

California Department of Transportation

Its Poor Management of State Route 710 Extension
Project Properties Costs the State Millions of Dollars
Annually, Yet State Law Limits the Potential Income
From Selling the Properties

August 2012 Report 2011-120



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

Dear Governor and Legislative Leaders:

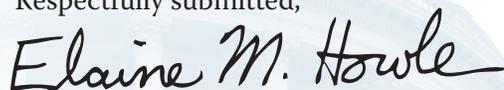
As requested by the Joint Legislative Audit Committee, the California State Auditor (state auditor) presents this audit report concerning the Department of Transportation's (Caltrans) management of the State Route 710 extension project parcels and properties (SR 710 properties). This report concludes that Caltrans has spent nearly \$22.5 million to repair the properties it owns between July 1, 2008, and December 31, 2011, which exceeds the rental income it collected by \$9.7 million. Caltrans charges the majority of the SR 710 property tenants rents that are on average 43 percent below market rate. By doing so, we estimate that Caltrans has foregone \$22 million in rental income between July 1, 2007, and December 31, 2011. Further, our legal counsel advises us that generally Caltrans' rental of the SR 710 properties at below-market rates may constitute a prohibited gift of public funds.

Caltrans has spent an average of \$6.4 million per year on repairs to SR 710 properties; however, it could not demonstrate that the repairs for many of the properties were reasonable or necessary. Caltrans maintains the SR 710 properties by either contracting directly with service providers or by requesting that the Department of General Services (General Services) complete specific repairs. However, Caltrans did not always perform annual inspections to determine whether repairs were necessary. Furthermore, Caltrans often authorized repairs that far exceeded the properties' potential rental income. Also, General Services exerts insufficient oversight over several project cost areas. For example, General Services' construction unit does not properly monitor its labor charges. General Services also did not follow state law and policies governing purchases from small businesses. We found that the owner of a small business that does a large amount of business with General Services is related to the owners of two other small businesses that General Services made purchases from, and these companies with related owners bid against each other. Consequently, other qualified suppliers may not have had a fair opportunity to participate in the competitive solicitation process.

As of March 1, 2012, Caltrans estimated that the market value of the SR 710 parcels was \$279 million, with single and multifamily residential parcels comprising \$238 million, or 85 percent, of the estimated market value. However, if the State were to deem these residential parcels as surplus and sell them in accordance with the state law known as the Roberti Bill, it could potentially receive only \$40 million, or 17 percent of their estimated market value. Further, if the SR 710 residential parcels were sold under the Roberti Bill, they would generate only a fraction of the property tax revenues that they would otherwise if the State sold them at fair market value.

While Caltrans is determining whether it will proceed with the SR 710 extension project, the State could consider certain alternatives that would allow it to retain access to the right-of-way needed for the extension project. One option Caltrans could consider is contracting with one or more private contractors to provide property management services to maintain the SR 710 properties. Another option to consider is the establishment of a joint powers authority that would include Caltrans and the cities of Pasadena, South Pasadena, and Los Angeles to manage the SR 710 properties.

Respectfully submitted,



ELAINE M. HOWLE, CPA
State Auditor

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Summary

Results in Brief

The California Department of Transportation (Caltrans) is responsible for constructing, operating, administering, and maintaining the State's comprehensive transportation system. For decades, Caltrans has proposed the State Route 710 extension project (SR 710 extension project) to close a roughly 4.5-mile unconstructed gap in the freeway just north of State Route 10 in Los Angeles and State Route 210 in Pasadena. This gap affects the cities of Alhambra, Pasadena, South Pasadena, and a portion of Los Angeles. However, the project has been in the planning stage since 1953 for a variety of reasons related to the federal environmental review process. Caltrans is currently considering several options for moving forward, including either building a tunnel instead of a freeway or not building anything at all. By 2014 Caltrans hopes to have identified how it intends to proceed, but in the meantime the right-of-way division of Caltrans' District 7 office, which is located in the city of Los Angeles, is responsible for managing the hundreds of SR 710 extension project parcels and property units (SR 710 properties), ranging from residential to commercial properties to vacant land, that it purchased beginning in 1954 for use as land on which to build the project.

Because of Caltrans' poor management, we estimate that it missed the opportunity to generate roughly \$22 million in rental income for the SR 710 properties between July 1, 2007, and December 31, 2011. In addition, the State spent millions of dollars more maintaining the SR 710 properties than it received in rental income. Although Caltrans collected net rental income of \$12.8 million, it spent \$22.5 million to repair the SR 710 properties from July 1, 2008, through December 31, 2011. A primary reason for this shortfall is that Caltrans failed to charge rents at the market rate for the majority of the 404 SR 710 properties it rents. Our review found that Caltrans charged rents for 345 of these properties that were, on average, 57 percent of the rents it identified in its market rent determinations. Moreover, because Caltrans' market rent determinations for the 345 properties are, on average, nearly four years old, the discrepancy between the rents it is charging and current market rates is likely even larger. Caltrans asserted that it recently completed market rent determinations for all of the SR 710 properties; however, these determinations were completed subsequent to the end of our fieldwork.

Caltrans also stated that it does not charge market rates for many of the SR 710 properties because in 2002 the former Caltrans director instructed the District 7 office not to increase rents to market rates. However, our legal counsel advised us that Caltrans' rental of the SR 710 properties at below-market values constitutes a gift of public funds, which is prohibited by the California Constitution unless such

Audit Highlights . . .

Our review of the State's management of state property along the proposed State Route 710 (SR 710) extension project highlighted the following:

- » *The California Department of Transportation (Caltrans) passed up roughly \$22 million in rental income for these properties between July 1, 2007, and December 31, 2011, because of poor management.*
- » *Caltrans failed to charge rents at the market rate for the majority of the 404 properties it rents.*
 - *It charged rents for 345 of these properties that were, on average, 57 percent of the rents in its market rent determinations that were prepared nearly four years ago.*
 - *Rental of these properties at below-market values constitutes a prohibited gift of public funds, unless such rentals serve a public purpose.*
 - *For state employees renting these properties, the difference between the market rental value of the properties and the rent paid by these employees should be included in their gross income.*
- » *Caltrans' affordable rent program for certain low-income tenants—who in 1981 qualified for affordable rent—is costing the State more than \$940,000 per year because the rent they pay is much lower than the fair market rental value.*
 - *Caltrans has not been verifying income eligibility annually for the tenants in this program as required.*
 - *For those tenants who no longer qualify, the difference between the fair market rental value of the property and the rent they pay would be considered a gift of public funds.*

continued on next page . . .

» *Although Caltrans collected net rental income of \$12.8 million, it spent \$22.5 million to repair the properties from July 1, 2008, through December 31, 2011.*

- *It spent an average of \$6.4 million per year on repairs to these properties, but could not demonstrate that repairs for 18 of the 30 projects we reviewed were reasonable or necessary.*
- *It did not always perform annual inspections and often authorized repairs that far exceeded the properties' potential rental income.*

» *Since fiscal year 2005–06, Caltrans has transferred an average of \$4.7 million each year to the Department of General Services (General Services) to maintain the properties. However, the departments have operated without an interagency agreement for over a decade.*

- *Caltrans has not monitored General Services to ensure funds are properly spent.*
- *General Services has limited justification for the fees it charges clients such as Caltrans.*
- *General Services' construction unit does not properly monitor its labor charges—we identified roughly 330 hours that may have been inappropriately charged to projects related to the SR 710 properties.*
- *General Services did not follow state law and policies governing purchases from small businesses.*
- *Caltrans has not sufficiently evaluated options to having General Services perform the repairs.*

» *Because of legislation enacted in 1979 known as the Roberti Bill, selling these properties may require the State to offer the properties at significantly reduced prices to any current tenants who have low or moderate incomes, and have not owned real property in the three years prior to the sale.*

rentals serve a public purpose. If it charged market rents for the 345 SR 710 properties, Caltrans could potentially generate as much as \$3.8 million more per year in rental income.¹ These are public funds that Caltrans is, in effect, giving to its tenants. Moreover, in performing our analyses of the rent Caltrans charges its SR 710 property tenants, we identified 15 state employees to whom Caltrans was renting properties at below-market rates as of February 2012. The difference between the market rental value of the properties and the rent paid by these employees constitutes either income in the form of compensation from a fringe benefit or a gift of public funds. As such, the State should be including the difference in the employees' gross income that is reported for federal and state income tax purposes.

Caltrans also rents 58 of the SR 710 properties units under an affordable rent program for certain low-income tenants who originally qualified for affordable rent before March 3, 1981, in order not to impose hardship on them. Our review found that Caltrans charged rents for these 58 properties that were, on average, 26 percent of the rents it identified in its market rent determinations. Based on our comparison of Caltrans' market rates and the rates it actually charges these tenants, we estimate that this program is costing the State more than \$940,000 per year. However, Caltrans has not been performing income eligibility verifications annually for the tenants in the affordable rent program, as its own policies require. Consequently, it cannot be sure that all of the tenants continue to qualify for the program. For those tenants who no longer qualify, the difference between the fair market rental value of the property and the rent they pay—an average of \$16,200 per year per property—would be considered a gift of public funds.

Caltrans has spent an average of \$6.4 million per year on repairs to SR 710 properties; however, it could not demonstrate that the repairs for 18 of the 30 projects we reviewed were reasonable or necessary. Caltrans maintains the SR 710 properties by either contracting directly with service providers or—more frequently—by requesting that the Department of General Services (General Services) complete specific repairs. However, Caltrans did not always perform annual inspections to determine whether repairs were necessary. Moreover, Caltrans often authorized repairs that far exceeded the properties' potential rental income. In fact, for 20 of the 30 properties we reviewed, Caltrans authorized repairs for which it will take more than three years' worth of rental income to recover the costs.

To maintain the SR 710 properties, Caltrans has transferred an average of \$4.7 million each year to General Services since fiscal year 2005–06. However, Caltrans does not provide proper oversight of the repairs General Services performs. Caltrans and General Services had no interagency agreement in place for over a decade, and it has not

¹ One of the 404 SR 710 properties Caltrans rents did not have a market rent determination.

monitored General Services to ensure that it spends the transferred funds properly. For example, in some instances Caltrans was unable to provide us with records to substantiate its approval of General Services' work either before or after the work was performed. Moreover, Caltrans has not sufficiently evaluated alternatives to having General Services perform the work, which might be resulting in Caltrans spending more state funds than needed to perform the repairs on these properties. For example, General Services has limited justification for the fees it charges clients such as Caltrans. Specifically, General Services was unable to substantiate the \$50 hourly rate it charges to clients for its Direct Construction Unit's (construction unit) operational costs that include the salaries and benefits for its permanent employees, known as its hourly burden rate, and its direct administration fees for each project.

Further, General Services exerts insufficient oversight over several project cost areas. In particular, General Services' construction unit does not properly monitor the labor charges of its temporary employees, known as casual trades or day laborers. For example, we identified roughly 330 hours that may have been inappropriately charged by the casual laborers to projects related to the SR 710 properties. General Services also did not follow state law and policies governing purchases from small businesses. Specifically, General Services made purchases for amounts under \$5,000 without using competing bidders or justifying that the price was fair and reasonable. For the purchases for which General Services did solicit competitive bids, we found that the owner of a small business that does a large amount of business with General Services is related to the owners of two other small businesses that General Services made purchases from, and these companies with related owners bid against each other. Consequently, other qualified suppliers may not have had a fair opportunity to participate in the competitive solicitation process. We also reviewed invoices for five small businesses to which the construction unit paid a total of more than \$300,000 between July 2011 and May 2012 and found in some instances that the businesses do not appear to serve a commercially useful function. For example, our review found that two of the small businesses obtained goods either from The Home Depot or online vendors at retail prices and charged the State an average markup of 35 percent for the goods, instead of the construction unit purchasing the goods directly from the suppliers.

Once Caltrans completes the necessary reviews and plans for the SR 710 extension project, it can determine if it requires all of the properties that it currently owns. It can then proceed with selling surplus properties. However, the sale of these properties will be restricted by legislation enacted in 1979 known as the Roberti Bill, which requires the State to offer the properties at significantly reduced prices to any current tenants who have low or moderate incomes and have not owned real property in

the three years prior to the sale. As of March 1, 2012, Caltrans estimated that the market value of the SR 710 parcels was \$279 million.² However, as a result of the Roberti Bill, the actual sale price for many or potentially all of the residential SR 710 parcels could be roughly 80 percent less than Caltrans' estimated market value. These discounted prices would have long-term ramifications because the properties would generate only a fraction of the property tax revenues that they would generate if sold at market price. Because state law requires Caltrans to restrict the use of these properties exclusively as affordable housing, and Caltrans plans to implement these restrictions for 45 to 55 years, the reduction in property tax revenues would likely exceed many millions of dollars.

While Caltrans is determining whether it will proceed with the SR 710 extension project, the State could consider certain alternatives that would allow it to retain access to the SR 710 properties for right-of-way purposes while eliminating its need to directly manage the properties. One possibility is that Caltrans could contract with one or more private contractors to provide property management services to maintain the SR 710 properties. Another option the Legislature could consider would be the establishment of a joint powers authority (JPA) that would include Caltrans and the cities of Pasadena, South Pasadena, and Los Angeles to manage the SR 710 properties. This option would allow the affected cities an opportunity to have an equal voice in the management of the properties.

Recommendations

To ensure that it collects fair market rents for the SR 710 properties on the State's behalf, Caltrans should do the following:

- Using the fair market rent determinations for all SR 710 properties it recently prepared, excluding those in its affordable rent program, adjust the tenants' rents to fair market after providing them with proper notice.
- Make only limited exceptions to charging fair market rent and document the specific public purpose that is served in any case where it does not charge fair market rent.

To ensure that all taxable fringe benefits or gifts state employees receive are appropriately included in their gross income, Caltrans should take the following actions:

² A parcel is a plot of land that can contain more than one single-family or multifamily residential property unit.

- Establish procedures to notify state employees who rent SR 710 properties that they may be subject to tax implications.
- Work with the State Controller's Office (state controller) to identify the difference between the fair market rental value of the SR 710 housing and the rent the state employees paid for that housing during the applicable calendar years within the federal and state statute of limitations.
- Work with the state controller to identify the statute of limitations for employers to report adjustments to employee gross income to the federal Internal Revenue Service and the Franchise Tax Board.

To ensure that only eligible tenants receive the benefit of the affordable rent policy, Caltrans should annually review the tenants' household incomes and document their incomes using income certification forms. If tenants no longer qualify for the program because their income exceeds the income requirement or one of the income-producing tenants in the household has been replaced by a new tenant, it should increase their rent to fair market rates after giving proper notice.

To ensure that the repairs it makes to the SR 710 properties are necessary and reasonable, Caltrans should do the following:

- Conduct annual field inspections of the properties.
- Develop a written policy to ensure that it considers the cost-effectiveness of repair costs in relation to the potential rental income for a property.
- Establish a process to ensure that it evaluates the cost-effectiveness of any repair before authorizing it.
- Retain in its project files evidence to support the necessity and reasonableness of repairs, such as change orders, annual field inspections, and analyses of the cost-effectiveness.

To ensure that the State achieves cost savings for the repairs made to the SR 710 properties, Caltrans should periodically perform more comprehensive analyses of viable options for repairing the properties. If Caltrans determines that General Services is the best option, it should ensure that it properly executes an interagency agreement in accordance with the *State Contracting Manual*.

To ensure that it charges its clients appropriately for the work it performs, General Services should reassess its methodologies for determining the hourly burden rate and direct administration fees.

To ensure that the construction unit complies with the State's procurement laws and policies, General Services should do the following:

- Provide training to its construction unit employees regarding the State's procurement laws and policies.
- Conduct an investigation of the small businesses we discuss in this report to determine if they are performing a commercially useful function.

To ensure that casual laborers charge only for their actual hours worked on projects, General Services should ensure that the daily time reports for casual laborers contain the appropriate task codes, the laborer's signature, and the approval of a civil service supervisor.

To pursue alternatives to its management of the SR 710 properties, Caltrans should:

- Prepare a cost-benefit analysis to determine if the State would save money by hiring a private vendor to manage the properties.
- Perform an analysis to compare the cost of establishing a JPA to its current costs of managing the properties.

To pursue alternatives to the State's management of the SR 710 properties that would preserve its access to the right-of-way needed for the SR 710 extension project, to the extent that Caltrans has determined it to be cost-beneficial to do so, the Legislature should consider the establishment of a JPA that would allow Caltrans and the affected cities to jointly manage the SR 710 properties.

Agency Comments

The Business, Transportation and Housing Agency (BTH) stated that it appreciates the identification of opportunities for improvement and recommendations for best practices that Caltrans can follow. In addition, Caltrans stated that it has implemented recommendations, is in the process of implementing recommendations, or will work with BTH to determine how best to address the issues raised in our report.

General Services stated that it agrees that additional actions need to be taken to improve the construction unit's administrative processes. General Services also stated that, in general, the recommendations have merit and that it will promptly address them.

Introduction

Background

The California Department of Transportation (Caltrans) is responsible for constructing, operating, administering, and maintaining the State's comprehensive transportation system. For decades, Caltrans has proposed the State Route 710 extension project (SR 710 extension project) to close a roughly 4.5-mile unconstructed gap in the freeway just north of State Route 10 in Los Angeles to State Route 210 in Pasadena. This gap affects the cities of Alhambra, Pasadena, South Pasadena, and a portion of Los Angeles. The California Highway Commission, the predecessor to the California Transportation Commission, adopted a location for the SR 710 extension project in 1953. However, since that time, the SR 710 extension project has experienced delays for a variety of reasons. In Appendix A, we present a timeline of the history of the SR 710 extension project from 1951 through 1996, excerpted from our 1996 report titled *Department of Transportation: Further Improvements Can Be Made in the Management of Properties Along the State Route 710 Right-of-Way*.

Federal regulations establish procedures of the Federal Highway Administration (highway administration) for implementing the National Environmental Policy Act of 1969 (NEPA). These regulations provide that highway projects subject to NEPA, such as the SR 710 extension project, cannot proceed with final design activities, property acquisition, purchase of construction materials, or project construction until the highway administration approves a final environmental impact statement and makes it available to the public for a prescribed period of time. The highway administration will then sign a record of decision, which acknowledges the highway administration's acceptance of the general project location and the concepts described in the project's environmental review documents. Although in April 1998 the highway administration signed a record of decision allowing the SR 710 extension project to move forward, it rescinded it in 2003, stating that Caltrans would need a supplemental environmental impact statement and a new record of decision to advance the project as a federal aid highway project. In 2007, as part of its surface transportation project delivery pilot program, the highway administration delegated its authority for approving environmental impact statements and signing records of decision to Caltrans.

Caltrans has examined a number of different possibilities for addressing the freeway gap. Specifically, it has worked with the Los Angeles County Metropolitan Transportation Authority (Metro) to examine the technical feasibility of constructing an underground tunnel. In 2006 Metro's consultant submitted to Metro a report that concluded that the tunnel concept was feasible. In September 2011 Caltrans issued an SR 710 extension project scoping summary report stating that the proposed project might include, but not be limited to, surface and

subsurface (tunnel) freeway construction, heavy rail and bus/light rail systems, local street upgrades, and traffic management systems. It also stated that it was considering not building anything as an alternative.

Caltrans' report indicates that it expects to complete the project approval process by the winter of 2014. In October 2011 Metro's board of directors authorized its chief executive officer to award a contract to a consultant to prepare an environmental impact statement for the project. Metro hired its consultant on November 7, 2011. Figure 1 presents the key actions since 2003 to assess the feasibility of the SR 710 extension project.

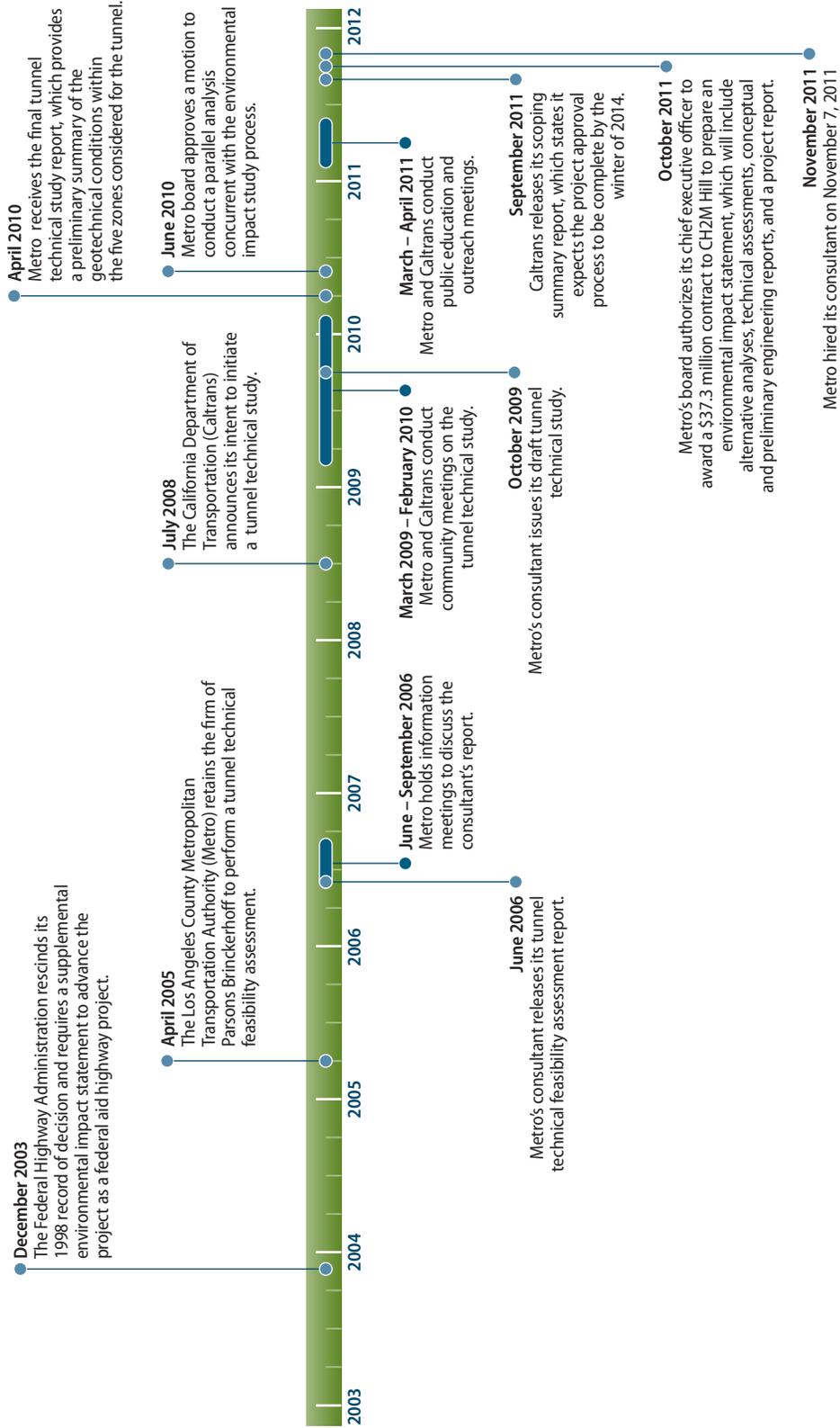
Caltrans' Role in Managing the SR 710 Extension Project Properties

Caltrans' Division of Right of Way and Land Surveys (ROW headquarters division) administers its statewide program for right-of-way acquisition and real property management. Caltrans' 12 district offices throughout the State each maintain a right-of-way division (ROW division) that is responsible for implementing the ROW headquarters division's right-of-way and administrative policies. One of the primary responsibilities of the district ROW divisions is appraising and purchasing property for transportation purposes, which includes relocating affected families and businesses and clearing the property before construction. In addition, the district ROW divisions are responsible for managing all property held for future transportation projects, all excess properties, and Caltrans' employee housing. For example, the district ROW divisions maintain an inventory of state-owned properties, market rentable properties, establish tenancies, collect rent, inspect the properties, and arrange for maintenance of the properties. Finally, the district ROW divisions are responsible for disposing of property that Caltrans no longer needs for transportation purposes.

Caltrans' District 7 office in the city of Los Angeles manages the SR 710 extension project parcels and property units (SR 710 properties). The District 7 ROW division is composed of four offices staffed by about 120 employees as of June 2012. Of these 120 employees, about 30 are responsible for, among other things, renting, inspecting, and maintaining properties in the district. In addition to its staff, Caltrans hires private contractors and the Department of General Services (General Services) to perform repairs on the properties.³ General Services' Direct Construction Unit (construction unit) is the State's in-house construction contractor, and as of June 2012, it had 16 permanent employees. The construction unit provides supervisors and crafts persons who are capable of working on any construction project for any state agency in an emergency or when it has been determined it is in the best interest of the State to directly undertake the work in accordance with state law. General Services also hires temporary employees, known as casual trades or day laborers, to assist its construction unit employees.

³ For the purposes of our report, we use the term *repair* to refer to any Caltrans-directed property maintenance or repair.

Figure 1
Key Actions Since 2003 Related to Determining the Feasibility of the State Route 710 Extension Project



Sources: Caltrans' and Metro's records.

As of February 9, 2012, Caltrans owned 460 parcels of land related to the SR 710 extension project. A map with the location of these parcels is shown in Appendix B. A parcel is a plot of land that can contain more than one single-family or multifamily residential property unit. As shown in Table 1, the 460 parcels fall into the following categories: single-family residential parcels, multifamily residential parcels, commercial/industrial parcels, and vacant land parcels. Caltrans purchased most of the parcels between 1954 and 1976, with a 1969 median acquisition date. State law authorizes Caltrans to lease any lands it owns but does not presently need for state highway purposes on such terms and conditions as its director determines, and to maintain and care for such property in order to secure rent. Table 1 provides a breakdown of the number of SR 710 parcels and the number of property units Caltrans' data show were rentable. According to Caltrans' Right-of-Way Property Management System, 449 of the 555 property units were rentable as of February 9, 2012.

Table 1
Rental Status of Historic and Nonhistoric State Route 710 Extension Project Properties as of February 9, 2012

	NUMBER OF PARCELS	HISTORIC PROPERTIES		NONHISTORIC PROPERTIES		TOTAL PROPERTIES	
		RENTABLE	NOT RENTABLE	RENTABLE	NOT RENTABLE	RENTABLE	NOT RENTABLE*
Single-family residence	357	75	6	255	21	330	27
Multifamily residence	41	19	8	84	24	103	32
Subtotals—Residential	398	94	14	339	45	433	59
Commercial/industrial	6	1	0	4	2	5	2
Vacant land	56	0	0	11	45	11	45
Totals	460	95	14	354	92	449	106

Source: California State Auditor's (state auditor) analysis of data obtained from the California Department of Transportation's (Caltrans) Right-of-Way Property Management System as of February 9, 2012. Please refer to the Introduction's Scope and Methodology for the state auditor's assessment of the reliability of these data.

* According to Caltrans' right-of-way manual, residential property units are not rentable when they do not meet the requirements specified in Civil Code, sections 1941, 1941.1, and 1941.3; Health and Safety Code, Section 13113.7; and Health and Safety Code, sections 17900–17995. According to Caltrans, the two commercial and industrial properties are not rentable because they do not have a functional business purpose.

As shown in Table 1, Caltrans owns 108 historic residential property units and 384 nonhistoric residential property units. For the historic properties, state law requires Caltrans to coordinate with the State Historic Preservation Officer (preservation officer) before performing repairs. In Appendix C, we describe the process for identifying historical resources and for seeking the preservation officer's approval of repairs.

For both historic and nonhistoric properties, Caltrans must comply with various state laws that govern real property. For example, state law requires Caltrans to maintain the structures that it acquires for state and highway purposes in conformance with the standards set in

the building and safety ordinances in the city or county having jurisdiction at the time of its acquisition. Local building ordinances can address structural requirements related to roofs, floors, walls, and foundations, and mechanical requirements related to heating, electrical wiring, and ventilation. State law also requires property owners to maintain their buildings in a manner that does not substantially endanger the health and safety of the residents or the public.

Finally, Caltrans must also adhere to the order issued in the 1999 federal court case *City of South Pasadena v. Slater*, which is commonly referred to as the Slater case. The plaintiffs claimed that the defendants, which included the highway administration and Caltrans, violated the Department of Transportation Act, NEPA, and the Clean Air Act in developing the SR 710 extension project record of decision signed in 1998, as discussed earlier. The plaintiffs sought a preliminary injunction preventing future planning and expenditures for the SR 710 extension project and imposing certain requirements on the defendants. The text box presents the court's order for the Slater case.

Restrictions on the Sale of the SR 710 Properties

In 1979 the Legislature enacted the law known as the Roberti Bill. The Roberti Bill reaffirms that “the provision of decent housing for all Californians is a state goal of the highest priority.” At that time the Legislature found, among other things, that highway and other state activities had contributed to the severe shortage of decent, safe, and sanitary housing that persons of low or moderate income could afford within the urban and rural areas of the State. The Legislature declared that “the actions of state agencies including the sales of surplus residential properties which result in the loss of decent and affordable housing for persons and families of low or moderate income is contrary to state housing, urban development, and environmental policies and was a significant environmental effect” within the meaning of the California Constitution. State law defines surplus residential property as “land and structures owned by an agency of the state that is determined to be no longer necessary for the agency’s use, and that is developed as single family or multifamily housing, except property being held by the agency for the purpose of exchange.”

The Court's Order for the Slater Case

1. Defendants are prohibited from expending federal or state funds to construct any portion of the State Route 710 Freeway Project (SR 710 extension project), without permission from the court.
2. Defendants are prohibited from expending federal or state funds to allow any acquisitions of properties for the proposed SR 710 extension project, except for the acquisition of hardship properties or protective purchases, without permission from the court.
3. Defendants shall provide plaintiffs with notice within five days of entering into any agreement to make a hardship acquisition or protective purchase under the hardship acquisition or protective purchase exceptions set forth in paragraph 2.
4. State defendants are ordered to maintain all state-owned properties acquired for the SR 710 extension project in conditions of good repair according to a timetable submitted to the Court within 90 days from the issuance of this order, unless the condition of the property is such that repair of the property would constitute waste.
5. Defendants shall provide 60 days' advance notice to plaintiffs of defendants' intent to demolish or substantially alter properties under the waste exception set forth in paragraph 4 above (except in case of emergency, in which case defendants shall provide immediate notice to plaintiffs and afford plaintiffs a reasonable opportunity to inspect the property and circumstances).
6. State defendants are ordered to receive approval of the State Historic Preservation Officer for repair or modification to state-owned properties in the corridor that are listed or eligible for listing on the national or California historic registers.
7. State defendants must report to the court and the plaintiffs semiannually, commencing within 90 days from the issuance of this order, on the condition and progress of maintenance and rehabilitation of all state-owned properties within the corridor.

Source: 1999 court case *City of South Pasadena v. Slater* (C.D.Cal. 1999) 56 F Supp. 2d 1106, 1148–1149.

To preserve, upgrade, and expand the supply of housing available to persons and families of low or moderate income, the Legislature established the priorities and procedures for the disposition of surplus residential properties shown in Figure 2. For the purposes of the Roberti Bill, “persons and families of low and moderate income” do not include persons and families who have owned real property in the last three years. Figure 2 shows surplus property is first offered to its former owner, if the owner currently occupies the property. If that owner does not currently occupy the property or chooses not to accept the offer, the State must offer the property to the current occupants if they meet the conditions shown in the figure. If these occupants do not meet the conditions or choose not to accept the offer, the State must offer the property to entities that provide affordable housing; if these entities do not accept the offer, the State may sell the property at fair market value.

Figure 2
Summary of Sales Process for the State’s Surplus Residential Properties Under the Roberti Bill



Source: California Government Code, sections 54235 through 54238.7.

* Fair market value is the value as of the date the offer of sale is made by the selling agency pursuant to the provisions of this article.

† The State must calculate the affordable price for a low-income buyer by ensuring that the buyer’s monthly payments will not exceed a portion of his or her household’s adjusted income as determined in accordance with the regulations of the United States Department of Housing and Urban Development.

The State must calculate the affordable price for a moderate-income buyer by ensuring that the buyer’s monthly payments will not exceed a portion of his or her household’s adjusted income as determined in accordance with the regulations of the United States Department of Housing and Urban Development, issued pursuant to Section 235 of the National Housing Act.

Affordable price may not be less than the acquisition price paid by the selling agency for the property, unless that price is greater than the current fair market value.

‡ Reasonable price is a price best suited to economically feasible use of the property as decent, safe, and sanitary housing at affordable rents and prices for persons and families of low and moderate income.

The Department of Housing and Community Development establishes the official California income limits for each county by household size; these limits are used to determine the present occupant's eligibility for purchasing property under the Roberti Bill. The second step in Figure 2 uses the moderate income limit to calculate the threshold for selling surplus residential property to the present occupants at an affordable price. In 2012 this moderate income limit was \$77,750 for a household of four in Los Angeles County. The third step in Figure 2 uses 150 percent of the area median income to calculate the threshold for selling surplus residential property to the present occupants at an affordable price. In 2012, 150 percent of Los Angeles County's area median income for a household of four was \$97,200.

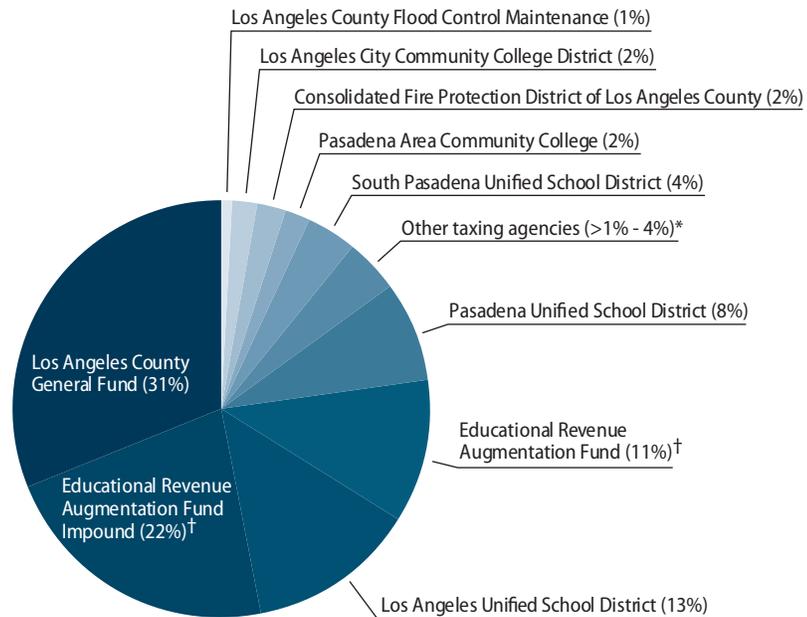
Property Tax Issues Affecting SR 710 Properties

State-owned property is not subject to property taxes. However, state law requires Caltrans to act as an agent for the payment of its tenants' possessory interest taxes for real property it holds for future state highway needs and before it sells or exchanges real property it originally held for that purpose but has determined is no longer needed.⁴ State law also requires Caltrans to pay 24 percent of the rent it collects to the county in which the real property is situated. If the amount Caltrans pays to the county from the rent it collects from its tenants is greater than the amount its tenants owe in possessory interest taxes, the rent it collects is considered full payment for the tenants' taxes. However, if 24 percent of the total rent is less than the total of the possessory interest taxes due, Caltrans must pay the remaining amount to the county. According to information we obtained from Los Angeles County's auditor-controller, between fiscal years 2006-07 and 2011-12, the possessory interest taxes due were, on average, about \$192,000 and 24 percent of the total rent Caltrans collected was an average of \$1.3 million.

State law requires the county to distribute half of the rental income it receives from Caltrans to the city in which the property is located. The county board of supervisors is responsible for determining how it will distribute the remaining amount between the county, each revenue district for which the county assesses and collects property taxes, and every other taxing agency within the county. Figure 3 on the following page shows Los Angeles County's distribution of these funds between it and the revenue districts and taxing agencies for fiscal year 2011-12.

⁴ A taxable possessory interest is a privately held property interest (such as a lease) in a publicly owned tax-exempt property.

Figure 3
Distribution of Los Angeles County's Share of Rental Income for State-Owned Property Including the State Route 710 Extension Project Property
Fiscal Year 2011–12



Source: Los Angeles County's auditor-controller.

Note: Figure 3 does not include the portion of the rental income Los Angeles County distributes to the cities in which the property is located.

* Includes other taxing agencies that received less than 1 percent of distributed funds, such as county sanitation districts, water districts, school districts, and community college districts.

[†] Pursuant to state law, amounts in these funds are allocated to school districts, county offices of education, and community college districts.

Scope and Methodology

The Joint Legislative Audit Committee (audit committee) asked the California State Auditor to audit the cost to the State of maintaining properties it owns in the proposed SR 710 extension project and to determine if any feasible alternatives to owning and maintaining the properties exist. The audit analysis that the audit committee approved contained 13 objectives. Table 2 lists these objectives and the methods we used to address them.

Table 2
Methods to Address Audit Objectives

	AUDIT OBJECTIVE	METHODS
1	Review and evaluate the laws, rules, and regulations significant to the audit objectives.	<ul style="list-style-type: none"> Reviewed relevant laws, regulations, and other background materials. Interviewed staff at the California Department of Transportation (Caltrans) and the Department of General Services (General Services).
2	Identify the number of state-owned parcels that Caltrans currently maintains along the SR 710 extension project (SR 710 extension project) right-of-way.	<ul style="list-style-type: none"> Compared data from Caltrans' Right-of-Way Property Management System to its property records and its acquisition maps. Compared Caltrans' list of historic properties to the State Historic Preservation Officer's master list.
3	Determine the roles and responsibilities of the entities involved in the maintenance of the state-owned parcels along the extension project right-of-way.	<ul style="list-style-type: none"> Reviewed relevant state law, regulations, and contracts. Interviewed Caltrans' and General Services' staff.
4	Review and evaluate Caltrans' policies and procedures for maintaining the properties along the SR 710 extension project right-of-way and determine whether they are consistent with applicable laws and regulations.	<ul style="list-style-type: none"> Reviewed both Caltrans' and General Services' internal policies and procedures. Reviewed the <i>State Administrative Manual</i> and the <i>State Contracting Manual</i>. Compared the policies and procedures to relevant laws and regulations.
5	For the most recent three-year period, identify the expenditures related to maintaining the SR 710 extension project right-of-way, including the expenditures for the repair and maintenance of the state-owned properties. For a sample of those expenditures, determine whether they are appropriate and reasonable.	<ul style="list-style-type: none"> Compiled the SR 710 parcels and property units (SR 710 properties) expenditure information from Caltrans' and General Services' computer databases for July 1, 2008, through December 31, 2011. Interviewed Caltrans' and General Services' staff. Haphazardly selected 30 projects to test to determine if the repairs were necessary and reasonable. Reviewed Caltrans' and General Services' files.
6	For a sample of expenditures identified in objective 5, to the extent possible, compare the costs Caltrans paid to the costs that private entities in the local area charge to perform similar work, particularly the costs to repair and replace roofs.	<p>We were unsuccessful in providing the requested comparison. We contacted a number of roofing companies but were able to find only two that were willing to look at the scope of work from one of General Services' roofing projects. Of these, one contractor stated that he would be unable to provide a price quote without additional information, such as the amount of materials required and the desired method for attaching the roof to the membrane. In addition, he stated that he could not include abatement work as part of his roofing quote because he does not perform this task. The second contractor did not provide us with a quote for the specific items in General Services' scope of work for the roofing project.</p> <p>We were also unable to compare General Services' work for other services using Caltrans' lowest bid contract information because the quoted line items within the contracts do not correspond to General Services' scope of work for projects. For example, General Services' scope of work has the line item "floor finish" but does not indicate if the task would include sanding the floor, which the lowest bid contract specifically excludes for this task. In addition, General Services' records do not reconcile original estimates to completed work, which often varied from the estimates. As a result, General Services could not provide us with a defined list of the tasks it had completed and their associated costs, making it impractical to compare the actual expenditures incurred by General Services to those of a private contractor.</p>
7	Review and assess the fees General Services charges for services it provides to maintain and repair state-owned properties along the SR 710 extension project right-of-way. Further, determine if Caltrans has explored alternatives to General Services providing services for the repair and maintenance of these properties.	<ul style="list-style-type: none"> Reviewed General Services' policies and procedures. Interviewed General Services' staff. Tested the fees General Services assesses to determine if it appropriately calculated and charged them. Reviewed Caltrans' analysis of alternatives to having General Services perform repairs.

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	AUDIT OBJECTIVE	METHODS
8	Determine what actions have been taken to assess the feasibility of completing the SR 710 extension project since the decision by the Federal Highway Administration in 2003 to rescind its record of decision.	<ul style="list-style-type: none"> • Interviewed Caltrans' staff. • Reviewed a summary of events provided by Caltrans.
9	To the extent possible, determine the amount of property tax revenue that would have been collected in the past five years and the amount that could be collected in the next five years if the state-owned properties along the extension project right-of-way were privately owned.	<ul style="list-style-type: none"> • Reviewed Caltrans' appraisers' estimates of the market value of the SR 710 properties. • Established fiscal year 2012–13 as the base year. Then, determined the rate of change for property values for fiscal years 2007–08 through 2011–12 and estimated the rate of change for fiscal years 2013–14 through 2017–18 using historical and forecast data from Moody's Analytics. • Determined a tax rate to apply to these home prices using tax information from the Board of Equalization. • Obtained property tax information from Los Angeles County's assessor.
10	Identify whether there are any restrictions on the use of proceeds from the sale of the state-owned properties along the extension project right-of-way.	Under the California Streets and Highways Code, Section 118, all proceeds from the sale of the SR 710 properties must be deposited in any fund in the State Treasury designated by the California Transportation Commission that is available to Caltrans for highway purposes. Regarding SR 710 properties that were purchased with revenues from motor vehicle fuel and use taxes, there is conflicting persuasive legal authority regarding whether the gains from these sales must be used for the transportation-related purposes specified for such revenues; however, these authorities agree that the principal from these sales must be used for the transportation-related purposes specified in the California Constitution.
11	To the extent possible, determine the approximate current market value of the state-owned properties along the extension project right-of-way.	<ul style="list-style-type: none"> • Interviewed Caltrans' staff. • Reviewed Caltrans' appraisers' estimates of the market value of the SR 710 properties.
12	Identify whether there are any alternatives to state ownership as a means of preserving the State's access to the right-of-way needed for the extension project.	<ul style="list-style-type: none"> • Interviewed Caltrans' staff and reviewed relevant documentation. • Reviewed relevant laws related to contracting for personal services and establishing a joint powers authority.
13	Review and assess any other issues that are significant to the extension project.	<ul style="list-style-type: none"> • Interviewed Caltrans' staff and reviewed relevant laws and policies related to the rental of the SR 710 properties. • Reviewed Caltrans' records to determine its assessments of market rental rates. • Compared rental rates Caltrans has charged to market rental rates. • Obtained information from Los Angeles County's auditor-controller on the distribution of rental income it receives from Caltrans for state-owned property, including the SR 710 properties. • Interviewed General Services' staff and reviewed relevant laws, policies, and procedures related to its oversight of repair project costs. • Analyzed labor hours charged to the SR 710 extension project by selected casual laborers who work for General Services' Direct Construction Unit (construction unit). • Reviewed General Services' construction unit's procurement practices related to selected small business. In addition, we contacted the small businesses to obtain supporting documentation for selected invoices.

Source: California State Auditor's analysis of Joint Legislative Audit Committee audit request number 2011-120 and the analysis of information and documentation identified in the table column titled *Methods*.

Assessment of Data Reliability

In performing this audit, we relied upon various electronic data files extracted from the information systems listed in Table 3. We adhere to the standards of the U.S. Government Accountability Office, which require us to assess the sufficiency and appropriateness of computer-processed information. Table 3 shows the results of this analysis.

Table 3
Methods of Assessing Data Reliability

INFORMATION SYSTEM	PURPOSE	METHOD AND RESULT	CONCLUSION
California Department of Transportation (Caltrans) Right-of-Way Property Management System (Caltrans database) Data as of February 9, 2012	To identify the number and types of State Route 710 extension project parcels and property units (SR 710 properties).	<ul style="list-style-type: none"> • We performed data-set verification procedures and electronic testing of key data elements and found no issues. • We performed completeness testing of the SR 710 properties by reconciling the Caltrans property records and acquisition maps to the Caltrans database and determined the data was complete. 	Sufficiently reliable for the purposes of this audit.
	To identify the total invoiced amount for contractors' repairs to SR 710 properties for the period from July 1, 2008, through December 31, 2011.	<ul style="list-style-type: none"> • We performed data-set verification procedures and electronic testing of key data elements and found no issues. • We performed accuracy testing on a random sample of 46 maintenance requests. Caltrans was not able to provide support for two sample items and we identified an additional 14 errors related to payment amounts. Due to the number of errors we identified, we stopped testing after 36 sample items. Further, because of the inaccuracies we identified in the payment amounts, we use invoiced amounts in our analysis. • Due to the number of errors we identified in our accuracy testing, we were able to determine the reliability of the data without conducting completeness testing. 	Not sufficiently reliable for the purposes of this audit. Nevertheless, we present these data, as they represent the best available data source of this information.
	To identify the rental income collected for each SR 710 property for the period from July 1, 2008, through December 31, 2011.	<ul style="list-style-type: none"> • We performed data-set verification procedures and electronic testing of key data elements and found no issues. • We performed accuracy testing on a random sample of 30 rental billings and payments for tenants and found four errors in the first 11 sampled items. Due to the number of errors, we did not test the remaining 19 items. • Due to the number of errors we identified in our accuracy testing, we were able to determine the reliability of the data without conducting completeness testing. 	Not sufficiently reliable for the purposes of this audit. Nevertheless, we present these data, as they represent the best available data source of this information.
	To identify the difference between the rents that Caltrans charged its tenants and the fair market rents for the SR 710 properties and the average age of the fair market rent determinations as of February 9, 2011.	<ul style="list-style-type: none"> • We performed data-set verification procedures and electronic testing of key data elements and found no issues. • We performed accuracy testing on a random sample of 30 rental rates Caltrans charged tenants and found four errors in the first nine sampled items. Due to the number of errors, we did not test the remaining 21 items. We also tested the accuracy of 30 fair market rents and their determination dates by tracing the data back to supporting documents. We found errors in seven of the fair market rents and in eight of the determination dates. 	Not sufficiently reliable for the purposes of this audit. Nevertheless, we present these data, as they represent the best available data source of this information.
	To estimate the amount of forgone rent for the period from July 1, 2007, through December 31, 2011, because Caltrans rented SR 710 properties below fair market value.	<ul style="list-style-type: none"> • Because of the number of errors we identified in our accuracy testing, we were able to determine the reliability of the data without conducting completeness testing. 	Not sufficiently reliable for the purposes of this audit. Nevertheless, we present these data, as they represent the best available data source of this information.
	To identify all tenants living in the SR 710 properties and compare the listing of tenants to the State Controller's Office's payroll records to determine if any of the tenants are state employees.	<ul style="list-style-type: none"> • We performed data-set verification procedures and electronic testing of key data elements and found no issues. • We performed accuracy testing on a random sample of 30 tenants and found no errors in this testing. • While performing completeness testing we identified a significant data limitation. Caltrans' database does not record all of the tenants living at a property. Thus, we may not have identified all of the state employees who were Caltrans' tenants. 	Not sufficiently reliable for the purposes of this audit. Nevertheless, we present these data, as they represent the best available data source of this information.

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INFORMATION SYSTEM	PURPOSE	METHOD AND RESULT	CONCLUSION
Department of General Services (General Services) Activity Based Management System (ABMS) Data as of March 2, 2012	To identify the total amount paid for General Services' repairs to the SR 710 properties for the period from July 1, 2008, through December 31, 2011. To identify hours charged by employees and descriptions of work performed for repairs to the SR 710 properties for the period from June 1, 2011, through December 31, 2011.	<ul style="list-style-type: none"> • We performed data-set verification procedures and electronic testing of key data elements and found no issues. • We did not perform completeness testing to identify all projects for SR 710 properties and the associated expenditures in ABMS because we were not able to identify a complete list of the projects or expenditures. Specifically, General Services' personnel could not provide a way to identify projects for SR 710 properties prior to January 2010. As a result, we could not ensure we identified a complete listing of projects for the SR 710 properties and the associated expenditures. • In our assessment of the accuracy of the ABMS data, we tested only key fields related to projects that we could identify as SR 710 property expenditures. Specifically, we pulled a random sample of 29 expenditures and tested the accuracy of these data by tracing the data to supporting source documentation. We found three errors in the time cards related to the first 16 expenditures we tested, so we did not test the remaining 13 items. 	Not sufficiently reliable for the purposes of this audit. Nevertheless, we present these data, as they represent the best available data source of this information.
State Controller's Office Payroll records Data as of March 2012	To identify if any of the tenants in Caltrans' database were state employees from July 2006 to March 2012.	We reviewed the testing of the payroll system's major control features performed as part of the State's financial audit for the fiscal years ending June 30, 2007, through June 30, 2011.	Sufficiently reliable for the purposes of this audit.

Sources: California State Auditor's analysis of various documents, interviews, and data obtained from Caltrans, General Services, and the State Controller's Office.

Chapter 1

CALTRANS' FAILURE TO ADEQUATELY MANAGE THE RENTAL OF STATE ROUTE 710 EXTENSION PROJECT PROPERTIES COSTS THE STATE MILLIONS OF DOLLARS EVERY YEAR

Chapter Summary

Although the California Department of Transportation's (Caltrans) right-of-way manual states that its policy is to charge fair market rents except under specific circumstances, it has charged the tenants of its State Route 710 extension project parcels and property units (SR 710 properties) rents that are far below market values for the past 10 years. Specifically, between July 1, 2007, and December 31, 2011, we estimate that Caltrans collected roughly \$22 million less in rent for these properties than it would have had it charged fair market rates. In comparing the below-market rents Caltrans charges to the expenditures for repairing the SR 710 properties, we found that Caltrans actually spent \$9.7 million more to repair the properties than it received in net rental income between July 1, 2008, and December 31, 2011, resulting in a net cost to the State of nearly \$2.8 million per year.

The roughly \$22 million difference between market-value rates and the rents Caltrans charged constitutes a gift of public funds, which the California Constitution expressly prohibits except under limited circumstances. In addition, for tenants who are state employees, the amount of the difference is potentially subject to income taxes. We found 15 state employees who were renting SR 710 properties at below-market rates as of February 9, 2012. We estimate that Caltrans is undercharging these employees by a total of \$229,000 each year. This constitutes income that should be reported for the employees' state and federal tax returns.

One of the exceptions to Caltrans' policy to charge fair market rates involves its affordable rent program, through which it rents 58 of the SR 710 properties to tenants for significantly below-market values. However, although Caltrans' right-of-way manual requires it to annually verify each tenant's income eligibility, it has not done so and therefore has no assurance that these tenants still qualify. Moreover, Caltrans' policy governing the affordable rent program may be unenforceable because it did not adopt regulations for the program in accordance with state law.

Caltrans Has Charged Rents Far Below Market Rates and Consequently Has Received Millions Less in Rental Income

As of February 9, 2012, Caltrans was renting 404 of the 449 available SR 710 properties. However, Caltrans rents most of these properties for rates that are significantly below market values. In fact, in comparing the rental income it collected to its costs to maintain the properties, we found that Caltrans spent more to maintain the properties than it collected in rent. Caltrans stated that it is not aware of any state law that requires it to collect sufficient rent to cover the costs of maintaining the properties. Nevertheless, we believe such an analysis is prudent for the State to consider when evaluating the management of the SR 710 properties. Table 4 shows that between July 1, 2008, and December 31, 2011, the net rental income Caltrans received for the SR 710 properties was nearly \$9.7 million less than the amount it paid to repair the properties. Consequently, the State had to make up the difference each year using funds primarily from the State Highway Account.

Table 4
Rental Income and Repair Expenditures for the State Route 710 Extension Project Properties

	FISCAL YEARS				TOTALS
	2008-09	2009-10	2010-11	2011-12*	
Rental income [†]	\$4,867,000	\$4,819,000	\$4,677,000	\$2,510,000	\$16,873,000
Less 24 percent provided to Los Angeles County [‡]	(1,168,000)	(1,157,000)	(1,122,000)	(602,000)	(4,049,000)
Net rental income	3,699,000	3,662,000	3,555,000	1,908,000	12,824,000
Repair expenditures					
Private contractors [§]	(2,266,000)	(1,754,000)	(1,144,000)	(520,000)	(5,684,000)
Department of General Services (General Services)	(3,266,000)	(4,461,000)	(4,303,000)	(4,781,000)	(16,811,000)
Total repair expenditures	(5,532,000)	(6,215,000)	(5,447,000)	(5,301,000)	(22,495,000)
Net rental income after expenditures	\$(1,833,000)	\$(2,553,000)	\$(1,892,000)	\$(3,393,000)	\$(9,671,000)

Sources: California State Auditor's (state auditor) analysis of revenue and expenditure data obtained from the California Department of Transportation's (Caltrans) Right-of-Way Property Management System and General Services' Activity Based Management System. Please refer to the Introduction's Scope and Methodology for the state auditor's assessment of the reliability of these data.

* Includes rental income and expenditures as of December 31, 2011.

† Rental income excludes fees that Caltrans collected from various sources such as deposits, late charges, and rejected check fees.

‡ The 24 percent calculation may not be precise because of rounding.

§ These amounts are for invoices received rather than expenses paid.

Caltrans Potentially Violates the State Constitution When It Does Not Charge Fair Market Rents to Its SR 710 Property Tenants

In violation of its policies, Caltrans has been charging the SR 710 property tenants rents that are significantly below fair market rates for the past 10 years. Caltrans' Division of Right of Way and Land Surveys (ROW headquarters division) issues a manual to ensure that its 12 district offices follow uniform procedures related to the right-of-way functions that we describe in the Introduction. The manual states that Caltrans' policy is to charge fair market rents and to rent only to tenants who are willing and able to pay these rates, although the policy allows for a few exceptions, such as the properties included in its SR 710 extension project affordable rent program, which we discuss later. The manual also states that Caltrans' policy is to review rental rates annually and increase them appropriately after giving proper notice to tenants. Specifically, the policy requires Caltrans to adjust rents that are 25 percent or less below fair market rates by 10 percent annually until the tenant's actual rent equals the market rate. For tenants whose rents are more than 25 percent below fair market rent, Caltrans' policy is to adjust the rent by 10 percent every six months until it is 25 percent or less below fair market rent and then adjust it by 10 percent annually until it reaches the market rate. Caltrans' standard residential rental agreement states that property rental is on a month-to-month basis and that it will review the rental rate annually and adjust the rent according to its policies after providing 60-day notice.

However, Caltrans has been charging the SR 710 property tenants rents that are significantly below fair market rates for the past 10 years. The chief of its ROW headquarters division stated that a former Caltrans director instructed the District 7 office not to raise rents. Specifically, in May 2002, Caltrans' District 7 office sent notices to the SR 710 property tenants who were paying less than 80 percent of the market rate announcing its plan to increase their rents effective August 1, 2002. However, in response to a letter from and a subsequent meeting with a member of the Legislature, the former director sent a letter dated August 13, 2002, to the legislator stating that Caltrans had suspended all rent increases until January 1, 2003. According to staff in Caltrans' District 7 office and information we received from its audits and investigations division, the former director subsequently extended the suspension through August 2006.

In August 2007 Caltrans' ROW headquarters division staff prepared a request to the governor's office seeking the governor's approval regarding the disposition of the SR 710 properties, which included an alternative that would require Caltrans to continue to manage the properties and to immediately raise the tenants' rent by 15 percent annually until the rents were at the market rate.

Caltrans has been charging the SR 710 property tenants rents that are significantly below fair market rates for the past 10 years.

Caltrans' rental of the SR 710 properties at below-market values may constitute a prohibited gift of public funds.

However, according to the chief, Caltrans did not receive a response from the governor's office and has therefore not taken any action to raise rents since 2007. Further, the chief of the ROW headquarters division stated that it is the division's current policy not to raise the rents for the tenants in SR 710 properties without instruction from Caltrans' director, and that the division would advise the director to communicate with the governor before making a decision.

Our legal counsel advised us that Caltrans' rental of the SR 710 properties at below-market values may constitute a prohibited gift of public funds. Section 6 of Article 16 of the California Constitution prohibits gifts of public funds unless they serve a public purpose, such as that served by the affordable housing terms of the Roberti Bill. In fact, as an additional explanation of why it has not raised rents, the deputy district director of Caltrans' District 7 office stated that an Office of the Attorney General's (attorney general) opinion related to the Roberti Bill (which we discuss in the Introduction) does not prohibit Caltrans from charging its tenants below-market rents. However, our legal counsel advised us that the opinion in question, which was written in 2009, expressly applies only to property that qualifies under the Roberti Bill as "surplus residential property" and that serves the public purpose of the affordable housing terms of the Roberti Bill. State law defines surplus residential property as "land and structures owned by any agency of the state that is determined to be no longer necessary for the agency's use, and that is developed as single family or multifamily housing, except property being held by that agency for the purpose of exchange." The attorney general's opinion would apply to the SR 710 properties only if they met this definition, and it does not appear that they do.

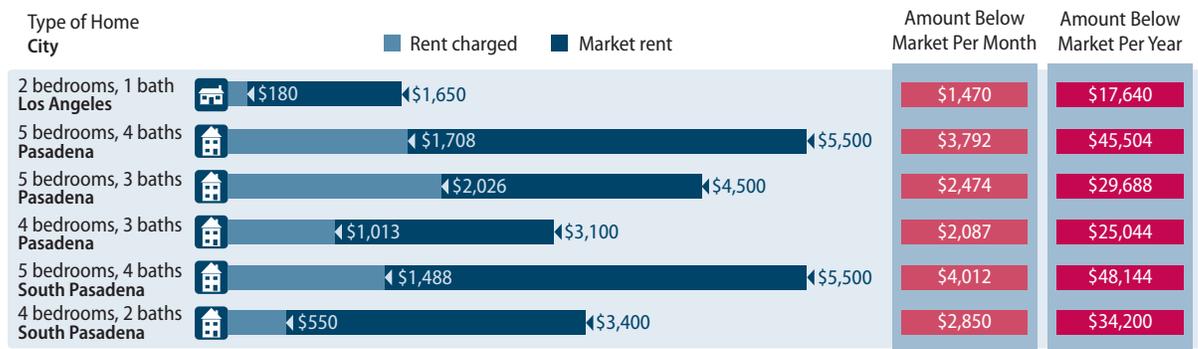
Moreover, even if the SR 710 properties met this definition, our legal counsel advised us that the attorney general's opinion would apply only if the below-market rentals also served the public purposes of the Roberti Bill, which include preserving and expanding the low- and moderate-income housing supply. According to the chief of its ROW headquarters division, any rents that are below fair market rates and that are not a part of the affordable rent program, which we discuss later, are a result of Caltrans not raising the rents to market values. Thus, it does not appear as though these below-market rentals serve a public purpose. In our November 1996 report titled *Department of Transportation: Further Improvements Can Be Made in the Management of Properties Along the State Route 710 Right-of-Way*, we recommended that Caltrans charge market-rate rents for its properties unless it documents that a lower rate is justified. In his response to the audit, the secretary of the Business, Transportation and Housing Agency at that time concurred with our recommendations. Thus, by charging below-market rates that do not serve a public purpose, Caltrans is making a gift of public funds in violation of the California Constitution.

Caltrans' Failure to Prepare Annual Market Rent Determinations Makes It Difficult to Determine How Much the State Could Be Charging Its Tenants

In violation of its policies, Caltrans also has not prepared annual fair market rent determinations for the SR 710 residential properties. Caltrans' right-of-way manual states that, as part of its annual review of the rental rates, its property management staff should prepare these determinations, which represent an estimate of the amount of rent the properties could command in the open market if Caltrans were to offer them under the terms and conditions typical of the market for similar properties. However, as of February 9, 2012, Caltrans' market determinations for the 345 properties it was renting—or 77 percent of its rentable property inventory—were, on average, nearly four years old, and nine of them were more than 10 years old. One property did not have a determination. We discuss Caltrans' market determinations for the 58 properties in its affordable rent program later.

Using Caltrans' outdated determinations as a basis, our review found that the monthly rents Caltrans charges for the 345 properties average 43 percent less than their fair market rents. These determinations suggest that Caltrans charges the SR 710 property tenants rents that are nearly \$3.8 million per year below market rates. However, this amount could be significantly higher because Caltrans' fair market rent determinations are outdated and, according to the federal Bureau of Labor Statistics, the rent for primary residences in the Los Angeles region increased by almost 2.5 percent between January 2009 and April 2012.⁵ Figure 4 provides examples of the below-market rental rates Caltrans charges some SR 710 property tenants.

Figure 4
Examples of Below-Market Rents Charged by the California Department of Transportation



Sources: California State Auditor's (state auditor) analysis of data obtained from the California Department of Transportation's (Caltrans) Right-of-Way Property Management System as of February 9, 2012. Please refer to the Introduction's Scope and Methodology for the state auditor's assessment of the reliability of these data. In addition, the state auditor obtained the type of home and city for these properties from Caltrans' parcel information records located in its District 7 office.

⁵ The Los Angeles region includes Los Angeles, Riverside, and Orange counties.

Between July 1, 2007, and December 31, 2011, we estimate that Caltrans chose to forego roughly \$22 million in rental income for the SR 710 properties and cost Los Angeles County \$5.3 million in potential revenue.

Because Caltrans retains its most recent fair market rent determinations only for properties with current tenants and then for only three years after a change in tenancy, we could not estimate how much Caltrans has cost the State in forgone rental income for the SR 710 properties since 1995. However, between July 1, 2007, and December 31, 2011, we estimate that Caltrans chose to forego roughly \$22 million in rental income for the SR 710 properties. Further, as we discuss in the Introduction, 24 percent of this revenue would have been shared with Los Angeles County. We estimate that Caltrans' actions cost the county \$5.3 million in potential revenue, which it would have shared with the county's other revenue districts and taxing agencies and the cities in which the properties are located. Caltrans asserted that it recently prepared market rent determinations for all SR 710 properties; however, these determinations were completed as recently as June 23, 2012, which was subsequent to the end of our fieldwork.

Potential Tax Implications Exist for State Employees Who Rent SR 710 Properties at Below-Market Rates

In performing our analyses of the rent Caltrans charges to its SR 710 property tenants, we identified 16 state employees who were renting SR 710 properties as of February 9, 2012. While one of these state employees was paying the fair market rental rate, the other 15 were paying between \$50 and \$1,950 per month below market values, a discount of between \$600 and \$23,400 per year. Figure 5 on page 26 depicts information related to the state employees who were renting SR 710 properties at below-market rates as of February 9, 2012. In addition to the employees shown in Figure 5, we noted that 14 other state employees had previously rented SR 710 properties at below-market rents during the period we reviewed.

As previously discussed, our legal counsel advised us that unless Caltrans' rentals of the SR 710 property at below-market rents serves a public purpose, it constitutes a gift of public funds in violation of Section 6 of Article 16 of the California Constitution. For state employees, although the gift would be improper under the state constitution, the difference between such rentals and their fair market value would also be subject to federal and state income tax as employer-provided gifts. If the below-market rentals to the employees serve a public purpose and thereby are not an improper gift, the difference between the fair market rent of the property and the rent paid by the employees could constitute income in the form of compensation from a fringe benefit and must be included in the employees' gross income unless all three of the following conditions are met: (1) The housing is on the business premises of the employer, (2) the lodging is provided for the convenience of the employer, and (3) the employee is required to accept the housing as a condition of his or her employment. For federal and state income tax purposes, the State Controller's Office (state controller) is the designated employer on behalf of the State of California. The state controller's payroll procedures manual states that the difference between the fair market rental value of employer-provided housing and the rent the employee pays for that housing is reportable tax

income. Further, according to the state controller's payroll procedures manual, the business premises of the employer means the place where the employee performs a significant portion of his or her duties. The manual also states that to meet this requirement, the housing must be on the employer's premises, not near the premises. California uses a standard form for agencies to report the value of state housing to the state controller on a monthly basis.

When asked, only three state agencies whose employees rent SR 710 properties reported that they provide housing as a condition of employment in the cities of Pasadena, South Pasadena, or Los Angeles. Specifically, California State University, Los Angeles, stated that seven of its Housing Services employees must reside on campus as a condition of their employment. Similarly, California State University, Northridge, stated that 10 of its employees must reside on campus as a condition of their employment. Because these university employees do not reside in SR 710 properties, they are not included in Figure 5. In addition, Caltrans stated that it provides housing as a condition of employment to four employees at its state-owned property in Chilao, but when this housing was destroyed in a fire, it temporarily relocated the employees to SR 710 properties in September 2009 and June 2010. The four employees are not included in Figure 5 because they were no longer renting the SR 710 properties as of February 9, 2012. These employees rented the SR 710 properties at rates between \$306 and \$466 per month, which was almost the same as the rate they paid to rent the state-owned property in Chilao. Caltrans stated that for 2009 and 2010 it reported the value of this housing for three employees to the state controller for inclusion in their gross income.

However, our review of the amounts reported by Caltrans to the state controller for the three employees found that it did not consider the value of the SR 710 properties when calculating the fringe benefit. Specifically, instead of using the fair market value of the SR 710 properties to calculate the amount to report, Caltrans used the fair market value of the Chilao properties. As a result, Caltrans underreported the monthly fringe benefit amount for these employees by as much as \$1,550. Caltrans stated it did not report information for the fourth employee because the fair market value was determined to be lower than the value of the housing received. However, if Caltrans had used the fair market value of the SR 710 property to calculate the fringe benefit, rather than the fair market value of the Chilao property, it would have reported \$1,385 more each month for this employee. Further, Caltrans stated that since January 2011 it has not reported the value of state housing for its employees to the state controller on a monthly basis because its information technology division has had problems generating the necessary payroll deduction data. The chief of Caltrans' travel policy section stated that he continues to work with the information technology division to generate the report that the travel policy section needs to resume reporting the value of housing information to the state controller.

Caltrans stated that since January 2011 it has not reported the value of state housing for its employees to the state controller on a monthly basis because its information technology division has had problems generating the necessary payroll deduction data.

Figure 5
State Employees Renting State Route 710 Extension Project Properties at Below-Market Rates as of February 9, 2012

Employee	Department	Effective Occupancy Date	Type of Home City	Rent charged	Market rent	Amount Below Market Per Month	Amount Below Market Per Year
A	California State University, Los Angeles	8/30/1974	4 bedrooms, 3 baths Pasadena	\$1,650	\$3,600	\$1,950	\$23,400
B	California State University, Los Angeles	11/15/1992	3 bedrooms, 1 bath South Pasadena	\$1,476	\$2,800	\$1,324	\$15,888
C	California State University, Los Angeles	8/1/1999	1 bedroom, 1 bath South Pasadena	\$550	\$1,050	\$500	\$6,000
D	California State University, Pomona	11/10/1994	3 bedrooms, 3 baths South Pasadena	\$1,563	\$3,300	\$1,737	\$20,844
E	Department of Health Care Services	3/1/1992	2 bedrooms, 1 bath Los Angeles	\$840	\$1,650	\$810	\$9,720
F	Department of Motor Vehicles	11/14/1987	2 bedrooms, 1 bath Los Angeles	\$750	\$1,575	\$825	\$9,900
G	Department of Motor Vehicles	6/1/1997	2 bedrooms, 1 bath Los Angeles	\$849	\$1,700	\$851	\$10,212
H	California Department of Transportation	12/15/1995	3 bedrooms, 1 bath Los Angeles	\$870	\$1,785	\$915	\$10,980
I	California Department of Transportation, District 7	8/1/2010	2 bedrooms, 1 bath Los Angeles	\$800	\$1,550	\$750	\$9,000
J	California Department of Transportation, District 7	1/1/1996	3 bedrooms, 1 bath Los Angeles	\$1,045	\$2,000	\$955	\$11,460
K	California Department of Transportation, District 7	6/8/2002	2 bedrooms, 1 bath Los Angeles	\$565	\$1,350	\$785	\$9,420
L	Employment Development Department	4/14/2011	1 bedroom, 1 bath Los Angeles	\$850	\$900	\$50	\$600
M	Employment Development Department	6/10/1996	2 bedrooms, 1 bath Los Angeles	\$750	\$1,500	\$750	\$9,000
N	Military Department	3/4/1986	2 bedrooms, 1 bath Los Angeles	\$800	\$1,575	\$775	\$9,300
O	State Water Resources Control Board	8/1/2003	2 bedrooms, 2 baths South Pasadena	\$1,250	\$2,400	\$1,150	\$13,800

Sources: California State Auditor's (state auditor) analysis of data obtained from the California Department of Transportation's (Caltrans) Right-of-Way Property Management System and State Controller's Office payroll records. Please refer to the Introduction's Scope and Methodology for the state auditor's assessment of the reliability of these data. In addition, the state auditor obtained the type of home and city for these properties from Caltrans' parcel information records located in its District 7 office.

In all other instances, the state agencies stated that they did not provide housing as a condition of employment in the cities of Pasadena, South Pasadena, or Los Angeles. For the Caltrans' employees shown in Figure 5, the chief of the ROW headquarters division stated that the below-market rents were a result of Caltrans not raising rents to market values. The remaining state agencies were not aware until we brought it to their attention that their employees were renting SR 710 properties from Caltrans at below-market rates. Because these state agencies maintain the personnel information for these employees, they are responsible for reporting as taxable income the difference between the fair market rental value of the SR 710 housing and the rent their employees actually pay for that housing. However, because Caltrans maintains the SR 710 property rental records, it seems reasonable that it should notify the other state agencies of their employees who are renting SR 710 properties at below-market rents so that they can properly submit the information to the state controller. To accomplish this task, Caltrans' District 7 office would need to provide its accounting staff at headquarters with a list of relevant information for state employee tenants, which it does not currently do.

Caltrans Has Not Regularly Reviewed Income Eligibility for Tenants in Its Affordable Rent Program, and the Policy Governing the Program May Be Unenforceable

As previously mentioned, Caltrans' right-of-way manual states that its policy is to charge fair market rents, with certain exceptions. One of these exceptions involves tenants who originally qualified for affordable rent before March 3, 1981. According to Caltrans' manual, before March 3, 1981, Caltrans put into effect administrative controls limiting rent increases to protect lower-income tenants from a rapidly rising real estate market. Caltrans initiated a new residential rental rate policy on March 3, 1981, with the goal of raising rents to fair market rates when possible. However, to avoid imposing severe hardship on existing lower-income tenants, the policy established an affordable rent program for qualifying tenants. To qualify for the program, the tenants must meet four criteria:

- Occupy the property on or before March 3, 1981.
- Have a gross annual household income that does not exceed 120 percent of the area median household income for a family of four.
- Be ineligible for monetary relocation benefits under the federal Uniform Relocation Assistance and Real Property Acquisition Policies Act of 1970.
- Be paying less than fair market rent on March 3, 1981.

Using Caltrans' market rent determinations, we estimate that each year Caltrans charges the tenants in its affordable rent program rents that total at least \$940,000 less than market rates. In one instance, Caltrans is renting a house in Pasadena that has a monthly fair market rent of \$2,750 for \$310 per month.

As of February 9, 2012, Caltrans was renting 58 of the SR 710 properties to tenants under its affordable rent program for significantly below-market rates. Our review found that the average monthly rents Caltrans was charging for the 58 properties were 26 percent of the market rents it had identified in its determinations, which at that time were themselves an average of more than four years old. The right-of-way manual states that Caltrans will charge qualified tenants the lower of the fair market rent or 25 percent of their anticipated gross monthly household income. For example, in accordance with its policy, Caltrans is renting a four-bedroom, three-bathroom house in the city of Pasadena that has a fair market rent of \$2,750 per month for \$310 per month. According to Caltrans' files, this tenant reported a gross income of \$1,114 per month on June 1, 2010. Using Caltrans' market rent determinations, we estimate that each year Caltrans charges the tenants in this program rents that total at least \$940,000 less than market rates.

Although the chief of Caltrans' ROW headquarters division stated that the affordable rent program serves a public purpose because it subsidizes housing for individuals with low- or moderate incomes, we found that the District 7 office has not been performing required eligibility verifications for the tenants in the program to ensure that they still meet the income requirements. The 2012 income limits published by the California Department of Housing and Community Development set the area median income for a family of four residing in Los Angeles County at \$64,800. Thus, the income for the tenants currently in the affordable rent program cannot exceed \$77,760, which is 120 percent of \$64,800. Caltrans' right-of-way manual instructs the district to annually review the tenants' household income and to document their income using an income certification form; if the tenants fail to provide complete or accurate income information, they will no longer qualify for the program. However, the deputy district director of Caltrans' District 7 ROW division stated that the district has not completed these income certifications on an annual basis because it has not had sufficient staff to do so. In addition, he stated that although the district receives funding for both project delivery and nonproject delivery functions such as property management, the right-of-way agents prioritize project delivery because it is Caltrans' primary mission. He also stated that because the district received two additional right-of-way agents in March 2012, it will begin doing the income certifications.

Nevertheless, because Caltrans has not completed annual eligibility verifications, it cannot be sure that all of the tenants continue to qualify for the program. The right-of-way manual allows Caltrans to increase the tenants' rent to the fair market rate if the household income exceeds the income requirement or if one of the income-producing tenants in the household is replaced by a new tenant. By identifying those tenants who may no longer qualify

for the program and charging them fair market rents, Caltrans could potentially generate an average of \$16,200 each year for each of the 58 properties. Further, Caltrans' lack of annual income certifications prevents it from verifying the combined income of all occupants residing at the property using information such as W-2 forms and income tax returns to ensure that only the tenants listed on the rental agreement still reside in the home and that those tenants have not sublet the property.

Finally, our legal counsel advised us that a court would likely hold that the section of Caltrans' right-of-way manual that establishes the affordable rent program is unenforceable because it establishes rules that meet the definition of *regulations* in the Administrative Procedure Act (APA), yet Caltrans did not adopt the program in accordance with the APA. State law authorizes Caltrans to lease any lands held but not presently needed for highway purposes under the terms and conditions its director determines. Because the section of the manual governing the program specifies how Caltrans will determine the fair market rent to charge and the circumstances under which it will consider charging less than fair market rent for a certain class of tenants (those residing in the SR 710 properties on or before March 3, 1981), it could be viewed as meeting the definition of a regulation because it establishes rules of general application for implementing that state law. State law generally requires state agencies to follow the APA when issuing regulations, which allows the public and the Office of Administrative Law to vet them. A regulation adopted in accordance with the APA has the force of a law, but a regulation adopted by an agency without complying with the APA generally cannot be enforced. State law defines these as underground regulations.

Because Caltrans did not comply with the APA when establishing its affordable rent program, the public has not had the opportunity to provide input on those regulations. Further, Caltrans has created the risk that someone may sue to have a court declare the regulations invalid, which would increase the State's legal costs.

Recommendations

To ensure that it collects fair market rents for the SR 710 properties on the State's behalf, Caltrans should do the following:

- Using the fair market rent determinations for all SR 710 properties it recently prepared, excluding those in its affordable rent program, adjust the tenants' rents to fair market rents after providing them with proper notice.
- Make only limited exceptions to charging fair market rent and document the specific public purpose that is served in any case where it does not charge fair market rent.

To ensure that all taxable fringe benefits or gifts state employees receive are appropriately included in their gross income, Caltrans should take the following actions:

- Establish procedures to notify state employees who rent SR 710 properties that they may be subject to tax implications.
- Continue to work with its information technology division to generate the reports necessary for it to provide the state controller with the value of the state housing its employees receive monthly.
- Work with the state controller to identify the statute of limitations for employers to report adjustments to employee gross income to the federal Internal Revenue Service and the California Franchise Tax Board.
- Work with the state controller to identify the difference between the fair market rental value of the SR 710 housing and the rent state employees paid for that housing during the applicable calendar years within the federal and state statute of limitations.
- Work with the state controller to determine whether it needs to revise the W-2 forms for the other employees to whom Caltrans provided housing benefits, including the four employees who worked at its Chilao Maintenance Station.
- Provide information to the other state agencies so that they can submit the standard form for reporting the value of the housing provided to their employees for the applicable past calendar years to the state controller. Caltrans should continue to submit this information monthly to the applicable state agencies until state employees are no longer renting the SR 710 properties at below-market rates.

To ensure that the affordable rent policy is enforceable and that only eligible tenants receive the benefit of the policy, Caltrans should do the following:

- Adopt regulations in accordance with the APA if the director determines that it is appropriate to continue to offer affordable rent to certain tenants.
- Annually review and document the tenants' household incomes using income certification forms. If tenants no longer qualify for the program because their income exceeds the income requirement or one of the income-producing tenants in the household has been replaced by a new tenant, it should increase their rent to fair market rates after giving proper notice.

Chapter 2

CALTRANS' INADEQUATE OVERSIGHT OF THE REPAIRS TO STATE ROUTE 710 EXTENSION PROJECT PROPERTIES HAS RESULTED IN POTENTIALLY UNNECESSARY WORK AND EXCESSIVE COSTS

Chapter Summary

The California Department of Transportation (Caltrans) has not appropriately managed repairs related to the State Route 710 extension project parcels and property units (SR 710 properties). Our review of 30 projects found that in most cases Caltrans was unable to demonstrate that the repairs it paid for were necessary and reasonable or that they were cost-effective. For example, it will take more than three years of rental income to recover the repair costs for 20 of the properties, and for seven of the 20 properties, it will take more than nine years of rental income to recover the costs. Moreover, Caltrans has poorly managed the Department of General Services' (General Services) repairs to the SR 710 properties. Caltrans transferred an average of \$4.7 million annually to General Services to conduct repairs since fiscal year 2005-06; however, for at least the past six years, the agencies have been operating without an interagency agreement. Caltrans has also not appropriately evaluated alternatives to hiring General Services to perform the repair work, and it has not monitored General Services' expenditures to ensure that work on the properties is consistent with approved repair estimates.

Caltrans Could Not Demonstrate That Many Repairs to the SR 710 Properties Were Necessary and Reasonable

In violation of its own policies, Caltrans could not provide evidence that many of the repairs it paid General Services or private contractors to perform on SR 710 properties were necessary. We reviewed 30 repair projects Caltrans primarily initiated between July 1, 2008, and December 31, 2011, for which it paid nearly \$2.2 million, or nearly 10 percent of its total repair expenditures for this period. General Services performed the repairs for 24 of the 30 projects, while private contractors performed the repairs for the other six. For 11 of General Services' 24 repair projects, Caltrans' records did not include documentation that the repairs were necessary, such as notes, photographs, or the results of its annual and emergency inspections.

We found that for six of the 30 repair projects we tested, change orders increased the initial estimated project costs by an average of 64 percent without sufficient documentation of why the changes were necessary.

For some of these projects, the final repair costs were significantly higher than the original estimates, yet Caltrans could provide no evidence of the need for the additional work. Overall, we found that for six of the 30 repair projects we tested, change orders increased the initial estimated project costs by an average of 64 percent without sufficient documentation of why the changes were necessary. For example, the scope of work for one project originally consisted of replacing the roof on an unoccupied 2,574 square foot single-family residence and garage at an estimated cost of \$56,535. However, the estimated cost was amended by a \$140,163 change order to perform miscellaneous interior repairs for a total estimated cost of \$196,698. The actual final cost of the project was \$184,253, which was 15 percent of Caltrans' estimated market value of \$1.2 million for the property. The majority of the change order related to painting the interior of the residence and upgrading two bathrooms, but it did not identify why the repairs were necessary. When asked, the senior right-of-way agent for property maintenance in Caltrans' District 7 office stated that these repairs occurred before he was hired.

When we asked the senior right-of-way agent about the remaining five projects, he stated that he did not know the reasons for the changes primarily because they either occurred before he was hired, or General Services may have discovered more work that needed to be done when performing repairs. General Services' Direct Construction Unit (construction unit) manual defines *discovery items* as unknown conditions that require action, such as abating asbestos, lead paint, or mold or addressing structural defects because of termites or dry rot. Yet Caltrans' files for these five projects did not indicate that such conditions were present. In fact, one change order in the amount of \$107,665 changed the scope of the project to include performing miscellaneous repairs to the second floor of a 2,920 square foot single-family residence that the original scope of the project specifically excluded. In total, Caltrans paid \$426,762 for this repair project, which was 33 percent of Caltrans' estimated market value of \$1.3 million for the property. Finally, in three of these instances, Caltrans was unable to provide us with a copy of the approved change orders and we had to obtain them from General Services. Without documentation to support the rationale for the change orders, we cannot conclude that the additional work was necessary or reasonable.

This failure to document the reasons for the repairs it performed violates Caltrans' policies. Caltrans' Division of Right of Way and Land Surveys' (ROW headquarters division) manual states that district offices will perform field inspections of all properties at least annually to ensure that Caltrans maintains them as well as, or better than, the other properties in the neighborhood. The manual requires the agent to use a checklist for interior and exterior inspections to document the

property's condition, any storm water concerns, and any deficiencies. The agents must also solicit the tenants' comments and concerns and note them on the back of the inspection form. The agent is to keep a log of the deficiencies he or she notes during the inspection and the actions Caltrans takes to resolve them. For emergency repairs, the manual states that the agent is responsible for determining if the extent of a maintenance deficiency classifies it as an emergency situation by physically inspecting the property and identifying any health and safety concerns. If the agent determines that an emergency condition exists, the agent must schedule corrective measures within 24 hours.

However, Caltrans has not routinely performed annual field inspections to determine if property repairs are necessary. For example, the district did not conduct inspections in a timely manner for 12 of the 30 properties we reviewed. The chief of property services in Caltrans' District 7 office stated that the district did not conduct inspections on an annual basis because its priority was addressing emergency maintenance issues and managing repairs of vacant units to make them rentable. In addition, the deputy district director stated that the right-of-way agents prioritize transportation project delivery first; then repairs that affect the life, health, and safety of the tenants; and finally nonproject delivery functions such as property management. However, because Caltrans did not routinely perform annual field inspections, we cannot conclude that the repair work performed was necessary or reasonable.

Caltrans asked General Services to complete an assessment of roof conditions for many SR 710 properties in 2008 and 2009. Our review of the roof assessments for 13 of General Services' 22 non-emergency repair projects found that it had rated two roofs as "Grade A" and did not include an assessment for another, yet all received roof repairs. According to the District 7 senior right-of-way agent, an "A" grade means that the roof has up to 10 years of remaining life. The district's senior right-of-way agent could not explain why a roof with a Grade A rating would require repairs, stating that the repairs occurred before he was hired and he is not sure of the reason repairs were made to roofs in good condition. The expenditure records indicate that \$208,980 was spent on these three repair projects. For the first project related to a 1,157 square foot single-family residence with the roof rated as "Grade A", the roofing repairs cost \$26,953. For the other project related to a 1,380 square foot single-family residence with the roof rated as "Grade A" the roofing repairs cost \$13,386. We were unable to determine the exact cost of the third roofing project related to a 23,786 square foot industrial property because the records do not separately itemize the costs and, according to General Services' staff services manager, it does not typically reconcile the estimates with the actual expenditures once it completes a project. General Services estimated that the roof repairs for this project would cost \$88,212.

Because Caltrans did not routinely perform annual field inspections, we cannot conclude that the repair work performed was necessary or reasonable.

Although a deputy district director stated that it performs comparisons informally to determine the cost-effectiveness of completing repairs, Caltrans could not provide evidence that it compared the estimates for any of the 30 repair projects we reviewed to the demand for rentable SR 710 properties.

Moreover, Caltrans could not provide evidence that it compared the estimates for any of the 30 repair projects to the demand for rentable SR 710 properties, despite the fact that the deputy district director of Caltrans' District 7 right-of-way division stated that it performs such comparisons informally to determine the cost-effectiveness of completing the repairs. Specifically, although he was unable to provide us with a written policy, the deputy district director asserted that when assessing the cost of repairs to make an unoccupied nonhistoric property habitable, it considers the repairs to be financially infeasible if the district cannot recover the cost of repairs for the property through rental income within three years, and in such cases will board up the property. The deputy district director stated that if an occupied property becomes uninhabitable, Caltrans has the option of moving the tenant to a habitable property and then evaluating the cost-effectiveness of repairing the property that has become uninhabitable. The deputy district director also pointed out that the California Civil Code, sections 1941 and 1942, govern the repair and habitability of occupied rental property.

Our legal counsel advised us that Civil Code, Section 1941, requires Caltrans, as a landlord of the SR 710 properties, to put them in a condition fit for human occupation and to repair subsequent dilapidations that render the properties uninhabitable, except in cases in which an SR 710 property tenant must repair the property when repairs are required as a result of the tenant's negligence. Civil Code, Section 1941.1, specifies certain property conditions that make a property uninhabitable, including a substantial lack of any of the following: effective waterproofing and weather protection of the roof and exterior walls, including unbroken windows and doors; plumbing or gas facilities; a water supply approved under applicable law that is under control of the tenants, capable of producing hot and cold running water, or a system that is under control of the landlord that produces hot and cold running water; heating facilities that conformed with applicable law at the time of installation; electrical lighting, with wiring and electrical equipment that conformed with applicable law at the time of installation; and areas free from all accumulations of debris, filth, rubbish, garbage, rodents, and vermin.

However, Civil Code, Section 1942, does not require a landlord such as Caltrans to make repairs; rather, it provides a remedy for tenants whose landlord fails to make repairs. Specifically, if a reasonable amount of time has passed since a tenant provided notice to his or her landlord that a property needs repairs because it is uninhabitable, and the landlord has failed to make the repairs, the tenant is authorized to either (1) vacate the property and be excused from further rent payments or (2) repair the property and deduct the cost of repairs from his or her monthly rent, as long as the cost of the repairs does not exceed one month's rent. Further, Civil Code, Section 1942.5(a), provides Caltrans the option of removing the

property from the rental market after providing 180 days' notice to the tenant. Finally, in 2003 the California Supreme Court held that California Government Code, Section 7060, called the Ellis Act, permits landlords "to go out of business" in good faith. Our legal counsel advised us that this court ruling allows Caltrans to remove an SR 710 property from the rental market if it determines in good faith that the cost of repairing the property is unreasonable.

We also found that Caltrans often failed to consider the cost-effectiveness of the repairs it performed on historic properties. Of the nearly \$2.2 million spent on the properties for the 30 repair projects we tested, more than \$1.2 million was spent on repairing eight historic residential properties. For those eight projects, Caltrans did not perform any cost analyses, although its policy states that all repair work for historic properties will be designed as cost-effectively as possible. In fact, the deputy district director pointed out that the 1999 federal court case *City of South Pasadena v. Slater*, commonly referred to as the Slater case, governs the district's maintenance decisions related to historic properties, and our legal counsel advised us that the Slater case expressly authorizes Caltrans to forgo making repairs if the condition of the property is such that the repairs would constitute waste. However, the senior environmental planner in the District 7 office's environmental branch stated that Caltrans does not perform cost analyses as a normal course of business because it is not required to do so and it would involve funds that would otherwise go toward maintenance and repairs. The senior environmental planner also stated that she receives an analysis of the cost of materials for some specific work from General Services to justify her decisions when necessary, as opposed to getting independent cost estimates from outside contractors.

We believe that when considering the cost of repairs, the district should generally apply its three-year time frame for recouping such costs through rental income to all types of repairs. Our analysis of Caltrans' total expenditures between July 1, 2008, and December 31, 2011, for the 30 properties we tested indicated that it would take more than three years of rental income to recover the total repair costs for 20 of the properties. Historic residential properties generally have additional repair requirements, which we discuss in Appendix C, and as a result some exceptions may need to be made to the three-year cost recovery time frame. For example, our analysis showed that the average cost-recovery period for repairs Caltrans performed on the eight historic properties is more than four years, while the cost-recovery period for the nonhistoric properties is more than six years. Table 5 on the following page shows the cost-recovery periods for the 30 properties we tested. Until Caltrans performs cost-effectiveness analyses for the repairs it makes, it cannot ensure that they are reasonable and the best use of the State's resources.

Of the nearly \$2.2 million spent on the properties for the 30 repair projects we tested, more than \$1.2 million was spent on repairing eight historic residential properties and, for those eight projects, Caltrans did not perform any cost analyses.

Table 5
Cost-Recovery Period for Repairs to 30 State Route 710 Extension Project Properties

COST-RECOVERY PERIOD	PROPERTY UNIT TYPE	
	HISTORIC	NONHISTORIC
Three years or less	3	7
More than three years up to six years	4	6
More than six years up to nine years	0	3
More than nine years	1	6
Totals	8	22

Sources: California State Auditor's (state auditor) analysis of data obtained from the Department of General Services' Activity Based Management System's expenditures and the California Department of Transportation's Right-of-Way Property Management System's expenditure and rental income records. Please refer to the Introduction's Scope and Methodology for the state auditor's assessment of the reliability of these data.

Notes: The cost-recovery period is the number of years of rental income required to recoup the repair expenditures for the property.

The costs are based on expenditures from July 1, 2008, through December 31, 2011. However, some expenditures, such as emergency repairs, may not identify the address where the work was done. Therefore, we may not have included all expenditures related to the 30 properties for this time period. The rental income is based on rental rates effective February 9, 2012. For properties not rented as of February 9, 2012, we used Caltrans' most recent market rent determination.

Caltrans Poorly Manages General Services' Repairs to the SR 710 Properties

Although Caltrans has transferred funds to General Services to perform repairs on the SR 710 properties for at least the past six years, it did not enter into a contract with General Services until December 2011, and it has not sufficiently evaluated alternatives to having General Services perform its repairs. In addition, Caltrans' records do not demonstrate that it has been appropriately monitoring General Services' repair work.

For Years, Caltrans Paid General Services Millions of Dollars Annually Without a Contract

Caltrans has paid General Services to repair the SR 710 properties since at least fiscal year 2005–06 without an interagency agreement, routinely transferring an average of \$4.7 million to General Services each year primarily to perform repairs on these properties. State law authorizes state agencies such as Caltrans and General Services to contract with each other to perform work, subject to the approval of the director of General Services. However, the last agreement between Caltrans and General Services was executed in July 1996, with the term of the agreement ending on June 30, 1999.

Therefore, until December 30, 2011, Caltrans had no agreement in place with General Services despite the significant amount of money it paid each year.

Moreover, when Caltrans finally entered into a formal agreement with General Services on December 30, 2011, it did not follow state requirements for doing so. The *State Contracting Manual* recommends that agencies execute interagency agreements using the standard state form and that they include, among other things, a statement acknowledging the advance payment amount and provisions stating that the charges will be computed in accordance with the full cost-recovery policy in the *State Administrative Manual*. The full cost-recovery policy states that the agency performing a service should charge its client the full cost directly attributable to the activity plus a fair share of its indirect costs. However, Caltrans did not enter into an interagency agreement with General Services using the recommended standard state form. Instead, on December 30, 2011, Caltrans and General Services' construction unit executed a memorandum of understanding that does not include a clause to address the full cost-recovery policy.

The deputy district director of Caltrans' District 7 right-of-way division (ROW division) stated that he did not request an interagency agreement because he was told by the chief of General Services' construction services branch that General Services does not enter into interagency agreements. Consequently, the deputy district director thought that the Public Works Board Authorization and Transfer Request (transfer request) the district uses to transfer funds to General Services to perform repairs for the SR 710 properties was sufficient. The transfer request allows Caltrans to make advance payments to General Services, as we discuss later. In addition, the deputy district director did not seek the approval of Caltrans' Division of Procurements and Contracts (DPAC) before executing the memorandum of understanding. The DPAC staff services manager in its headquarters office was unaware that the district had not been coordinating its agreements with General Services through DPAC until we brought it to her attention. The deputy district director does not appear on DPAC's list of individuals with the authority to sign contracts. Thus, we question whether the memorandum of understanding is even valid.

The chief of General Services' construction services branch stated that he did not tell Caltrans' deputy district director that General Services does not enter into interagency agreements, but that he agreed to enter into a memorandum of understanding with Caltrans because he thought it would be sufficient. When we asked General Services about the lack of an interagency agreement between it and Caltrans to perform this work, its Office of Legal Services (legal services) informed us that an interagency agreement

The last agreement between Caltrans and General Services was executed in July 1996, with the term of the agreement ending on June 30, 1999. Thus, until December 30, 2011, Caltrans had no agreement in place with General Services despite the significant amount of money it paid each year.

The State Contracting Manual expressly contemplates and establishes requirements for state agencies to contract with each other.

is not required because the construction and maintenance of state buildings and property is within General Services' statutory authority. The *State Contracting Manual*, however, does not provide an exception to its requirements for interagency agreements when General Services or other state agencies are performing services pursuant to statutory authority. Legal services also informed us that it does not believe "it is legally correct for the State of California to contract with itself." However, the *State Contracting Manual* defines an interagency agreement as "a contract between two or more state agencies" and specifies certain requirements for such agreements. Therefore, the *State Contracting Manual* expressly contemplates and establishes requirements for state agencies to contract with each other.

Legal services also stated that California Government Code, Section 11256, which authorizes interagency agreements subject to the approval of the director of General Services, provides the director the authority to except from his approval or to grant blanket approval for the performance of work and the entering into of any such agreements. According to legal services, because not using interagency agreements for repair work such as the work the construction unit performs for Caltrans has been a long-standing practice of General Services, this practice has been approved and meets the requirements of California Government Code, Section 11256. This state law, however, provides this authority for exceptions "upon such terms and conditions" as the director prescribes. When we asked General Services whether it had ever provided a policy memo to state agencies stating that interagency agreements are not required under certain circumstances, legal services responded that it was not aware of any such policy memo. We would expect, if the director of General Services had prescribed the terms and conditions for exempting certain types of interagency agreements from the requirements of the *State Contracting Manual*, that those terms and conditions would either be stated in that manual or would have been communicated to all state agencies in some manner.

Caltrans Did Not Sufficiently Consider Alternatives to Hiring General Services to Perform Repairs

We asked Caltrans if it had considered other alternatives to having General Services repair the SR 710 properties and found that in May 2011 Caltrans conducted a limited analysis to support its decision to have General Services perform emergency repairs for non-historic SR 710 properties. The senior right-of-way agent for property maintenance at Caltrans' District 7 office stated that he randomly selected 10 items from existing contracts with private businesses for electrical, plumbing, painting, carpentry, and fence work and compared the prices to quotes he received from General Services'

construction unit. However, our review found that Caltrans did not compare the quotes General Services gave it to prices the construction unit included in its estimates for past SR 710 projects to complete this analysis. We found inconsistencies between the construction unit's quotes for this analysis and its estimates for past SR 710 projects. For example, the price to install a doorbell system was quoted at \$400, but the construction unit had previously estimated the price at \$720 for an SR 710 project. The chief of the construction services branch explained that amounts can vary because of the scope of the project. In addition, Caltrans did not obtain quotes from the construction unit for roofing services, which is a major component of many property repairs. According to the senior right-of-way agent, he did not include roofing as a part of the analysis because the construction unit has always been responsible for roof repairs for the properties. Because Caltrans did not include roofing services in its comparison, it may not be aware of competitive rates available from private contractors that may be lower than General Services' construction unit's rates. Further, because it has not performed a more comprehensive analysis of viable options for repairing the SR 710 properties, such as using private contractors instead of General Services, Caltrans may be paying more for the repair of SR 710 properties than necessary and cannot ensure that General Services is the best option for the State.

Caltrans Cannot Demonstrate That It Appropriately Monitors General Services' Repair Costs

Our review of 24 repair projects performed by General Services found that, in some cases, Caltrans could not provide records to substantiate its approval of General Services' work either before or after completion of the project. Both the *State Contracting Manual* and Caltrans' handbook require contract managers to document in writing all communications about the contract and to keep a copy of the communications in the file. Further, General Services' construction unit manual requires its clients to approve a repair project's work plan before the project begins. Two of the repair projects were for emergency repairs and did not require a work plan. Caltrans did not have the work plans for six of the 22 non-emergency repair projects and, for the plans it did have, 16 were incomplete because they were missing signatures. Further, General Services' construction unit manual requires its clients to approve a repair project certification confirming that General Services has completed all work in the original scope and any augmentations to the scope made by an approved change order. However, Caltrans did not have repair project certifications on file for eight of the 20 completed non-emergency projects. The senior right-of-way agent for property maintenance at Caltrans' District 7 office could not explain why the project files did not contain evidence of the approvals, and stated that it was difficult to find documents from previous years because the previous managers had retired.

Without a more comprehensive analysis of viable options for repairing the properties, Caltrans may be paying more for the repairs than necessary and cannot ensure that General Services is the best option for the State.

For 14 of the 22 non-emergency repair projects, Caltrans did not reconcile the actual work performed by General Services with the work approved by the Department of Finance. In fact, the actual repair costs for the work General Services performed rarely matched the estimates.

Moreover, for 14 of the 22 non-emergency repair projects, Caltrans did not reconcile the actual work performed by General Services with the work approved by the Department of Finance (Finance) on the transfer request. As previously mentioned, Caltrans transfers funds to General Services to perform repairs for the SR 710 properties using a transfer request. Finance approves this form, which includes a list of properties needing repairs and a cost estimate for each one. However, the actual repair costs for the work General Services performed rarely matched the estimates shown in this list. For example, in the fiscal year 2010–11 transfer request form, Caltrans identified a residential property as needing a roof replacement at an estimated cost of \$45,000 and additional work for window, carpentry, and cabinetry repairs at an estimated cost of \$30,000. However, General Services' actual cost for replacing the roof was \$55,436, which exceeded the roof estimate in the transfer request by \$10,436. For another residential property, Caltrans' fiscal year 2009–10 transfer request form identified interior and exterior painting and main line sewer, plumbing, heating, electrical, window, carpentry, and cabinetry repairs having an estimated cost of \$90,000. However, the repair project's actual costs were \$165,175, and the exterior painting—originally estimated to cost \$10,000—did not even occur. Further, in its fiscal year 2008–09 transfer request, Caltrans had also identified a roof replacement and plumbing, heating, electrical, carpentry, and cabinetry repairs for this same property at an estimated cost of \$113,000. Caltrans ultimately paid General Services a total \$209,714 for both fiscal years for the same type of work on the same property.

Caltrans also did not track the actual expenditures for projects related to the SR 710 properties. Each year General Services establishes an account in the State's Architecture Revolving Fund to receive the transfers per the transfer request form, as well as subsidiary accounts for each repair project related to the SR 710 properties. However, Caltrans did not reconcile the expenditures for each project approved by Finance in the transfer request form to the expenditures from General Services' subsidiary accounts. Although variations from the repair work planned and the estimated costs as shown in the transfer request form may be reasonable, until Caltrans establishes a method to reconcile General Services' actual expenditures to its estimated expenditures and the amounts on the transfer request form, Caltrans cannot ensure that it is properly managing the SR 710 properties' repairs.

The deputy district director of Caltrans' District 7 ROW division stated that the district understands the need for better monitoring of the repair projects related to the SR 710 properties. He stated that the district spent the last year developing a tracking system to capture the actual expenditures for each repair project by address and parcel number, which it implemented on March 1, 2012, for

the fiscal year 2011–12 transfer request form. To obtain the actual expenditure information, the district intends to request that this information be reported by General Services. Our review of the district’s spreadsheet found that, although it may assist with reconciling the estimated and actual project repair costs, it is insufficient to reconcile the actual repair work performed by General Services with the work approved by Finance. For example, the transfer request form captures information on 11 types of repairs, but the district’s spreadsheet appears to use a broader category of “miscellaneous” repairs for most projects. The spreadsheet also includes projects related to SR 710 property that Finance did not approve on the transfer request form, and the deputy district director could not explain why they are included on the spreadsheet. Until the district modifies its tracking spreadsheet, it will continue to lack sufficient information to effectively monitor repair costs for the SR 710 properties.

Recommendations

To ensure that the repairs it makes to the SR 710 properties are necessary and reasonable, Caltrans should do the following:

- Document its rationale for approving project change orders.
- Conduct annual field inspections of the properties.
- Discontinue performing roofing repairs on properties its roof assessments indicate are in good condition, unless a new assessment indicates a repair is needed.
- Incorporate roof assessments as part of its annual field inspections of the properties.
- Develop a written policy to ensure that it considers the cost-effectiveness of repair costs for historic and non-historic projects in relation to the potential rental income for the property. Such a policy should establish the maximum acceptable cost-recovery period for the amount it will spend for repairs, above which the repairs will be considered wasteful.
- Establish a process to ensure that it evaluates the cost-effectiveness of any repair before authorizing it.
- Retain in its project files evidence to support the necessity and reasonableness of repairs, such as change orders, annual field inspections, and analyses of cost-effectiveness.

To ensure that the State achieves cost savings for the repairs made to the SR 710 properties, Caltrans should periodically perform more comprehensive analyses of viable options for repairing the properties. If Caltrans determines that General Services is the best option, it should ensure that it properly executes an interagency agreement in accordance with the *State Contracting Manual*.

To ensure that it appropriately executes interagency agreements with other state agencies, General Services should provide training to its construction unit staff.

To ensure that General Services performs only necessary repairs and that its costs are reasonable, Caltrans should do the following:

- Ensure that its staff adhere to relevant contracting policies, including retaining evidence of its approval of General Services' repair work before and after the completion of a project in the project file.
- Reconcile General Services' estimates for the repair projects with the scope of work Finance approved in the transfer request form and, if applicable, explain any differences.
- Reconcile the actual work General Services performs to the scope of work approved in the project work plans.
- Reconcile the actual expenditures for the projects listed in the transfer request form approved by Finance and the approved budget in the project work plans with General Services' actual expenditures for each project.
- Modify its March 2012 tracking spreadsheet to ensure that it contains sufficient information for Caltrans to effectively monitor repair costs.

Chapter 3

GENERAL SERVICES CANNOT JUSTIFY THE FEES IT CHARGES CLIENTS SUCH AS CALTRANS, AND IT HAS NOT PROVIDED PROPER OVERSIGHT OF ITS REPAIR PROJECT COSTS

Chapter Summary

The Department of General Services (General Services) has limited justification for the fees it charges its clients such as the California Department of Transportation (Caltrans). Specifically, General Services was unable to substantiate the hourly rate it charges for its Direct Construction Unit's (construction unit) operational costs and the direct administration fees it assesses for each repair project. Without clear and accurate fee methodologies, General Services could easily overcharge or undercharge the state agencies with which it contracts. General Services also exercises insufficient oversight over several repair project cost areas. For example, General Services' construction unit does not properly monitor its labor charges, which affects the costs it charges to its clients such as Caltrans. General Services also did not follow state law and policies governing purchases from small businesses and made purchases for amounts under \$5,000 without using competing bidders or justifying that the price was fair and reasonable. We also reviewed invoices for five small businesses that provide goods to the construction unit and found that in some instances the businesses may simply have been enabling the construction unit to achieve the appearance of meeting its small business participation goal.

General Services Cannot Fully Justify the Fees It Charges to Its Clients

General Services can improve its methodology for arriving at the hourly rate it charges clients for the construction unit's operational costs, known as its hourly burden rate. It is also unable to provide documentation that substantiates the percentages for the direct administration fees that it charges clients such as Caltrans for each project. Without clear and accurate fee methodologies, General Services could easily overcharge or undercharge the state agencies with which it contracts.

The *State Contracting Manual* generally requires state agencies that contract with each other to comply with the State's full cost-recovery policy, which specifies that the agency performing a service should charge its client the full cost directly attributable to the activity plus a fair share of its indirect costs. To meet this requirement, General Services' construction unit charges clients an

Department of General Services' Direct Administration Fees

- **Constructability review (1%):** This fee covers a general review of the project to determine if it can be constructed in accordance with the state fire marshal's and the Department of General Services' (General Services) Division of State Architect's design drawings.
- **Nonrecoverable estimating costs (1%):** This fee covers the cost of compiling a project scope or estimate to ensure that this cost is covered if the project is canceled.
- **Client consultation (1%):** This fee covers any expenses incurred when contacting the client regarding project problems.
- **Permits, right-of-way clearance, and delays (0.5%).**
- **Subcontract and change order review/preparation (0.5%):** This fee covers expenses incurred by project personnel who prepare unanticipated subcontracts, change orders, and emergency purchase orders.
- **Quality control oversight inspection (0.5%):** This fee covers expenses incurred by the project construction team leader when making site inspections.
- **As-built drawings, photo records, and transmittals (0.5%):** The fee covers the preparation of plans for the client.
- **Post-job reconciliation (1%):** This fee covers the cost to review the job costs to ensure that they agree with the accounting records and the client's records.
- **General equipment (1.4%):** This fee covers equipment that is not included in the detailed estimate and will not be left with the client upon completion of the project.
- **Warranty (0.5%):** This fee covers the work of the temporary employees that may fail after the project is complete.
- **Construction design support (2%).***
- **Contract administration:*** This fee is applied to each estimate to cover the cost of the personnel who manage contract and service orders. The amount varies per project.

Sources: General Services' Direct Construction Unit manual, Administrative Memo #6, dated July 1, 2011.

* General Services eliminated these charges as of fiscal year 2009–10, which resulted in a maximum fee of roughly 8 percent.

hourly burden rate to recover its operational costs that includes the salaries and benefits for its permanent employees and assesses a direct administration fee to each project that represents a percentage of its administrative costs. The staff services manager in General Services' construction unit stated that it adds the hourly burden rate to every hour that its temporary employees, known as casual trades or day laborers, work on a repair project.

According to a staff services manager in its construction unit, General Services' management set the hourly burden rate for fiscal year 2011–12 at \$50 because it wanted to lower the costs for its clients. However, General Services' decision was inconsistent with the State's full cost-recovery policy because the \$50 rate was insufficient to cover the construction unit's costs. For fiscal years 2009–10 and 2010–11 the construction unit's hourly burden rate was \$67, and for fiscal year 2008–09 the rate was \$52. The text box explains the various administrative fees the construction unit may charge, although the actual amount the construction unit assesses its clients varies by project, because not all of the fees shown may be applicable. If the direct administration fees are applicable, the construction unit includes them in the cost estimates it develops for its clients.

To determine its hourly burden rate, the construction unit divides its total costs by its total billable hours for the entire year. However, in reviewing the construction unit's methodology for determining the hourly burden rate, we noted that it does not instruct staff to consistently use prior year actual expenditure data. Specifically, the construction unit's instructions appropriately require staff to use prior year actual expenditures to determine its operating expenditures and its indirect costs. In addition, the construction unit's instructions require staff to compute the total billable hours by using the prior year billable hours and adding to those hours an estimate of the hours for any significant upcoming projects, which appears reasonable. However, the construction unit instructs its staff to use

job classification wages from the State Personnel Board's Web site to estimate the salaries for the construction unit's permanent employees, instead of using its prior year actual expenditure data, which would provide a more accurate depiction of its expenditures. Further, to estimate employee benefits, the construction unit's instructions require staff to apply 37.5 percent to the salaries for the construction unit permanent employees and 35 percent to wages, which are based on historical experience, for its temporary employees. Again, if the construction unit were to use its prior year actual expenditure data it would have a more accurate depiction of its expenditures to use to establish its hourly burden rate.

Our recalculation of the hourly burden rates for fiscal years 2008–09 through 2010–11 using the construction unit's prior year actual expenditure and billable hour data shows that the construction unit should have been charging its clients between \$57 and \$61 per hour. Further, we found that in fiscal year 2008–09 the construction unit undercharged its clients by \$7 per hour and in the next fiscal year it overcharged them by \$10 per hour. The staff services manager could not explain why the construction unit chose to use estimates rather than actual prior year expenditure data to calculate certain components of the hourly burden rate for fiscal years 2008–09 through 2010–11. He stated that the methodology was in place when he became the construction unit support operations manager in September 2010 and that there are no documents that explain the construction unit's rationale. Similarly, the staff services manager did not provide an explanation for the construction unit's inability to document how it arrived at the percentages for the direct administration fees. The construction unit manual states that the direct administration fees are based on the best information the construction unit is able to obtain using past history and past experience. However, the staff services manager did not provide us with documentation to identify the factors the construction unit considers when using its historical knowledge and experience. Without clear and accurate fee methodologies that it can support, General Services cannot demonstrate that the fees it charges to its clients are appropriate.

General Services Lacks Proper Oversight of Certain Costs It Charges to Its Projects

General Services exercises insufficient oversight over several repair project cost areas. First, General Services' construction unit does not properly monitor its labor charges. For example, we identified roughly 330 hours that may have been inappropriately charged to projects related to the State Route 710 extension project parcels and property units (SR 710 properties). General Services is required by its policies to procure certain goods and services from small

We identified roughly 330 hours that may have been inappropriately charged to projects related to the SR 710 properties.

businesses when appropriate and state law requires agencies to establish participation goals for obtaining goods and services from these businesses. Although General Services encourages its employees to meet a 25 percent small business participation goal, the construction unit stated that its goal is to contract 100 percent with small businesses. We found that the construction unit used five small businesses when soliciting bids and purchasing goods, four of which are owned by individuals who are related to each other and who bid against each other. Further, General Services' construction unit did not adhere to state laws and policies that govern the procurement of goods that cost less than \$5,000 for various projects, including the SR 710 properties. Finally, it appears as though these five small businesses' participation in the construction unit's purchase of goods may have been simply to enable the construction unit to achieve the appearance of meeting its small business participation goal.

General Services' Construction Unit Does Not Properly Monitor Labor Charges for Its Temporary Employees

General Services' construction unit hires temporary employees, known as casual trades or day laborers, to assist its employees in performing repairs on projects. However, we found several instances in which casual laborers may have inappropriately charged hours to projects for the SR 710 properties. In addition, many of the daily job reports supporting these labor charges were missing from the project files, and many of the daily time reports we reviewed did not have the casual laborer's or supervisor's signature. Instead, the construction unit area manager approved the daily time reports, which is inconsistent with the construction unit's manual, which states that the civil service supervisor who approves a casual laborer's time must have knowledge of the time the casual laborer worked. The fact that two of the casual laborers involved in the issues described above had a personal connection outside of work with the construction unit area manager who signed their time sheets raises concerns that General Services did not ensure that its permanent employees comply with its policy prohibiting nepotism, which it defines as the practice of an employee using his or her influence to either assist or interfere with the employment of another individual solely because of a personal relationship.

Based on data between June 2011 and December 2011 for 14 Caltrans repair projects related to the SR 710 properties, we identified unusual patterns—two casual laborers charged almost 160 labor hours to clean up and procure goods at job sites for which no other work was being or had been performed.

Our analysis of General Services' Activity Based Management System (ABMS) data between June 2011 and December 2011 for 14 Caltrans repair projects related to the SR 710 properties identified unusual patterns. Specifically, we found that two casual laborers charged almost 160 labor hours to clean up and procure goods for job sites, yet in several instances there were either no other laborers working at the site or no work had been performed at the site for the entire seven-month period we reviewed. In other instances, we found no

indication that work was performed at the sites after the two laborers charged hours for procuring goods for those sites. The construction unit's use of these two casual laborers to perform site cleanup and procurement is inconsistent with the job specifications established by the State Personnel Board. Specifically, the job specification states that the casual laborers are to do skilled work of a craft or trade, under direction, on short-term projects and to do other related work. Moreover, the duty statements for these two casual laborers state that under general supervision they will perform services such as clean, lubricate, and adjust tools, machinery, and equipment; load and deliver equipment, tools, machinery, and materials to specific jobs; assist tradespeople such as cabinet makers, sheet metal workers, plumbers, and electricians on construction jobs; and run errands and make deliveries to various job sites.

When we discussed the unusual pattern of the labor charges with the construction unit area manager, he stated that his use of these casual laborers for work in the office such as procurement is his way of ensuring that the work will get done. He also stated that the two casual laborers also sometimes clean up job sites. However, the area manager did not provide sufficient explanations as to why these laborers were cleaning up sites or procuring goods at addresses for which no other work was being or had been performed. For example, the area manager stated that for several of the dates in question, the laborers charged their time to the wrong projects in the ABMS. Yet when we reviewed the dates for the projects identified by the area manager as the correct ones, we found that the casual laborers' hours did not correspond with the actual work performed on those days.

In explaining the construction unit's use of these two casual laborers to perform site cleanup and procurement, its assistant chief added that the casual laborer workforce is designed to be flexible and work on an as-needed basis, and that they are used to help with the workload when there is not enough work available to justify adding a permanent employee. The assistant chief also stated that, because of the State's budget cuts and hiring freeze, the construction unit was unable to hire more permanent employees. The assistant chief believes that a cost analysis would show that using casual laborers for office work such as procurement was less expensive than hiring an office technician. General Services pays the casual laborers the prevailing wage for the area. The text box on the following page provides a description of the State's prevailing wage requirement. These two casual laborers are paid an hourly rate of \$44.68, which would result in about \$7,150 for the almost 160 hours to perform services that a permanent state employee could most likely perform at a much lower hourly rate. Until the construction unit performs an analysis comparing the costs of paying casual laborers at prevailing wage rates with the cost of paying permanent civil service employees, it has no way to verify the assistant chief's assertion.

The construction unit area manager did not provide sufficient explanations as to why these laborers were cleaning up sites or procuring goods at addresses for which no other work was being or had been performed.

Prevailing Wage Definition

State law requires the State to pay the prevailing wage to workers employed on public works projects that cost more than \$1,000. Public works projects include construction, alteration, demolition, installation, or repair work done under contract and paid for in whole or in part by public funds.

The State's director of the Department of Industrial Relations (director) establishes the wage rate, and it is generally based on the rate paid to the majority of workers for a specific craft in a specific area. The wage rate varies by location. The director determines the rates by considering applicable wage rates established by collective bargaining agreements and the rates that may have been predetermined for federal public works, within the locality and in the nearest labor market area. State law requires that collective bargaining units submit copies of their collective bargaining agreements after they are executed and all modifications and extensions that affect per diem wages or holidays.

The prevailing wage rate stipulates the basic hourly pay rate and rate for holiday and overtime work. It also takes into account employer payments for any benefits for employees and their dependents, and retirees, including the following:

- Medical benefits.
- Retirement plan benefits.
- Paid holidays and vacations.
- Compensation for work injuries.
- Life insurance.
- Supplemental unemployment benefits.
- Occupational health and safety research, safety training, job hazard monitoring, etc., as specified in the applicable collective bargaining agreement.
- Other benefits as the director may determine.

Sources: California Labor Code, sections 1720, 1770, 1771, 1773, and 1773.9; California Code of Regulations, Title 8, Section 16000.

Further, many of the daily job reports to support these labor charges were missing from the project files. Although the construction unit manual does not describe the daily job reports, the construction unit's staff services manager stated that the construction unit's use of the daily job reports is a standard practice for recording the activities that occur at the job site each day and must be signed by the site supervisor and verified by the civil service supervisor. However, for the two casual laborers performing site cleanup and procurement duties, we could not locate five of the 10 daily job reports we selected for review. For the five daily job reports we were able to review, we noted that the laborers themselves signed three of the reports, instead of the site supervisor. The construction unit area manager also could not provide us with daily job reports to support his identification of the correct projects these two laborers should have charged. When asked, the construction unit area manager stated that it is difficult to manage the supervisors and compel them to turn in the daily job reports, but that they should be maintained in the project files.

Our analysis of the ABMS data also identified unusual patterns with 168.5 of the 241 hours that casual laborer electricians charged for the installation of smoke detectors between June 2011 and December 2011. In several instances, the construction unit sent two casual laborers at a time to install smoke detectors at the same address. The casual laborers generally charged anywhere from 30 minutes to two hours for this task at a rate of more than \$60 per hour. In addition, the laborers installed smoke detectors at 14 addresses more than once in the seven-month period. When asked about this, the construction unit area manager stated that Caltrans provided the construction unit with a directive to install smoke detectors in all of the SR 710 residential

properties sometime in fiscal year 2010–11. To support this explanation, the area manager gave us a list of addresses at which the construction unit had completed smoke detector installations under this directive. However, the list indicates that the construction unit's installations occurred between January 2012 and June 2012, which is after the period we reviewed. Therefore, we question the 168.5 hours that were charged by casual laborer electricians, because these hours were charged before Caltrans'

approval to transfer funds to the construction unit to perform the installation of the smoke detectors on December 29, 2011. Further, we found that some of the addresses associated with the 168.5 hours we question that were charged in 2011 also appear on the list of installations occurring in 2012 that the area manager gave us, indicating that the laborers charged additional hours for installing smoke detectors at these same addresses on later dates. We estimate that the construction unit may have inappropriately charged roughly \$10,000 to Caltrans' SR 710 projects.

During our fieldwork we also observed that many of the daily time reports on file at the construction unit were unsigned either by the casual laborer, the civil service supervisor, or both. California regulation states that each appointing power shall keep complete and accurate time and attendance records for each employee and officer employed within the agency over whom it has jurisdiction. In addition, the *State Administrative Manual* requires state agencies to maintain and certify complete records of attendance and absences for each employee during each pay period. Further, General Services' construction unit manual states that the civil service supervisor who approves a casual laborer's time in its ABMS must have knowledge of the time the casual laborer works. The construction unit manual also states that the daily time reports for casual laborers must contain the appropriate task codes and the approval of a civil service supervisor.

We reviewed 99 daily time reports related to eight casual laborers. Of these, 43 had not been signed by both the casual laborer and the supervisor and 56 had been signed by the supervisor only. The construction unit area manager had approved 46 of the 56 daily time reports instead of the civil service supervisor. The fact that the construction unit area manager signed most of the daily time reports is inconsistent with the construction unit's manual. The construction unit area manager acknowledged that all the time reports should be signed, although he did not provide an explanation as to why the supervisors and laborers had not signed them or why he had approved them without the appropriate signatures. In an email sent by the area manager in March 2011 to certain construction unit employees, he stated that he had previously taken on the responsibility of signing time reports because he felt it was important that he see all facets of the operation in the construction unit offices. The area manager further stated in the email that he was returning that responsibility to the construction unit supervisors on April 1, 2011, although our review found that he continued to sign the daily time reports after this date.

Many of the daily time reports on file at the construction unit were unsigned either by the casual laborer, the civil service supervisor, or both. In fact, 43 of the 99 daily time reports related to eight casual laborers, were unsigned by both the casual laborer and the supervisor.

We question the need for the area manager to circumvent the construction unit's policy for signing daily time reports instead of the construction unit supervisors who have direct knowledge of the work performed by casual laborers. We also noted that the area manager has a close personal relationship with one of the casual laborers we previously identified as possibly having inappropriately charged hours for cleaning up and procuring goods for job sites, and with this laborer's husband, who is one of the casual laborer electricians responsible for installing the smoke detectors. In fact, the area manager acknowledged that he has known these two casual laborers for years.

General Services has a policy prohibiting nepotism, which it defines as an employee using his or her influence to either assist or interfere with the employment of another individual solely because of a personal relationship. General Services' nepotism policy, dated August 9, 2004, states that work situations that involve temporary authorization utilization appointments, such as the appointments for the casual laborers, are particularly susceptible to charges of nepotism. The policy also states that "temporary authorization utilization appointments will be considered on a case-by-case basis and must receive approval from General Services' office of human resources before a proposed candidate's official starting date." However, the construction unit did not obtain the office of human resources' prior approval for any of the casual laborers it hired, because the staff services manager did not realize that casual laborers were considered temporary authorization utilization appointments. Until General Services significantly improves its oversight of the casual laborers it hires, it cannot ensure that the hours they charge to its projects represent actual hours worked. Further, it cannot ensure that it appropriately charges repair project costs to its clients, such as Caltrans.

The Use of Certain Small Businesses by General Services' Construction Unit Is Questionable

State law requires the directors of General Services and other state agencies to establish goals consistent with those established by the Office of Small Business Certification and Resources for the extent of participation by small businesses in providing goods, services, and information technology to the State. In 2006 the former governor issued an executive order stating that each agency secretary, department director, and executive officer shall ensure that they administer the State's procurement and contracting processes in order to meet or exceed its goal of 25 percent small business participation. On December 31, 2009, General Services' acting director issued an administrative order that states, "Effective for solicitations issued on or after January 1, 2010, all procurements for goods, services,

and information technology under \$250,000 and public works up to \$250,000 must be awarded to a small business or disabled veterans business enterprise (DVBE), unless a waiver is sought and approved in advance.”⁶ The chief of the construction services branch, the construction unit assistant chief, and the construction unit area manager stated that it was the goal of the construction unit to contract 100 percent with small businesses. The construction unit employees cited General Services’ acting director’s administrative order to support this goal. However, the purchasing manager of General Services’ office of small business and DVBE services stated that the intent of the administrative order was to encourage General Services’ employees to meet the 25 percent small business participation goal. The purchasing manager also acknowledged that clarifying the waiver process in the administrative order may help eliminate any confusion employees may have.

We selected five small businesses that procured goods for the construction unit between July 2011 and May 2012. According to General Services’ accounting records, the construction unit paid more than \$300,000 to these five small businesses, and \$272,000, or almost 90 percent, went to two of the five. In our review of information related to these businesses, we found that the owners of some of the businesses are related. Table 6 presents the initial certification date of the businesses, the relationships between the owners, and the amount the construction unit paid them between July 2011 and May 2012.

Table 6
Relationships of and Amounts Paid to Selected Small Businesses Used by the Department of General Services’ Direct Construction Unit

SMALL BUSINESS	DATE OF INITIAL CERTIFICATION	RELATIONSHIPS	VENDOR PAYMENTS MADE BY GENERAL SERVICES BETWEEN JULY 2011 AND MAY 2012
Blue Eagle Enterprises	December 9, 2003	Brother-in-law to owner of Skyward Construction	\$179,738
Knight Muse & Associates	April 18, 2011	None identified	92,301
Blue Eagle Supply, Inc.	April 25, 2011	Brother-in-law to owner of Skyward Construction	29,913
Skyward Construction*	October 6, 2006	Brother-in-law to owner of Blue Eagle Enterprises and Blue Eagle Supply, Inc. and father of owner of Nizami Supplies	3,750
Nizami Supplies	September 16, 2009	Son of owner of Skyward Construction	1,067
Total			\$306,769

Sources: The Department of General Services’ (General Services) Web site, bid solicitation packages and vendor payment information.

Note: The owner of Blue Eagle Enterprises and Blue Eagle Supply, Inc. is the same person.

* The owner of Skyward Construction is the husband of the owner of Skyward Supplies, which was initially certified on August 1, 2011. We noted that, although General Services made the payment to Skyward Construction, its construction unit received the bid for the purchase from Skyward Supplies.

⁶ Effective January 12, 2012, General Services increased the threshold for public works to \$270,000.

The manner in which the area manager selected these small businesses to procure goods for the construction unit could be perceived as demonstrating favoritism toward them.

As the table shows, four of the small businesses are owned by members of the same family. When asked about the construction unit's use of these particular small businesses, the chief of the construction services branch stated that he was not aware of the relationships between their owners. When we asked the area manager how the construction unit selected the small businesses, he stated that he had a prior working relationship with the owner of Blue Eagle Enterprises and Blue Eagle Supply, Inc. and knew that the owner was reliable. The construction unit area manager also stated that he was later approached by Skyward Supplies and Nizami Supplies and included them as bidders after he checked their certifications. Further, the construction unit area manager stated that he met the owner of Knight Muse & Associates when the owner was a salesperson for a sewer company that does business with Caltrans. When the salesperson lost the job, the area manager told this individual how to obtain a certification so that she could obtain business from the State. The *State Contracting Manual* states that "buyers conducting competitive procurements shall provide qualified suppliers with a fair opportunity to participate in the competitive solicitation in a manner conducive to sound State fiscal practices emphasizing the elimination of favoritism, fraud, and corruption in awarding contracts." The manner in which the area manager selected these small businesses to procure goods for the construction unit could be perceived as demonstrating favoritism toward them.

We reviewed five construction unit bid solicitation packages for purchases greater than \$5,000, and six for purchases less than \$5,000. According to state law, if the estimated value of the goods is greater than \$5,000 and less than \$250,000, a state agency may award a contract for the acquisition of the goods to a certified small business as long as the state agency obtains price quotations from two or more certified small businesses or two or more DVBES. If the estimated cost of the goods is less than \$5,000, a state agency must obtain at least two price quotations from responsible suppliers whenever it has a reason to believe that a response from a single source is not a fair and reasonable price. The *State Contracting Manual* states that departments may purchase goods, other than for information technology, valued at less than \$5,000 if they can establish fair and reasonable pricing. It also provides techniques for the departments to determine whether or not the supplier's price is fair and reasonable, such as performing price comparisons, reviewing established and verifiable catalog pricing, and analyzing historical prices. Further, the manual states that departments must retain documentation to support fair and reasonable pricing in their procurement files.

We found that the construction unit appropriately obtained two bids as state law requires for the purchases greater than \$5,000. However, the bidders for three of the five purchases, Blue Eagle Enterprises, Skyward Supplies, and Nizami Supplies, were small businesses owned by related parties. Although not shown in Table 6, the owner of Skyward Supplies is the sister-in-law of the owner of Blue Eagle Enterprises and the mother of the owner of Nizami Supplies. Because these three bidders are related, we question whether the procurement process was done in a manner that promoted open, fair, and equal competition among all qualified suppliers. Table 7 on the following page presents the 11 purchases we reviewed and the bid activity.

We encountered a similar situation when we reviewed the six bid solicitation packages for purchases less than \$5,000. Specifically, we found that the bidders for one of the six purchases were Blue Eagle Enterprises and Skyward Supplies, who are related, which again causes us to question the openness and fairness of the procurement process. For two other purchases under \$5,000, the construction unit sought only one bidder, which was Knight Muse & Associates. We contacted Knight Muse & Associates to obtain the supporting documentation related to these purchases. For one of the purchases, the construction unit's records indicated that it solicited the bid on February 2, 2012, from Knight Muse & Associates and received the owner's response on February 9, 2012. Our comparison of the invoice Knight Muse & Associates submitted to the construction unit for the purchase and the supporting documentation for the invoice found that Knight Muse & Associates purchased the goods on February 1, 2012, one day before the construction unit solicited the bid. Similarly, for the other purchase, the construction unit's records indicated that it solicited the bid on February 2, 2012, from Knight Muse & Associates and received the owner's response on February 9, 2012. Our comparison of the invoice submitted to the construction unit and the supporting documentation for the invoice found that Knight Muse & Associates purchased the goods on January 30, 2012, three days before the construction unit solicited the bid. We question how the owner of Knight Muse & Associates could know the precise goods that the construction unit would need and purchase them from The Home Depot before receiving the construction unit's bid solicitation. Furthermore, the construction unit's use of a single supplier without establishing and documenting in the procurement file its determination that the prices were fair and reasonable is inconsistent with the *State Contracting Manual*.

The construction unit appropriately obtained two bids as state law requires for the purchases. However, the bidders for three of the five purchases were small businesses owned by related parties.

Table 7
Bid Activity for 11 Purchases We Reviewed

PURCHASE ORDER NUMBER	NUMBER OF BIDS SOLICITED	DIRECT CONSTRUCTION UNIT LOCATION	WINNING BIDDER	PURCHASE ORDER DATE	PURCHASE ORDER AMOUNT	BIDDER NUMBER TWO	BID AMOUNT	BIDDER NUMBER THREE	BID AMOUNT	BIDDER NUMBER FOUR	BID AMOUNT
1	4	North	Blue Eagle Enterprises	May 18, 2011	\$7,047	Unrelated	\$7,447	Unrelated	\$8,706	Unrelated	\$10,630
2	4	North	Blue Eagle Enterprises	August 25, 2011	6,900	Unrelated	6,970	Unrelated	8,148	Unrelated	8,199
3	2	South	Blue Eagle Enterprises	August 31, 2011	9,365	Nizami Supplies	10,181	-	-	-	-
4	2	South	Blue Eagle Enterprises	February 2, 2012	8,979	Skyward Supplies	9,347	-	-	-	-
5	2	South	Blue Eagle Enterprises	February 9, 2012	5,719	Skyward Supplies	6,235	-	-	-	-
6	2	South	Blue Eagle Enterprises	November 17, 2011	2,364	Skyward Supplies	2,594	-	-	-	-
7	2	South	Knight Muse & Associates	January 24, 2012	2,174	Blue Eagle Enterprises	2,240	-	-	-	-
8	1	South	Knight Muse & Associates	February 9, 2012	517	-	-	-	-	-	-
9	1	South	Knight Muse & Associates	February 13, 2012	290	-	-	-	-	-	-
10	2	South	Knight Muse & Associates	April 9, 2012	3,411	Blue Eagle Enterprises	3,419	-	-	-	-
11	2	South	Knight Muse & Associates	April 9, 2012	3,461	Blue Eagle Enterprises	3,644	-	-	-	-

Sources: The Department of General Services' bid solicitation packages.

Further, we found that the procurement processes outlined in General Services' construction unit manual for certain purchases valued at less than \$5,000 are inconsistent with the *State Contracting Manual*. Specifically, the July 2011 procurement section of the construction unit manual states that the construction unit area offices and headquarters office do not need to obtain second or third bids for purchases between \$50 and \$500, which results in a purchase with prices obtained from a single source. For these purchases, the construction unit manual does not address the *State Contracting Manual's* requirement of establishing, and documenting in the procurement file, its determination that the prices obtained from the single source are fair and reasonable. When asked, the construction unit staff services manager stated that he did not realize that the manual contradicted the *State Contracting Manual* and that his intention was to make the procurement process easier for less expensive items. The staff services manager also stated that he was in the process of updating the procurement section of the manual and would ensure that the new language is consistent with the *State Contracting Manual*.

Finally, when we looked at the role these small businesses played in procuring the goods ordered by the construction unit, we found that they do not appear to serve any commercially useful function as defined in the text box. In particular, as we explain later, some of the businesses appear to be extra participants in the procurement process solely in order for the construction unit to achieve its small business participation goal.

The Small Business Procurement and Contract Act states that a certified small business or micro business performs a commercially useful function so long as it does all of the following:

1. It is responsible for the execution of a distinct element of the work of the contract.
2. It carries out its obligations by actually performing, managing, or supervising the work involved.
3. It performs work that is normal for its business services and functions.
4. It is not further subcontracting a portion of the work that is greater than that expected to be subcontracted by normal industry practices.
5. Its role is not limited to that of an extra participant in a transaction, contract, or project through which funds are passed in order to obtain the appearance of small business or micro business participation.

Source: California Government Code, Section 14837.

We contacted the five small businesses to obtain supporting documentation for selected invoices. We observed that, for six of the nine invoices paid to Blue Eagle Enterprises and Blue Eagle Supply, Inc., the owner ordered goods from his office in Northern California to be picked up at the vendors' locations in Southern California. Because these businesses do not have offices in Southern California, it appears as though the construction unit may be picking up the goods from the vendors, such as KarnAir HVAC Supply, Inc. located in Colton, California. If the construction unit is, in fact, picking up the goods, we question why it could not order the goods directly from the vendors itself. Our review of five of the 11 invoices the construction unit paid to Knight Muse & Associates found that the owner obtained the goods primarily from either The Home Depot or an online vendor at retail prices. Similarly, our review of the invoice paid to Nizami Supplies also found that the owner ordered the goods from an online vendor

at retail prices. By not ordering directly from the supplier, the State paid \$1,653, or 35 percent, more for the goods. Table 8 shows the markup the small businesses received for these purchases.

Table 8
Small Businesses' Markup on a Selection of the Department of General Services' Construction Unit's Purchases

SMALL BUSINESS	DATE OF INVOICE	SMALL BUSINESS PURCHASE AT RETAIL PRICES	AMOUNT BILLED TO THE DEPARTMENT OF GENERAL SERVICES	MARKUP AMOUNT ABOVE RETAIL	MARKUP PERCENTAGE ABOVE RETAIL
Knight Muse & Associates	September 20, 2011	\$1,839	\$2,461	\$623	34%
Knight Muse & Associates	January 28, 2012	1,475	1,999	524	36
Knight Muse & Associates	January 24, 2012	219	283	64	29
Knight Muse & Associates	February 16, 2012	162	267	105	65
Knight Muse & Associates	February 13, 2012	352	475	123	35
Nizami Supplies	November 28, 2011	678	892	214	32
Totals		\$4,725	\$6,377	\$1,653	35%

Sources: The Department of General Services' bid solicitation packages and supporting documentation provided by small businesses.

Note: We did not include taxes and shipping in the prices.

When we asked the area manager why he had purchased the goods from the businesses rather than buying them directly from suppliers, he stated that it is his understanding that the construction unit's policy prohibits it from buying directly from the supplier because the construction unit is required to use small businesses. However, the construction unit's use of these small businesses to procure goods, when it could purchase the goods directly from the suppliers for 35 percent less, gives the appearance that the businesses are simply aiding the construction unit in achieving its small business participation goal.

The chief of the construction services branch stated that the construction unit's practice has been to use General Services' list of certified small businesses, and that his assumption is that if a business is certified, someone has verified the business's information. When we spoke with the purchasing manager in General Services' office of small business and DVBE services, he stated that currently the certification process for small businesses is based on information the businesses self-report. The purchasing manager told us that if concerns about a small business are brought to its attention by the state agencies purchasing the goods and services, the office will conduct an investigation of the small business's inappropriate use of certifications, including fraud or intentional misrepresentation related to commercially useful functions. The purchasing manager also stated that the office expects to implement comprehensive regulations by fall 2012 to provide more detailed standards for evaluating commercially useful functions and clarifying the roles

and responsibilities for enforcing violations of these requirements. Although the five small businesses we discuss in this report do not appear to be performing all of the commercially useful functions previously described in the text box, until the office conducts an investigation, we cannot conclude whether they are acting as extra participants to the transactions to assist the construction unit in meeting its small business participation goal.

Recommendations

To ensure that it charges its clients appropriately for the work it performs, General Services should do the following:

- Reassess the construction unit's methodologies for determining the hourly burden rate and direct administration fees.
- Ensure that the construction unit's methodologies are sound and that it can properly support them.

To determine if the construction unit's use of casual laborers to perform work not in their job specifications, such as procurement, is cost-effective, General Services should perform an analysis comparing the cost of paying the casual laborers at the prevailing wage rate and the cost of paying permanent civil service employees. If it finds that using permanent employees is cost-effective for the State, General Services should seek approval for additional permanent employees to perform those functions.

To ensure that the casual laborers charge only for their actual hours worked on projects, General Services should do the following:

- Require that the civil service supervisor who has knowledge of the time the casual laborer works approve the casual laborer's daily time report and ABMS time charges.
- Ensure that the daily time reports for casual laborers contain the appropriate task codes, the laborer's signature, and the approval of a civil service supervisor.
- Update its construction unit manual to formalize its standard practice of using daily job reports for each project.
- Retain the daily job reports and the daily time reports in the project files.

To ensure that it complies with its nepotism policy, General Services should have its office of human resources review and approve its existing temporary authorization appointments for

casual laborers. If the office of human resources finds that personal relationships exist, General Services should take appropriate action in accordance with its policy.

To ensure that the construction unit complies with the State's procurement laws and policies, General Services should do the following:

- Require the construction unit to immediately discontinue its current procurement practices that are inconsistent with the State's procurement laws and policies.
- Require the construction unit to modify the procurement section of its manual to conform to the State's procurement laws and policies.
- Provide training to its construction unit employees regarding the State's procurement laws and policies.
- Clarify the waiver process in the administrative order governing the small business participation goal.
- Continue its efforts to implement regulations that govern the small business certification process related to defining and enforcing violations of the commercially useful function requirements.
- Conduct an investigation of the small businesses we discuss in this report to determine if they are performing a commercially useful function.

Chapter 4

STATE LAW LIMITS ALTERNATIVES TO STATE OWNERSHIP OF THE STATE ROUTE 710 EXTENSION PROJECT PROPERTIES

Chapter Summary

Given the possibility that the California Department of Transportation (Caltrans) will not build the State Route 710 extension project (SR 710 extension project) as originally planned, the State at some point may have to dispose of the SR 710 extension project parcels and property units (SR 710 properties).⁷ If it disposes of the properties, the State will have to take into consideration the impact of the Roberti Bill on the SR 710 properties. As discussed in the Introduction, in 1979 the Legislature enacted the Roberti Bill, which reaffirms that “the provision of decent housing for all Californians is a state goal of the highest priority.” This state law limits the State’s ability to sell the SR 710 properties should it determine that the properties are no longer necessary for state highway purposes.

As discussed in the previous chapters, Caltrans has struggled in past years to effectively manage the SR 710 properties. We noted that there are a few alternatives the State could consider that would allow it to retain access to the SR 710 properties for right-of-way purposes while eliminating its need to directly manage the properties until it reaches a final decision regarding the SR 710 extension project.

The Roberti Bill Limits the Potential Sales Proceeds and Property Tax Revenues If the State Sells the SR 710 Properties

As of March 1, 2012, Caltrans estimated that the market value of the SR 710 parcels was \$279 million, with single and multifamily residential parcels making up \$238 million, or 85 percent, of the total estimated market value.⁸ Table 9 on the following page presents the average market value by type of residential parcel for each city in the SR 710 extension project. In addition, Appendix D presents images of select residential properties in each city. However, Caltrans stated that its estimate does not take into consideration the sales requirements of the Roberti Bill that we discuss in the Introduction. Caltrans’ estimated market value would be substantially less if the restrictions of the Roberti Bill were taken into consideration.

⁷ A parcel is a plot of land that can contain more than one single-family or multifamily residential property unit.

⁸ Caltrans stated that its estimate is based on a statistical analysis of sales data primarily from between March 2011 and January 2012 and does not take into account the condition of the individual properties or any variance in market value as a result of deferred maintenance. The California State Auditor did not assess the reliability of Caltrans’ estimate.

Table 9
Average Property Values of the State Route 710 Extension Project Parcels

	NUMBER OF SINGLE-FAMILY PARCELS	AVERAGE	NUMBER OF MULTIFAMILY RESIDENTIAL PARCELS	AVERAGE
Pasadena	90	\$1,000,000	11	\$2,314,000
South Pasadena	62	737,000	11	900,000
Los Angeles	205	292,000	19	316,000
Totals	357		41	

Source: California Department of Transportation's estimate of the value of the State Route 710 extension project parcels as of March 1, 2012.

Once Caltrans declares that a property is surplus residential property and no longer needed for a project, it can sell the property only in accordance with the restrictions of the Roberti Bill. Caltrans' Division of Right of Way and Land Surveys' (ROW headquarters division) manual currently outlines the specific procedures for the process of selling surplus properties, and between 2000 and 2007 Caltrans sold 16 surplus residential SR 710 properties that it had determined it no longer needed. However, in 2007 a superior court deemed the portion of Caltrans' manual that governed the process used to sell the 11 properties that were the subject of the lawsuit to be an invalid or underground regulation that is unenforceable because Caltrans did not follow the Administrative Procedure Act (APA) when adopting it. A regulation adopted in accordance with the APA has the force of a law, but a regulation adopted by an agency without complying with the APA generally cannot be enforced. Because Caltrans did not adopt the sales procedures as regulations under the APA, the court reversed the sale of 11 surplus residential properties related to the SR 710 extension project that were the subject of the lawsuit. According to the court ruling, Caltrans must retain ownership of these parcels until it adopts an appropriate regulation under the APA to sell properties under the Roberti Bill or until a later order by the court.

As of June 2012 Caltrans still had not established regulations to govern the Roberti Bill sales process. According to Caltrans' office chief of Real Property Services, its ROW headquarters division and its legal department continue to work together to finalize the regulations. Until it adopts the required regulations, Caltrans cannot sell any of the 11 surplus residential properties related to the SR 710 extension project that were the subject of the 2007 court case unless ordered by the superior court.

Because the sales of the surplus residential properties shown in Table 10 were not the subject of the lawsuit, the court did not reverse them. These properties were sold because they

were deemed by Caltrans to no longer be needed for the SR 710 extension project. Table 10 presents a comparison of the fair market value and the sale price at which the five SR 710 properties sold. In total, the State sold these five properties at \$2.6 million below their market values. Consequently, the State provided these five households with affordable housing that cost it \$2.6 million, or an average of \$520,000 per household. If the State were to deem the remaining 398 SR 710 single-family and multifamily residential parcels shown in Table 9 as surplus and sell them in accordance with the Roberti Bill, it could potentially receive only roughly \$40 million, or 17 percent, of their estimated market value of \$238 million.

Table 10
Sales of State Route 710 Extension Project Residential Properties Under the Roberti Bill Since 2000

RESIDENTIAL PROPERTY ADDRESS	CITY	FAIR MARKET VALUE	SALE PRICE	DIFFERENCE BETWEEN THE SALE PRICE AND MARKET VALUE	DATE OF SALE
Foothill Street	South Pasadena	\$306,500	\$170,875	\$135,625	October 20, 2000
Pasadena Avenue	Pasadena	879,000	90,971	788,029	March 30, 2005
Highland Street	South Pasadena	600,000	56,500	543,500	December 19, 2005
West Arlington Drive	Pasadena	625,000	68,885	556,115	December 22, 2005
Foothill Street	South Pasadena	765,000	144,942	620,058	December 28, 2006
Totals		\$3,175,500	\$532,173	\$2,643,327	

Source: California Department of Transportation's records of sales and appraisals completed at the time of sale.

State Law Would Also Limit Property Tax Revenues If the SR 710 Extension Properties Were Privately Owned

State-owned property is not subject to property taxes. However, if the SR 710 properties were privately owned, they would be subject to property taxes each year. Property is taxed in California by applying a tax rate to the value of the property: For example, if the tax rate is 1 percent and the value of a piece of property is \$100, the property tax on that property would be \$1. Except for certain property assessed by the Board of Equalization (BOE), the taxable value of the property is determined by the county assessor, and the rate at which it can increase over time is subject to limits established by state law. In this regard, state law provides an upper limit on the taxable value, which is calculated by increasing the initial assessed value when purchased by the lesser of 2 percent or the annual inflation rate each year. The taxable value is the lesser of this amount or the market value. For example, if a property was assessed at \$100 when first acquired, that would be the taxable value in that year. If the market value increased to \$105 the next year, and the inflation rate was 2.5 percent, the maximum taxable value would increase to \$102.

Hypothetically, if the SR 710 parcels were privately owned and not subject to the Roberti Bill, they would generate significant property tax revenues for Los Angeles County—we estimate that the property tax revenues for those parcels could range between \$3.4 million and \$4.4 million between fiscal years 2013–14 and 2017–18.

State law requires each county to impose a tax rate of 1 percent and generally prohibits other local entities from imposing a property tax rate except in specified circumstances. One exception occurs when a county or other local entity in a county imposes a property tax rate to make annual payments for certain debt. In Los Angeles County, properties are subject to taxation by a number of taxing agencies such as cities, school districts, and special districts. On average, rates set by taxing agencies increased Los Angeles County's tax rate to 1.168 percent of the assessed value in fiscal year 2009–10.

Hypothetically, if the SR 710 parcels were privately owned and not subject to the Roberti Bill, they would generate significant property tax revenues for Los Angeles County. We estimate that the market value for the SR 710 parcels would have been \$467 million as of January 1, 2007.⁹ According to the BOE's 2008 annual report, the fiscal year 2007–08 average tax rate for Los Angeles County was 1.133 percent. Applying this average tax rate to the estimated market value of the SR 710 parcels would have resulted in an additional \$5.3 million in property tax revenue for the county in fiscal year 2007–08.

However, because real estate values decreased significantly between fiscal years 2007–08 and 2011–12, the property tax revenues would also have decreased. We estimate that the market value for the SR 710 parcels could range from a low of \$280 million to a high of \$370 million between fiscal years 2013–14 and 2017–18.¹⁰ Based on the historical average tax rate trends for Los Angeles County, we estimate that the property tax revenues could range between \$3.4 million and \$4.4 million for these fiscal years.

State law specifies that the county assessor should consider government-imposed restrictions on property during its assessment. In addition, the BOE issued a letter in 1981 to county assessors on the valuation of single-family residential properties subject to the right-to-purchase agreement between Caltrans and buyers under the Roberti Bill. In this letter, among other things, the BOE stated that the valuation of properties subject to the right-to-purchase agreement should be based on the individual property's purchase price. Consequently, SR 710 residential

⁹ To estimate the amounts, we used Moody's Analytics' historical data for the home price index in the Los Angeles metropolitan area to determine the change in real estate values. This estimate assumes that the properties have not changed ownership, have not had new construction, and have not undergone any other actions that would affect their taxable value since January 1, 2007. The California State Auditor (state auditor) did not assess the reliability of Moody's Analytics' historical data.

¹⁰ To estimate the amounts, we used Moody's Analytics' forecast data for the home price index in the Los Angeles metropolitan area to determine the change in real estate values. This estimate assumes that the properties have not changed ownership, have not had new construction, and have not undergone any other actions that would affect their taxable value since January 1, 2007. The state auditor did not assess the reliability of Moody's Analytics' forecast data.

properties sold under the Roberti Bill would generate only a fraction of the property tax revenues that they would otherwise generate if the State sold them at fair market value. Table 11 presents the property taxes the Los Angeles County assessor's office billed the private owners in 2010 for the five properties the State sold under the Roberti Bill since 2000 and our estimate of the property tax bill if the properties had not been sold under the Roberti Bill.

Table 11
County of Los Angeles Property Tax Information for State Route 710 Extension Project Properties Sold Under the Roberti Bill and Tax Estimate if Not Sold Under the Roberti Bill

ADDRESS	CITY	DATE OF SALE	2010 ASSESSED VALUE	OWNERS' 2010 PROPERTY TAX BILL	ESTIMATE OF TAX BILL IF PROPERTY WAS NOT SUBJECT TO THE ROBERTI BILL
Foothill Street	South Pasadena	October 20, 2000	\$340,698	\$4,850	\$6,228
Pasadena Avenue	Pasadena	March 30, 2005	55,036	934	17,861
West Arlington Drive	Pasadena	December 22, 2005	72,925	1,168	12,192
Highland Street	South Pasadena	December 19, 2005	59,814	1,690	12,700
Foothill Street	South Pasadena	December 28, 2006	150,438	2,022	15,545
Totals			\$678,911	\$10,664	\$64,526

Sources: Los Angeles County assessor and the California State Auditor's estimate of property taxes.

Moreover, when it sells the SR 710 residential properties at a price that is less than fair market value, the Roberti Bill requires Caltrans to impose terms, conditions, and restrictions to assure that the housing will remain available to persons and families of low or moderate income and households with incomes no greater than the incomes of the present occupants in proportion to the area median income. In its right-to-purchase agreements for the five properties sold under the Roberti Bill, Caltrans included the relevant terms, conditions, and restrictions and stated that they would generally be in effect until 30 years after the date the agreement was recorded by the assessor's office. As shown in Table 11, the owners of these five properties were billed a total of \$10,664 in taxes in 2010, or roughly 1.6 percent of their assessed value of \$678,911, which was 27.6 percent more than the properties' initial sale price of \$532,173. If the State had sold the properties at fair market value of \$3,175,500 and their value had increased by 27.6 percent to \$4.1 million, the owners could have potentially paid \$64,526 in taxes in 2010. If extrapolated over the average remaining period of 21 years for the right-to-purchase agreements, these numbers suggest that the below-market sales of these five properties alone will result in lost revenue to Los Angeles County of more than \$1 million.

Selling the remaining 398 single-family and multifamily SR 710 residential parcels under the Roberti Bill would potentially decrease the county's property tax revenues by many millions of dollars over a 45- to 55-year period.

Caltrans stated that future sales of SR 710 surplus residential property will be based on California Code of Civil Procedure, Section 1245.245, which became effective on January 1, 2007, and applies only to property acquired on or after that date. This law states that if certain publicly owned single-family residences are offered at a price that is less than their fair market value, the public entity should impose terms, conditions, and restrictions to ensure that the residence will either remain occupied by the owner from whom the State initially acquired the property for at least five years or remain available to persons and families of low or moderate income and households with incomes no greater than the incomes of the present occupants in proportion to the area median income for the longest time feasible, but not less than 55 years for rental units and 45 years for owner-occupied units. Thus, selling the remaining 398 single-family and multifamily SR 710 residential parcels under the Roberti Bill would potentially decrease the county's property tax revenues by many millions of dollars over a 45- to 55-year period.

Alternatives to State Ownership Are Few Because an Environmental Review of the SR 710 Extension Project Is in Progress

The Joint Legislative Audit Committee is interested in identifying alternatives to the State's ownership of the SR 710 properties that will preserve its access to the right-of-way needed for the extension project. As we discuss in the Introduction, the Los Angeles County Metropolitan Transportation Authority's (Metro) consultant is in the process of preparing an environmental impact statement for the SR 710 extension project. Federal regulations provide that highway projects subject to the National Environmental Policy Act of 1969, such as the SR 710 extension project, cannot proceed with final design activities, property acquisition, purchase of construction materials, or project construction until the Federal Highway Administration approves this final environmental impact statement and signs a record of decision acknowledging its acceptance of the general project location and the concepts described in the project's environmental review documents.¹¹ Furthermore, according to Caltrans' chief counsel, it cannot sell the SR 710 properties until there has been a formal determination that they are surplus residential properties, as defined in the Roberti Bill, and are no longer necessary for state highway purposes. Finally, according to the deputy district director of Caltrans' District 7 right-of-way division, none of the SR 710 properties are surplus residential properties because they may be needed in some manner for the future proposed project.

¹¹ In 2007 the Federal Highway Administration delegated its authority for approving environmental impact statements and signing records of decision to Caltrans.

However, there are a few alternatives the State could consider that would allow it to better manage the SR 710 properties. Since at least 1996, Caltrans' management of the SR 710 properties has been subject to criticism. For example, in our 1996 report titled *Department of Transportation: Further Improvements Can Be Made in the Management of Properties Along the State Route 710 Right-of-Way*, we stated that Caltrans' District 7 could make further improvements by controlling those instances in which tenants paid for repairs and then offset the cost of these repairs against their rent payments, improving its handling of delinquent accounts, and charging market rents for its properties or document the reasons for the lower rates. In addition, in the 1999 federal court case *City of South Pasadena v. Slater*, the plaintiffs sought a preliminary injunction to, among other things, impose maintenance requirements on Caltrans and the other defendants. Further, in our 2000 report titled *Department of Transportation: Inadequate Strategic Planning Has Left the State Route 710 Historic Properties Rehabilitation Project Nearly Without Funds and Less Than Half Finished*, we identified problems with Caltrans' management of the SR 710 historic properties rehabilitation project. Chapters 1 and 2 of this report also discuss Caltrans' poor management of the SR 710 properties.

Given this level of criticism, we believe it prudent for the Legislature to consider alternatives to Caltrans' continued role as property manager. In 1996 Caltrans issued a request for proposals to select a bidder to manage 50 single-family SR 710 residences under a master tenancy lease agreement. Under this agreement, the bidder would have collected the rent and provided maintenance and repair services. However, the State Personnel Board (board), which is responsible for enforcing the State's civil service system, issued a decision in December 1997 stating that the master tenancy lease agreement was a personal services contract that was not justified under California Government Code, Section 19130(b)(4). This section permits state agencies to enter into personal services contracts if the services are incidental to a contract for the purchase or lease of real or personal property, and it defines *contracts* under this criterion as service agreements that include, but are not limited to, agreements to service or maintain office equipment or computers that state agencies lease or rent.

However, under California Government Code, Section 19130(a), state agencies may generally enter into personal services contracts with private vendors if the agencies can clearly demonstrate that doing so would achieve cost savings to the State. In these instances, state law requires state agencies to notify the board. One alternative to the need for Caltrans to directly manage the properties is for it to use a private vendor to manage the SR 710 properties under California Government Code, Section 19130(a). This alternative

Given this level of criticism, we believe it prudent for the Legislature to consider alternatives to Caltrans' continued role as property manager.

would require Caltrans to prepare a cost-benefit analysis to demonstrate that this alternative would provide a cost savings to the State.

Another alternative the Legislature could consider would be the establishment of a joint powers authority (JPA) to manage the SR 710 properties. State law allows two or more public agencies such as a state and a city to enter into an agreement to jointly exercise any power common to the contracting parties, if the parties receive authorization from their legislative or governing bodies. The Legislature could clearly define the purpose of the JPA, its membership, its property management requirements, its reporting requirements, and the requirements for its dissolution after the State either completes or abandons the SR 710 extension project. The members of this JPA would include Caltrans and the cities of Los Angeles, Pasadena, and South Pasadena. In establishing the JPA, the Legislature could also redefine the sales process for the properties, such as excluding the SR 710 properties from the Roberti Bill restrictions. Further, if the Legislature were to establish a JPA, it could potentially reduce conflict between Caltrans and the affected cities by providing each city with a voice in the control of the SR 710 properties. However, before making the decision to establish a JPA, the State would need to perform further research, such as holding public meetings to seek input from the affected cities and preparing a comprehensive analysis of the costs and benefits of this alternative.

Recommendations

To ensure that the State properly manages its resources, the Legislature should consider amending the state law known as the Roberti Bill to allow Caltrans to sell SR 710 properties that have a high market value at fair market prices.

To comply with the 2007 court ruling and the APA until such time as the Legislature may choose to act, Caltrans should establish regulations to govern the sales process for the SR 710 properties affected by the Roberti Bill.

To pursue alternatives to its management of the SR 710 properties, Caltrans should:

- Prepare a cost-benefit analysis to determine if the State would save money by hiring a private vendor to manage the properties. If such savings would occur, Caltrans should seek an exemption under California Government Code, Section 19130(a), to hire a private vendor.

- Perform an analysis to compare the cost of establishing a JPA to its current costs of managing the properties.

To pursue alternatives to the State's management of the SR 710 properties that would preserve its access to the right-of-way needed for the extension project, to the extent that Caltrans has determined it to be cost-beneficial to do so, the Legislature should consider the establishment of a JPA that would allow Caltrans and the affected cities to jointly manage the SR 710 properties.

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, CPA
State Auditor

Date: August 16, 2012

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

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Appendix A

HISTORY OF THE PROPOSED STATE ROUTE 710 EXTENSION PROJECT

The proposed State Route 710 extension project (SR 710 extension project) has been the subject of a number of environmental studies suggesting several alternatives to the original proposed route. Of all the alternatives studied for the environmental reports, three route alignments received the greatest scrutiny: the Meridian Route, the Westerly Route, and the Meridian Variation. In 1996 the Meridian Variation was the proposed route for the SR 710 extension project. The following is a chronology of the major events affecting the SR 710 extension project. Many of these events contributed to the more than 40-year delay the California Department of Transportation (Caltrans) has experienced in its attempt to close the gap that exists in the freeway between State Route 10 in Los Angeles and State Route 210 in Pasadena.

Events

1951

State Route 167 (now called State Route 710) was designated, through legislation, as a route from the city of Long Beach to Huntington Drive in Los Angeles. Caltrans subsequently completed a major portion of State Route 710 from the city of Long Beach to State Route 10 in Los Angeles; however, a gap in the route still exists from just north of State Route 10 in Los Angeles to State Route 210 in Pasadena.

July 24, 1953

The California Highway Commission (CHC), predecessor to the California Transportation Commission (CTC), adopted the location designated in 1951 for State Route 7 (now called State Route 710). This adoption allowed Caltrans to exercise Eminent Domain and acquire necessary right-of-way properties along the route.

1954

Caltrans began acquiring some of the necessary right-of-way properties along the designated route in preparation for construction of the SR 710 extension project.

November 18, 1964

The CHC adopted the Meridian Route as the preferred alignment for the SR 710 extension project.

1970

The National Environmental Policy Act (NEPA) and the California Environmental Quality Act (CEQA) became law and required

environmental impact studies for proposed highway construction projects. However, the laws did not specify that such studies were required for projects already in progress. Up to this point, Caltrans was not required to complete an Environmental Impact Statement for the Meridian Route.

February 7, 1973

The city of South Pasadena and others prevailed in a federal civil suit that compelled Caltrans to conduct environmental impact studies and to comply with NEPA and CEQA before construction could begin on the SR 710 extension project.

1975

The city of South Pasadena requested consideration of the Westerly Route alternative, a route that went around rather than through the city. The Westerly Route was found to be unfeasible.

1973 through 1984

Caltrans prepared several environmental impact documents and reports in an effort to comply with NEPA and CEQA. The State Historic Preservation Officer (preservation officer) and the Advisory Council on Historic Preservation (ACHP) became involved in the legal battle in part because the city of South Pasadena contended that several historic districts were located along the Meridian Route. The ACHP submitted a proposal to Caltrans outlining several alternatives to the Meridian Route and Westerly Route for Caltrans to study.

September 14, 1984

Caltrans distributed a conceptual study of the ACHP-recommended alternatives, each of which was determined to have significant shortcomings that outweighed potential benefits.

December 6, 1984

The ACHP responded to Caltrans' conceptual study and recommended a "no-build" option if no other feasible alternative to the Meridian Route and Westerly Route was found.

December 30, 1986

A third Draft Environmental Impact Statement was circulated for review and comment. The document focused on the Meridian Variation alternative, developed by Caltrans as an alternative to avoid historic properties.

1986 through 1990

Caltrans, the Federal Highway Administration (highway administration), and the CTC continued to meet resistance from the city of South Pasadena as well as from the ACHP and the preservation officer. The primary source of conflict was the

classification of historic properties and Caltrans' efforts (or lack thereof) to avoid those properties. The ACHP, the preservation officer, and the city of South Pasadena have focused their efforts on approval of a "low-build" alternative (referred to as the "Raymond-Arroyo Couplet" by Caltrans) for the SR 710 extension project that would include alternate transportation methods and mitigating devices such as Traffic Management Systems, converting two-directional streets to one-way streets, extending the freeway further north to Mission Street, and eliminating on-street parking.

March 2, 1992

The highway administration provisionally approved the 1992 Final Environmental Impact Statement as adequate in describing the effects the SR 710 extension project would have on the environment and selected the Meridian Variation as the preferred alignment. The highway administration directed Caltrans to form a Mitigation and Enhancement Advisory Committee (advisory committee) to further reduce project impacts before proceeding with federal approval. The advisory committee included representatives from Caltrans; the highway administration; the Southern California Association of Governments; the Los Angeles County Metropolitan Transportation Authority; the National Trust; the Sierra Club; the Los Angeles Conservancy; and the cities of Pasadena, South Pasadena, Los Angeles (El Sereno), and Alhambra.

December 14, 1992

Caltrans asked the highway administration to sign the record of decision on the SR 710 extension project. The record of decision completes the NEPA process and is the document that the highway administration uses to notify Caltrans that a proposed project has federal approval and support.

January 15, 1993

The ACHP referred the proposed SR 710 extension project to the President's Council on Environmental Quality (CEQ), stating that earlier historic property surveys were incomplete and outdated and that no attempt had been made to address a "low-build" alternative. The highway administration subsequently responded to the referral, essentially disagreeing with the ACHP's opinion.

January 26, 1993

The highway administration declined to sign the record of decision until the advisory committee completed its work and the CEQ referral was addressed.

1994

A draft Third Supplemental Historic Architectural Survey Report was released. The report identified the properties with historic significance along the Meridian Variation. Caltrans subsequently

requested that the highway administration forward the report to the preservation officer for a determination of eligibility of additional professed historic properties. Caltrans and the preservation officer did not reach an agreement and the preservation officer advised the highway administration to submit the draft Third Supplemental Historic Architectural Survey Report to the “Keeper” of the National Register of Historic Properties for a federal determination of eligibility (for inclusion in the National Register) for these properties.

September 14, 1994

The CTC voted to approve the SR 710 extension project. This action rescinded the Meridian Route as the adopted route and substituted the Meridian Variation alternative. Shortly thereafter, Assembly Bill 2556 was enacted, which relieved Caltrans, under certain conditions, of having to acquire freeway agreements with local governments when local streets need to be closed for freeway construction. A freeway agreement between Caltrans and local governments gives Caltrans permission to proceed with construction.

January 10, 1995

The Major Investment Review Committee that included representatives from the Southern California Association of Governments, the Federal Transit Authority, the highway administration, and the Los Angeles County Metropolitan Transportation Authority met and determined that the SR 710 extension project has fulfilled the Major Investment Study requirement of the Intermodal Surface Transportation and Efficiency Act of 1991.

March 25, 1995

Three community activist groups from El Sereno in the city of Los Angeles filed an environmental justice complaint with the United States Department of Transportation. The basis of the complaint was that the community of El Sereno, which has a predominantly Hispanic population, did not get equal treatment regarding project mitigation when compared to the cities of South Pasadena and Pasadena, which have predominantly Caucasian populations. Historic properties were among the specific areas for which the groups claimed unequal mitigation. Caltrans refuted each issue in the complaint in a July 14, 1995, letter to an interested member of the United States Congress.

September 13, 1995

Activist groups from El Sereno filed suit against the CTC and Caltrans claiming “Environmental Racism.”

November 20, 1995

The Keeper of the National Register signed the determination of eligibility designating properties in the Short Line Villa Tract in the community of El Sereno as historic. As a result, to avoid including these historic properties in the right-of-way for the SR 710 extension project, Caltrans made a minor shift in the alignment of the proposed route.

April 19, 1996

The highway administration Region 9 recommended federal approval of the SR 710 extension project and submitted a memorandum to the highway administration administrator requesting completion of the record of decision.

September 1996

The city of Alhambra filed a complaint for Mandamus against the highway administration and others seeking to compel the highway administration to issue the record of decision for the completion of the SR 710 extension project. The completed SR 710 extension project will relieve the congestion and related environmental hazards that the complaint asserted are now present in Alhambra.

The city of Alhambra also filed a complaint for Declaratory and Injunctive relief against the highway administration and Caltrans for their failure to comply with NEPA and its implementing regulations. This action also challenges the federal government to approve the SR 710 extension project.

October 1996

The highway administration had not yet completed the record of decision on the SR 710 extension project.

Source: California State Auditor's report issued in November 1996 titled *Department of Transportation: Further Improvements Can Be Made in the Management of Properties Along the State Route 710 Right-of-Way*.

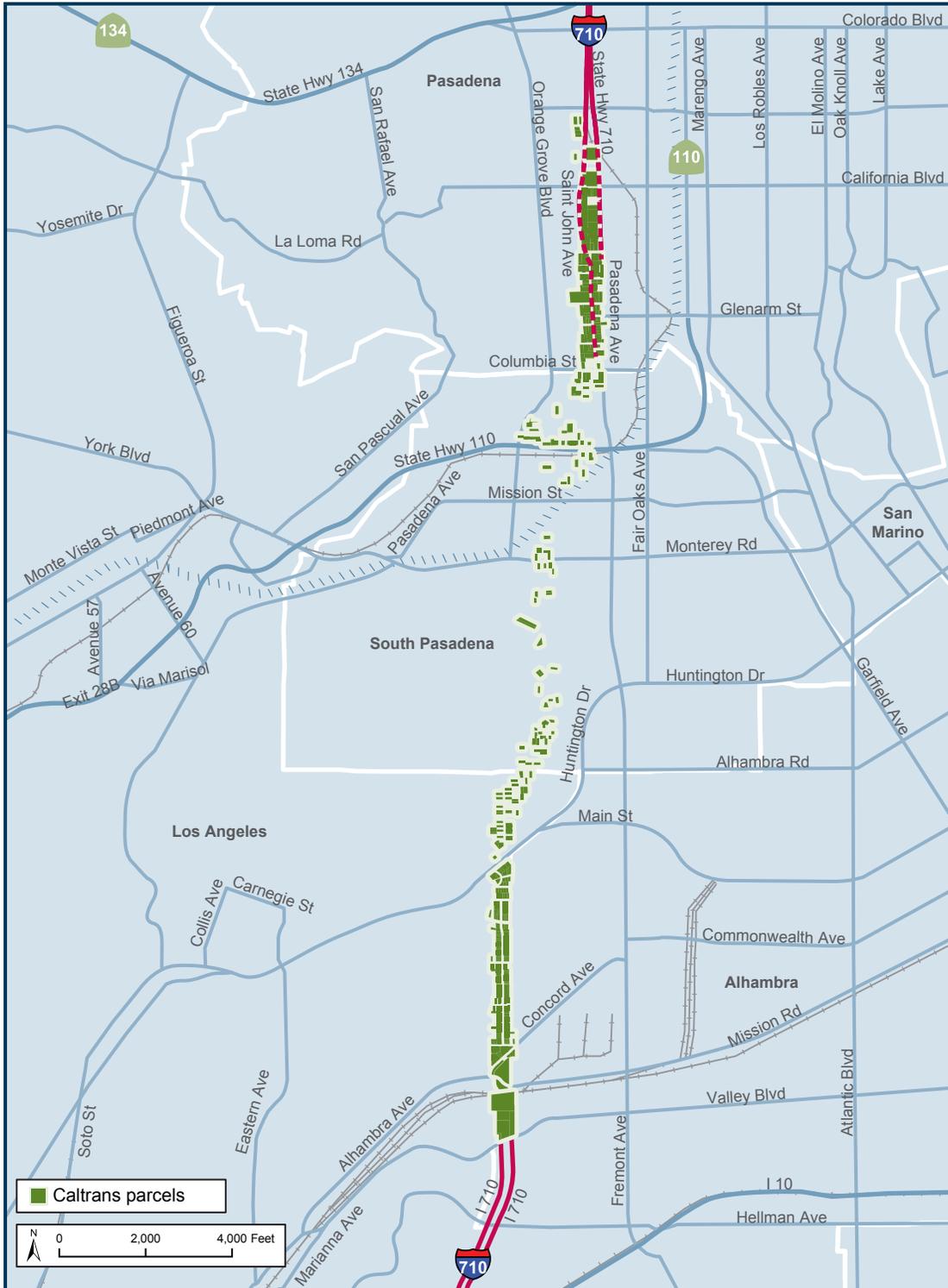
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Appendix B

MAP OF THE STATE ROUTE 710 EXTENSION PROJECT PARCELS

The map in Figure B on the following page indicates the location of the property parcels that the California Department of Transportation owned as of February 2012 related to the State Route 710 extension project. A parcel is a plot of land that can contain more than one single-family or multifamily residential property unit.

Figure B
State Route 710 Extension Project Parcels



Source: California Department of Transportation.

Appendix C

STATE LAW RELATING TO THE MAINTENANCE OF HISTORIC STATE ROUTE 710 EXTENSION PROJECT PROPERTIES

State law places a number of restrictions on state agencies in order to ensure the preservation of the State's historical resources. According to state law, a historical resource is "any object, building, structure, site, area, place, record, or manuscript that is historically or archaeologically significant, or is significant in the architectural, engineering, scientific, economic, agricultural, educational, social, political, military, or cultural annals of California." To preserve the State's historic structures, state law requires agencies such as the California Department of Transportation (Caltrans) to submit to the State Historic Preservation Officer (preservation officer) an inventory of all state-owned structures under their jurisdiction that are more than 50 years old and meet one of the following four criteria:

- The structure is listed in the National Register of Historic Places.
- The structure may be eligible for inclusion in the National Register of Historic Places.
- The structure is registered as a state historical landmark.
- The structure may be eligible for registration as a state historical landmark.

Further, state law requires that state agencies inventory any state-owned structures in a freeway right-of-way before approving any undertaking that either would alter their original or significant features or would require that they be transferred, relocated, or demolished. A character-defining feature may be defined by the form and detailing of exterior materials, such as masonry, wood, and metal; exterior features, such as roofs, porches, and windows; interior materials, such as plaster and paint; and interior features, such as moldings and stairways, room configuration, and spatial relationships. Features might also include a building's structural and mechanical systems or its setting. Once a property has been determined to be eligible for inclusion in the National Register of Historic Places, a Caltrans qualified architectural historian identifies the property's character-defining features using a condition assessment report.

Each state agency must submit annual updates of their inventory to the preservation officer by July 1 of each year. The preservation officer reviews this information and compiles a master list of

State Office of Historic Preservation's Master List

The master list includes the following types of structures:

- All structures from state agency inventories that the preservation officer determines to be significant.
- State-owned historical resources currently listed in the National Register of Historic Places.
- State-owned historical resources that are registered as state historical landmarks.

Source: California Public Resources Code, Section 5024 (d).

historical resources as shown in the text box. Caltrans must then notify the preservation officer before altering the original or significant historical features or fabric of any of the SR 710 extension project property units that are on the master list. If the preservation officer determines that the alteration will have an adverse effect on the property, Caltrans must work with the officer to adopt measures to eliminate or mitigate the adverse effects.

In addition, state law imposes requirements regarding work on other historical resources, regardless of whether the resources are on the master list. For example, state law requires each state agency to submit to the preservation officer for comment any project having the potential to affect historical resources listed in or potentially eligible for inclusion in the National Register of Historic Places or registered as or eligible for registration as a state historical landmark.

Appendix D

IMAGES OF SELECT STATE ROUTE 710 EXTENSION PROJECT PROPERTIES

The images in Figures D.1 to D.3 on the following pages represent select residential properties that the California Department of Transportation owned as of February 2012 related to the State Route 710 extension project.

Figure D.1
Images of State Route 710 Properties in South Pasadena



Sources: California State Auditor's images and the California Department of Transportation's property records, estimate of the State Route 710 extension properties value as of March 1, 2012, and data obtained from its Right-of-Way Property Management System as of February 9, 2012.

Figure D.2
Images of State Route 710 Properties in Pasadena



Sources: California State Auditor's images and the California Department of Transportation's property records, estimate of the State Route 710 extension properties value as of March 1, 2012, and data obtained from its Right-of-Way Property Management System as of February 9, 2012.

Figure D.3
Images of State Route 710 Properties in Los Angeles



Sources: California State Auditor's images and the California Department of Transportation's property records, estimate of the State Route 710 extension properties value as of March 1, 2012, and data obtained from its Right-of-Way Property Management System as of February 9, 2012.

(Agency response provided as text only.)

Business, Transportation and Housing Agency
980 9th Street, Suite 2450
Sacramento, CA 95814-2742

July 13, 2012

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

Dear Ms. Howle:

Attached please find a response from the California Department of Transportation (Department) to your draft audit report *Department of Transportation: Its Poor Management of State Route 710 Properties Costs the State Millions of Dollars Annually, Yet State Law Limits the Potential Income From Selling the Properties* (#2011-120). Thank you for allowing the Department and the Business, Transportation and Housing Agency (Agency) the opportunity to respond to the report.

As noted in its response, the Department has implemented recommendations, is in the process of implementing recommendations, or will work with Agency to determine how best to address the issues raised in your report. We appreciate your identification of opportunities for improvement and your recommendations for best practices the Department can follow.

If you need additional information regarding the Department's response, please do not hesitate to contact Michael Tritz, Agency Deputy Secretary for Audits and Performance Improvement, at (916) 324-7517.

Sincerely,

(Signed by: Brian P. Kelly)

BRIAN P. KELLY
Acting Secretary

Attachment

July 11, 2012

Brian P. Kelly
Acting Secretary
Business, Transportation and Housing Agency
980 9th Street, Suite 2450
Sacramento, CA 95814

Dear Mr. Kelly:

Thank you for the opportunity to review and comment on the Bureau of State Audits' (BSA) draft audit report entitled "Department of Transportation: Its Poor Management of State Route 710 Properties Costs the State Millions of Dollars Annually, Yet State Law Limits the Potential Income From Selling the Properties."

At the request of the Joint Legislative Audit Committee, the BSA conducted an audit of the cost to the State of maintaining properties it owns in the proposed State Route (SR) 710 extension project and to determine if any feasible alternatives to owning and maintaining the properties exist. The BSA concluded that Caltrans has not adequately managed the rental of SR 710 extension properties or provided adequate oversight of SR 710 property repairs. In addition, the report noted that State law limits alternatives to State ownership of the SR 710 extension properties.

For background, it is worth noting that Caltrans started acquiring properties in the cities of Pasadena, South Pasadena, and Los Angeles for the 710 Freeway construction project in 1954. A federal injunction and public controversy halted acquisition in 1973 and Caltrans started renting the SR 710 properties (properties) it had already acquired. At this same time, the Affordable Rent Program (Program) was established to protect lower income tenants from a rapidly rising real estate market. The Program was terminated in 1981 for any new affordable rent tenants, but grandfathered any tenant in the Program as long as they were in tenancy with Caltrans and met all the affordable rent criteria. Caltrans continued the ongoing maintenance needs of the properties without applying market rents. By 2002, Caltrans' approach to manage the properties included repairing historic homes first and then increasing rent schedules to fair market. Properties to be rented were repaired to habitable and desirable residential market condition, the work for some of which was costly. A rental rate increase was issued for those tenants paying less than eighty percent (80%) market value; however, through complaints from tenants to their legislative representative, Caltrans suspended all rent increases until

January 1, 2003, and subsequently extended the suspension to August 2006.

Subsequent efforts to raise rents during the previous gubernatorial administration were unsuccessful.

In the draft audit report, the BSA auditors noted the following:

- Caltrans has charged rents far below market rates and consequently has received millions less in rental income.
- Potential tax implications exist for state employees who rent SR 710 properties at below-market rates.
- Caltrans has not regularly reviewed income eligibility for tenants in its Affordable Rent Program, and the policy governing the program may be unenforceable.

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- Caltrans could not demonstrate that many repairs to the SR 710 properties were necessary and reasonable.
- Caltrans poorly manages the repairs to the SR 710 properties.
- The Roberti Bill limits the potential sales process and property tax revenues if the State sells the SR 710 properties.
- State law would also limit property tax revenues if the SR 710 extension properties were privately owned.
- Alternatives to State ownership are few because an environmental review of the SR 710 extension project is in process.

BSA's recommendations and Caltrans' responses are listed below:

Recommendation No. 1:

To ensure that it collects fair market rents for the SR 710 properties on the State's behalf, Caltrans should do the following:

- a) Using the fair market rent determinations for all SR 710 properties it recently prepared, excluding those in its affordable rent program, adjust the tenants' rents to fair market rents after providing them with proper notice.
- b) Make only limited exceptions to charging fair market rent and document the specific public purpose that is served in any case that it does not charge fair market rent.

Caltrans Response:

Caltrans will work with the Business, Transportation and Housing Agency (Agency) to develop the best course of action for Caltrans and the State.

Recommendation No. 2:

To ensure that all taxable fringe benefits or gifts state agencies provide to their employees are appropriately included in the employees' gross income, Caltrans should take the following actions:

- a) Establish procedures to notify state employees who rent SR 710 properties that they may be subject to tax implications.
- b) Continue to work with its information technology staff to generate the reports necessary for it to provide the SCO with the value of state housing for employees monthly.
- c) Work with the SCO to identify the statute of limitations for employers to report adjustments to employee gross income to the federal Internal Revenue Service and the California Tax Board.
- d) Work with the SCO to identify the difference between the fair market rental value of the SR 710 housing and the rent the state employees paid for that housing during the applicable calendar years related to the federal and state statute of limitations.

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- e) Work with the SCO to determine if it needs to revise the W-2 forms for the other employees to whom it provided housing benefits, including the four employees who worked at its Chilao Maintenance Station.
- f) Provide information to the other state agencies so that they can submit the standard form for reporting the value of the housing provided to their state employees for the applicable past calendar years to the SCO. Caltrans should continue to submit this information monthly to the state agencies until the employees are no longer renting the SR 710 properties at below-market rates.

Caltrans Response:

Caltrans will immediately seek guidance from the State Controller's Office and other entities as necessary for the appropriate course of action.

Recommendation No. 3:

To ensure that the affordable rent policy is enforceable and that only eligible tenants receive the benefit of the policy, Caltrans should do the following:

- a) Adopt regulations in accordance with the APA if the director determines that it is appropriate to continue to offer affordable rent to certain tenants.
- b) Annually review the tenants' household incomes and document their income using certification forms. If tenants no longer qualify for the program because their income exceeds the income requirement or one of the income-producing tenants in the household has been replaced by a new member, it should increase their rent to fair market rates after giving proper notice.

Caltrans Response:

Caltrans will immediately work with Agency to determine if the Affordable Rent Program will be continued and, if applicable, proceed with the APA process, implement appropriate procedures and provide training to staff.

Recommendation No. 4:

To ensure that the repairs it makes to the SR 710 properties are necessary and reasonable, Caltrans should do the following:

- a) Document its rationale for approving project change orders.

Caltrans Response:

Caltrans will immediately instruct staff to document the rationale for approving project change orders. Specific policy and procedures to ensure compliance will be completed, and training will be provided to appropriate staff, by December 31, 2012.

- b) Conduct annual field inspections of the properties.

Caltrans Response:

Caltrans will reinforce existing procedures immediately and, by December 31, 2012, will complete field inspections of any properties that have not been inspected within the past year. Field inspections of all properties will occur annually thereafter.

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- c) Discontinue performing roofing repairs on properties its roof assessments indicate are in good condition unless a new assessment indicates a repair is needed.

Caltrans Response:

Caltrans will immediately ensure updated assessments are completed before repairs are performed, and repairs will be performed only if an assessment indicates repairs are warranted. The specific policy and procedures to ensure compliance will be completed by December 31, 2012.

- d) Incorporate roof assessments as part of its annual field inspections of the properties.

Caltrans Response:

Caltrans will immediately incorporate roof assessments with its annual field inspections of the properties. The specific policy and procedures to ensure compliance will be completed by December 31, 2012.

- e) Develop a written policy to ensure it considers the cost-effectiveness of repair costs in relation to the potential rental income for property. Such a policy should establish the maximum acceptable cost recovery period for the amount it will spend for repairs before it considers the repairs to be wasteful.

Caltrans Response:

Caltrans will develop a written policy to assess cost effectiveness of repair costs and will evaluate establishing a cost recovery period for repairs. The policy will be developed, and training will be given to all employees who have responsibility for maintenance on SR 710 properties, by December 31, 2012.

- f) Establish a process to ensure it evaluates the cost-effectiveness of any repair before authorizing it.

Caltrans Response:

Caltrans will develop an appropriate process and provide training to appropriate staff by December 31, 2012.

- g) Retain in its project files evidence to support the necessity and reasonableness of the repairs such as change orders, annual field inspections, and analyses of cost-effectiveness.

Caltrans Response:

Caltrans will immediately instruct staff to retain the requisite evidence in the project files. Specific policy and procedures to ensure compliance will be completed, and training will be provided to appropriate staff by December 31, 2012.

Recommendation No. 5:

To ensure that the State achieves cost savings for the repairs made to the SR 710 properties, Caltrans should periodically perform more comprehensive analyses of viable options for repairing the 710 properties. If Caltrans determines that General Services is the best option, it should ensure that it properly executes an interagency agreement in accordance with the State Contracting Manual.

Caltrans Response:

Caltrans will implement processes that will allow for the comparison of options for the maintenance of the SR 710 properties by December 31, 2012. Caltrans will comply with the State Contracting Manual and immediately execute an Interagency Agreement with General Services for the interim period.

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Recommendation No. 6:

To ensure that General Services performs only necessary repairs and that its costs are reasonable, Caltrans should do the following:

- a) Ensure its staff adhere to relevant contracting policies, including retaining evidence of its approval of General Services' repair work before and after the completion of a project in the project file.

Caltrans Response:

Caltrans will immediately ensure staff adhere to relevant contracting policies and retain evidence of its approval of General Services' work before and after project completion in the project file.

- b) Reconcile General Services' estimates for the repair projects with the scope of work Finance approved in the transfer request form, and, if applicable, explain any differences.

Caltrans Response:

Caltrans will develop a process to reconcile General Services' estimates for repair projects with the scope of work Finance approved in the transfer request form by December 31, 2012.

- c) Reconcile actual work General Services performs to the scope of work approved in the project work plans.

Caltrans Response:

Caltrans will develop a process to reconcile actual work performed by General Services to the scope of work approved in the project work plans by December 31, 2012.

- d) Reconcile the actual expenditures for the projects listed in the transfer request form approved by Finance and the approved budget in the project work plans with General Services' actual expenditures for each project.

Caltrans Response:

Caltrans has already taken corrective action by creating the March 2012 Tracking Spreadsheet that will allow Caltrans to reconcile actual expenditures approved by Finance and the approved budget in the project work plans with General Services actual expenditures.

- e) Modify the March 2012 tracking spreadsheet to ensure it contains sufficient information for Caltrans to effectively monitor repair costs.

Caltrans Response:

Caltrans will immediately modify the March 2012 tracking spreadsheet to effectively monitor repair costs.

Recommendation No. 7:

To ensure that the State properly manages its resources, the Legislature should consider amending the state law known as the Roberti Bill to allow Caltrans to sell SR 710 properties that have high market value at fair market process.

Caltrans Response:

Because this recommendation is addressed to the Legislature, Caltrans is not providing a response.

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Recommendation No. 8:

To comply with the 2007 court ruling and the APA until such time as the Legislature choose to act, Caltrans should establish regulations to govern the sales process for the SR 710 properties affected by the Roberti Bill.

Caltrans Response:

Caltrans is in the process of finalizing the proposed regulations to govern the sales process under Government Code 54235 et seq (Roberti Act). Upon completion, the proposed regulations will be submitted to the Office of Administrative Law for approval.

Recommendation No. 9:

To pursue alternatives to its management of the SR 710 properties, Caltrans should:

- a) Prepare a cost-benefit analysis to determine if cost savings to the State would exist if it were to hire a private vendor to manage the properties. If savings exist, Caltrans should seek an exemption under Government Code Section 19130 (a) to hire a private vendor.
- b) Perform an analysis to compare the cost of establishing a JPA to its current costs of managing the properties.

Caltrans Response:

Caltrans will work with Agency on the best strategy for Caltrans and the State.

Recommendation No. 10:

To pursue alternatives to the State's management of the SR 710 properties that would preserve its access to the right of way needed for the extension project, to the extent that Caltrans has determined it to be cost beneficial to do so, the Legislature should consider the establishment of a JPA that would allow Caltrans and the affected cities to jointly manage the SR 710 properties.

Caltrans Response:

Because this recommendation is addressed to the Legislature, Caltrans is not providing a response.

Caltrans appreciates the opportunity to provide a response to the draft audit report. If you have any questions or require further information, please contact Bob Pieplow, Acting Deputy Director, Project Delivery, at (916) 654-6490, or William E. Lewis, Acting Assistant Director, Audits and Investigations, at (916) 323-7122.

Sincerely,

(Signed by: Richard Land for)

MALCOLM DOUGHERTY
Director

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(Agency response provided as text only.)

State and Consumer Services Agency
915 Capitol Mall, Suite 200
Sacramento, CA 95814

July 13, 2012

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

Re: Bureau of State Audit's Draft Report – 2011-120

Pursuant to the above audit report, enclosed are the Department of General Services' comments pertaining to the results of the audit.

The State and Consumer Services Agency would like to thank the BSA for its comprehensive review. The results provide us with the opportunity to better serve our clients and protect the public.

Sincerely,

(Signed by: Anna M. Caballero)

Anna M. Caballero, Secretary
State and Consumer Services Agency

Enc.

Date: July 13, 2012

To: Anna M. Caballero, Secretary
State and Consumer Services Agency
915 Capitol Mall, Suite 200
Sacramento, CA 95814

From: Fred Klass, Director
Department of General Services

Subject: RESPONSE TO BUREAU OF STATE AUDITS' REPORT NO. 2011-120

Thank you for the opportunity to respond to the Bureau of State Audits' (BSA) Report No. 2011-120 which addresses recommendations to the Department of General Services' (DGS) resulting from its audit of the State Route 710 extension project (extension project). The audit included the review of Caltrans-directed property repair, rehabilitation, and maintenance services performed by the DGS' Direct Construction Unit (DCU). The following response addresses each of the recommendations regarding the DGS' operations.

OVERVIEW OF THE REPORT

The DGS acknowledges the BSA's audit which, in part, focused on the processes used by the DCU to charge fees and costs to extension projects. In summary, the BSA identified a number of areas for improvement with the DCU's administrative processes used for calculating fees and overseeing project repair costs.

Although the DGS agrees that additional actions need to be taken to improve the DCU's administrative processes, it should be noted that almost uniformly the DCU has received positive feedback from its customers on the professionalism exhibited by its staff and the high quality and timely work performed by those individuals.

Based on the results of its fieldwork, the BSA developed the following recommendations to further improve the DCU's administrative processes. In general, the BSA's recommendations have merit and will be promptly addressed.

RECOMMENDATIONS

CHAPTER 2

RECOMMENDATION: *To ensure that it appropriately executes interagency agreements with other state agencies, General Services should provide training to DCU staff.*

DGS RESPONSE:

The DCU will schedule its contracting staff to attend the Services Contracting course offered by the California Procurement & Contracting Academy (Cal-PCA). The Cal-PCA course is taught by staff from the DGS' Office of Legal Services (OLS) and includes coverage of the State's requirements for the use of interagency agreements to contract with other State agencies.

The OLS oversees the State's contracting program and publishes State Contracting Manual Volume 1 as a resource to those persons in State government who are involved in the service contract process, including those persons who process contracts between two or more State agencies.

CHAPTER 3

RECOMMENDATION # 1: *To ensure that it charges its clients appropriately for the work it performs, General Services should do the following:*

- *Reassess the DCU's methodologies for determining the hourly burden rate and direct administration fees.*
- *Ensure that the DCU's methodologies are sound and that it can properly support them.*

DGS RESPONSE # 1:

The DGS will take action to ensure that the DCU's hourly burden rate and direct administration fees are accurately and properly calculated based on prior year expenditure data and projected billable hours. As part of this process, the DCU will consult with appropriate DGS budget, accounting and information technology staff on improvements that can be made in its rate and fee calculation function.

RECOMMENDATION # 2: *To determine if the DCU's use of casual laborers to perform work not in their job specifications, such as procurement, is cost-effective, General Services should perform an analysis comparing the cost of paying the casual laborers at the prevailing wage rate and the cost of paying civil service permanent employees. If it finds that using permanent employees is cost-effective for the State, General Services should seek approval for additional permanent employees to perform those functions.*

DGS RESPONSE # 2:

In August 2012, the DCU will start work on an analysis of the cost effectiveness of its current practice of using a limited number of casual trades' staff to occasionally perform office administrative type tasks, such as procurement. The analysis will include the comparison of the cost of paying casual laborers at the prevailing wage rate and the cost of paying civil service permanent employees.

RECOMMENDATION # 3: *To ensure that the casual laborers only charge their actual hours worked to projects, General Services should do the following:*

- *Require that the civil service supervisor who has knowledge of the time the casual laborer works approves the casual laborer's daily time report and ABMS time charges.*
- *Ensure that the daily time reports for casual laborers contain the appropriate task codes, the laborer's signature, and the approval of a civil service supervisor.*
- *Update its DCU manual to formalize its standard practice of using daily job reports for each project.*
- *Retain the daily job reports and the daily time reports in the project files.*

DGS RESPONSE # 3:

The DCU has placed a high priority on strengthening its time reporting practices to ensure the accurate charging of projects for casual laborer work. As part of this process, the DCU is updating the time reporting provisions within its policy manual. Upon the completion of the update process, the time reporting policies will fully address the BSA's recommended actions regarding time report completion, laborer signature, supervisor approval and file retention. The DCU plans that the policy manual will be updated and training provided to staff by September 30, 2012.

RECOMMENDATION # 4: *To ensure that it complies with its nepotism policy, General Services should have its office of human resources review and approve its existing temporary authorization appointments for casual laborers. If the office of human resources finds that personal relationships exist, General Services should take the appropriate action in accordance with its policy.*

DGS RESPONSE # 4:

The DGS is currently updating its nepotism policy, as well as the nepotism process contained in the department's Personnel Operations Manual, to provide additional guidance to staff. Upon the issuance of this policy, the DGS' Office of Human Resources will work with the DCU to assist in ensuring that nepotism did not occur in the hiring of existing casual laborers and future hires.

RECOMMENDATION # 5: *To ensure that the DCU complies with the State's procurement laws and policies, General Services should do the following:*

- *Require the DCU to immediately discontinue its current procurement practices that are inconsistent with the State's procurement laws and policies.*
- *Require the DCU to modify the procurement section of its manual to conform to the State's procurement laws and policies.*
- *Provide training to its DCU employees regarding the State's procurement laws and policies.*
- *Clarify the waiver process in the administrative order governing the small business participation goal.*
- *Continue its efforts to implement regulations that govern the small business certification process related to defining and enforcing violations of commercially useful function requirements.*
- *Conduct an investigation of the small businesses we discussed in the report to determine if they are performing a commercially useful function.*

DGS RESPONSE # 5:

The DCU is taking prompt actions to immediately discontinue any procurement practices that do not fully comply with State requirements. The actions include implementing additional policies and procedures that ensure the rotating of suppliers, conduct and documenting of fair and reasonable pricing analyses and verification of the performance of a commercially useful function by certified small businesses (SB) and disabled veteran business enterprises (DVBE). As part of this process, the DCU will update the procurement section of its policy manual to conform to the State's procurement requirements. Further, the DCU will enroll its purchasing staff in Cal-PCA courses which are offered to provide acquisition specialists with the knowledge essential to conduct purchases in compliance with State requirements.

To provide additional clarity on circumstances that may warrant a policy waiver, the DGS will amend its administrative order that requires its operating entities to procure goods and services under certain dollar thresholds from SBs and DVBEs. Specifically, the DGS' Office of Small Business and DVBE Services (OSDS), which is the entity responsible for granting waivers, will develop and provide additional examples of situations (such as excessive cost impact) when waivers may be granted from purchasing from certified SBs and DVBEs.

As to the implementation of regulations that address the performance of a commercially useful function (CUF) by suppliers that bid or participate in a State contract, pending approval of the Office of Administrative Law, the DGS has developed new DVBE regulations which further expand and clarify CUF requirements. Once the DVBE regulations are approved and implemented which is expected by the end of September 2012, the DGS will embark on a comprehensive revision of the SB regulations that will include new CUF provisions which are consistent with those contained in the DVBE regulations.

Finally, in consultation with the DCU and OSDS, the DGS' Office of Audit Services will investigate the small businesses discussed in the report to determine if they are performing a CUF.

CONCLUSION

The DGS is firmly committed to ensuring that the repair, rehabilitation, and maintenance services conducted by the DCU are performed in an effective and efficient manner. As part of its continuing efforts to improve that process, the DGS will take appropriate actions to address the issues presented in the report.

If you need further information or assistance on this issue, please contact me at (916) 376-5012.

(Signed by: Fred Klass)

Fred Klass
Director

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