



February 23, 2011

To: Finance and Administration Committee
From: Will Kempton, Chief Executive Officer *W. Kempton for*
Subject: Review of Real Estate and Right-of-Way Administration

Overview

The Internal Audit Department has completed a review of the Orange County Transportation Authority's real estate and right-of-way administration. The review found that controls over real property management and consultant services are not consistently effective and should be improved. The Internal Audit Department has offered six recommendations to improve controls, policies and procedures, and compliance with laws and regulations.

Recommendation

Direct staff to implement recommendations in the Review of Real Estate and Right-of-Way Administration, Internal Audit Report No. 09-015.

Background

The Orange County Transportation Authority's (OCTA) real property includes the Orange/Olive subdivisions right-of-way (ROW), the Pacific Electric ROW, the Anaheim, Garden Grove, Irvine, and Santa Ana bases, several park and rides, several transit centers, two future use properties, and excess parcels in Anaheim, Buena Park, Garden Grove, Irvine, and Orange. The net book value of OCTA's real property, including land and buildings, was approximately \$327 million at June 30, 2010.

OCTA leases the use of some of its property. There are approximately 1,075 active tenants, 131 of which generate revenue. Many of the leases were transferred to OCTA at acquisition of the property; however, OCTA also enters into new leases with interested parties. For the fiscal year 2009-10, lease income totaled approximately \$1.3 million.

Discussion

The objectives of the review were to determine if appropriate and adequate controls exist over real property management and to evaluate the effectiveness of controls over real property consultant services and invoices. The Internal Audit Department (Internal Audit) reviewed a sample of leases of OCTA property and a sample of consultant services agreements and invoices.

Internal Audit found that OCTA's 2010 report of taxable possessory interests did not include all leases with private possessors. Reporting is required by the Revenue and Taxation Code and is submitted to the Orange County Assessor's Office for identification of taxable possessory interests. Internal Audit recommended that management ensure all leases with private possessors are reported as required. Management agreed to develop a system to ensure possessory interest reporting information is updated for new or modified tenant information on a monthly basis and to reconcile the annual report prior to submission.

Internal Audit identified instances where consumer price index and fair market adjustments were not always implemented in accordance with lease terms. Internal Audit recommended that policies and procedures over fair market adjustments be developed and that adjustments to lease rates be consistently applied. Management agreed to develop policies and procedures for enforcement of fair market adjustment terms and conditions as agreed in the license agreements. Also, management agreed to review leases with terms greater than one year on a monthly basis to determine if a fair market adjustment is warranted.

Internal Audit identified several instances where insurance certificates did not reflect all insurance coverage required by the lease, and two leases that were transferred to OCTA included no insurance requirements. Internal Audit recommended that insurance certificates be reviewed for inclusion of all required insurance, and that transferred leases be reviewed to ensure the agreements contain appropriate insurance requirements. Management agreed to review all leases to identify insurance certificate update needs and to coordinate insurance requirements with Risk Management staff.

The review of the consultant service contracts included a few master on-call contracts, and the contract task orders (CTO) issued on those contracts. Internal Audit identified two instances of CTO proposals that included subcontractors that were not identified in the master on-call contracts at CTO execution. These subcontractors were added to the master contracts through amendments after the work was performed. Internal Audit recommended that all subcontractors be

added to master contracts in a timely manner and before work is authorized. Management agreed to direct staff to comply with requirements of master agreements before work is authorized and indicated they would work with Contracts Administration and Materials Management (CAMM) staff to incorporate language in the CTO to reduce the probability of work being performed prior to approval.

Internal Audit also noted two instances of CTO proposals without a break-out of the subcontractor proposed amounts by job category, hourly rates, and hours. Internal Audit recommended that OCTA obtain sufficient detail in CTO proposals to ensure that subcontractor pricing is in accordance with master on-call contract pricing. CAMM management agreed to request that subcontracting pricing be a part of the CTO price proposal in order to ensure that the CTO proposal pricing is in accordance with the master contract pricing.

Summary

Based on the review, Internal Audit offered six recommendations to improve contract administration. Management provided responses addressing all recommendations.

Attachment

- A. Review of Real Estate and Right-of-Way Administration, Internal Audit Report No. 09-015

Approved by:

Janet Sutter
Acting Executive Director
714-560-5591

ORANGE COUNTY TRANSPORTATION AUTHORITY INTERNAL AUDIT DEPARTMENT



Review of Real Estate and Right-of-Way Administration

INTERNAL AUDIT REPORT NO. 09-015

February 14, 2011



Internal Audit Team: Janet Sutter, CIA, Acting Executive Director
Serena Ng, CPA, Senior Internal Auditor

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Conclusion

The Internal Audit Department (Internal Audit) has completed a review of the Orange County Transportation Authority's (OCTA) real estate and Right-of-Way (ROW) administration. The objectives were to determine if appropriate and adequate controls exist over real property management and to evaluate the effectiveness of controls over real property consultant services and invoices.

Based on the procedures performed, Internal Audit found that controls over real property management and consultant services are not consistently effective and should be improved. Internal Audit has offered six recommendations to improve controls, policies and procedures, and compliance with laws and regulations.

Background

OCTA Real Property

OCTA's real property includes the Orange/Olive subdivisions ROW, the Pacific Electric ROW, the Anaheim, Garden Grove, Santa Ana, and Irvine bases, several park and rides, several transit centers, two future use properties, and excess parcels in Anaheim (1), Buena Park (2), Orange (2), Garden Grove (1), and Irvine (1). The two future use properties are the Anaheim Regional Transportation Intermodal Center and the land adjacent to the Laguna Niguel/Mission Viejo station. The net book value of OCTA's real property, including land and buildings, was approximately \$327 million at June 30, 2010.

The Orange/Olive subdivisions are made up of the Orange subdivision, a 42-mile operating railroad ROW beginning at Fullerton Junction and ending at the Orange County/San Diego county line, and the Olive subdivision, a 5.5-mile operating rail ROW beginning at Atwood Junction and ending in the City of Orange. The Orange/Olive subdivisions are operated by the Southern California Regional Rail Authority (SCRRA) for Metrolink trains, Amtrak trains, and Burlington Northern Santa Fe Railway trains. The Orange/Olive Subdivisions were appraised at \$697 million in May 2009, but are carried at cost of \$113 million.

The Pacific Electric ROW, used formerly as a rail corridor, extends diagonally across Orange County's road system through the cities of Anaheim, Buena Park, Cypress, Garden Grove, La Palma, Santa Ana, and Stanton. The Orange County Transit District (OCTD) purchased seven miles of the Pacific Electric ROW in 1982. In 1992, OCTA purchased approximately five additional contiguous miles of the Pacific Electric ROW northwest to the Los Angeles County line. The Pacific Electric ROW was appraised at \$147 million in September 2008, but is carried at cost of \$37 million.

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OCTA leases or licenses the use of some of its property. As of report date, there were approximately 1,075 active tenants, 131 of which are revenue-generating. Many of the leases/license agreements (leases) were transferred to OCTA at acquisition of the property. OCTA also enters into new leases with interested parties, primarily utilities, with agreements being reviewed by ROW management and legal counsel. For leases on the Orange/Olive Subdivisions, SCRRA approval is required. Lease and license fees (lease income) totaled approximately \$1.3 million for fiscal year 2009-10.

Database and Inventory of Real Property

The ROW Department (Department) maintains two Microsoft Access databases, one with property and lease information for the Orange/Olive subdivisions and one for properties other than the Orange/Olive subdivisions. The Department also maintains tickler files in Microsoft Excel for revenue-generating leases. These tickler files identify the lease payment terms including fee amount, term and fee adjustment anniversaries if applicable, as well as insurance expiration dates.

General Accounting maintains an inventory of all OCTA capital assets including real property. Every fiscal year, General Accounting sends ROW and Risk Management a spreadsheet of the Fixed Asset Property Statement of Values Summary with the detailed asset listing for ROW's confirmation as to completeness and Risk Management's determination as to the replacement value of insurable property.

Objectives, Scope and Methodology

The objective of this review was to determine if appropriate and adequate controls exist over real property management. Objectives also included an evaluation of the effectiveness of controls over real property consultant services and invoices.

In meeting this audit objective, Internal Audit employed the following methodologies:

- Reviewed prior audits;
- Reviewed OCTA real property inventory;
- Reviewed a judgmental sample of 20 licenses/leases of OCTA property; and
- Reviewed a sample of ROW consultant agreements and invoices.

The scope of the review was limited to controls over real property management and monitoring of consultant services and invoicing.

This review was conducted in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

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Audit Comments, Recommendations and Management Responses

Noteworthy Accomplishments

The ROW Department (Department) maintains tickler files of revenue-generating lease agreements of OCTA property that include the current fees, fee adjustment anniversaries, and insurance expiration dates. These tickler files are part of a monitoring system of fees and insurance that has been helpful in monitoring agreement requirements of revenue-generating leases.

The ROW agent responsible for property management handles lease agreements with 1,075 tenants, 131 of which are revenue-generating. Our review found that invoices for the lease fees are being sent out and collected in a timely manner.

The Department also maintains an Active Contract Summary to track current ROW consultant agreements. The summary ensures that the Department is aware of all open agreements and agreement values.

Possessory Interest Reporting Should be Complete

A taxable possessory interest is a possessory interest that is separately taxable to the possessor (lessee or licensee) of publicly owned real property. Revenue and Taxation Code Section 480.6 requires every state or local governmental entity that is the fee owner of real property in which a taxable possessory interest has been created to either (1) file the required preliminary change in ownership report or change in ownership statement with respect to renewal of a taxable possessory interest; or (2) file an annual real property usage report.

The Possessory Interest Annual Usage Report filed by OCTA in 2010 is incomplete. The report submitted to the Orange County Assessor's Office did not include three revenue-generating Pacific Electric ROW and miscellaneous leases with income totaling approximately \$36,000, revenue-generating leases in the Orange and Olive Subdivisions with income from private possessors totaling over \$400,000, and leases with private possessors that do not generate revenue.

Recommendation 1: Internal Audit recommends that the ROW Department include all of OCTA's leases with private possessors in its Possessory Interest Annual Usage Reports.

Management Response (ROW Department): ROW staff will develop a system to update possessory interest reporting (PIR). On a monthly basis, staff will update new tenant information, make changes to any existing tenants, if needed, and delete information from terminated agreements from the prior year's PIR. Staff will then

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reconcile the annual PIR to make sure it is accurate prior to its submittal to the Orange County Assessor's Office.

Procedures over Lease Income Adjustments Should be Formalized

Most leases of OCTA property allow for annual consumer price index (CPI) adjustments and for fair market adjustments of rates to the then-fair market value of leased property at intervals of three or five years. However, Internal Audit noted that there are no formal procedures for fair market analysis of lease rates. There have been some fair market analyses that resulted in negotiations with lessees, but those have been done mainly in the last couple years and there was no specific criteria used in choosing the leases for review.

Recommendation 2: Internal Audit recommends that that the ROW Department develop policies and procedures for fair market adjustments to lease rates.

Management Response (ROW Department): ROW staff will develop policies and procedures to enforce, within reasonable measures, the fair market (FM) adjustment terms and conditions for revenue-generating uses as agreed in OCTA's Standard License Agreement and as agreed in prior railroad owner license and lease agreement formats (Atchison, Topeka and Santa Fe, and Southern Pacific).

Lease Rate Adjustments Should be Consistently Implemented

During testing, Internal Audit noted instances where CPI and fair market adjustments to lease rates were not consistently implemented and/or enforced in accordance with lease terms:

1. For one lease with a recent fair market analysis, the lessee would not agree to a rate increase from its current annual lease payment of \$18,668, to around \$85,000, and indicated that it will abandon the facility if rent is raised. The lessee is using the leased area for a trailer, boat, and RV storage yard. The ROW Department has taken no further action on the lease.
2. For one lease, OCTA increased the lease payments to fair market value over a three-year period, but the invoice for the first of the three-year period was billed at the unadjusted rate of \$443 instead of \$1,699¹.
3. One agreement with a utility company to construct, maintain, and use an electric supply line allows for revision in rent after the end of each 5-year period, but the revisions have not been applied in a consistent fashion. OCTA increased the rent to \$39,924 for fiscal year 2001-02 by the annual CPI change over the preceding five years and then increased the rent to \$41,589 for fiscal year 2005-06 by the

¹ After Internal Audit inquired about this invoice, ROW staff requested that Accounts Receivable bill for the difference. As of report date, the difference has been collected.

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same index but only over a one-year period. Although the rate could be revised upward again in fiscal year 2010-11, OCTA invoiced at the same \$41,589 rate as fiscal year 2005-06.

The existing ROW Policies and Procedures Manual states that the property manager should apply periodic rental adjustments per the lease/license agreement, but does not provide specific guidance on the adjustments.

Recommendation 3: Internal Audit recommends that the ROW Department consistently implement fair market adjustments and CPI adjustments with lease terms greater than one-year. Policies and procedures over periodic rate adjustments should be more detailed and include approvals for departures from policy.

Management Response (ROW Department): ROW staff will review leases with terms greater than one year on a monthly basis to determine if a FM adjustment is warranted. Staff will produce an inventory list of those types of lease agreements to better monitor rental rates. As needed, ROW staff will coordinate its efforts with Accounting staff for billing adjustments.

Lease Insurance Requirements Should be Enhanced

The ROW Department requests certificates of liability insurance every year for all leases that require insurance and then files the certificates in the lease files. However, Internal Audit noted the following during testing:

- There were five instances of insurance certificates not reflecting insurance required by the lease, mainly automobile liability and workers compensation and employers' liability insurance.
- Leases that don't generate revenue are not included in the tickler files that identify insurance expiration dates. As a result, there were three non-revenue-generating leases, two with cities, that require insurance, but the lease files do not contain the certificates or letters indicating self-insurance.
- Two leases, one with a utility company for an electric supply line and another for an oil pipeline, that were transferred to OCTA do not contain any insurance requirements.

Recommendation 4: Internal Audit recommends that the ROW Department review insurance certificates for inclusion of all required insurance. For non-revenue-generating leases, a review of insurance certificates should be done on a periodic or cycle basis. Additionally, the ROW Department should review transferred leases to ensure agreements contain appropriate insurance requirements.

Management Response (ROW Department): ROW staff will review leases to determine insurance certificate update needs and that transfer lease language is

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updated. ROW staff will coordinate insurance requirements with Risk Management staff.

Subcontractors Should be Approved in Master Agreements

The ROW Department has agreements for various activities, including ROW engineering, ROW maintenance, general ROW services, appraisal services, and utility services. Several of the agreements are for on-call services and contract task orders (CTO) are executed as needs arise. During testing, Internal Audit identified two instances of CTO proposals that included subcontractors that were not identified in the master agreements at CTO execution, but were later added to the master agreements through amendments:

- A CTO under Agreement No. C-9-0749 was issued on June 25, 2010, for \$220,250, with \$45,150 for an unapproved subcontractor, for ROW services in support of the environmental mitigation program. The amendment to add the subcontractor was executed on October 10, 2010.
- A CTO under Agreement No. C-6-0653 was issued on March 26, 2010, at \$31,000, with \$12,000 for an unapproved subcontractor, for ROW services for Phase I Environmental Site Assessments and review appraisal services for the Placentia grade separation project. The amendment to add the subcontractor was executed in December 15, 2010 after work was complete.

Recommendation 5: Internal Audit recommends that all subcontractors be added to master agreements in a timely manner and before work is authorized.

Management Response (ROW): ROW staff will be reminded to comply with requirements of master agreements before work is authorized. ROW staff will work with CAMM staff to incorporate language in the initial CTO to avoid possible amendments during the term of the CTO and to reduce the probability of work being performed prior to approval.

The Capital Programs Division staff will work with CAMM staff to include specific amendments in a CTO rather than amending the master agreement and use a multiplier contract rather than showing individual consultant hourly rates. These changes could reduce the amount of time needed to execute and administer a CTO and ensure subcontractor and other contract changes be made in a timely manner.

Contract Task Order Pricing Should be Detailed for Subcontractors

During testing of seven firm-fixed-price CTO's and CTO amendments, Internal Audit noted that two CTO proposals did not include a break-out of the subcontractor proposed amounts by job category/classification, hourly rates, and hours.

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Recommendation 6: Internal Audit recommends that Contracts Administration & Materials Management (Camm) obtain sufficient detail in CTO proposals to ensure that subcontractor pricing is in accordance with master agreement pricing.

Management Response (Camm): Camm agrees to request that subcontracting pricing be a part of the CTO price proposal in order to ensure that the CTO proposal pricing is in accordance with the master agreement pricing.