



ARIZONA BOARD OF REGENTS

ASU ♦ NAU ♦ UA

October 11, 2019

Ms. Lindsey Perry, Auditor General
Arizona Office of the Auditor General
2910 North 44th Street,
Suite 410 Phoenix, Arizona 85018

Auditor General Perry,

Thank you for the opportunity to respond to your audit on the Arizona Board of Regents' real estate policies. ABOR appreciates the role that the Auditor General plays in reviewing and advising ABOR and the universities and compliments you and your team for your professionalism and diligence in undertaking this complex audit.

While ABOR will implement the audit recommendations, some additional explanation is required. Prior to the audit, ABOR took a number of steps to establish robust oversight of commercial real estate activity. ABOR established a property oversight subcommittee, contracted with a third-party professional to review ABOR's real estate governance structure and survey best real-estate practices at other universities and university systems across the country, adopted governance principles and established a thorough set of policies to govern commercial real estate activity. Those policies set forth the expectations for the universities regarding commercial real estate transactions requiring board approval.

The Auditor General has determined that additional written guidance is warranted to implement ABOR's real estate policies and that a lack of such guidance increases the risk of inappropriate use of public resources leased to private parties. However, as the Auditor General acknowledges, no lease transactions have been submitted to ABOR since its policies have been updated to address commercial real estate transactions. The policies as revised became effective in December 2018. Thus, this finding is based on speculation regarding how effectively ABOR will exercise its governance responsibilities in the future when implementing the recently revised policies. The revised policies include requirements that will allow ABOR to obtain the information necessary for it to make decisions regarding specific commercial real estate transactions and ensure appropriate governance.

ABOR is confident that its policy strikes the appropriate balance between articulating the considerations it will employ in making decisions and retaining the flexibility necessary to permit the universities to propose a variety of projects that support their institutional missions and address those considerations. ABOR's confidence in this regard is supported by the fact that it already engages in numerous processes to define the missions of the universities, receive reports regarding

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their progress in meeting ABOR-defined goals, and obtain information regarding capital planning and real property leasing. See, e.g., ABOR Policies 7-104, 7-105, 7-106, and 7-107.

The long-term leasing activity on which the Auditor General has focused takes place in the overall context of the regular direction and oversight ABOR provides to the universities regarding their institutional missions and goals, giving ABOR the background necessary to critically evaluate the information the universities will submit under revised policy 7-207.

The report also fails to note that while many universities and university systems across the country engage in commercial real estate activity, the Auditor General was unable to identify any other state with a similarly well-defined policy structure, and it may be that ABOR's commercial lease policy is the only one currently developed and in place, essentially making ABOR the model and best practice in the United States.

Because the Auditor General could not identify a policy structure specific to higher education against which to compare ABOR's policies, the Auditor General instead adopted model policies articulated by the Government Finance Officers Association (GFOA) and the Pew Charitable Trusts designed for state and local governments engaged in economic development activities. The title of the cited GFOA policy is "Establishing an Economic Development Incentive Policy." The Auditor General's reliance on this standard is misplaced.

The inappropriate application of the selected standard creates two main flaws in the report. First, the report equates granting a tax benefit to private entities in exchange for an undefined benefit, such as economic development, with generating additional lease revenue by monetizing the university tax status. Economic development outcomes, such as new jobs, are difficult to track and source. The recommendations outlined in the report, such as clear performance standards and tracking mechanisms, are designed for municipalities engaged in economic development to help them better track the economic performance of tax incentive programs. ABOR engages in no such programs. Thus, the recommendations do not directly apply to ABOR leases, which are simple to track and enforce.

Second, the GFOA and Pew guidelines assume economic growth is the objective of land development. ABOR's stated objective for commercial land development is to "optimize the value of the property to the university and enhance the institutional mission of the university" (ABOR policy 7-207 B.1.A). Recommendations that apply to land development for economic growth, such as clearly defined guidelines on how to calculate economic benefits, will not necessarily apply to all ABOR leases.

Finally, recommendation 1a requires the inclusion of specific performance standards in each lease agreement and remedies should these standards not be met. ABOR lease agreements include performance standards and remedies. This recommendation is once again based on GFOA guidance to local municipalities providing tax incentives for economic development. Recommendations that are generally not applicable to ABOR transactions.

To help the reader better understand the context of the report, we have included ABOR's policies pertaining to leases of real property as an attachment to this response. (See Exhibit A). We have also included a list of all policies referenced in ABOR's response (See Exhibit B).

Once again, we appreciate the partnership we have enjoyed throughout this audit process.

Sincerely,

John Arnold
Arizona Board of Regents

Attachments

Finding 1: ABOR's lack of written guidance for implementing its real estate policies and approving commercial subleases increases the risk of inappropriate use of public resources leased to private parties

Recommendation 1: ABOR should develop and implement written guidance for the universities to follow regarding commercial lease agreements that:

Recommendation 1a: Requires each agreement to include measurable performance standards related to its policy objective for entering the agreement and a process through which ABOR may take action if a private entity receiving a benefit through an agreement does not meet the performance standards.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation Finding 1 and the related recommendations (recommendations 1-5), ask the Arizona Board of Regents (ABOR) to add clarifying guidance to its recently established commercial real estate policies. While the ABOR will implement the recommendations, please see the general concerns about the audit approach outlined in the agency cover letter. Please also note, the Auditor General found **no** examples of inappropriate use of public resources leased to private parties. The report only suggests additional guidance will strengthen the already robust governance structure.

Recommendation 1b: Outlines a process for complying with ABOR's policy requirement to document the proposed lease agreement's economic benefits, tax treatment of the real property and proposed improvements and its impact on other taxing jurisdictions, and how it furthers the university's institutional mission, including:

- An assessment of how the proposal aligns with ABOR's objectives for such agreements.
- A comparison of the costs and benefits of the proposed agreement that identifies its financial and nonfinancial costs and benefits.
- An assessment of the proposal's impact on the tax base and potential tax revenue for other taxing jurisdictions.
- An explanation of any assumptions used in the evaluation, such as those used to develop estimates of indirect economic benefits and the limitations of the results.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Recommendation 1c: Requires that each agreement receiving a tax benefit be periodically evaluated, on a schedule determined by ABOR's need for updated information and the evaluator's capacity, to ensure the private entity receiving the benefit is meeting the agreement's performance standards and to determine the agreement's actual benefits and costs.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: ABOR policy 7-207.B.3 already provides that each university must annually report on the status and performance of all executed long-term leases that are commercial in nature. In implementing this recommendation, ABOR will develop additional guidance as to the elements of the required annual reports.

Recommendation 2: ABOR should develop and implement criteria on the appropriate use of the real estate policy requirement waiver and written guidance for the universities on how they should document justification for policy waiver requests.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Recommendation 3: ABOR should develop and implement written guidance for the universities on how to determine fair market rental value for property it leases.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Recommendation 4: ABOR should develop and implement a process to track and monitor ongoing approval and reporting requirements to help ensure the universities comply with the requirements.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: ABOR currently has approval and reporting processes in place, including the following:
ABOR Policy 2-207 (A) states that “All lease agreements and amendments of lease agreements of real property. . . shall be reviewed by the Finance, Capital and Resources Committee and approved by the board before becoming effective” except for those leases exempted under the policy because they fall under certain thresholds established by the policy. ABOR Policy 2-207(B)(3) requires the universities to report at least annually “on the status of all executed long-term leases subject to subsection B, and the performance of such long-term leases. The report shall include timelines and financial information relative to the terms of executed agreements, the intended use of any revenue received by the university, and other information as coordinated with the executive director of the board.” ABOR Policy 2-207(C) requires that “All leases entered into shall be reported to the board office annually in accordance with procedure developed by the executive director.”

Recommendation 5: ABOR should develop and implement written guidance similar to its leasing policy requirements for commercial leases that its designees should follow when

approving commercial development sublease agreements under its master lease agreements.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation:

Recommendation 6: ABOR should review existing master lease agreements and determine if they can be amended to include approval requirements that are consistent with its new guidance on master lease agreements and amend them accordingly.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: As noted in the report, ABOR uses master lease agreements that allow lessees to enter into subleases. ABOR will implement Recommendation 6 by including additional details governing the sublease process in the master lease agreements. This recommendation is not intended to require ABOR to approve each sublease.

Finding 2: Operation of some ABOR property has lacked oversight and accountability, resulting in inappropriate use of proceeds and limited transparency

Recommendation 7: ABOR should develop and implement a process to help ensure its designees fulfill the oversight duties delegated to them, such as conducting periodic monitoring or requiring designees to provide periodic reports or documentation detailing the fulfillment of their oversight duties.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: As noted in the report, the UA tech park was established over 25 years ago. Like many organizations, CRC has adjusted its business practices over that time and, as the Auditor General noted, its recent practices do not strictly adhere to the requirements of the master lease agreements. ABOR, in conjunction with the University of Arizona and the CRC, will undertake a review and modernize the requirements of the master lease agreements to meet the desired outcomes of the relevant leases.

Recommendation 8: ABOR should develop and implement policies that prohibit a university president and/or their designee who has been delegated oversight responsibilities for any real estate agreement with a third party from also participating in governance and/or operational responsibilities related to that third party.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation:

For true unaffiliated third parties, ABOR complies with conflict of interest statutes. For related entities, university employees can and should participate in governance and/or operation in order to provide oversight and safeguard ABOR's interests. Forbidding university employees from serving on the board of a related entity, such as a research park for example, would deprive ABOR of a meaningful opportunity to ensure the entity complies with contractual requirements and acts consistently with university interests. ABOR's understanding of this recommendation is that it is limited to specific, formal, written delegated authority to university presidents or other university officers regarding ABOR oversight responsibilities. As long a separation of official duties exists between governance of related entities and ABOR oversight, university officers may serve on related entity boards.

Recommendation 9: ABOR should work with its legal counsel to determine whether any actions should be taken to address the improper advances from the Rita Road property to the Bridges property.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Recommendation 10: ABOR should develop and implement procedures to track and act on its oversight responsibilities prescribed in master lease agreements, such as ensuring it receives and appropriately reviews annual reports if the CRC does not provide them in accordance with master lease agreements.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Recommendation 11: ABOR should ensure its legal counsel works with the universities to review their classification of public records in accordance with public records laws.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Recommendation 12: ABOR should comply with public records laws by maintaining records that are reasonably necessary to provide an accurate accounting of its official activities, such as those described in its master lease agreements.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Finding 3: ABOR lacks comprehensive property information to independently oversee and manage the use of its property

Recommendation 13: ABOR should develop and implement policies and/or written guidance for developing and regularly updating property listings, including clearly identifying the property information that should be maintained in the listings, such as parcel numbers, description of the property, location, use restrictions, and current and planned uses.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Recommendation 14: ABOR should continue with its efforts to develop a complete and accurate property listing of all ABOR properties using information compiled by the universities, containing all land and improvements, with sufficient information to allow it to oversee the universities' use of its property, including unique property identification, location, use restrictions, and current and planned use.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Recommendation 15: ABOR should develop and implement procedures to verify property ownership and the accuracy of information in the property listings, such as working with the county assessors' and recorders' offices to verify property ownership. These procedures could include a risk-based approach and sampling methods for performing this verification work, as appropriate.

ABOR Response: The finding of the Auditor General is agreed to and the audit recommendation will be implemented.

Response explanation: [Click to enter explanation.](#)

Exhibit A
to
Arizona Board of Regents' Response to the Auditor General's
Performance Audit Regarding Commercial Real Estate

Policy Number: 7-207	Policy Name: Leases of Real Property
Policy Revision Dates: 12/2018, 9/18, 4/18 (effective 7/1/18), 6/09, 6/05, 4/99 (Previous 7-306 Leases of Real Property 1/94, 3/92, 9/90, 1/88 - 7-403 Lease-Back Agreements)	Page 1

7-207 Leases of Real Property

- A. All lease agreements and amendments of lease agreements of real property, including lease agreements in connection with any development of capital projects, as defined in board policy 7-102(B)(3) shall be reviewed by the Finance, Capital and Resources Committee and approved by the board before becoming effective, except as provided below:
1. A university may enter into a lease or lease amendments as Landlord or Lessor without board approval (except for use of athletic facilities by professional teams), provided all of the following criteria are met:
 - a. The lease term including all renewals shall not exceed 120 months;
 - b. The annual base lease amount does not exceed \$1,000,000; and
 - c. The rental rate meets or exceeds the fair rental value of the property.
 2. A university may enter into leases or lease amendments as tenant or lessee without board approval provided all of the following criteria are met:
 - a. The original lease term shall not exceed a total of 60 months;
 - b. Renewal options in total shall not exceed an additional 60 months;
 - c. The total annual base lease amount does not exceed \$1,000,000;
 - d. The rental rate does not exceed fair rental value; and
 - e. Funds are available.

Policy Number: 7-207	Policy Name: Leases of Real Property
Policy Revision Dates: 12/2018, 9/18, 4/18 (effective 7/1/18), 6/09, 6/05, 4/99 (Previous 7-306 Leases of Real Property 1/94, 3/92, 9/90, 1/88 - 7-403 Lease-Back Agreements)	Page 2

- B. A university may seek board approval for a long-term lease that is commercial in nature. Such leases are subject to the following additional considerations:
1. When considering a long-term lease described in subsection B:
 - a. Such long-term leases of university property should, to the extent possible, optimize the value of the property to the university and enhance the institutional mission of the university.
 - b. The university should use financial transactions (whether sale, lease, sale-leaseback or other means) that support the needs of the university to facilitate development of university property.
 - c. In general, when a transaction is commercial in nature, the university should consider long-term leases over the sale of university property unless the university can demonstrate to the board that a sale will provide a greater long-term benefit.
 - d. Universities shall not engage in long-term leases that are commercial in nature if the primary purpose is to remove private land or real property improvements from property tax rolls.
 - e. The university shall document the economic benefits to the university and the state of each such long-term lease, including the university's understanding of the tax treatment of the real property and proposed improvements, and shall document how such long-term lease furthers the institutional mission of the university.
 - f. Board review of proposed long-term leases that are commercial in nature shall include a review of any payment to the university in lieu of taxes, the property tax impacts on other taxing jurisdictions, and any service agreements, including payments, with relevant governmental entities.

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- g. Board review of proposed long-term leases will include a review of appropriate community outreach and coordination with community partners and relevant governmental entities.
2. All long-term leases and agreements described in subsection B shall be non-binding until reviewed by the Finance, Capital and Resources Committee and approved by the board as follows, and as applicable, reports may be given in executive session:
- a. Notification. The university shall report to the Finance, Capital and Resources Committee chair and vice-chair and the board office on its intent to solicit proposals or to enter into transactions with possible partners for long-term leases on university property that will be commercial in nature. The report shall include the preliminary development concept associated with the long-term lease.
 - b. Preliminary Presentation of Lease. Following entering into a letter of intent or other agreement to provide exclusive rights under a long-term lease that is anticipated to be commercial in nature, a university shall present its preliminary lease plan to the Finance, Capital and Resources Committee. The presentation shall include the following elements, as appropriate to the scope and structure of the transaction:
 - i. Conformance with the principles and requirements outlined in subsection B, paragraph 1.
 - ii. Preliminary transaction timing and project schedules.
 - iii. Preliminary financial terms and conditions, including income and cost estimates, as applicable.
 - iv. Other information as coordinated with the executive director of the board.
 - c. Final Lease Approval. After the completion of due diligence, the university shall request a final review of the long-term

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lease that is commercial in nature from the Finance, Capital and Resources Committee and approval of such lease from the board. The final lease plan submitted to the committee and the board shall include the following elements, as appropriate:

- i. Conformance with the principles and requirements outlined in subsection B, paragraph 1.
- ii. Terms and conditions of the long-term lease, including any considerations regarding any future transfer or sale of the lease or leasehold interest.
- iii. Market analysis.
- iv. Risk assessment.
- v. Information related to agreements with other jurisdictions.
- vi. Other information as coordinated with the executive director of the board.

3. Ongoing Monitoring and Reporting. At a time agreed to by the executive director of the board, the university shall at least annually report on the status of all executed long-term leases subject to subsection B, and the performance of such long-term leases. The report shall include timelines and financial information relative to the terms of executed agreements, the intended use of any revenue received by the university, and other information as coordinated with the executive director of the board.

C. All leases entered into shall be reported to the board office annually in accordance with procedures developed by the executive director of the board.

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D. For the purposes of this policy:

1. "Commercial in Nature" means that a majority of business, calculated either by lease revenues generated or by allocation of square footage, conducted at the leased property is anticipated to come from the non-university population.
2. "Long-Term Lease" means a lease of land or real property improvements with a term that exceeds 120 months.
3. "University Property" means property, the title of which is owned and held by the Arizona Board of Regents.

Exhibit B
to
Arizona Board of Regents' Response to the Auditor General's
Performance Audit Regarding Commercial Real Estate

Policies cited in the ABOR Response include the following:

ABOR Policy 7-104: Strategic Planning

<https://public.azregents.edu/Policy%20Manual/7-104-Strategic%20Planning.pdf>

ABOR Policy 7-105: Master Plans

<https://public.azregents.edu/Policy%20Manual/7-105-Master%20Plans.pdf>

ABOR Policy 7-106: Annual Capital Improvement Plans

<https://public.azregents.edu/Policy%20Manual/7-106-Annual%20Capital%20Improvement%20Plans.pdf>

ABOR Policy 7-107: Capital Development Plan

<https://public.azregents.edu/Policy%20Manual/7-107-Capital%20Development%20Plan.pdf>

ABOR Policy 7-207: Leases of Real Property

<https://public.azregents.edu/Policy%20Manual/7-207-Leases%20of%20Real%20Property.pdf>