissier)

Adrienne J. Tissier
Chair

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE METROPOLITAN TRANSPORTATION COMMISSION AND BAY AREA TOLL AUTHORITY

To provide clarity and perspective, we are commenting on the Metropolitan Transportation Commission's (transportation commission) and Bay Area Toll Authority's (toll authority) response to our audit. The numbers below correspond to the numbers we have placed in the margin of the transportation commission's and toll authority's response. For ease of reading, we refer to both entities collectively as the transportation commission, unless otherwise noted.

1. We believe our net present value (NPV) presentation and analysis is appropriate. Our analysis on pages 16 through 22 discuss how the transportation commission did not disclose the financial risk to its board and the public when it concluded in September 2011 that the new headquarters building had a "net after building investment"—or profit—of $40 million over a 30-year period. A central part of the transportation commission's argument for purchasing the building was that toll payers would be protected because the toll funds contributed towards the purchase would be repaid. As we state on page 16, our NPV analysis compared contributed toll revenue (cash outflows) with the building's projected net income (cash inflows) as measured in today's dollars to ultimately conclude as to whether toll revenues will be repaid over a 30-year period. Our analysis revealed that in some circumstances the toll authority will be repaid within 30 years while under other circumstances it will not. Our conclusions are shown in tables 2 and 3 on pages 19 and 21, respectively.

2. The transportation commission states that it will grow in the future, suggesting that it was justified in purchasing a building with roughly 497,000 square feet. However, as we note on pages 24 through 25, the transportation commission's reasons for searching for buildings with at least 350,000 square feet are unclear. As noted on pages 24 and 25, the transportation commission's chief financial officer explained that his agency's space needs were based on management's best guess of its future responsibilities, the specifics of which have not yet been determined. Further, the transportation commission's chief executive officer explained that he was trying to accommodate future growth for his agency and others. However, as we note on page 25, the transportation commission's own financial projections do not assume the transportation commission will occupy progressively more space in the building over a 30-year period.

3 We disagree with the transportation commission's assertion that our NPV analysis is incomplete. As we state on page 19 of the report, we chose not to consider the building's residual value because the transportation commission did not mention to its board and the public any plan to sell the building in the future to ensure toll funds contributed towards the purchase would be repaid. Further, the amount of space in the new building that could be sold is highly uncertain given the significant changes to the building's proposed layout revealed in May 2012.

4 We believe the two recommendations in our report are warranted and supported by the report's conclusions. Our first recommendation is based on our discussion on page 11 where we describe state law that allows the toll authority "to do all acts necessary or convenient" to exercise its power, including acquiring office space. Based on this broad authority and the transportation commission's inability to provide analysis justifying why it needed a building with so much space—other than general expectations for its future growth—we believe members of the Legislature may wish to reconsider existing law. Our second recommendation is based on pages 13 and 14, which explain that the Legislature intended for the toll authority to be separate from the transportation commission but that the executive management for both entities are the same.

cc: Members of the Legislature
Office of the Lieutenant Governor
Little Hoover Commission
Department of Finance
Attorney General
State Controller
State Treasurer
Legislative Analyst
Senate Office of Research
California Research Bureau
Capitol Press