



**STATE OF COLORADO
OFFICE OF THE STATE AUDITOR**

Performance Evaluation of State Capital Asset
Management and Lease Administration Practices

November 2012

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November 21, 2012

Members of the Legislative Audit Committee:

This report contains the results of a performance evaluation of the State's capital asset management and lease administration practices. The evaluation was conducted pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of State government. The Office of the State Auditor contracted with Deloitte Financial Advisory Services LLP to conduct the performance evaluation. The report presents findings, conclusions, and recommendations and the responses of the Office of State Planning and Budgeting, the Office of the State Architect, the Judicial Department, and the Departments of Personnel & Administration and Labor and Employment.

Yours truly,

A handwritten signature in black ink that reads "Deloitte Financial Advisory Services LLP". The signature is written in a cursive, flowing style.

Deloitte Financial Advisory Services LLP
By: Josh Leonard, Partner

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Glossary of Terms and Abbreviations

BOMA – Building Owners and Managers Association

COP – Certificate of Participation

IBS Building – Institute of Behavioral Science Building–University of Colorado-Boulder.

Judicial Center – Ralph L. Carr Judicial Center

OSPB – Governor’s Office of State Planning and Budgeting

ProLease – the State’s lease administration database, managed by Jones Lang LaSalle, the State’s contract real estate broker

“State” or “Colorado” – State of Colorado

STATE CAPITAL ASSET MANAGEMENT AND LEASE ADMINISTRATION PRACTICES Performance Evaluation, November 2012

Report Highlights

PURPOSE

To compare the State's management practices for real estate assets and leases with real estate industry practices to identify opportunities for improvement and cost savings.

BACKGROUND

- In Fiscal Year 2011, the State's real estate portfolio included nearly 70 million gross square feet of owned space and 3.4 million rentable square feet of leased space.
- For Fiscal Years 2009 through 2013, the State approved funding of more than \$2.1 billion for State-funded capital projects, and \$2.3 billion for cash-funded capital projects for institutions of higher education since January 2010, and made \$230 million in lease payments to third party landlords.
- A variety of agencies oversees and manages the State's real estate portfolio in a decentralized fashion.

OUR RECOMMENDATIONS

The Governor's Office of State Planning and Budgeting and the Office of the State Architect should:

- Seek to improve the information used to prepare capital project justifications and support decision-making.
- Improve the tracking, monitoring, and reporting on capital construction projects for Executive Branch agencies and institutions of higher education, and work with the Capital Development Committee (CDC) to propose legislation as needed.
- Work with the CDC to develop options, such as lease surcharges, to address controlled maintenance funding needs.
- Work with the CDC to complete a master plan for the Capitol Complex.

The Office of the State Architect should strengthen lease administration practices and conduct lease audits to reduce the risk of operating expense payment errors.

The agencies agreed with our recommendations.

EVALUATION CONCERN

State practices for analyzing capital construction requests, monitoring capital projects once approved, and conducting long-term planning for its real estate portfolio vary from recognized real estate practices. Additionally, the State's lease administration practices and contract provisions lack protocols to mitigate the risk of lease payment errors.

FACTS AND FINDINGS

- State practices for justifying capital construction requests are not consistent across branches of government, State agencies, or individual projects and do not include analyses of costs before initiation and approval by the CDC and the General Assembly.
- State mechanisms for tracking, monitoring, and reporting on expenditures, project assumptions, and cost savings are inconsistent across agencies and projects and in some cases, do not align with recognized real estate practices. Additionally, agencies generally do not perform post-mortem reviews to assess the validity of project assumptions at project closeout.
- The State lacks sufficient funding for controlled maintenance and if not addressed, controlled maintenance needs will likely result in higher repair and replacement costs for taxpayers. If the \$522 million in estimated controlled maintenance needs over the next five years is deferred, repair or replacement of the State's owned building portfolio could cost the State over \$2 billion.
- The State generally lacks a comprehensive mechanism for long-term planning (such as a master plan), for its real estate assets. Such a mechanism could assist the State in its efforts to maximize the value of its real estate assets, reduce facility costs, and support funding decisions.
- State lease administration practices lack protocols to assist it in identifying, investigating, and correcting potential overpayment and underpayment of lease operating expenses.
- The State's standardized leases are not aligned with recognized real estate leasing practices and do not adequately protect State agencies from paying more in lease costs than they should.

For further information about this report, contact the
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RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
1	30	Improve the completeness and comprehensiveness of the information used to prepare capital project justifications by (a) revising capital budget instructions to require all project justifications to provide total lifecycle costs; (b) clarifying that all assumptions in capital project justifications must be supported by adequate and complete supporting documentation; (c) considering development of a repository to capture major project assumptions; and (d) evaluating the potential for identifying a pool of specialists which State agencies can resource when preparing their capital construction project justifications and funding requests.	Office of State Planning and Budgeting	Agree	May 2013
			Office of the State Architect	Agree	May 2013

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
2	40	Improve the tracking, monitoring, and reporting on capital construction projects for Executive Branch agencies, including institutions of higher education, by working with the Capital Development Committee to propose legislation where appropriate. Specifically: (a) establish formal policies for the construction and administration phase of capital construction projects; (b) propose legislation outlining the criteria, length of reporting term, and circumstances under which agencies should analyze and monitor project lifecycle costs, project assumptions, and cost savings estimates; and (c) propose legislation outlining the criteria and circumstances under which capital construction projects should engage an independent third-party to monitor and track project costs.	Office of State Planning and Budgeting	Agree	May 2013
			Office of the State Architect	Agree	May 2013
3	41	Report to the Capital Development Committee and the Joint Budget Committee on its monitoring of project assumptions and lifecycle costs related to the Ralph L. Carr Judicial Center, including (a) annually reporting current expected cost savings from the Judicial Center project due to the co-location of justice-related agencies and consolidation of various operational and administrative support functions; (b) providing a current report on any significant unresolved building issues; and (c) providing a final closeout evaluation of the project to the Office of the State Architect and the Capital Development Committee.	Judicial Department	Agree	November 2013

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
4	48	Work with the Capital Development Committee to proactively identify potential solutions for addressing increasing controlled maintenance funding needs by proposing legislation to (a) implement a lease surcharge for State tenants to pay for controlled maintenance and (b) require all new capital construction projects to include a funding mechanism for controlled maintenance as part of the approved operating budgets.	Office of State Planning and Budgeting	Agree	May 2013
			Office of the State Architect	Agree	May 2013
5	54	Work with the Capital Development Committee to develop a framework for creating a long-term real estate master plan for the State by (a) seeking funding to complete a master plan for the Capitol Complex and (b) considering proposing legislation requiring all real estate-related capital requests be evaluated against an approved master plan.	Office of State Planning and Budgeting	Agree	September 2013
			Office of the State Architect	Agree	September 2013

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
6	69	Work with State agencies to strengthen lease administration practices and reduce the risk of operating expense payment errors by (a) promulgating guidance to agencies outlining their responsibilities for annually reviewing operating expense rental obligations and working with the contract broker to establish standardized procedures for these reviews; (b) developing base-line trainings and materials for lease administration that assist agencies with reviewing their operating expenses, tracking critical lease dates, maintaining complete lease files, and working with landlords to resolve any issues identified; (c) working with the contract broker and the Attorney General's Office to revise the contract service agreement and better define the responsibilities, expectations, and deliverables to be provided by the contract broker; (d) working with State agencies and the contract broker to improve utilization of the ProLease lease administration system; and (e) considering contracting with an outside vendor to perform centralized review of operating expense reconciliation statements and to conduct lease audits on the State's entire lease portfolio.	Office of the State Architect	a. Agree b. Agree c. Agree d. Agree e. Agree	a. May 2013 b. May 2013 c. July 2013 d. March 2013 e. March 2013

RECOMMENDATION LOCATOR

Rec. No.	Page No.	Recommendation Summary	Agency Addressed	Agency Response	Implementation Date
7	72	Review operating expenses from prior years and the overpayments identified in this evaluation and work with landlords to recover all overpayments identified.	Department of Personnel & Administration	Agree	June 2013
			Department of Labor and Employment	Agree	June 2013
8	77	Engage the advice and assistance of the State's contract broker and work with the Attorney General's Office to update and revise the State's Standardized Lease Agreements to better protect the State and reduce the risk of overpaying certain rental obligations.	Office of the State Architect	Agree	March 2013

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Overview of Capital Asset Management and Lease Administration in Colorado

Chapter 1

Background

The State of Colorado (“State” or “Colorado”) has a diverse real estate portfolio of owned and leased assets managed in a decentralized fashion through the activities of a number of State agencies. During Fiscal Year 2011, Colorado’s real estate portfolio included owned space from all funding sources totaling nearly 70 million in gross square feet and leased space totaling 3.4 million in rentable square feet. Over the five-year period spanning Fiscal Years 2009 through 2013, the State appropriated a total of more than \$2.1 billion for capital projects from all funding sources, excluding some cash-funded projects at institutions of higher education. Another \$2.3 billion in cash-funded capital projects has been approved for institutions of higher education since January 2010. Over the same period, the State has spent about \$230 million in lease payments to third party landlords. Together, these real estate assets represent a significant investment of taxpayer dollars in the construction, acquisition, maintenance, and leasing of State building space.

Agency Roles and Responsibilities

A variety of State entities with different roles and responsibilities oversee and manage the State’s real estate portfolio in a decentralized fashion. The following table outlines the primary agencies charged with overseeing the State’s real estate assets and includes a summary of their responsibilities and the applicable statutory charge(s).

Table 1 – Overview of State Real Estate Responsibilities

Name	Role	Governing Statute
Capital Development Committee	<ul style="list-style-type: none"> • General review and oversight of all capital projects statewide, including projects initiated by the executive, judicial, and legislative branches and institutions of higher education, and including purchase, construction, renewal, and controlled maintenance. 	Section 2-3-1304, <i>et seq.</i> , C.R.S.
Governor’s Office of State Planning and Budgeting	<ul style="list-style-type: none"> • Review, approval, and prioritization of Executive Branch capital project requests for funding consideration by the Capital Development Committee. • Review of program plans for State departments in the Executive Branch. 	Section 24-37-201, <i>et seq.</i> , C.R.S. Section 24-37-302, <i>et seq.</i> , C.R.S.
Office of the State Architect	<ul style="list-style-type: none"> • Administration of State-funded capital construction in the Executive Branch and prioritization of controlled maintenance requests for submission to the Capital Development Committee. • Oversight of leasing and real estate transactions at State departments and institutions of higher education. 	Section 24-30-1303, <i>et seq.</i> , C.R.S.
Colorado Commission on Higher Education and the Department of Higher Education	<ul style="list-style-type: none"> • General review and oversight of capital projects undertaken by institutions of higher education on State-owned or State-controlled land, including purchase, construction, renewal, and controlled maintenance. • Review and approval of institutions’ master and program plans. • Prioritize institutions’ capital projects and submit to OSPB and the Capital Development Committee, when required by the type of funding source. 	Section 23-1-106, <i>et seq.</i> , C.R.S.
Joint Budget Committee and General Assembly	<ul style="list-style-type: none"> • Study the management, operations, programs and fiscal needs of State agencies and institutions. • Make recommendations to the General Assembly for funding of projects per Capital Development Committee guidance for inclusion in the Long Bill. • Approve capital projects initiated by legislation. 	Section 2-3-203, <i>et seq.</i> , C.R.S.

The Department of Personnel & Administration, Office of the State Architect, has a central role in managing the State’s real estate assets. The Office of the State Architect has responsibility for administering capital construction, prioritizing controlled maintenance requests, ensuring code compliance, tracking facilities’ condition, approving emergency maintenance funds, managing energy conservation, and overseeing and approving leasing and real estate transactions for Executive Branch agencies, including higher education. [Section 24-30-1303, C.R.S.] As defined in statute [Section 24-75-301, C.R.S.], capital construction broadly includes purchase of land; purchase, construction, or demolition of buildings, remodeling or renovation; site improvements; purchase and installation of equipment necessary to operate the building; purchase of the services of architects, engineers, and other

consultants to prepare plans, studies, and analyses; purchase of instructional or scientific equipment costing more than \$50,000; and purchase of services from the Office of Information Technology. The Office of the State Architect establishes policies and procedures and provides statutory oversight of the State's capital construction process once the decision to construct a building has been made. This process includes: solicitation and procurement of professional design and construction services; development of standard contract language; establishment of project management guidelines including cost management; adoption and implementation of building codes and compliance requirements; and administration of the ongoing controlled maintenance program. The Office of the State Architect is funded by State general funds and had six FTE and total appropriations of just under \$560,900 during Fiscal Year 2013.

Working with the Governor's Office of State Planning and Budgeting ("OSPB"), the Office of the State Architect also provides support and input to the Capital Development Committee of the General Assembly which reviews and recommends funding for all capital construction projects, including lease purchase agreements, valued at more than \$500,000. The Capital Development Committee also reviews capital construction projects at institutions of higher education that do not require any general or capital development funds, but have been approved by the governing boards of the institutions and the Colorado Commission on Higher Education.

The Office of the State Architect also has statutory responsibility for overseeing controlled maintenance of buildings constructed or acquired with capital construction or general funds. As explained in more detail in Chapter 2, controlled maintenance is generally defined as "corrective repairs and replacement used for existing State-owned, general-funded buildings," not paid for through an agency's operating budget. [Section 24-30-1301 (2) (a) (I), C.R.S.] The Office of the State Architect coordinates the initiation of budget requests and prioritizes and recommends funding for controlled maintenance projects to the Capital Development Committee and OSPB. During the 2012 Legislative Session, the General Assembly, through Senate Bill 12-040, extended the projects eligible for controlled maintenance funding to include academic facilities funded and operated by cash funds.

Aside from new construction, the Office of the State Architect is responsible for negotiating and executing leases on behalf of the State government for land, buildings, and office or other space. [Section 24-30-1303, C.R.S.] As discussed later in this chapter, Colorado has a *Centralized Leasing Policy* that requires all Executive Branch agencies (with a few exceptions), including institutions of higher education, to work through the Office of the State Architect to acquire leased space. According to the Office of the State Architect, the *Centralized Leasing Policy* is triggered once an agency's Executive Director identifies a need for leased space and the agency has received an appropriation for its lease costs. The *Centralized Leasing Policy* requires

the Office of the State Architect to execute a contract with a real estate broker (the “contract broker”) to assist with evaluating leased space options in the metropolitan area counties of Denver, Douglas, Arapahoe, Boulder, Broomfield, Adams, and Jefferson as well as for El Paso and Pueblo Counties in southern Colorado. The current contract broker, Jones Lang LaSalle, is required to maintain an inventory of all leased space statewide and provide support to State agency tenants during the lease term, including addressing problems with landlord compliance, monitoring lease expiration dates, and performing “operating cost audits.” The contract broker does not receive a fee from any State agency for performing services on the agency’s behalf; rather, the contract broker receives a commission, paid for by third-party landlords, for every transaction the contract broker negotiates and closes on behalf of the State. The contract broker returns 25 percent of all commissions received back to State agencies, in accordance with the contract broker’s *State Commission Sharing Agreement*.

Finally, the Office of the State Architect is responsible for other real estate activities such as the purchase of real estate for the State and sale or lease of State-owned real estate. The Office of the State Architect does not oversee three areas including: (1) acquisitions by the Department of Transportation; (2) acquisitions or disposition of State land by the State Land Board; and (3) management of certain easements, rights-of-way, and vacant land leases and acquisitions by Colorado Parks and Wildlife, a division within the Department of Natural Resources.

State Agency Responsibilities

In addition to the responsibilities of the Office of the State Architect and the agencies and entities outlined in the table above, individual agencies within the Executive, Judicial, and Legislative Branches have responsibilities with respect to the State’s real estate portfolio. For example, Judicial and Legislative Branch agencies have authority to manage their own capital acquisition and construction projects without oversight by the Office of the State Architect or OSPB. Additionally, the Judicial and Legislative Branches are not subject to the *Centralized Leasing Policy*, but may use the services of the Office of the State Architect and its contract broker to assist with procuring leased space if desired. Further, the Executive Directors of individual State agencies have input on real estate decisions and capital project requests and have authority to make leasing decisions, if funds have been appropriated for that purpose. State agencies are also responsible for managing their own leases, once the agreement has been executed.

Capital Acquisition and Construction Financing

Financing for capital acquisition, construction, and controlled maintenance projects is complex. In Colorado, capital projects are funded by (1) State funds—which are primarily general funds transferred to the Capital Construction Fund and allocated

to specific projects; (2) cash funds—which are funds derived from private donors and public sources, including fees collected for specific services performed by State or local agencies; and (3) federal funds—which are funds provided by the federal government for specific grants and programs. As discussed in Chapter 2, Executive Branch agencies receive funding for capital projects by submitting their requests to the OSPB, which prioritizes the projects for review by the Capital Development Committee. The Capital Development Committee makes recommendations for project prioritization and submits its recommendations for funding to the Joint Budget Committee for appropriation through the Long Bill.

Prior to January 1, 2010, most cash-funded projects at institutions of higher education were subject to the prioritization and appropriation process described above. During the 2009 Legislative Session, the General Assembly made significant changes to the process for approving cash-funded higher education capital construction projects. These changes were intended to provide institutions with more flexibility to respond to their capital construction needs. In accordance with Section 23-1-106 (9), C.R.S., effective January 1, 2010, cash-funded projects at institutions of higher education are now independently reviewed and approved by the Colorado Commission on Higher Education and the Capital Development Committee, but are no longer subject to prioritization or appropriation through the Long Bill.

During the past five years (Fiscal Years 2009 through 2013), the funds appropriated for capital projects have decreased significantly due to the economic recession as well as State budget-balancing measures. The following table shows the change in capital project appropriations over that time period:

**Table 2 - State Capital Project Appropriations
Fiscal Years 2009 through 2013 (in millions)**

Fiscal Year	State Funds	Cash and Federal Funds ¹	Total Funds ¹
2009	\$117.7	\$774.3	\$892.0
2010	42.2	726.2	768.4
2011	23.2	80.5	103.7
2012	50.2	137.0	187.2
2013	63.1	108.8	171.8
TOTAL	\$296.4	\$1,826.8	\$2,123.1

Source: Colorado Legislative Council.

Note: ¹Effective January 1, 2010, cash-funded higher education projects are no longer subject to appropriation and therefore, are omitted in the totals in the “cash and federal funds” and “total funds” columns above.

State agencies use a variety of methods to fund capital projects, including debt financing, Certificates of Participation, lease-purchase agreements, and fees. Certificates of Participation (“COPs”) are a type of financing vehicle where the investor purchases a portion of the lease revenues and the proceeds of the purchase are used by the government agency to pay for construction costs. Statute requires

all lease-purchase agreements for real property in excess of \$500,000 over the term of the agreement, regardless of whether financed by COPs or “rent-to-own” agreements, to be specifically authorized by a separate bill enacted by the General Assembly other than by the Long Bill or a supplemental appropriations bill. [Section 24-82-801 (1) (a), C.R.S.] Prior to the State Treasurer executing any lease-purchase transaction, OSPB (for Executive Branch agencies) and the Capital Development Committee must first review and approve the plans for the project. [Section 24-82-802 (3) (d), C.R.S.] Subsequent lease payments are then annually appropriated in the operating or capital budget. The lease agreement itself is renewed each year through the Long Bill appropriations process.

State Building Growth

The Office of the State Architect tracks statistics on State-owned buildings. According to the Office of the State Architect *Annual Report* dated December 2011, State-owned buildings paid from all funding sources comprise nearly 70 million gross square feet and have an estimated replacement value of \$14 billion. State-owned building space is located in the Capitol Complex and throughout metropolitan Denver as well as at institutions of higher education and in other areas of the State, including Colorado Springs, Pueblo, and the western slope. A large portion (46 percent) of the “State-funded” building inventory (e.g., inventory funded primarily with general fund dollars) was built prior to 1971. The table below shows the number of buildings, and gross square footage (in millions), in Colorado’s “State-funded” building inventory since before 1900:

Table 3 - Age, Gross Square Footage in Millions (“GSF/M”), and Number of “State-Funded” Buildings Acquired or Constructed Each Year Pre-1900 to December 2011

Year Constructed*	Pre-1900	1901-1910	1911-1920	1921-1930	1931-1940	1941-1950	1951-1960	1961-1970	1971-1980	1981-1990	1991-2000	2001-present
GSF/M	0.942	0.693	0.577	1.564	2.507	1.545	4.280	7.107	7.166	3.607	5.726	6.804
Number	98	54	76	92	155	78	190	348	276	334	399	236
% of Total GSF	2.2%	1.6%	1.3%	3.6%	5.8%	3.6%	9.9%	16.4%	16.5%	8.3%	13.2%	15.7%

Source: Office of the State Architect December 2011 *Annual Report*.

Note: There are 55 buildings equaling 1.8 percent, or 788,618 Gross Square Feet of the “State-funded” inventory with the date of construction unknown at this time.

Applicable Policy Documents

The State has developed a number of policy documents through the years to help guide real estate decision-making. In accordance with Executive Order D 016 03, dated August 2003, the Office of the State Architect developed a *Centralized Leasing Policy*. According to the Executive Order, the purpose of the *Centralized Leasing Policy* was to “ensure optimum use of State-owned and leased space.” The *Centralized Leasing Policy*, effective December 15, 2005, applies to all space

acquisitions by executive departments and institutions of higher education whether by lease, sublease, lease/purchase, or license. Also in 2005, the Office of the State Architect hired a consulting firm to help it develop the *State of Colorado Strategic Real Estate Plan* to provide comprehensive asset management services for the State's real property portfolio with the goal of reducing overall real estate costs and improving the efficiency and utilization of State-leased and owned assets. The strategic plan has subsequently been updated four times: during 2006, 2007, 2009, and 2011. Through creation of a comprehensive *Annual Report* to the Capital Development Committee, the Office of the State Architect reports on acquisitions, dispositions, lease summaries, and other real estate management issues including ongoing controlled maintenance expenditures and needs. The Office of the State Architect also maintains office space standards for leased space. Finally, while the State currently does not have a master plan to guide decision-making for capital construction and asset management in the Capitol Complex and Denver metropolitan area, in accordance with statute [Section 23-1-106 (3), C.R.S.], the Colorado Commission on Higher Education requires every higher education institution to have a master plan to help guide their capital development activities.

Evaluation Scope and Methodology

The Colorado Office of the State Auditor contracted with Deloitte Financial Advisory Services LLP ("Deloitte FAS") to conduct this performance evaluation pursuant to Section 2-3-103, C.R.S., which authorizes the State Auditor to conduct audits of all departments, institutions, and agencies of State government. The primary objective of this performance evaluation was to develop findings and recommendations that would help the State document, substantiate, and identify cost savings that the State could realize from improving its tools, processes, efficiencies, and performance around the management of its real estate assets. Work was conducted in accordance with consulting standards promulgated by the American Institute of Certified Public Accountants and performed from April through October 2012. The services rendered by Deloitte FAS do not constitute an engagement to provide audit, compilation, review, or attestation services as described in the pronouncements on professional standards issued by the American Institute of Certified Public Accountants.

The evaluation involved the extensive assistance of the various State agencies referenced in this report. The performance evaluation included the following two issues:

Issue One – Space Acquisition Analysis: The analysis of this issue involved the practices, mechanisms, and tools the State uses to evaluate options and support its decisions to acquire building space via lease, purchase, or build. We did not evaluate the basis for the State's decision to proceed with the acquisition. We read

and analyzed relevant statutes, rules, policies, procedures, and other documentation related to the State's management of its real estate assets. In consultation with the Office of the State Auditor, the Office of the State Architect, and the Department of Higher Education, we selected a judgmental, non-statistical sample of four representative projects to evaluate:

- **The Capitol Complex Parking Garage - Department of Personnel & Administration.** The construction of the new five-level Capitol Complex Parking Garage was authorized by the General Assembly through Senate Bill 04-233. The garage is located on the southeast corner of East 14th Avenue and Lincoln Street and the approximately 660 spaces have been occupied since completion in December 2005. The budget for the Capitol Complex Parking Garage was \$9.37 million and was financed through COPs.
- **Proposed Capitol Complex Mixed-Use Building - Department of Personnel & Administration.** The Mixed-Use Building was proposed by the Department of Personnel & Administration in 2005 and the General Assembly approved funding of \$1.7 million for planning and partial design in Fiscal Year 2007. The proposed location on the corner of Colfax Avenue and Lincoln Street is owned by the State and is a surface parking lot. The plan was for a 10-story class A office building of approximately 188,608 gross square feet of office space with underground parking for 264 cars and an additional 14,770 gross square feet of retail space. However, due to rapidly escalating construction costs as a result of hurricane Katrina, the proposal did not proceed and in late 2007 the Department of Personnel & Administration requested that the approved funding be reallocated for other purposes.
- **The Ralph L. Carr Judicial Center - Judicial Branch.** The construction of the new 695,797 square foot Ralph L. Carr Judicial Center ("Judicial Center") was authorized by the General Assembly through Senate Bill 08-206. The new Judicial Center is located at East 14th and Broadway and will house the Supreme Court, Appellate Courts, State Court Administrator's Office, Attorney General's Office, Independent Ethics Commission, and all Judicial Branch agencies including the Public Defender's Office, Attorney Regulation, Judicial Discipline, Judicial Performance, Office of the Child's Representative, and Alternate Defense Counsel. The budget for the Judicial Center was almost \$283 million, including land for the parking structure, and is financed through COPs. The Judicial Center was planned to meet LEED Gold certification (the standard just below Platinum, the highest level of energy and environmental design) and will be ready for occupancy beginning December 2012.

- **The Institute of Behavioral Science Building–University of Colorado-Boulder.** The construction of the new 50,565 square foot Institute of Behavioral Science building (“IBS Building”) was authorized by the General Assembly through House Bill 08-1375, with additional funding approved through Senate Bill 09-259. Construction was completed in October 2010. The building, which is LEED Platinum certified, is located on the corner of 15th Street and Grandview in Boulder and houses the faculty, staff, and assistants of the Institute of Behavioral Science. The budget for the IBS Building was \$15.7 million and was cash funded.

We read and analyzed documents related to the four projects as provided by each responsible agency; completed site inspections of each project; conducted in-person meetings with various project stakeholders; and researched the practices of other states (Georgia, Utah, Massachusetts, Wisconsin, Virginia, California, Minnesota, Iowa, Maryland, Washington, Texas, and Florida) with respect to their decision-making processes for real estate acquisition. Our evaluation scope specifically excluded capital construction project management by the agency or oversight of capital construction administration by the Office of the State Architect.

Issue Two – Review of Lease Operating Expense Payments: The analysis of this issue involved the State’s processes surrounding lease operating expense payments and recovering overpayments. We consulted with the Office of the State Auditor and the Office of the State Architect to select a judgmental, non-statistical sample of eight leases from eight State agencies and institutions of higher education: the Departments of Regulatory Agencies, Labor and Employment, Revenue, Corrections, and Personnel & Administration; the Governor’s Office of Information Technology; Front Range Community College; and Colorado State University System. Together, the rent payments for these eight leases totaled about \$9.7 million, or about 20 percent of the total of \$48.9 million in rent payments made by all State agencies during Calendar Year 2011.

We performed high-level inspections of Calendar Year 2011 operating expenses for each of the leases in our sample. We performed an in-depth onsite inspection of the books and records related to operating expenses conducted at the landlord’s premises for Calendar Year 2011 operating expenses for two leaseholds located at 633 17th Street in Denver. We also conducted interviews with lease administration staff at the Departments of Labor and Employment, Revenue, and Personnel & Administration; Front Range Community College; and the Colorado State University System, as well as with staff from the Office of the State Architect and the State’s contract broker. We read and analyzed the Office of the State Architect’s contract with the real estate contract broker, the State’s standardized lease agreements, the Office of the State Architect’s leasing policies, and other relevant documents.

The results of our analyses are specific to the projects and leases evaluated and therefore cannot be projected to the population of capital construction projects and leases in the State's real estate portfolio. However, the results provide a sufficient basis to understand the State's practices and controls as they pertain to the objectives of this evaluation. Our conclusions on the projects and leases can be found in the findings and recommendations section of this report.

Managing Capital Assets

Chapter 2

Comparable to other states across the country, Colorado is struggling to manage an aging owned real estate portfolio with increased and more sophisticated space usage requirements. The Office of the State Architect estimates that just under half of Colorado's owned buildings were built before 1971 and that controlled maintenance funding needs for State-owned, general funded buildings will total \$522 million for the period spanning September 2011 to January 2016. Due to continuing budget constraints, funding for maintaining, refurbishing, and acquiring space remains extremely limited. Consequently, strong mechanisms are needed to manage ongoing costs and maximize available funding in order to protect the State's real estate assets going forward.

Against this backdrop, the State has a number of additional constraints, which impact its ability to manage its real estate:

- Leadership changes in the Executive Branch as new governors are elected, and in the General Assembly and on the Capital Development Committee due to elections and term limits, help create a shifting landscape of funding priorities.
- The sharing of oversight responsibilities among a variety of State agencies coupled with the lack of a centralized agency responsible for managing the real estate and capital construction processes statewide complicates the decision-making process and can result in competition among agencies for limited funds. Other states contacted during this evaluation, including Georgia, Utah, Massachusetts, Wisconsin, Virginia, California, Minnesota, Iowa, Maryland, Washington, Texas, and Florida, provide centralized services for their real estate and capital construction processes.
- Finally, resource constraints and limited staff with specialized experience could inhibit the State's capacity to evaluate and monitor ongoing projects.

Despite these limitations Deloitte FAS identified a number of space acquisition processes that appear consistent with our understanding of industry practices, including: (1) use of a centralized leasing policy and leveraging of Office of the State Architect staff and an outside contract broker to access required leasing expertise; (2) creation and active use of a real estate strategic plan to provide asset management of the State's real property assets; (3) required use of facilities' program plans when justifying capital construction requests for Executive Branch departments; (4) centralized review of Executive Branch capital construction funding requests by the Governor's Office of State Planning and Budgeting ("OSPB")

or the Department of Higher Education prior to submission to the Capital Development Committee; (5) centralized review by the Capital Development Committee staff of real estate acquisition projects prior to submission to the Joint Budget Committee; (6) application of formal space planning standards when estimating agency office space usage; (7) development of mechanisms for funding controlled maintenance for the new Judicial Center; and (8) rigorous, standardized evaluations of capital construction projects required by Colorado Commission on Higher Education Program Plan Policies, including full lifecycle cost analysis, identification of controlled maintenance funding mechanisms, and recognition of input from project stakeholders including end space users and the community.

Deloitte FAS identified the following areas where we see opportunities for additional improvement: (1) further standardizing the capital evaluation processes used to support decision-making, including delineating required assumptions and requiring full lifecycle cost analyses; (2) increased monitoring and reporting of project cost estimates and savings against projections and assumptions; (3) creating a strategy to address ongoing controlled maintenance issues; and (4) implementing a long-term capital planning process. Each of these issues is addressed within this chapter.

Capital Construction Project Evaluation

Over the past five years (Fiscal Years 2009 through 2013), the State has appropriated more than \$2.1 billion for capital projects from all funding sources, excluding cash-funded projects at institutions of higher education, which have not been appropriated through the Long Bill since January 1, 2010. Capital project appropriations include funds for construction, acquisition, controlled maintenance, program planning, large information technology projects, furnishings, and equipment. Of the \$2.1 billion in appropriated capital project funds, a total of \$296 million was funded by “State funds,” which are primarily general fund monies allocated to specific projects through the Long Bill; and a total of \$1.8 billion was funded by cash funds from other sources (e.g., fees, bonds issued by institutions of higher education, and funds provided by donors, among others). In addition, the Capital Development Committee and the Colorado Commission on Higher Education have approved another \$2.3 billion in cash-funded capital projects at higher education institutions since January 1, 2010.

Capital Construction Approval Process

According to statute, “it is the policy of the General Assembly not to acquire sites or authorize or initiate any program or activity requiring capital construction or acquisition of a capital asset . . . for any State department or subdivision thereof unless the program or activity is an element of the facilities program plan for the

department.” [Section 2-3-1304.6, C.R.S.] Consequently, capital construction projects are program driven and an agency must justify a capital request based on how the project will allow it to improve or alter its ability to provide a certain program or services.

The process for seeking funding and approval for capital projects differs among agencies and branches of Government. For example:

- **Projects initiated by Executive Branch agencies (excluding institutions of higher education).** Capital construction and acquisition projects are initiated by individual agencies. Agencies prepare program plans and justify their capital construction requests in accordance with criteria outlined by OSPB. Agencies then submit their requests to OSPB, which reviews the projects and prioritizes the agency requests based on priorities outlined by the Governor. The prioritized list of capital construction project requests is submitted to the Capital Development Committee, which reviews and holds hearings on the requests, requesting additional information, if needed. The Capital Development Committee then makes prioritized funding recommendations to the Joint Budget Committee for State-funding requests. The Capital Development Committee also makes recommendations for cash-funded projects for State agencies. The Joint Budget Committee then makes a recommendation for inclusion of certain State- and cash-funded capital construction projects in the annual Long Bill, which delineates actual appropriations.
- **Projects initiated by institutions of higher education.** Capital construction and acquisition projects are initiated by each individual institution of higher education. Statute [Section 23-1-106 (3), C.R.S.] requires institutions of higher education to develop master plans, which must be approved by the institutions’ respective governing board and by the Colorado Commission on Higher Education. Institutions must prepare program plans to justify their capital construction requests and align their program plans with their master plans. Governing boards review and approve the institution’s capital construction program plan and ensure the request aligns with the institution’s master plan. The Department of Higher Education also reviews the institution’s capital construction request to ensure alignment with the institution’s master plan; if projects are not aligned, the Department will not approve the request. If the Department of Higher Education determines that the capital construction request aligns with the institution’s master plan, the project is submitted to the Colorado Commission on Higher Education. If the institution’s capital construction request requires any amount of “State funds,” which are primarily general funds deposited in the Capital Construction Fund, the Colorado Commission on Higher Education submits a prioritized list of higher education projects to

OSPB for review and inclusion in the statewide prioritized list, and the project is processed in the same manner as the Executive Branch capital construction requests described above. However, since January 1, 2010 and in accordance with statute [Section 23-1-106, C.R.S.], if the project is paid for with 100 percent cash funds—which are funds derived from private donors and public sources, including fees—the project is not submitted to OSPB. The Capital Development Committee and the Colorado Commission on Higher Education each independently review and approve the projects as part of their respective oversight roles. The project is not submitted to the Joint Budget Committee, is not appropriated in the Long Bill, and does not require approval through a specific bill passed by the General Assembly.

- **Projects initiated through specific legislation.** Projects initiated by the Judicial Branch and the Legislative Branch, as well as certain projects initiated in the Executive Branch, may be initiated by specific legislation. These projects are reviewed by the Capital Development Committee, but are not reviewed by OSPB and are not subject to the specific criteria OSPB requires for project justifications and analyses in support of capital construction requests.

What work was performed and what was the purpose?

We completed the following steps for the analysis of the State's processes for evaluating real estate capital projects:

- Read applicable State statutes with respect to planning, evaluating, and approving real estate capital projects;
- Interviewed Office of the State Architect, Capital Development Committee, and OSBP staff to understand their roles and processes in evaluating real estate capital projects;
- Analyzed the processes used by OSPB and the Capital Development Committee for capital construction project justifications, including an example project analysis;
- Interviewed staff at the Department of Personnel & Administration, Judicial Department, and University of Colorado-Boulder to understand how they undertake real estate capital construction projects;
- Analyzed project justifications for the four selected projects to understand whether the assumptions and the analyses support the construction or acquisition decision. The four selected projects and their justifications, described in detail in Chapter 1, were prepared by their respective owner-agencies and included the following: (1) the Capitol Complex Parking Garage—Department of Personnel & Administration; (2) the Proposed Mixed-Use Building—Department of Personnel & Administration; (3) the

- Ralph L. Carr Judicial Center—Judicial Branch, and (4) the Institute of Behavioral Science Building—University of Colorado-Boulder; and
- Analyzed real estate capital construction processes and evaluation tools used by select other states, including Georgia, Utah, Massachusetts, Wisconsin, Virginia, California, Minnesota, Iowa, Maryland, Washington, Texas, and Florida.

The purpose of our work was to analyze the State's practices and policies for real estate capital project acquisition and construction decisions. Our work did not include evaluating or opining on decisions to proceed with acquisition or construction projects.

How were the results of the work measured?

Our analysis of the State's practices for analyzing and evaluating real estate capital projects considered whether project justifications and analyses: (1) are complete and transparent, (2) include support and documentation for major assumptions and conclusions, and (3) capture costs over the life of the project. Based on our experience and discussions with agency personnel, capital project justifications and analyses should include:

- Total lifecycle cost analysis, that is, including the total and up-to-date costs of constructing, acquiring, operating, and maintaining a facility over its useful life. These include purchase, acquisition, and construction costs; operation, maintenance, and repair costs; replacement costs; residual values after resale, salvage, or disposal; finance charges; and non-monetary benefits or costs;
- Assumptions (for example rental rates; building square footages; space backfill costs; controlled maintenance, operations, repairs, replacement, construction, and project management costs; among others) used as the basis of decision-making which are clearly defined and supported by adequate documentation and market data whenever possible;
- Up-to-date analysis of the costs and benefits of all alternative options (e.g., comparing the costs and benefits of buying, building, or leasing the required space);
- Analysis of projected or promised cost savings from the project, when used to support the decision, which is based on appropriate assumptions and is supported by documentation that establishes a clear baseline for tracking and measuring the savings once the project is complete;
- Mechanisms for facilitating ongoing communication between all transaction stakeholders from project initiation to completion to assist with validating assumptions, identifying potential problems, and facilitating commitment and buy-in; and

- Use of industry-specific specialists to acquire expertise when needed, including expertise for preparing initial estimates or for reviewing project assumptions.

What problem did the work identify?

Our evaluation of the State's practices for justifying capital construction projects found inconsistent practices across branches of government, State agencies, and individual projects. The evaluation also found instances where projects lacked complete and comprehensive analysis of project costs and assumptions before initiation and approval by the Capital Development Committee and the General Assembly. Specifically we found the following:

- **Project justifications and analyses.** For the Capitol Complex Parking Garage, our analysis found that the Department of Personnel & Administration did not prepare a project justification and analysis. The Capitol Complex Parking Garage was initiated by the Department of Personnel & Administration's Executive Director at the time and was authorized by the General Assembly through Senate Bill 04-233. The project was not reviewed or prioritized by OSPB.
- **Consideration of total lifecycle costs.** For three of the four projects evaluated (the Capitol Complex Parking Garage, Proposed Mixed-Use Building, and Judicial Center), total lifecycle costs were not up-to-date or documented in the project justification analysis.
 - The fiscal note for the Capitol Complex Parking Garage did not include any lifecycle costs beyond the estimated construction and financing costs. Although the Capitol Parking Fund has been used to provide controlled maintenance and repairs since construction, these costs were not identified up front to support decision-making.
 - The Proposed Mixed-Use Building did not include future controlled maintenance costs, ongoing operational costs, or costs for renovating or backfilling of space being vacated. As discussed later in this chapter, controlled maintenance costs over the life of a building can be significant. Including complete costs provides transparency and helps decision-makers evaluate the full costs of a variety of options.
 - The Judicial Center's project analysis did not take into account the costs of renovating and backfilling of space being vacated by the Attorney General's offices at 1525 Sherman, a State-owned building. Judicial Department staff report that renovation and backfill costs

were not available at the time. According to the Office of the State Architect, backfilling the 1525 Sherman space will cost \$3 million for planning, design, build-out, and relocation of the Department of Personnel & Administration into five vacated floors and certain Legislative Branch agencies into two floors.

- **Valid and complete project assumptions.** The Judicial Center project analysis did not include up-to-date assumptions for the amount of square feet the tenant agencies would ultimately be occupying. Specifically, we found that although space estimates were included in the original project justification, several agencies increased their space needs after project approval and during the space planning phase. In their current locations, the Judicial Department, the Judicial Branch agencies, and the Attorney General's Office together occupy a total of 255,145 rentable square feet while in the new Judicial Center, these agencies will occupy a total of 394,026 rentable square feet. As a result of occupying additional space, total rent expenditures for these agencies will increase from about \$4.5 million to \$5.7 million annually, a difference of \$1.2 million. It is to be expected that these State agencies would occupy more space in the new Judicial Center, since many of these agencies do not have adequate space for their staff and programs in their current space. However, the project analysis should have included updated square footage and associated rental cost for the various tenants as part of the project justification so that both decision-makers and tenant agencies had complete space and cost estimates available for review.
- **Analysis of all potential options.** None of the four projects we evaluated included a comprehensive assessment of alternatives to building. Such an assessment, in our experience, would typically include an up-to-date and comprehensive analysis of the full costs of buying, building, or leasing space to support a recommendation to proceed with a specific option. According to the Department of Personnel & Administration, neither buying nor leasing were viable options for the Capitol Complex Parking Garage, so including a buy-build-lease analysis may not have been appropriate for that project. For the Judicial Center, an analysis of buy-build-lease options was performed by a consultant several years before project approval; however, the analysis was not updated and included as part of the project justification package. The analysis undertaken for the Institute of Behavioral Science Building at the University of Colorado-Boulder did include a brief discussion of program alternatives to new construction, but not to the level typically undertaken in a more comprehensive evaluation of alternatives. Ideally, a comprehensive buy-build-lease analysis provides a transparent presentation of total life-cycle costs for each option, so that decision makers have complete information and the rationale supporting the recommended option. Recently, OSPB and the Office of the State Architect have developed criteria

for completing a buy-build-lease analysis for project justifications initiated by Executive Branch agencies and reviewed by OSPB and the Capital Development Committee.

- **Substantiated cost savings estimates.** For the Judicial Center, the project justification and analysis lacked support for \$60 million of projected operational cost savings. Specifically, the Judicial Department provided information to the General Assembly projecting operational cost savings of \$60 million over 30 years from consolidating the Attorney General's Office and Judicial Branch agencies into one location. The projections anticipated savings in the following three areas: (1) \$15 million from reduced rental costs; (2) \$15 million from reduced utility costs; and (3) \$30 million from consolidating and streamlining Judicial Branch and Attorney General's Office agency operations and functions. Section (1) (f) (III) of Senate Bill 08-206, the legislation which authorized the construction of the new Judicial Center, stated that the consolidation of justice-related offices into the Judicial Center was expected to achieve a number of financial benefits, including achieving "greater programmatic efficiencies and decrease[d] operating costs by eliminating duplicative expenses resulting from multiple justice-related office locations. The Judicial Department was unable to provide detailed documentation to support the assumptions underlying the \$60 million cost savings estimate. Development of valid cost savings assumptions, supported by adequate documentation, is key to establishing a baseline for measuring and assessing cost savings once construction is complete.
- **Communication with project stakeholders, including end space users.** For the Judicial Center, communication with project stakeholders could have been improved. Specifically, Judicial Branch agencies and the Attorney General's Office reported they were not adequately informed of the impact of tenant decisions on the load factor and on their rental costs before project approval or final space planning began. The load factor, which represents additional charges for common areas, typically ranges between 1.1 and 1.2 times the base rent for most commercial office space. In contrast, the load factor for the Judicial Center is 1.43 times the base rent, since the building includes more common areas than most commercial office buildings. Tenant agencies also reported that they did not receive complete information on their total proposed rental charges until last year, well after construction had started, and then only after receiving draft copies of their leases. As we understand, operating savings were discussed during the project approval period but agencies reported that specific discussions on how services and operations would be consolidated did not occur prior to project approval. As noted above, operational efficiencies were critical components of the estimated cost savings used to justify approval for construction.

We also found that, with the exception of capital construction projects completed at institutions of higher education, capital construction funding requests are generally prepared by agency personnel who have financial backgrounds, but lack specific capital construction expertise. Additionally, most State agencies, with the exception of institutions of higher education, lack required specialists to assist with developing comprehensive capital construction project analyses and justifications. The Judicial Department, recognizing its need for additional expertise to complete the planning and construction of the Judicial Center engaged, among others, the Urban Land Institute to evaluate site options and Trammel Crow to provide project management services.

Why did the problem occur?

The inconsistencies we observed appear to relate to: (1) the State's decentralized structure for overseeing capital planning and decision-making, and (2) the lack of a statutory framework or governance structure requiring all agencies, regardless of the branch or agency initiating the project, to complete comprehensive project justifications for capital projects that include a complete lifecycle analysis or that outlines the factors agencies must include as part of their up-front capital project evaluations.

No policies, with the exception of those that apply to institutions of higher education and are promulgated by the Colorado Commission on Higher Education, require agencies to analyze the ongoing costs of a capital project over its entire economic life. By contrast, the General Assembly has required lifecycle cost analysis for energy conservation projects: "Facility designs must take into consideration the total lifecycle cost, including the initial construction cost, the cost, over the economic life of the facility, of the energy consumed, replacement costs, and the cost of operation and maintenance of the facility, including energy consumption." [Section 24-30-1304 (1) (d), C.R.S.]

No statutory requirement or governance structure exists mandating that all State agencies submitting capital project requests, regardless of the branch, provide a complete, up-to-date package, including documentation of valid market data to support their project assumptions and approvals for space needs, before funding approval. Additionally, no statute or policy requires agencies and branches to consider and evaluate all possible options (buy-build-lease) when making or justifying a space decision. Further, no statutory requirement exists requiring all capital projects, regardless of the branch, to undergo the same level of review and prioritization by the Capital Development Committee. Finally, there are no statutory requirements or policies requiring all State agencies, regardless of branch, to provide cost savings projections in support of their capital project justifications that have a reasonable basis or to provide documentation of the baseline upon which the cost savings will ultimately be assessed.

Without mechanisms to consistently evaluate key components and assumptions and capture the full lifecycle cost for every capital project before requesting approval for funding, project justifications provided to decision-makers will not be adequate to support a funding decision.

Improving consistency among project justifications, establishing a governing structure, and aligning Colorado's framework for capital decision-making would require action by the General Assembly. Specifically, the General Assembly could enact legislation setting forth the key elements, including total lifecycle costs and buy-build-lease analyses, which agencies must analyze and report in every capital construction project evaluation, regardless of the funding source or mechanism. For example, the General Assembly could consider authorizing the Office of the State Architect to create standardized policies and project evaluation checklists that require identification and analysis of key assumptions and total lifecycle costs. Another option would require every capital project, with the exception of projects initiated by institutions of higher education, to undergo the same level of review and prioritization by the Capital Development Committee. Adopting these approaches would provide more centralization of capital project planning and decision-making, consistent with existing practices in many other states. However, moving toward increased centralization of capital project planning is a policy decision and the purview of the General Assembly.

Outside of establishing a centralized framework outlining requirements for all capital projects, there are opportunities for OSPB, with the assistance of the Office of the State Architect, to improve the consistency and completeness of the information included to support decision-making for project justifications submitted by Executive Branch agencies through OSPB and the Capital Development Committee's review process. Specifically:

- **Total lifecycle costs.** Current OSPB budget instructions for capital projects do not require State agency project justifications to include costs for controlled maintenance and capital renewal expenses. OSPB does not include these costs because controlled maintenance and capital renewal projects have a separate approval and funding process and operating expenses are paid for through agency operating budgets. However, these costs are part of the total lifecycle costs for a proposed project and can be significant. Additionally, OSPB budget instructions include a line item for relocation costs; however, specific instructions or line items for capturing renovation, retrofit, temporary lease costs, and backfilling costs are not included in the budget instructions. To provide a complete picture of the total costs for moving forward with a project, all of these costs should be presented and evaluated as part of the project justification, regardless of whether separate processes exist for approving and funding some of these costs.

- **Tools for preparing project assumptions.** Currently tools for assisting State agencies with preparing project assumptions and identifying lifecycle costs for capital project justifications are lacking. For example, no repository exists that maintains prior project evaluations and captures key project assumptions for use by agency staff in developing justifications and analyses for new capital projects. Additionally, budget instructions should be clarified and expanded to require that project justifications include adequate supporting documentation for all cost assumptions (e.g. feasibility reports, studies, and construction costs). As noted previously, the agency staff that develop capital project justifications and analyses do not typically have capital construction expertise. Currently, the State relies on staff within the oversight agencies (OSPB and the Department of Higher Education) as well as staff supporting the Capital Development Committee, to ensure the appropriateness and consistency of project assumptions across projects. However, historical project evaluations along with benchmark data for various building operating and expense assumptions (e.g., rental rates, utilities and maintenance expenses, and construction costs) could be maintained within a single repository and access provided to individual agencies or the oversight agencies for use in preparing and reviewing project evaluations and justifications.
- **Technical assistance.** Most State agencies (with the exception of institutions of higher education) appear to lack required specialists to provide input on cost estimates and project assumptions for capital construction and acquisition projects. The Office of the State Architect only has six full-time employees within three program areas (State Buildings, Real Estate, and Energy Management), and is not involved in the preparation of project evaluations unless requested. Identifying a pool of resources with specialized expertise (either internal or third parties) that agencies can utilize as needed would help ensure that analyses are comprehensive in nature and utilize consistent assumptions.

Why does this problem matter?

Inconsistencies in the capital construction project evaluation process could lead to incorrect conclusions and have significant cost implications to the State. For example, omitting the ongoing cost of controlled maintenance from a project analysis, as was the case with the Proposed Mixed-Use Building, results in an understatement of full lifecycle project costs and could potentially lead to future operational funding issues. Omitting the cost of renovating and backfilling space in the project analysis, as was the case with the Judicial Center project, also understates the full cost of the project (as noted previously, the costs for backfilling 1525 Sherman are estimated to be \$3 million). An approved plan for backfilling

including estimates of costs and resulting lease costs savings would have been beneficial. Complete and consistent analysis of the same components on every project would also greatly assist the entities responsible for reviewing such projects (OSPB, the Department of Higher Education, and the Capital Development Committee) in evaluating and prioritizing projects as well as drawing appropriate conclusions to support funding recommendations.

Recommendation No. 1:

The Office of State Planning and Budgeting (OSPB) should work with the Office of the State Architect to improve the completeness and comprehensiveness of the information used to prepare capital project justifications and support decision-making by:

- a. Revising capital budget instructions to require all project justifications to provide a complete and transparent presentation of total lifecycle costs for the projects. Total lifecycle costs include, but are not limited to, costs for controlled maintenance, capital renewal, ongoing operations, renovation, retrofit, temporary leases, and backfilling space.
- b. Expanding requirements in the capital budget instructions to clarify that all assumptions in capital project justifications must be supported by adequate and complete supporting documentation.
- c. Considering development of a repository to capture major project assumptions (e.g., common area space requirements and construction/operating cost estimates) for future use by all stakeholders in preparing and evaluating capital construction requests.
- d. Evaluating the potential for identifying a pool of specialists (either existing State agency staff or third parties) which State agencies can resource when preparing their capital construction project justifications and funding requests.

Office of State Planning and Budgeting Response:

Agree. Implementation date: May 2013.

- a. OSPB concurs that its capital construction budget instructions can be improved with the inclusion of a requirement that departments describe the total lifecycle costs of a new capital purchase. OSPB will consult with the Office of the State Architect and will include these elements in its capital construction budget instructions for the Fiscal Year 2015 budget cycle. It is anticipated that these instructions will be published in May 2013.
- b. OSPB concurs that its capital construction budget instructions can be improved with the inclusion of a requirement that all assumptions must be supported by adequate documentation. It should be noted, however, that OSPB already validates the veracity of any assumptions provided by departments as part of its review process. OSPB will consult with the Office of the State Architect and will include these elements in its capital construction budget instructions for the Fiscal Year 2015 budget cycle. It is anticipated that these instructions will be published in May 2013.
- c. OSPB concurs that a searchable repository containing major project assumptions could prove beneficial to departments in their preparation of capital construction requests. It is possible, however, that the development and publishing of such a repository may prove prohibitively expensive within the Office's existing appropriations. OSPB will consult with the Office of the State Architect and other stakeholders to consider the development of such a repository. If existing appropriations allow, this repository will be made available as part of OSPB's next annual publication of capital construction instructions, which will likely be in May 2013.
- d. OSPB concurs that an available pool of specialists may prove helpful to departments as they develop capital construction requests. OSPB will consult with the Office of the State Architect and other stakeholders to further evaluate the process by which these experts could be made available to State agencies. If it is determined that this would be broadly useful, the process by which these experts may be contacted will be included as part of OSPB's next annual publication of capital construction instructions, which will likely be in May 2013.

Office of the State Architect Response:

Agree. Implementation date: May 2013.

- a. The Office of the State Architect will work with OSPB to revise the capital budget instructions to require all project justifications to include total lifecycle project costs.
- b. The Office of the State Architect will work with OSPB to expand the requirements in the capital budget instructions to clarify that all capital project assumptions are supported by adequate and complete supporting documentation.
- c. The Office of the State Architect will work with OSPB to consider the applicability of and the resources required to develop a repository to capture major capital project assumptions to be used by future stakeholders.
- d. The Office of the State Architect will work with OSPB to evaluate the potential for identifying a pool of specialists as a resource for State agencies and institutions of higher education when preparing their capital construction project assumptions.

Monitoring and Reporting Capital Construction Cost Estimates and Cost Savings

Once an Executive, Judicial, or Legislative Branch agency or institution of higher education receives an appropriation or spending authority for its capital construction project, the agency is responsible for monitoring the project assumptions and managing the project against the approved budget. Depending on the agency and branch of government, several other State agencies may also be involved in project oversight and tracking. For example:

- Office of the State Architect – Personnel within the Office of the State Architect are responsible for capital construction administration for Executive Branch projects (including most institutions of higher education) inclusive of: solicitation and procurement of professional design and construction services; development of standard contract language; establishment of project management guidelines including cost management; and adoption and implementation of building codes and compliance requirements. The Office of the State Architect may provide advice, but it is

not responsible for overseeing budgets or tracking project assumptions for any Executive, Judicial, or Legislative Branch agencies.

- Office of the State Controller – Personnel within the Office of the State Controller assist Executive Branch State agencies in complying with State fiscal rules and in following generally accepted accounting principles with respect to their capital construction projects. The Office of the State Controller also tracks and reports capital construction expenditures monthly to the Capital Development Committee, with the exception of cash-funded, non-appropriated projects initiated by higher education institutions since January 1, 2010.
- Capital Development Committee – The Capital Development Committee receives reports on the progress of all capital construction projects, regardless of the agency or branch of government, and typically tours completed capital construction and controlled maintenance projects in a different region of the State every other year.

What work was performed and what was the purpose?

We completed the following steps to evaluate the State's processes for monitoring capital construction projects and evaluating project assumptions against actual results:

- Read applicable State statutes with respect to the ongoing tracking of capital construction projects;
- Analyzed documentation and interviewed Office of the State Architect, Capital Development Committee, and OSBP staff to understand their responsibilities and processes for monitoring capital construction projects;
- Interviewed Department of Personnel & Administration, Judicial Department, and University of Colorado-Boulder staff to understand their roles in overseeing capital construction projects within their agencies;
- Analyzed ongoing and post-completion analyses completed for the four selected projects to confirm whether project assumptions were tracked and monitored throughout the project. The four selected projects, described in detail in Chapter 1, included the following: (1) Capitol Complex Parking Garage—Department of Personnel & Administration; (2) Proposed Mixed-Use Building—Department of Personnel & Administration; (3) Ralph L. Carr Judicial Center—Judicial Branch; and (4) the Institute of Behavioral Science Building—University of Colorado-Boulder; and
- Analyzed real estate capital construction monitoring processes and tools used by selected other states, including Georgia, Utah, Massachusetts,

Wisconsin, Virginia, California, Minnesota, Iowa, Maryland, Washington, Texas, and Florida.

The purpose of our work was to analyze the State's mechanisms for monitoring ongoing capital construction projects and gauge the processes used to compare up-front project assumptions against post-closeout results.

How were the results of the work measured?

We evaluated the State's mechanisms for monitoring ongoing capital construction projects and comparing up-front project assumptions against post-close out results. According to our industry experience, mechanisms for initiating and tracking project assumptions should include:

- Establishing mechanisms for tracking major lifecycle cost assumptions and monitoring, tracking, and reporting on these assumptions throughout the life of the project;
- Performing post-mortem analysis at project close-out of the assumptions made to justify the project and to identify lessons learned to be applied to future projects;
- Establishing mechanisms for tracking capital project expenditures against the original budget in total, as well as between expense categories;
- Developing a "business case" to support any major reallocation of funds between line items or for reinvesting project savings into additional construction upgrades or enhancements;
- Implementing mechanisms for tracking and reporting on any projected cost savings and assumptions against the baseline used to justify and support project approval;
- Executing the key agreements, such as leases, Memoranda of Understanding, and contracts, to ensure the estimates and assumptions supporting the project justifications can be successfully achieved; and
- Engaging independent third parties separate from the project management team and other third-party contractors involved in the project, to provide independent monitoring of large, complex projects and track expenditures and project assumptions.

What problem did the work identify?

Overall, we found inconsistent mechanisms for tracking, monitoring, and reporting on expenditures, project assumptions, and cost savings across agencies and projects and in some cases, these mechanisms do not appear to align with industry practices. We also found that, on the basis of the projects analyzed, the State does not engage third parties to provide independent monitoring of large construction projects and

the sampled agencies did not always perform post-mortem reviews to understand the validity of project assumptions at project closeout. Specifically:

- **Monitoring of total project lifecycle costs and post-mortem review and reporting of major assumptions and estimates.** We identified information indicating total project lifecycle cost monitoring and performance of post-mortem review for only one of the four projects reviewed (the Institute of Behavioral Science Building). According to University of Colorado-Boulder staff, monitoring and reporting of total project lifecycle costs and underlying assumptions are standard practices for capital construction projects at the University. Additionally, University staff report that post-mortem reviews of costs and assumptions occur at project closeout. As noted previously, neither the Judicial Center nor the Capitol Complex Parking Garage projects had complete and updated total lifecycle costs available; the Judicial Department did not provide an updated total lifecycle cost analysis as part of its project justification for the Judicial Center and the Department of Personnel & Administration did not complete a capital construction request and project justification for the Capitol Complex Parking Garage. Additionally, construction was never approved for the Mixed-Use Building; therefore, no monitoring was required. Further, the Judicial Center is not yet complete, so no post mortem review would have yet occurred.
- **Construction expenditure monitoring at the line-item level.** We found inconsistencies in agency practices for monitoring expenditures for capital construction projects. Generally, most agency staff we interviewed reported that they tracked expenditures at a higher level and focused primarily on ensuring that total costs did not exceed the overall project budget. Further, staff reported that requests for change orders and movement of funds between expense line items did not always undergo a comprehensive business case analysis and review process before approval. For one project (the Judicial Center), cost savings on construction bonds were used to offset changes to the library space to provide for a Learning Center valued at \$2 million. The Learning Center was not contemplated as part of the original project design. The \$2 million savings could not be used to repay bondholders and the most appropriate alternative was to reinvest the savings in project improvements. However, we did not identify a business case analysis that was completed before reallocating the project savings into the addition rather than reallocating funds for other purposes. Best practices require presentation, review, and approval of a business case analysis before reinvesting project savings for new purposes not identified in the project plan. By contrast, expenditures for the Capitol Complex Parking Garage and the Institute of Behavioral Science Building appear to have been rigorously tracked against the budget and significant controls were in place to monitor change orders and movement of expenditures between expense categories.

The Institute of Behavioral Science Building at the University of Colorado-Boulder is a representative example of good construction oversight and the project also evidenced an established “business case” review and approval process for evaluating whether to reinvest cost savings from one area into upgrades or expansions in other areas. As noted previously, the Mixed-Use Building was never constructed.

- **Mechanisms to monitor and track cost savings.** The project justification for the Judicial Center included information projecting operational cost savings of \$60 million. The Judicial Department, however, lacked adequate baseline data and mechanisms for monitoring and tracking this cost savings assumption. During our evaluation, we requested documentation from the Judicial Department on its progress made towards achieving the \$60 million cost savings. After the end of our field work, the Judicial Department provided the following information:

Component	First-Year Savings Estimate at Project Approval (2008)	Current First-Year Savings Estimate	30-Year Savings Estimate at Project Approval (2008)	Current 30-Year Savings Estimate	Notes
Rent	\$2,900,000	\$-308,000	\$15,000,000	\$1,513,009	Market rental rates did not increase as expected
Utilities	504,000	504,000	15,000,000	15,120,000	To be determined after first year of operation
Staff and Operating	936,000	281,983	30,000,000	3,523,514	Security costs higher than anticipated
TOTAL	\$4,340,000	\$477,983	\$60,000,000	\$20,156,523	

Source: Information provided by the Colorado Judicial Department.

The table shows current projected savings of approximately \$20 million, or about \$40 million less than the initial savings estimated at project approval. It is important to note that the Judicial Department also provided information to offset the reduced savings figures detailed above. For example, State agency tenant rental costs will be almost \$3.50 per square feet lower than original estimates, due to lower construction costs, favorable financing, and larger than expected revenue from court fees. Further, the Judicial Department provided estimates of future lease cost avoidance of \$163 million over 30 years, assuming market rental rates increase as projected.

- **Execution of key agreements.** For the Judicial Center, key agreements crucial to achieving project assumptions were not executed timely. For example as of the end of our evaluation, leases with the tenant agencies, which were proposed by the project to document space plans and costs, were not in place. Since the lease captures the services the tenants will receive and the rent and expenses tenants will be paying, and since the revenue from the lease payments is also an important component of repayment of the construction bonds, the lease agreement should have been executed and finalized very soon after project initiation, well before any space or build-out costs were incurred. As another example, we found that no Memoranda of Understanding had been executed between the Judicial Branch and the tenant State agencies outlining agency commitments toward consolidating operations, streamlining or sharing functions, or reducing staff prior to beginning construction. Formalized agreements, executed early in project initiation, are crucial for documenting the parties' understandings related to achieving operational cost savings.
- **Third-party resources for independent monitoring of large, complex projects.** None of the projects evaluated made use of a third-party contractor, separate from the project team or other contracted resources, to independently monitor construction projects, track budgets and expenditures, and evaluate project assumptions. The Judicial Department did engage third-party contractors to assist with project planning and construction management; however, the contractors engaged did not include a third-party independent monitor. For large-scale projects involving significant expenditures, an independent third-party monitor can be a cost-effective option to help ensure adequate controls are in place to track project assumptions and prevent cost overruns. Independent third parties can provide an independent assessment of the documentation supporting change orders, increased space needs, reinvestment of project savings, and reallocation of expenditures between line items. Additionally, an independent third party can identify effective mechanisms for tracking and monitoring assumptions and help mitigate limited staff resources at agencies with specific construction or project management expertise. Large projects, such as the Judicial Center, are good candidates for engaging an independent third party for independent project monitoring and oversight.

Why did the problem occur?

Currently, no statute or policies require agencies to establish strong mechanisms for ongoing monitoring of capital construction projects. Specifically, with the exception of the Colorado Commission on Higher Education, which has promulgated policies requiring institutions to track and monitor lifecycle project costs during the entire economic life of a project, there are no requirements specifying that agencies must track and report on lifecycle costs. Additionally, there are no requirements for State agencies to monitor capital construction budget line-items, make the business case before reallocating funds or reinvesting project savings, monitor and track cost savings against baseline estimates, or compare up-front project assumptions against post-close out results. Further, there are no requirements establishing criteria for when independent third parties should be engaged to monitor and track complex, high-cost construction projects. Finally, there are no requirements for agencies to complete a post-mortem review of capital construction projects and report lessons learned so that the State, as a whole, can benefit and improve the development of cost assumptions for future capital construction projects.

The State Architect, who has authority to oversee and develop policies for construction project management for Executive Branch agencies, lacks authority to establish policies requiring lifecycle cost and project assumption monitoring. Additionally, the Colorado Commission on Higher Education, which is a planning and coordinating body, lacks clear authority to require institutions of higher education to establish specific mechanisms for tracking, monitoring, and reporting on project assumptions or to require post mortem review and reporting of project results.

Further, due to staff funding limitations, most State agencies (with the exception of institutions of higher education) appear to lack specialists to assist with tracking and monitoring major capital construction projects and assumptions. Our research indicated that some other states (including Virginia, Maryland, Minnesota, California, and Florida) overcome the lack of real estate expertise at the agency level by providing access to such personnel through an appropriately staffed centralized real estate function or by utilizing third-party independent contractors.

Establishing requirements in legislation that State agencies track, monitor, and report on their project assumptions beyond the initial capital project evaluation and justification process could provide valuable information to improve the capital construction process statewide. For example, results of post-closeout evaluations of projects, including assessments of the validity of project assumptions and lessons learned, could be incorporated in the database discussed in Recommendation No. 1 and used by other agencies when developing their capital construction requests, improving the information available to support decision-making.

The State Architect currently has authority to develop policies requiring State agencies to prepare project monitoring reports and thorough project closeout evaluations, including written assessments of lessons learned, during the project construction and administration phases. OSPB, with the assistance of the State Architect, could work with the General Assembly to propose legislation authorizing the State Architect to establish tracking, monitoring, and reporting standards for lifecycle costs and project assumptions that apply to Executive Branch agencies, including institutions of higher education. The General Assembly, during deliberations, could then consider the policy decision of whether to extend these monitoring requirements to all agencies statewide.

Why does this problem matter?

Tracking, monitoring, and reporting on capital construction projects may help the State understand how limited available funds are invested. Ongoing oversight could also help the State confirm that assumptions contained in the upfront project justifications are consistent with actual experience once projects are completed and operational. Strong tracking and monitoring mechanisms could result in better information to support future capital construction decisions and decrease the likelihood of missing key assumptions or understating the estimates presented during the project evaluation process.

Inconsistencies in capital construction project monitoring could result in significant cost implications for the State. As an example, the expectation that cost savings would occur through consolidating and reducing the operational costs of Judicial Branch agencies and the Attorney General's Office was a major justification for approving construction of the Judicial Center. As we have discussed, the Judicial Department could not provide an adequate basis for this savings estimate in the project analysis and has not taken sufficient steps during the project to establish appropriate tracking mechanisms to ensure consolidation occurs and cost savings are realized. Similarly, by not undertaking post-closeout analyses on completed capital construction, including evaluating major assumptions and estimates utilized in the project justification, incorrect or inconsistent decisions might occur on future projects. As noted previously, the State has appropriated a total of more than \$2.1 billion to capital projects from all funding sources, excluding cash-funded projects at institutions of higher education authorized since January 1, 2010, from Fiscal Years 2009 through 2013. Capital construction investments should be subject to the same level of focused review as other types of investments made by the State.

Recommendation No. 2:

The Office of State Planning and Budgeting (OSPB) and the Office of the State Architect should improve the tracking, monitoring, and reporting on capital construction projects for Executive Branch agencies, including institutions of higher education, by working with the Capital Development Committee to propose legislation where appropriate. Specifically, the Office of State Planning and Budgeting and the Office of the State Architect should:

- a. Establish formal policies for the construction and administration phase of capital construction projects to ensure State agencies prepare project monitoring reports and thorough project closeout evaluations, including a written assessment of lessons learned upon completion. Closeout evaluations and written assessments regarding the construction and administration phase of capital construction projects should be made available to other State agencies for review.
- b. Propose legislation outlining the criteria, length of reporting term, and circumstances under which departments receiving capital construction appropriations should conduct ongoing analysis and monitoring of full project lifecycle costs, project assumptions, and cost saving estimates.
- c. Propose legislation outlining the criteria and circumstances under which capital construction project funding should require engaging independent third parties to provide lifecycle cost monitoring and tracking of complex, high-cost construction projects.

Office of State Planning and Budgeting Response:

Agree. Implementation date: May 2013.

- a. OSPB concurs that thorough closeout evaluations of the construction and administration phases of any project should be completed and published for review. OSPB will support the Office of the State Architect in ensuring that these evaluations are completed, and will assist in their publication as necessary.
- b. OSPB concurs that post-construction monitoring of specific projects can help inform the best possible decisions concerning future capital construction projects. OSPB will consult with the Office of the State Architect and the Capital Development Committee during the 2013 Legislative Session to consider when such analyses would be most appropriate to occur. However, it should be noted that departments may

be unable to comply with such requirements within existing budgetary resources, and any bill proposed as part of this recommendation may require additional appropriations.

- c. OSPB concurs that post-construction monitoring of certain large projects may best be accomplished by an independent third party. OSPB will consult with the Office of the State Architect and the Capital Development Committee during the 2013 Legislative Session to consider criteria for when capital construction appropriations should include a component for post-construction analysis by a third-party vendor. However, it should be noted that such a requirement will likely increase the total cost of construction for some future projects.

Office of the State Architect Response:

Agree. Implementation date: May 2013.

- a. The Office of the State Architect will work with OSPB to establish formal policies for State agencies and institutions of higher education for the construction and administration phase of capital construction projects to require project monitoring and closeout reports including written assessments of lessons learned upon completion.
- b. The Office of the State Architect will work with OSPB and the Capital Development Committee to evaluate possible legislation for establishing criteria for State agencies and institutions of higher education to conduct ongoing analysis of project lifecycle costs, project assumptions, cost savings and length of reporting term. Contingent upon passage of legislation, policies would be established.
- c. The Office of the State Architect will work with OSPB and the Capital Development Committee to propose legislation for capital construction project funding to include the engagement of independent third party lifecycle cost monitoring and construction cost tracking. Contingent upon passage of legislation, policies would be established.

Recommendation No. 3:

The Judicial Department should report to the Capital Development Committee and the Joint Budget Committee on its monitoring of project assumptions and lifecycle costs related to the Ralph L. Carr Judicial Center. This reporting could serve as a pilot for the procedures outlined in Recommendation No. 2. Specifically, the Judicial Department should:

- a. Beginning November 1, 2013 annually report current expected cost savings from the Judicial Center project due to the co-location of justice-related agencies and consolidation of various operational and administrative support functions. The report should include adequate supporting detail and an annual assessment of the actual cost savings achieved throughout the life of the project.
- b. Provide a current report by November 1, 2013 on any significant unresolved building issues, including the status of signed leases and Memoranda of Understanding with the various Judicial Center tenants.
- c. Provide a final closeout evaluation by November 1, 2013 of the project to the Office of the State Architect and the Capital Development Committee, including an assessment of lessons learned, with input from key stakeholders.

Judicial Department Response:

Agree. Implementation date: November 2013.

- a. The Judicial Department agrees with the items proposed in Recommendation No. 2 regarding a more comprehensive set of statewide policies for capital construction projects. We believe that the Judicial Department's experience with the project can provide valuable information to other State agencies coordinating capital construction projects in the future. The Department will continue to work with all tenants in the Ralph L. Carr Judicial Center to pursue any and all available cost savings and operational efficiencies that may be realized as a result of co-locating agencies in the building. The Department will work with the other tenants to compile and present cost savings to the Capital Development Committee and the Joint Budget Committee.
 - b. The Judicial Department agrees to compile any significant unresolved building issues and present them to the Capital Development Committee and the Joint Budget Committee.
 - c. The Judicial Department had planned on preparing a final closeout evaluation and review of the project shortly after the building was completed and all tenants had moved in. This process will include input from all tenants, consultants, and project managers.
-

Real Estate Controlled Maintenance and Capital Renewal Funding

Statute [Section 24-30-1301 (2), C.R.S.] generally defines controlled maintenance as corrective repairs or replacement of assets in existing State-owned buildings and other facilities supported by general funds. Once a building is acquired or constructed, regular maintenance must occur over the useful life of a building to keep it functioning properly and to protect against life and safety issues. The Office of the State Architect defines three types of maintenance projects:

- **Operational Maintenance-** paid for from State agency operating budgets. Operational maintenance is intended to maintain facilities and their component systems to the end of their expected useful lifecycles. Requests for operational maintenance funds are submitted directly to the Joint Budget Committee as part of the agencies' annual operating budget requests.
- **Controlled Maintenance-** paid for from the Capital Construction Fund and applies to "State-funded" buildings as well as to academic facilities at institutions of higher education paid for by cash funds. Controlled maintenance projects cost \$2 million or less and address facility component systems at the end of their useful life. Projects can be "system driven" (for example, when individual system parts, such as a heating or electrical system, needs replacement) or "maintenance driven," (for example, when floor tiles need repair or replacement). In accordance with statute [Section 24-30-1303 (1) (k.5), C.R.S.], controlled maintenance requests are reviewed and prioritized by the Office of the State Architect prior to submission to the Capital Development Committee. The Office of the State Architect also maintains a small fund for emergency funding requests to address health and safety issues.
- **Capital Renewal-** applies to "State-funded" buildings as well as to academic facilities at institutions of higher education paid for by cash funds. Capital renewal projects cost more than \$2 million and address issues that have grown in scope and are best addressed building-by-building. Capital renewal funding requests are reviewed and prioritized by the Office of the State Architect prior to submission to OSPB for legislative funding consideration.

Annually, the Office of the State Architect inspects all State-funded assets, evaluates each asset according to predetermined criteria, and categorizes and prioritizes the assets according to the following standards:

- Level 1: critical projects that predominantly involve life-safety issues or loss of use.
- Level 2: projects that are predominantly causing operational disruptions, energy inefficiencies, or environmental contamination.
- Level 3: projects that are predominantly containing differing levels of deterioration.

Circumstances preventing the timely performance of required facility maintenance may result in deferred maintenance. Deferred maintenance is the practice of postponing maintenance activities, such as repairs on real property infrastructure, or personal property such as machinery, in order to save costs, meet budget-funding levels, or realign available budget monies. A policy of continued deferred maintenance typically leads to higher costs, asset deterioration, and potential health and safety implications. In the case of Colorado, sustained delays in addressing controlled maintenance issues could negatively impact the value of the State's assets and increase real estate costs for taxpayers going forward.

What work was performed and what was the purpose?

We completed the following steps to evaluate the State's processes for managing controlled maintenance costs:

- Read applicable State statutes regarding controlled maintenance including the policies and procedures by which agencies submit controlled maintenance funding requests;
- Interviewed Office of the State Architect, Capital Development Committee, and OSPB staff to understand their controlled maintenance review and prioritization processes prior to submission to the General Assembly for funding consideration;
- Interviewed University of Colorado-Boulder staff to understand their processes for managing controlled maintenance costs on general-funded, auxiliary, and Research Property Services buildings; and
- Read discussion of the State's controlled maintenance issues found within the Office of the State Architect's *Annual Report* dated December 2011.

The purpose of our work was to evaluate the State's mechanisms for managing controlled maintenance costs.

How were the results of the work measured?

We applied the following criteria to evaluate the State's practices for managing ongoing maintenance of State-owned assets. Broadly speaking and in our experience, these criteria involve industry practices for identifying, evaluating, prioritizing, and funding controlled maintenance and capital renewal to mitigate repair and replacement costs. The criteria included practices to:

- Identify, evaluate, and prioritize controlled maintenance and capital renewal needs;
- Identify the dollars required to address current and future controlled maintenance and capital renewal needs;
- Provide adequate funds to address current and future controlled maintenance and capital renewal needs; and
- Optimize the timing of funding applied to controlled maintenance and capital renewal projects thereby mitigating costs for repairing and replacing assets.

What problem did the work identify?

Overall, we found that the Office of the State Architect appears to have practices for identifying, evaluating, and prioritizing statewide controlled maintenance and capital renewal needs for buildings funded with "State funds," which are primarily general funds. Additionally, we found that State agencies, including institutions of higher education and OSPB, generally appear to understand the Office of the State Architect's evaluation and prioritization processes and perceive them to be equitable. Further, we found that the Office of the State Architect's recommendations for prioritization of controlled maintenance and capital renewal projects have been generally adopted by the Capital Development Committee.

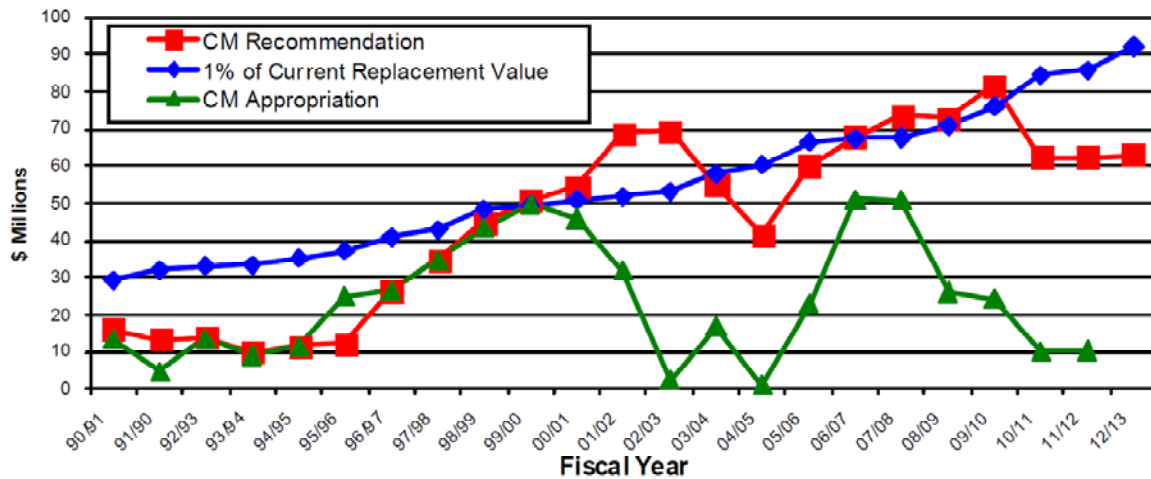
The Office of the State Architect recommends appropriating a minimum of 1 percent of the current replacement value of the State's building inventory for controlled maintenance on an annual basis to make critical repairs. The Office of the State Architect also recommends that an additional 1 to 3 percent of the current replacement value of the State's building inventory be appropriated to capital renewal projects on an annual basis. In our experience, these appear in line with the value of the States portfolio.

Although strong practices are in place in the areas noted above, we believe that the State lacks adequate mechanisms for providing sufficient funding for controlled maintenance needs, and that over time, the gap between available funding and controlled maintenance needs may result in higher repair and replacement costs for taxpayers.

Funding shortfalls for controlled maintenance requests is not a new topic because we found references to the significant ongoing gap between budget requests and actual appropriations for controlled maintenance in the Office of the State Auditor’s *Office of State Planning and Budgeting Performance Audit, September 1991*. More recently, the Office of the State Architect’s *Annual Report* dated December 2011 indicated that of the \$927 million recommended for controlled maintenance funding over the past 15 years, only \$480 million (equivalent to 52 percent of the recommended amount) was actually appropriated due to diminishing State revenues.

The chart below, prepared by the Office of the State Architect, shows a comparison of controlled maintenance requests and appropriations for “State-funded” assets over the past 23 fiscal years and further illustrates the widening differential between the two figures. The chart includes a comparison of controlled maintenance funding against the Office of the State Architect’s standard, which recommends that a minimum of 1 percent of current replacement value be set aside annually to maintain and make critical repairs. However, in Fiscal Years 2011 and 2020, controlled maintenance funding was only \$10.1 million and \$10.4 million respectively, or about 0.1 percent of the current replacement value for State-owned and general-funded buildings of \$9.2 billion.

Table 5 – Historical Controlled Maintenance Appropriation, Controlled Maintenance Recommendation, vs. 1% of Current Replacement Value



Source: Office of the State Architect December 2011 *Annual Report*.

Going forward, the State expects controlled maintenance funding issues to grow. As referenced earlier in this report, the Office of the State Architect estimates that just under half of Colorado’s owned buildings were built before 1971 and controlled maintenance costs generally increase as buildings age. Further, the Office of the State Architect estimates that between September 2011 and January 2016,

controlled maintenance costs for State-owned, general funded buildings and associated infrastructure will total \$522 million.

Why did the problem occur?

As we understand, the lack of adequate funding, revenue shortfalls, related conflicting budget pressures, and the need to limit spending has continued to exacerbate the State's ongoing controlled maintenance issues. The General Assembly has charged the Capital Development Committee with developing and making recommendations "concerning new methods of financing the State's ongoing capital construction needs and controlled maintenance" by January 1, 2016 [Section 2-3-1304 (1) (g), C.R.S.].

Historically, the State has funded controlled maintenance and capital renewal by appropriating funds to the Capital Construction Fund annually to cover project costs. The State has not made wide use of other mechanisms, such as incorporating a surcharge to cover the cost of controlled maintenance into rental rates for State buildings, to address its controlled maintenance funding needs.

Given Colorado's aging owned real estate portfolio, the State will need to be creative with respect to alternative funding sources for controlled maintenance. One such approach taken by the State of California for its owned real estate portfolio is including a lease surcharge not only for tenant improvements but also for special repairs. Reportedly, California's Department of General Services, Real Estate Leasing and Planning Section, is working to increase the percentage of rental funds allocated to maintenance fees. The federal General Services Administration also includes a charge for capital repairs funding within the rent it charges to government tenants in federally owned office buildings. Colorado should give serious consideration to a similar approach.

For capital construction projects going forward, Colorado should also consider mandatory inclusions of funding mechanisms for future controlled maintenance costs as part of the initial project approval process. As noted previously, the ongoing operating budget for the Judicial Center included an allocation of the lease costs for controlled maintenance. Additionally, dependent on the source of financing, the University of Colorado-Boulder's Auxiliary Enterprises and Research Property System buildings include a reserve for replacement as part of their operating budgets. Use of a reserve for replacement is also consistent with private sector financing practices for commercial buildings. Further, the General Assembly authorized a separate fund for maintenance for the State's parking structures, including the Capitol Complex Parking Garage. In our experience, these practices are consistent with the practices used in the private sector for funding controlled maintenance needs.

Why does this problem matter?

Without adequate mechanisms to address controlled maintenance and capital renewal needs, funding such needs may become challenging as future maintenance costs increase and asset values decline. This is particularly true where an asset becomes obsolete and needs to be replaced as opposed to being repaired. According to a July 2012 report on the Federal Buildings Fund prepared by the Government Accountability Office, the “National Research Council of the National Academies estimates that each \$1 in deferred maintenance results in a long-term capital liability of \$4 to \$5, and that an accumulation of deferred investments over the long-term may be significantly greater than the short-term savings that public-sector decision-makers were initially seeking.”

Without significant controlled maintenance and capital renewal investments, Colorado’s aging owned building portfolio will likely face significant future capital needs beyond the Office of the State Architect’s five-year estimate of \$522 million. If deferred, these costs could exceed over \$2 billion. Furthermore, should a building become obsolete and need to be replaced with third party leases, the costs to State taxpayers will likely be exponentially higher as market rental rates are projected to grow well in excess of inflation over time. As one example, Property and Portfolio Research, Inc., a company that provides real estate research and portfolio strategy services to the real estate community in the United States and internationally, estimates office building rental rate growth in the Denver Central Business District will average 4.81 percent annually between the 2012 Fourth Quarter and 2016 Fourth Quarter. By contrast, inflation is projected to average 2.2 percent annually over the same time period according to the Federal Reserve Bank of Philadelphia.

Recommendation No. 4:

The Office of State Planning and Budgeting (OSPB) and the Office of the State Architect should work with the Capital Development Committee to proactively identify potential solutions for addressing increasing controlled maintenance funding needs by considering proposing legislation to address the following options:

- a. Implementing a lease surcharge for State tenants to pay for controlled maintenance.
- b. Requiring all new capital construction projects to include a funding mechanism for controlled maintenance as part of the approved operating budgets.

Office of State Planning and Budgeting Response:

Agree. Implementation date: May 2013.

- a. OSPB concurs that the State of Colorado may benefit by the introduction of a more stable and predictable revenue stream for the controlled maintenance needs of State-owned buildings. As such, OSPB will consult with the Office of the State Architect, the Capital Development Committee, and other affected Legislative committees during the 2013 Legislative Session to consider the efficacy of a Capitol Complex lease surcharge to generate revenue for controlled maintenance on existing State-owned buildings. It should be noted, however, that such a surcharge would likely cause a need for increased appropriations in all departments' Leased Space and Capitol Complex Leased Space line items.
- b. OSPB concurs that the State of Colorado may benefit by the introduction of a more stable and predictable revenue stream for the controlled maintenance needs of State-owned buildings. As such, OSPB will consult with the Office of the State Architect, the Capital Development Committee, and other affected Legislative committees during the 2013 Legislative Session to consider the development of an ongoing funding mechanism to generate revenue for the controlled maintenance needs of new capital construction projects. It should be noted, however, that any such mechanism would likely increase the ongoing costs associated with new capital construction projects.

Office of the State Architect Response:

Agree. Implementation date: May 2013.

- a. The Office of the State Architect will work with OSPB and the Capital Development Committee to evaluate possible legislation to implement a lease surcharge for State tenants to pay for controlled maintenance. Contingent upon passage of legislation, policies would be established.
 - b. The Office of the State Architect will work with OSPB and the Capital Development Committee to evaluate possible legislation to require State agencies and institutions of higher education to include a funding mechanism for controlled maintenance in their capital construction project requests. Contingent upon passage of legislation, policies would be established.
-

Long-Term Real Estate Planning

Long-term, or “master” planning typically involves a comprehensive analysis of the functions and purposes of government buildings; analyzes issues of facility durability both technically and financially; identifies opportunities for co-locating services and programs; evaluates lease versus ownership options; identifies opportunity sites and scenarios for expansion; and provides implementation plans, including agency plans, leasing plans, and financing alternatives. Comprehensive master planning provides a framework for decision-making and has been shown to maximize the value of assets, decrease conflicts for limited funding, and reduce facility costs in both public and private sectors.

What work was performed and what was the purpose?

To evaluate the State’s long-term real estate planning processes, we completed the following:

- Read applicable State statutes with respect to real estate space and facilities planning;
- Interviewed Office of the State Architect, Capital Development Committee, and OSPB staff to understand the State’s prior and current efforts with respect to master planning;
- Interviewed University of Colorado-Boulder staff to understand how they undertake capital construction and facilities planning and also reviewed their master planning documents;
- Read and analyzed the Department of Personnel & Administration’s Capital Construction Request dated July 2011 for an Updated Capitol Complex Master Plan to be completed in Fiscal Year 2013;
- Read the *State of Colorado Strategic Real Estate Plan* dated March 2011;
- Read the *Colorado Judicial Heritage Complex Redevelopment Opportunities* report issued by the Urban Land Institute in 2005; and
- Read and analyzed long-term planning processes of selected states including: Georgia, Utah, Massachusetts, Wisconsin, Virginia, California, Minnesota, Iowa, Maryland, Washington, Texas, and Florida.

The purpose of our work was to evaluate the State’s long-term real estate planning processes.

How were the results of the work measured?

We applied the following criteria to analyze the State's mechanisms for long-term real estate planning. Broadly speaking and in our experience, these criteria represent accepted industry practices in the public and private sectors. These criteria also reflect practices in use by other states with long-term real estate planning processes (for example, Washington, Iowa, Virginia, Idaho, North Dakota, and Texas). The practices include:

- Development of a comprehensive physical master plan that addresses issues such as land use, facility construction and renovation, space utilization and needs, parking, security, grounds maintenance and use, pedestrian circulation, sustainability issues, financing options, and quality standards;
- Regular updating of the master plan to reflect changing needs and priorities; and
- Rigorous application of the master plan to guide real estate planning and development decisions.

What problem did the work identify?

Overall we found that, with the exception of institutions of higher education, the State generally lacks a comprehensive mechanism for long-term planning, such as a master plan, to maximize the value of its real estate assets, reduce facility costs, and support funding decisions. The State's *Strategic Real Estate Plan* contains certain elements of a master plan; however it is primarily focused on space utilization. As such, it does not focus on broader concepts such as land use, parking, security, grounds maintenance and use, pedestrian circulation, sustainability issues, and financing options. Furthermore, it does not address quality standards with respect to building renovations, which could result in poor work environments for occupants, ongoing maintenance demand, high-energy usage, and declining asset values.

A limited master plan that focused on space utilization in the Capitol Complex was completed by Pouw & Associates, Inc. and Geisler Smith Associates, Ltd. under contract with the Office of the State Auditor in 1989 but never updated. In Fiscal Year 2002, the General Assembly appropriated \$1 million in funds for a comprehensive plan but the funds were de-appropriated in September 2001 due to budget shortfalls. In 2008, \$1.4 million in funds were redirected for development of a Capitol Complex Master Plan but after work had started, nearly all of the funds were de-appropriated in 2009 due to State budget shortfalls.

Statute [Section 23-1-106 (4), C.R.S.] requires institutions of higher education to develop master plans to guide their capital construction and development efforts.

Facilities personnel at the University of Colorado-Boulder provided us with the University's 10-year master plan. The master plan includes discussion and evaluation of the University's ongoing real estate needs and is updated annually to reflect recent changes. The University also prepares a rolling five-year capital plan as part of its ongoing space management efforts. The rolling five-year capital plan is also updated annually and incorporates revisions to the 10-year master plan, when needed, to address changes in the University's priorities.

Institutions of higher education are required to adhere to their master plans and use them to guide their development decisions. In accordance with statute [Section 23-1-106 (4), C.R.S.], the Colorado Commission on Higher Education, through the Department of Higher Education, reviews all capital construction requests at institutions of higher education to ensure consistency with facility master plans and program plans. We found that the construction of the University of Colorado's Institute of Behavioral Science Building was an effective example of the use of long-term master planning for guiding development decisions. Specifically, the Institute of Behavioral Science Building was constructed on a longstanding designated site in the Grandview section of Boulder that had been extensively evaluated for this type of use through the master planning process.

Why did the problem occur?

The absence of mechanisms for long-term real estate planning in the State appears to result from a number of factors.

First, leadership changes in the Executive Branch (when new governors are elected) and membership changes in the General Assembly and on the Capital Development Committee (when new members are elected and other members leave due to term limits) create a shifting landscape of funding priorities. As a result, real estate decisions sometimes occur without a long-term view.

Second, the State has not made funding available for undertaking a master planning process. As previously noted, the State has twice de-appropriated funding for completion of a Capitol Complex Master Plan. Lack of available resources, including access to real estate specialists, is another major reason why the State lacks real estate planning capabilities. While the Department of Personnel & Administration and the Office of the State Architect are highly supportive of completion of a master plan for the Capitol Complex area, the Office only includes six full-time personnel across all three of its program areas (State Buildings, Real Estate, and Energy Management). In contrast, the Department of Facilities Management at the University of Colorado-Boulder includes 24 personnel including planning, design, construction, and facilities operation specialists.

Third, aside from funding issues, there is no statutory requirement for the State to complete a real estate master plan at the State level or within the Capitol Complex area. Further, there is no statutory requirement that capital construction projects align or comply with master planning documents. By contrast, individual State agencies are required to maintain facilities master plans and no capital construction may commence except in accordance with an approved facilities master plan. Similarly, in accordance with statute, the Colorado Commission on Higher Education requires individual institutions to complete updated master plans every ten years and any space decisions must align with the existing master plans. The other states we evaluated (Washington, Iowa, Virginia, Idaho, North Dakota, and Texas) appear to use their master plans to support decision-making around space acquisition/construction decisions.

Establishing a statutory requirement for a real estate master plan, including requiring all capital construction projects to align and comply with the master plan—similar to the statutory requirements for the Colorado Commission on Higher Education and institutions of higher education—could assist in overcoming these inherent process deficiencies and reduce costs to taxpayers over the long term.

Why does this problem matter?

Without an effective long-term real estate planning mechanism, the State lacks a stable framework for guiding decision-making related to maintaining, upgrading, buying, leasing, or selling real estate assets. Additionally, the State is not able to maximize the value of its real estate assets, stretch its limited funding availability, or decrease the likelihood for conflicts and isolated decision-making. Implementation of a master planning process will allow the State to work towards addressing these issues while establishing a process for projects to be evaluated, based on their merits, against an objective set of criteria within an existing planning document.

The lack of a master plan, particularly for the Capitol Complex area, could result in the development of projects in isolation without due consideration of their longer-term impacts. The development of the Capitol Complex Parking Garage is an example of such a project. The Capitol Complex Parking Garage was developed on prime State-owned real estate on a high-profile site located at Lincoln Street and East 14th Avenue in the Denver urban core. Given the scarcity of State-owned land, the State should have a long-term view of its real estate development needs to achieve highest and best use of its scarce land resources.

Similarly, absent a master plan, the State lacks a solid framework for making efficient use of both its owned and leased space or for identifying potential sites for co-locating agencies in the Capitol Complex area. The State currently has over 26 private sector leases comprising 660,870 square feet and spends over \$11 million in lease costs annually in downtown Denver buildings located adjacent to the Capitol

Complex. Without a comprehensive planning document to identify potential sites for co-location, opportunities to reduce lease costs cannot easily be evaluated.

Recommendation No. 5:

The Office of State Planning and Budgeting (OSPB) and the Office of the State Architect should work with the Capital Development Committee to develop a framework for creating a long-term real estate master plan for the State by:

- a. Seeking funding to complete a master plan for the Capitol Complex inclusive of space needs and usage requirements as well as broader concepts such as land use, parking, security, grounds maintenance and use, pedestrian circulation, sustainability issues, and financing options. The master plan should also address quality standards with respect to proposed building renovations.
- b. Considering proposing legislation requiring all real estate-related capital requests be evaluated against an approved master plan, similar to existing statutory requirements for the Colorado Commission on Higher Education and institutions of higher education.

Office of State Planning and Budgeting Response:

Agree. Implementation date: September 2013.

- a. OSPB concurs that the existence of a master plan for the Capitol Complex would lead to better decisions concerning the renovation and potential construction of new space for State operations. In a future budget cycle, OSPB will work with the Office of the State Architect and the Capital Development Committee to propose funding for such a master plan, contingent on available revenues for the project.
- b. OSPB concurs that, if a master plan were funded and completed, both the Governor and the Legislature should evaluate all construction requests related to real estate against such a plan. In the event that OSPB submits a request for a Capitol Complex master plan, it will work with the Office of the State Architect and the Capital Development Committee to propose companion legislation concerning the Plan's role in the evaluation of funding for related construction projects.

Office of the State Architect Response:

Agree. Implementation date: September 2013.

- a. The Office of the State Architect will work with OSPB and the Capital Development Committee to evaluate possible legislation for a master plan for the Capitol Complex. Contingent upon passage of legislation, the master planning would commence immediately.

 - b. The Office of the State Architect will work with OSPB and the Capital Development Committee to evaluate possible legislation to require all real estate related capital requests be evaluated against an existing approved master plan. Contingent upon passage of legislation, policies would be established.
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Monitoring Lease Operating Expenses

Chapter 3

During Calendar Year 2011, the State paid total rent of \$48.9 million for 419 in-place leases held by 21 State agencies and institutions of higher education. Reimbursement of the landlord's operating expenses is a key component of the State's rent expense. Operating expenses are the expenditures incurred (and paid) by the landlord and reimbursed by the State agency tenant to maintain and operate the property. Operating expenses typically include costs related to utilities, service contracts, maintenance, management, security, and insurance.

According to statute [Section 24-30-1303, C.R.S.], the Office of the State Architect within the Department of Personnel & Administration has responsibility for overseeing and approving leasing and real estate transactions for State agencies. In the performance of these duties, the Office of the State Architect has implemented the State's *Centralized Leasing Policy*, as established through the Governor's Executive Order D 016 03. This policy "will ensure optimum use of State-owned and leased space" and requires that Executive Branch departments, with a few exceptions noted previously, use one of the following three standardized lease agreements when procuring leased property:

- **Gross Lease Agreement ("Gross Lease")** – the most basic form of commercial real estate lease agreement, whereby the tenant's rent payment covers all of the building's operating expenses, including but not limited to utilities, service contracts, maintenance, management, security, and insurance.
- **Base Year Lease Agreement ("Base Lease")** – a modified form of the gross lease agreement, whereby the tenant's rent payment includes an additional amount to cover the operating expenses the landlord expects to incur in the base year (typically the first year) of the lease. After the first year, the tenant pays for any increases in operating expenses over the amount included in the base year. The landlord performs and provides the tenant with operating expense reconciliations annually to document the increase or decrease in operating expenses in each subsequent year after the base year.
- **Triple Net Lease Agreement ("NNN Lease")** – a lease agreement whereby the tenant pays for all (or its proportionate share of) the operating expenses of the property each year. Similar to the base year lease, the landlord provides the tenant with operating expense reconciliations annually to

determine if the operating expenses paid by the tenant during the prior year equal the operating expenses actually incurred by the landlord.

In accordance with the *Centralized Leasing Policy*, the Office of the State Architect has contracted with a real estate contract broker to assist State agencies in identifying leased space and negotiating rental terms. Once the agency executes the lease agreement with the landlord, the agency is responsible for managing the lease, making rent payments, reviewing operating expense reconciliation statements, and working with the landlord to resolve issues that may arise during the term of the lease.

As part of our performance evaluation and at the suggestion of the Office of the State Architect, we analyzed the State's lease administration practices, including (1) State agency oversight of operating expenses, (2) the management of lease administration services provided by the State's contract broker, (3) a comparison of the standardized lease provisions with recognized industry practices, and (4) the technical assistance provided by the Office of the State Architect to assist State agencies with managing the lease obligations.

The Office of the State Architect's use of an outside contract broker to identify and negotiate leased space for State agencies appears consistent with our experience with industry practice. We identified areas, however, where lease administration practices and contract provisions could be strengthened to mitigate the risk of lease payment errors, as discussed below.

Lease Administration

Once the contract broker has assisted State agency tenants with identifying leased space and negotiating lease agreements, State leases are administered through a decentralized process. As noted above, agencies are responsible for administering their own leases once the lease agreements are executed. Lease administration duties include monitoring and reviewing the operating expenses charged by the landlord to ensure State agency tenants do not pay more in operating expenses than required. Under the provisions of two of the State's standardized lease forms—the Base Lease and the NNN Lease—State agencies are required to reimburse the landlord for all or a portion (depending on the agencies' percentage of occupancy) of the operating expenses incurred at the property as part of the total rent paid. Each year, the landlord sends the tenant a statement that details the operating expenses incurred during the prior year, reconciles the operating expenses paid with the operating expenses actually incurred, and specifies the amount due from the tenant in the subsequent year to cover any operating expense increase. If the tenant wishes to question the operating expenses outlined in the statement, the tenant must notify the landlord of its interest to contest the operating expense increase and

trigger an independent inspection within the “lease audit window” outlined in the lease. The “lease audit window” under the State’s Base and NNN Lease is limited to 30 days.

What work was performed and what was the purpose?

We analyzed certain operating expense rental obligations and administrative oversight procedures to assist the State with its efforts to reduce the risk of lease overpayments. We performed lease inspections of the operating expense rental obligations incurred during Calendar Year 2011. For this sample, operating expenses totaled \$908,100. To complete our work we performed the following procedures:

Desktop Inspections - We performed high-level inspections on Calendar Year 2011 operating expenses for the following sample of eight leaseholds within the State’s lease portfolio:

**Table 6 - Desk Inspection Sample
State Agencies and Institutions of Higher Education
for Active Leases during Calendar Year 2011**

Agency	Address	Base Year²	Lease Type	Lease Square Footage	Total Rent Expenses Calendar Year 2011	Operating Expenses Calendar Year 2011¹
Department of Regulatory Agencies	1560 Broadway in Denver, CO	2006	Multiple (Base Year, Gross, and NNN)	160,325	\$2,664,329	\$135,905
Department of Labor and Employment	633 17th Street in Denver, CO	2005	Base Year	172,240	\$2,841,960	\$345,324
Front Range Community College	2121 and 2190 Miller Drive in Longmont, CO	n/a	NNN	117,106	\$1,210,876	\$144,007
Governor's Office of Information Technology	601 E. 18th Ave. in Denver, CO	2009	Base Year	59,220	\$886,787	\$16,443
Department of Revenue, Tax Audit and Compliance Division, Field Audit Unit	720 S. Colorado Blvd. in Denver, CO	2009	Base Year	16,339	\$293,122	\$1,964
Department of Corrections (Division of Adult Parole, Community Corrections, and Youthful Offender System)	940 Broadway in Denver, CO	2010	Base Year	28,600	\$461,675	\$129,517
Colorado State University System (CSU Online Plus) ²	475 17th Street in Denver, CO	2010 and 2012	Base Year	22,007	\$297,558	\$5,997
Department of Personnel & Administration	633 17th Street in Denver, CO	2005	Base Year	64,310	\$1,036,999	\$128,943
TOTAL				640,147	\$9,693,306	\$908,100
Source: Office of the State Architect <i>Annual Report</i> dated December 2011.						
Notes: ¹ Deloitte FAS analysis of 2011 operating expense statements for respective leaseholds.						
² Two base years are the result of two separately executed leases for CSU Online Plus.						

We performed the high level inspections to analyze the general accuracy of the operating expenses charged by a landlord to the tenant at a property. We applied our industry experience and understanding of commercial real estate practices to analyze the lease documents and landlord-provided annual summary operating expense invoices and compared the analysis with the lease requirements and market benchmarking data.

Field Inspections – We performed a field inspection on Calendar Year 2011 operating expenses for two leaseholds at 633 17th Street in Denver, Colorado. The

two leaseholds included the Department of Labor and Employment's leased premises totaling 172,240 rentable square feet and the Department of Personnel & Administration's leased premises totaling 64,310 rentable square feet. These leaseholds were selected because (1) the agencies had an unexpired contractual right to inspect the landlord's books and records, and (2) the agencies' operating expense rental obligations totaled \$474,267, or 52 percent of the total operating expenses in our sample. A field inspection involves an in-depth onsite inspection of the books and records of the operating expenses of the property. Typically, this includes a detailed inspection of the general ledgers, supporting invoices and work orders, and landlord building vendor contracts, as well as an evaluation and validation of significant calculations and estimates used by the landlord in determining the final operating expense rental obligation charged to the tenants of the property.

Interviews- We conducted interviews with: (1) lease administration staff at five of the eight sampled agencies (the Departments of Labor and Employment, Revenue, and Personnel & Administration, CSU Online Plus, and Front Range Community College); (2) the State's real estate contract broker; and (3) personnel from the Office of the State Architect. We conducted these interviews to analyze the State's lease administration practices, including oversight of operating expense rental obligations, management and use of services provided by the State's contract broker as they relate to maintaining files and controls over operating expenses, and assistance and oversight of operating expense management provided by the Office of the State Architect.

The purpose of our work was to evaluate whether the State's practices conform to commercial real estate industry practices and whether the practices identify and correct potential overpayment and underpayment of lease operating expenses.

How were the results of the work measured?

In accordance with our experience with commercial real estate industry lease administration practices, tenant agencies should perform timely annual reviews of their operating expense reconciliation statements and follow up with their landlord on any expenses that appear questionable, unsubstantiated, or inappropriate. Specifically, tenant agencies should:

- Perform reviews of their operating expense detail annually, well in advance of the expiration of the "lease audit window." The purpose of these reviews is to ensure that: (1) the operating expense obligation generally complies with the requirements in lease provisions; (2) the calculations provided are accurate; and (3) increases in operating expense components are consistent with historical trends. Historical trends are year-to-year and line item-to-

line item comparisons against prior year expenses and external benchmarks. Additionally, reviews should include inspection of the base year expenses of any sizable lease, which is established by the landlord at the conclusion of the first year, to ensure the comparability and consistency of these expenses in future years.

- Follow-up with the landlord to obtain additional documentation when expenses appear in question, significant, or potentially noncompliant with the State's lease provisions. Significant changes in expenses from the base year should be brought to the attention of, and explained by, the landlord over the remainder of the lease term. If the landlord is unable to provide adequate documentation to resolve significant, questionable, and unresolved operating expense issues, the tenant should request an independent lease audit of the landlord's documentation, on the landlord's premises. As noted previously, State agencies must perform their operating expense reviews and, if an independent lease audit is needed, notify the landlord of their intent to audit and then perform the audit within the 30-day "lease audit window" outlined in the lease.
- Request and maintain adequate and complete documentation related to their lease and annual operating expense obligations over the full term of their lease.

What problem did the work identify?

The State lacks adequate practices to consistently identify, investigate, and correct potential overpayment and underpayment of lease operating expenses. Our analysis of the eight leaseholds during the field and desk inspections identified overpayments totaling \$78,082 (8 percent) and underpayments totaling about \$28,605 (3 percent) of the \$908,100 in operating expenses inspected, for a net overpayment of \$49,477 (5 percent).

According to our experience, the average percent overpayment identified through an inspection of operating expenses typically ranges between 3 percent and 5 percent. The overpayment identified during our inspection is consistent with this percentage overpayment rate. Some of the overpayments and underpayments we identified may have occurred in prior years. The "lease audit window" for prior years has expired, which means that we could not confirm whether other over- or underpayments have occurred. We identified the following over- and underpayments, which may potentially affect payments in future years if the State agency tenant does not take appropriate action to correct these observations:

- **Overpayments.** We identified three overpayments for operating expense reimbursements that were erroneous or did not comply with the lease provisions.

- We identified an overpayment totaling \$28,369 (\$7,711 related to the Department of Personnel & Administration's lease and \$20,658 related to the Department of Labor and Employment's lease) for reimbursing the landlord's costs for replacing a sewer ejection pump. Under generally accepted accounting principles, a sewer ejection pump installation should be classified as a capital expenditure. However, the landlord categorized the expenditure as an operating expense for "normal maintenance and repair." The State's standard lease contracts preclude capital expenditures as part of operating expenses unless the expenditure results in a cost savings or is mandated by law. If the expenditure meets either of these exceptions, the capital expense can only be included in operating expenses if amortized over the asset's useful life. Although the sewer ejection pump met one of the exceptions (i.e., mandated by law), the expenditure was not amortized over its useful life. Instead, the total amount was included in operating expenses, in violation of the lease terms.
- We identified an overpayment of \$49,142 (\$13,268 related to the Department of Personnel & Administration's lease and \$35,874 related to the Department of Labor and Employment's lease) for asset management fees not permitted by the lease and also not included in operating expenses in the base year.
- We identified an overpayment of \$571 made by the Governor's Office of Information Technology for the landlord's personal property taxes. Personal property taxes are not an includable operating expense under the Governor's Office of Information Technology's lease.
- **Underpayments.** We identified an underpayment of \$28,605 (\$7,198 related to the Department of Personnel & Administration's lease and \$21,407 related to the Department of Labor and Employment's lease) caused by an error in the base year operating expense calculation, which inflated the applicable base year expenses.

In addition, we found that the agencies' operating expense rental obligations for 2011 appeared generally compliant with the agencies' leases and that the calculations, as presented within the reconciliation statements prepared by the agencies' respective landlords, were mathematically correct. We identified lease administration practices and controls at the eight agencies that could expose the State to potential overpayment of operating expenses in the future. Specifically, we identified the following problems:

- **Operating Expense Reviews.** We identified potential concerns or questions with prior year and/or base year operating expense billings for six of the

eight sampled leaseholds (the Departments of Regulatory Agencies, Labor and Employment, Corrections, and Personnel & Administration; the Governor's Office of Information Technology; and CSU OnLine Plus). Although some of these agencies performed certain levels of diligence in their review, none of the six agencies pursued these potential concerns or followed up with their respective landlords to satisfy the potential concerns or questions. For example:

- Certain operating expenses charged by the Department of Regulatory Agencies' landlord had increased notably from the 2006 base year. Although staff within the agency maintained records of caps on certain expenses, trended operating expenses, and observed certain increases or decreases, there was no evidence indicating that the Department of Regulatory Agencies had challenged the potentially understated base year operating expenses which could result in increased future rental liabilities.
- The Department of Corrections was charged property management fees that were more than twice the amount charged by comparable buildings on the market. We found no information indicating that Department of Corrections had identified or investigated this difference.
- Three agencies (the Departments of Regulatory Agencies and Corrections, as well as the Governor's Office of Information Technology) could not provide information showing they had investigated the potential anomalies or overcharges. The lease audit windows had expired, however, and the agencies could no longer challenge the landlord about these charges.

Finally, we found that although five of the agencies we interviewed (the Departments of Labor and Employment, Revenue, and Personnel & Administration; CSU Online Plus; and Front Range Community College) reported conducting some limited review of the operating expense statements received, only one agency (the Department of Revenue), had conducted the type of formalized, detailed analysis we recommend performing routinely.

- **Supporting documentation.** We found that three of the eight agencies in our sample (the Department of Revenue, the Governor's Office of Information Technology, and CSU Online Plus), had not requested adequate documentation from the landlord to perform sufficient operating expense review and analysis to determine if charges were appropriate. In addition, none of the eight agencies in our sample maintained complete lease-related

documentation for the entire term of the lease, a recognized industry practice. Complete lease-related documentation is essential for evaluating operating expense trends over time and to identify potential outlier expenses that require follow up and investigation.

Why did the problem occur?

Our evaluation identified several areas where the State's lease administration practices, including policies, training, and technical assistance, could be improved:

- **Standardizing lease administration procedures.** Procedures for performing operating expense reviews and conducting lease administration activities at both the State and agency level would benefit by standardization. Although the Office of the State Architect has promulgated lease policies for State agencies, these policies do not address any agency responsibilities for reviewing their lease operating expenses. For example, policies outlining the basic steps agencies should follow to evaluate operating expense trends, compare operating expenses against the base year expenses and lease provisions, or assess expenses to external benchmarks do not exist. In addition, guidance outlining the types of documentation that State agencies should require their landlords to provide when issuing their operating expense reconciliation statements is lacking. According to our interpretation of recognized commercial real estate practices, the minimum level of operating expense detail landlords should provide includes:
 - Major expense category breakouts, including utilities, janitorial services, security, maintenance, management, insurance, and abated property taxes.
 - Insurance invoices and policy coverage details to ensure alignment with lease parameters.
 - Calculations demonstrating that the landlord is in compliance with the operating expense cap required by the lease (e.g., not to exceed 105% over prior year expenses).
 - A trend or variance analysis, by major expense category, comparing the year-over-year change from the prior year's operating expenses and base year amounts, when applicable.
 - Schedules of occupancy adjustments that affect the amount of operating expenses charged to the State tenant.

Formalized policies and centralized support from the Office of the State Architect are particularly important since most of the agency personnel managing leases or reviewing operating expenses have not historically had specific real estate expertise. Additionally, the agency staff typically charged

with managing leases and reviewing operating expenses are not the same individuals who were involved in negotiating and executing the agency's lease. Further, the real estate lease administration duties often represent a relatively minor portion of their central job responsibilities.

- **Utilizing benchmarking and software review tools.** On the basis of the leases analyzed, State agencies would benefit by a more rigorous process to compare their operating expense reconciliation statements to standard benchmarking databases, such as the databases developed by the Building Owners and Managers Association ("BOMA"), which are widely used for benchmarking in the real estate profession. Additionally, State agencies are not consistently utilizing the available software tools in the ProLease database—a database and reporting system intended to hold information on all of the State's leases—to assist them with reviewing their lease operating expenses.
- **Increasing training and technical assistance.** In general, State agency staff assigned to specific lease administration tasks lack relevant training. For example, basic training on the lease administration process, such as training on performing operating expense reviews, maintaining adequate lease administration files, tracking critical dates such as renewal dates or early termination options, working with landlords to resolve questionable expenses, or activating the tenant's contractual right to contest operating expense increases, is not provided by the Office of the State Architect or the contract broker. Further, we found that when specific training has been offered, State agencies did not always attend the training. For example, when the Office of the State Architect's contract broker hosted training on its new lease administration system ProLease, only 11 of the 21 State agencies served by the contract broker participated in the training.

Staff also appear to be unaware of the contract broker's role in providing lease administration and other technical assistance services to State agencies because staff at only one of the five State agencies we interviewed were aware of the extent of the broker's role. In addition, baseline online training and lease administration forms, best practices, and other technical support are not available on the Office of the State Architect's website. A centralized, web-based real estate resource, including training materials, forms, and a "listserv," could be helpful for publicizing training, communicating policy changes, and providing technical assistance resources to assist State agency staff seeking additional support related to managing their leases.

- **Clarifying contract broker responsibilities.** Currently, the contract service agreement between the contract broker and the Department of Personnel & Administration lacks specificity about the expectations for deliverables to be

provided by the contract broker. According to the contract service agreement, the State's contract broker is responsible for providing lease administration services for the State's leaseholds located in the contract service area (City and County of Denver, City and County of Broomfield, Adams, Arapahoe, Boulder, Douglas, Jefferson, El Paso, and Pueblo Counties). According to the agreement, the contract broker is to assist the State with: (1) lease administration services including the "organization and maintenance of lease files, assistance/ organization/maintenance and all costs associated in maintaining software for the Office of the State Architect's Leased Property Inventory database (ProLease); (2) operating cost audits; (3) periodic review of space standards; (4) escalation (CPI) calculations; (5) market comparisons; and (6) other services as needed from time to time.

State agency lease administration personnel from only one of the five State agencies we interviewed was aware of the contract broker's responsibilities for assisting with lease administration support, including conducting desktop inspections and providing assistance to State agencies in analyzing and contesting their operating expense rental obligations. Interviews with contract broker staff also revealed that the contract broker has provided only a limited number of desk audits and no field audits related to challenging the State's operating costs with its landlords.

Contract broker staff reported that they typically become involved when notified by agencies of disputes, rather than providing proactive, ongoing lease administration services and analysis. A proactive approach to analyzing and monitoring operating expense obligations on behalf of the contract broker's clients is the industry standard, and should be the standard expected of the State's contract broker.

- **Increasing the use of the lease administration database.** Individual agencies and the State as a whole should have the ability to track the various components (or lease attributes) of their rental obligations for their real estate portfolio (by individual lease, types of lease, by agency, and in total). The State agencies in our sample are not using the State's lease administration database, ProLease, to administer, manage, and report on their leases. Components of rental obligations include items such as base rent, operating expenses, and additional rent (i.e., charges for above-standard services such as parking), and critical dates, among others. Tracking these expenses helps individual agencies and the State as a whole, assess trends and manage their rental obligations. Using ProLease could assist the State track basic metrics, such as the specific dollars spent on a portion of the \$48.9 million of lease payments in Calendar Year 2011 expended on operating expenses.

State agencies also do not use ProLease as the single repository for all of their lease administration files. As required by the contract, the State's contract broker uploads lease contract files negotiated on behalf of State tenant agencies into the ProLease lease administration system and retains the files for the term of the lease contract, plus seven years following its expiration. Instead of using this database to warehouse all lease-related documents, agencies are maintaining their own lease administration files, and in many cases, these files do not appear complete. As noted previously, four of the eight sampled agencies did not have complete lease administration files and the five agencies we interviewed were generally not aware that maintaining complete lease administration files for the term of the lease is a recognized industry practice.

The ProLease software has functionality and tools, such as automated notifications of critical dates or specific, and lease-related management reports, that could help agencies with their day-to-day lease administration tasks (i.e., sending timely notifications to the landlord or reconciling payments). Only one of the five State agencies we interviewed was aware of its ability to use the ProLease lease administration database as the single repository for all State agency leases to assist in administering, managing, and reporting on its lease.

- **Contesting lease operating expenses and the timing of lease inspection requests.** The Office of the State Architect and the State's contract broker were not aware of any instance where a State agency has triggered an audit of the landlord's books and records. Further, none of the eight agencies in our sample had contested their operating expenses or activated their right to inspect the landlord's books and records for any year during the lease term. When agencies identify questionable operating expense obligations that cannot be adequately resolved with the landlord through normal communications, the agency has imbedded in its lease a contractual right to audit the landlord's documentation and records through an independent inspection at the landlord's premises. In the commercial real estate industry, operating expense audits, or field audits, are typically conducted on a fixed fee, contingent fee, or combination fixed/contingent fee basis. Agencies could arrange for lease audits on their individual leases, or contact the contract broker for assistance with performing a lease audit, when agencies become aware of significant potential problems with their operating expense reconciliations that would warrant further inspection.

The Office of the State Architect should consider mitigating the risk of overpayments by contracting with an outside vendor for centralized operating expense review and lease audit services. This approach could reduce the administrative burden, including reducing the expense of providing training and technical assistance to

staff at 21 State agencies with lease administration duties, for both State agency and Office of the State Architect staff while increasing opportunities for recoveries. Specifically, the Office of the State Architect could contract with a lease audit firm on a contingent fee or combination fee basis to perform annual reviews of operating expense reconciliation statements, perform desk audits, and when indicated, conduct lease audits on the State's entire lease portfolio.

As noted previously, our experience shows that inspections of an entity's entire lease portfolio typically identify recoveries ranging from 3 to 5 percent of total operating costs, which was the recovery percentage identified during our desk and field inspections of the eight sampled agencies. Currently it is not possible to estimate the dollars the State might recover from centralized reviews and inspections of its entire lease portfolio, since as noted previously, total operating expenses are not available in the ProLease database. The Department of Personnel & Administration, through House Bill 10-1176, received authority to hire one or more consultants to conduct contingent-fee recovery audits to identify and recover overpayments made during Fiscal Years 2008 through 2010. The Department should consider requesting similar authority, if needed, to conduct centralized reviews and lease audits for the State's entire lease portfolio on a contingent-fee basis or combination fee basis in the future.

Why does this problem matter?

During Calendar Year 2011, State agencies spent \$48.9 million on their rental obligations, a portion of which was spent on reimbursing the landlord's operating expenses. Without strong lease administration practices State agencies could overpay their respective operating expenses.

Recommendation No. 6:

The Office of the State Architect should work with State agencies to strengthen lease administration practices and reduce the risk of operating expense payment errors. Specifically, the Office of the State Architect should:

- a. Promulgate guidance to agencies outlining their responsibilities for annually reviewing their operating expense rental obligations and work with the contract broker to establish standardized procedures for agencies to follow when performing their reviews. At a minimum, the guidance should address the level of detail and support to be obtained from landlords to document the operating expense obligations and require year-to-year comparisons against the base year, annual cost line item-by-line item trend analysis, confirmation

of the mathematical accuracy of the landlord's billing statement, and confirmation that all expenses included conform to the lease provisions.

- b. Develop base-line trainings and training materials for lease administration, in conjunction with the contract broker, that assist agencies with reviewing their operating expenses, tracking critical lease dates, maintaining complete lease files, and working with landlords to resolve any issues identified. This should include developing a listserv and other centralized web-based resources to support the State's real estate community, such as lease administration forms, review procedures, policies, and best practices.
- c. Work with the contract broker and the Attorney General's Office to revise the contract service agreement and better define the responsibilities, expectations, and deliverables to be provided by the contract broker when assisting State agencies with lease administration services. This should include requiring the contract broker to perform analytics on the data maintained in the ProLease database to identify trends and potential anomalies and assist State agencies with reviewing their operating expense rental obligations, performing desktop audits when requested, and conducting or arranging for lease audits in a timely manner consistent with lease-specified lease audit windows. The Office of the State Architect should monitor the contract broker's activities to ensure the contract provisions are fulfilled.
- d. Work with State agencies and the contract broker to improve utilization of the existing functionality in the ProLease lease administration system. This should include recommending that agencies use ProLease as the repository for all lease-related documents; activating tools such as critical date tracking and notification, trending, and other analytic functions; entering and maintaining key data for the State's entire lease portfolio; and testing for data reliability periodically within the database. Agencies should also be encouraged to enter and maintain data on the basic components of their lease obligations, such as base rent, operating expenses, and additional rent, by leasehold, in the ProLease database. Information should be used for analysis and reporting on the State's entire lease portfolio.
- e. Consider contracting with an outside vendor to perform centralized review of operating expense reconciliation statements and to conduct lease audits on the State's entire lease portfolio on a contingent fee or combination fee basis, requesting authority from the General Assembly if needed.

Office of the State Architect's Response:

- a. Agree. Implementation date: May 2013.

The Office of the State Architect will establish guidelines outlining agency responsibilities to review landlord statements including operating expense reconciliations annually. Guidelines will specify needed data from landlords to enable agency personnel to make year-to-year comparisons. The Office of the State Architect will also work with the contract broker to develop standardized procedures for agencies to follow when performing the annual reconciliations.

- b. Agree. Implementation date: May 2013.

The Office of the State Architect will continue to offer training to lease administrators to assist agencies with the review, tracking and maintaining of complete lease files, as well as how to work with landlords to resolve issues. The Office of the State Architect will also add resources to the Office of the State Architect website specifically designed to aid in annual operating lease reconciliations.

- c. Agree. Implementation date: July 2013.

The Office of the State Architect will work to clarify contract broker responsibilities relating to lease administration services. The Office of the State Architect will seek to add language to subsequent contracts with contract brokers to better define responsibilities. The Office of the State Architect will continue to work with State agencies to monitor the contract broker and ensure that contract provisions are fulfilled.

- d. Agree. Implementation date: March 2013.

The Office of the State Architect will continue to recommend that all State agencies utilize ProLease as the preferred database for lease transactions.

- e. Agree. Implementation date: March 2013.

The Office of the State Architect will explore opportunities to utilize both internal subject matter experts as well as outside vendors to assist in conducting reviews of annual operating expense reconciliation statements.

Recommendation No. 7:

The Departments of Personnel & Administration and Labor and Employment should review their operating expenses from prior years and the overpayments identified in this evaluation and work with their landlord to recover all overpayments identified. The Departments should seek assistance from the contract broker in performing reviews and resolving issues with the landlord, as needed.

Department of Personnel & Administration's Response:

Agree. Implementation date: June 2013.

The Department of Personnel & Administration will work with the Office of the State Architect and the contract broker, as appropriate, to review prior-year operating expenses and to pursue recovery of identified overpayments.

Department of Labor and Employment's Response:

Agree. Implementation date: June 2013.

The Colorado Department of Labor and Employment will review operating expenses billed by the landlord for years that fall within the Department's contractual rights to inspect the landlord's records. After this review, Department staff will seek assistance from the contract broker in resolving concerns with the landlord.

Lease Provisions

The State's *Centralized Leasing Policy* requires that Executive Branch departments, with a few exceptions outlined previously, use one of the State's three standardized lease agreements when leasing property. The Office of the State Architect works with the Attorney General's Office to develop the standardized lease agreements and the Attorney General's Office approves the provisions to ensure the agreements adequately protect the State. According to the Office of the State Architect, the standardized lease agreement required by the *Centralized Leasing Policy* allows for a more expeditious approval process, limits legal costs related to lease drafting, and controls risk.

What work was performed and what was the purpose?

We compared the provisions in the State's three standardized lease agreements and applied our experience reading commercial leases and providing lease advisory services in the public, private, and not-for-profit sectors. We also compared the lease provisions for each of the agencies in our sample with the appropriate standardized lease agreement to identify whether the standardized provisions were consistently applied.

The purpose of our work was to analyze the provisions in the State's standardized lease agreements to understand whether they generally conform to recognized real estate leasing practices.

How were the results of the work measured?

We evaluated whether the lease language in the State's standardized agreements conform to our experience with practices used in the real estate industry. Specifically, we evaluated whether the State's standardized agreements address the following areas:

- **Establish an adequate lease audit window.** In our experience, the time frame a tenant has for analyzing the landlord's reconciliation and executing the tenant's audit right should range between six and twelve months. For large leaseholds (i.e., greater than 30,000 rentable square feet), the duration of the audit right time frame may extend beyond one year or longer, particularly if the tenant State agency has good leverage with a high credit rating and occupies a significant portion of the building's leased space.
- **Exclude capital reserves and unrelated operating costs.** Capital reserves, used by the landlord to make capital improvements to the property, are not customarily a component of operating expenses and should be excluded. Additionally, costs unrelated to operating expenses, such as the costs for operating a parking facility in the building, should be specifically excluded from operating expenses in the lease.
- **Limit and define management fees.** In our experience, property management fees should have a stated limit (for example 3 percent of the building's gross rental receipts). Additionally, management fees should be established using a clearly defined standard, such as a comparison with market rates for specifically identified properties in the area.
- **Account for operating expenses.** Generally Accepted Accounting Principles (GAAP) is a standard framework for financial accounting and reporting

commonly used in accounting for real estate operating expenses within the United States. Including a GAAP requirement is a leading leasing practice and ensures consistency from one reporting period to another.

- **Adequately define key lease terms and methodologies.** Key lease terms, such as “Term,” “Building,” “Project,” “Premises,” and “Additional Rent” should be fully defined to ensure transparency and avoid manipulation of terms. In our experience, defining such terms also helps in allocating costs to the property cost centers. In addition, key methodologies in the lease, such as methodologies for reconciling and monitoring the State property tax exemption, should be defined so that both the landlord and tenant can understand and apply the methodology correctly. Statute [Section 39-3-124 (1) (b) (I) (E), C.R.S.] provides that neither the landlord nor the State agency shall receive an unfair financial benefit from the property tax exemption. Clearly defining the terms and methodologies helps to lessen errors on the part of both landlords and State agency tenants.

What problem did the work identify?

Overall, we concluded that the State’s three standardized lease agreements meet the basic needs of the State’s departments and agencies. We also concluded that the provisions in the eight leases reviewed generally conform to the State’s standardized lease provisions. We found, however, that certain provisions in the State’s standardized lease agreements could be enhanced to better align the agreements with recognized real estate leasing practices. This could help prevent State agencies from paying more in lease costs than they should. We identified opportunities for improvement in the following areas:

- **Expanded “lease audit window.”** The State’s standardized lease agreements include a 30-day “lease audit window” to give a State agency the opportunity to analyze the landlord’s operating expense reconciliation. In our experience, the industry standard “lease audit window” typically ranges from six to twelve months. Therefore, we concluded that the State’s standardized lease agreements do not provide sufficient time for State agency tenants to analyze the operating expense reconciliation statements provided by landlords.

The reconciliation statement compares the estimated operating expenses paid by the State for the prior year with the actual operating expenses incurred by the landlord. If actual operating expenses exceeded or were less than the estimated operating expenses, the tenant or the landlord would be responsible for paying or crediting to the tenant the difference and the State agency tenant’s lease payment would be adjusted. As noted previously, three

of the agencies that had potential anomalies or overcharges identified through our desk audit (the Departments of Regulatory Agencies and Corrections and the Governor's Office of Information Technology), were unable to contractually challenge their landlords to determine whether the charges complied with the lease provisions because their lease audit windows had expired.

- **Specifically excluding certain costs from operating expenses.** The State's standardized leases have no exclusions for certain costs not customarily included within operating expenses. For example, capital reserves are customarily excluded from operating expenses because these expenses are typically included in the tenant's base rent. However, the State's standardized leases define "operating expenses" to include "*a reasonable annual reserve for all other capital improvements and structural repairs and replacements . . .*" If State agency tenants are reimbursing their landlords for capital reserve contributions through their operating expenses, the State agency tenants may be funding the landlord's capital investment twice: once through the net base rent and once by reimbursing capital investment reserves charged to operating expenses.
- **Including a management fee limit and standards for market rate comparisons.** The State's standardized lease provisions do not include a limit (e.g., 3 percent of the building's gross rental receipts) to restrict the amount of management fees the landlord may charge. Additionally, the standardized lease provisions do not clearly define the standard by which management fees may be determined. For example, the provisions allow landlords to charge State agency tenants professional building management fees "*provided that such fees are comparable to fees charged by other similar office buildings in the area.*" The standardized lease, however, does not define the term "comparable office buildings" or identify the specific office buildings that should be included for comparison purposes.

Without a definition of the comparable market or the inclusion of a cap to limit the amount of management fees landlords can charge, there are risks that State agency tenants may be paying management fees that exceed the market rate. Further if the landlord and property manager are related parties, there is an increased risk that the management fees could be set above market. Therefore, management fees should be evaluated and benchmarked against the market on a regular basis.

- **Specifying required accounting principles.** The State's standardized leases currently require landlords to apply generally accepted accounting principles ("GAAP") to capital expenses, but the leases do not require that GAAP apply to all operating expense categories. GAAP accounting is

generally more favorable to tenants not only in its application of capital amortization, but also with respect to management fees in base years and accruals because of its “principle of regularity,” meaning conformity to enforced rules or standards. GAAP also incorporates its “principle of consistency,” which mandates that there is a constant method for the accounting treatment year-over-year, most notably for “base year” lease application.

- **Defining key lease terms and methodologies.** The State’s standardized leases do not include clear definitions for key lease terms such as: “Term,” “Building,” “Project,” and “Premises.” For example, the term “Premises” only identifies the specific property area for which the State agency tenant must reimburse operating expenses. If “Premises” is not clearly defined in the lease, and the State agency tenant and the landlord do not agree on the area included in “premises,” or the related allocated costs, the State agency may be charged for expenses it did not intend to incur.

The standardized leases also do not include an unambiguous methodology for State agency tenants or their landlords to reconcile and monitor the allocation of property taxes. Statute [Section 39-3-124, C.R.S.] exempts State agencies from paying property taxes when leasing property; therefore, property taxes must be allocated among the non-State agency tenants. The lease methodology for this reconciliation and allocation is complex and is intended to prevent the payment of property taxes that are not the responsibility of the landlord, the State agency, or any other building tenants.

We identified instances where both State agency staff and landlord staff had apparently misinterpreted property tax provisions. We also noted possible errors in applying the property tax exemption but these errors did not appear to affect the State agency tenants in our sample.

Why did the problem occur?

The State’s standardized lease agreements have been revised several times since Calendar Year 2008. As we understand, these revisions occurred when substantial modifications were made in preparation for the enactment of the new real property tax laws. An outside real estate lease expert was not engaged to assist with and advise the State on these revisions.

The State’s standardized leases are intended to apply to a broad range of real estate property types, uses, locations, and tenant/landlord experiences. As a result, if the lease terms are too specific, the standardized leases may not apply to the variety of leasing situations that State agencies may face. When negotiating lease terms, the State has limitations that private tenants do not have. For example, State agencies

cannot indemnify their landlords and State agencies are not bound by their leases beyond the current year if funding for making lease payments is not appropriated.

We believe there are opportunities to improve the lease provisions to better protect the State's interest and align with recognized real estate leasing practices while allowing for the use of standardized leases for a wide variety of properties and situations. Therefore, the Office of the State Architect should involve the State's contract broker in working with the Attorney General's Office to revise and update the standardized leases. These revisions and updates should specifically address the issues discussed in this evaluation.

Why does this problem matter?

The State may be paying more than it should be for certain lease-related expenses because from our experience, the State's standardized lease provisions vary from recognized real estate leasing practices. Further, the current standardized lease agreements may not provide adequate protection against other lease-related risks. For example, the standardized lease provision limiting the time the State has to review the landlord's operating expenses is 30 days. In our experience, a 30-day time frame limits an entity's ability to analyze the landlord's reconciliations, request additional information, conduct a desktop inspection to compare the operating expenses with historical data and external benchmarks, or arrange for a field inspection of the landlord's records when the State agency tenant has concerns about the accuracy of the landlord's operating expense reconciliation.

By addressing the concerns raised related to the standardized leases, the State could improve its economic protections and position related to its leased rental obligations.

Recommendation No. 8:

The Office of the State Architect should engage the advice and assistance of its contract broker and work with the Attorney General's Office to update and revise the State's Standardized Lease Agreements to better protect the State and reduce the risk of overpaying certain rental obligations. Specifically, the Office of the State Architect should, building on our comments, use the expertise of its contract broker and the comments to make improvements to address the issues identified above.

Office of the State Architect Response:

Agree. Implementation date: March 2013.

The Office of the State Architect will continue its practice of updating the lease form(s) as needed to reflect changes in law or practice. The Office of the Attorneys General, the Office of the State Controller, and the contracted broker will be involved in the review and approval process of the suggested contract language modifications in Recommendation No. 8.

The electronic version of this report is available on the website of the
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