RULES COMMITTEE:
ITEM:

CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: RULES COMMITTEE

FROM: **Councilmember Sam Liccardo**

SUBJECT: **INCUBATORS**

DATE: October 5, 2011

Approved Date 10-5-11

Revised Recommendation

In light of:

- revelations that have emerged with recent reports and an additional hearing on this matter, as described in the "Discussion," below, and

- the RDA's almost $35 million investment in the incubator program over its 18 year history, direct the City Auditor to add to her work plan an audit, to provide the and set of recommendations whether the RDA/the City should commence discussions with San Jose State University regarding moving the incubators outside of the management and oversight of the San Jose State University Research Foundation (SJSURF).

Discussion

The Redevelopment Agency and the San Jose State University Research Foundation (SJSURF) have signed subleases and co-sponsorship operating agreements to provide for the SJSURF management, operation, and fiscal oversight of the incubator facilities, while the Agency would provide capital and operating support.

Last week's hearing at the Community and Economic Development Committee revealed new information, including yet another report that had remained hidden from the Council and public. When viewed in the context of what we now know from the three independent consultants who prepared a 2009 report ("Chabin report), it compels the need for an objective analysis by the City Auditor. Namely, the new that information includes:

1. **FAILURE TO HEED OWN CONSULTANT'S RECOMMENDATION TO SEEK A DIFFERENT OPERATOR**

In 2007, the Redevelopment Agency commissioned Jim Robbins and Carol Kraus Lauffer to set a strategic plan for the incubators. Predictably – since Robbins ran two of the

incubators and (although they relied on inflated RDA & SJSURF data relating to job creation and corporate retention to do so).

Less predictably, though, they urged that a new, independent, non-profit organization take over the management of the incubators. Their conclusion was based on several explicit, but muted, criticisms:

- "Neither the Redevelopment Agency nor the SJSURF, as currently organized, are the most effective organizations to manage the large number of incubators now being funded by the Agency" (p. 13)
- SJSURF's "Board…is not focused on the private sector or familiar with business incubation practices" (p. 13)
- SJSURF's "own organizational structure and perceptions about appropriate levels of risk…have often limited opportunities for innovation and improvement of the incubator programs" (p. 13)
- the incubators need an operator "skilled at raising funds" from government grant-makers, corporations, and foundations, the lack of which at SJSURF was blamed for the incubators' excessive operating shortfalls (and consequent need for RDA subsidy). (p. 19-20)

2. FAILURE TO REPORT OBVIOUS CONFLICTS OF INTEREST

In recent weeks, it has become apparent that Executive Director of Prescience International, the company managing the Biocenter and Environmental Business Cluster under a sub-contract with SFSURF, had taken an equity and/or debt position in at least one tenant company for her own private account, while managing that company and other companies at the same facility. When questioned about whether she'd ever informed the Redevelopment Agency of this seemingly blatant conflict of interest, SJSURF Executive Director Mary Sidney told the CED committee that she didn't recall ever doing so.

The RDA Board similarly knew nothing about Prescience's work on behalf of other cities, such as South San Francisco, Seattle, and San Diego, seeking to build Biocenters of their own. Whether these business relationships create actual conflicts of interest or mere appearances of conflicting loyalties, it remains unconscionable that Members of the RDA Board remained in utterly the dark about those relationships while investing well over $30 million in public dollars to support the incubators' development.

3. INFLATED AND FALSE REPORTS OF RESULTS

Although the SJSURF had a responsibility to report accurate information to the Agency and its Board, it appears that they failed to do so, on several fronts, e.g.,:

Corporate Retention

In recent weeks, we've learned that the RDA and SJSU Research Foundation released a 2006 report that claimed that "...The incubators graduated 250 companies, and 70% remained in San Jose, filling empty industrial space." (Robbins, page 21) The three independent consultants ("Chabin report") that prepared the 2009 report found that fewer than 11% of the then- 285 graduate companies remained in San Jose to date.

Jobs "Created"

Job creation data appears heavily inflated by inclusion of employees whose employment pre-dated the entry of the company into the incubator, and wildly inconsistent. Even today, SJSURF appears to have exaggerated its jobs numbers, reporting to the CED committee that it had created 4,060 jobs at the three SJSURF-managed incubators since their inception. Two years ago, the independent consultants arrived a figure of 2,603 jobs—relying on the SJSURF's and RDA's inflated reporting. (Chabin, p. 10) (As has been noted in my August 11th memorandum, only about 150 of those jobs actually remained in San José.)

4. FAILURE TO SET INCUBATORS ON INDEPENDENT FINANCIAL FOOTING

Contrary to current claims that SJSURF is now engaged in an effort to formulate a "new" model of financial independence for the incubators, it appears clear that the incubators had been expected to be financially independent from their inception. For example, public documents reveal commitments that the Biocenter would become self-sufficient within two years of its founding in 2004. The SJSURF contract calls for an investment by the Agency for "start-up and other operating costs" for the Biocenter of a *total* of $450,000 over three years. Instead, the Agency invested a *minimum* of $400,000 a *each year* to cover operations (not including capital investment) to the present.

Simply, the "transition" to independence is old news. There is no apparent evidence that it will happen more effectively now than it did in 2005 or 2007. Robbins' 2007 report attributed the chronic shortfalls to the failure to generate sufficient grants and sponsorship dollars, as other incubators routinely do.

5. FAILURE TO PROVIDE SUFFICIENT OVERSIGHT AND MANAGMENT

Finally, it is now "old news" that SJSURF's management oversight of the incubators was lacking. Since the 2009 report has been released to the Council, we now know that 58% of the companies in all of the incubators—including the Biocenter--lacked a business license, and therefore paid no fee revenue to the City. All of the incubators ran at an operating loss, with runaway contractor fees, and three of the four incubators had neither a business plan nor a financial sustainability plan.

Rather than objectively monitoring and checking SJSURF's performance, the Redevelopment Agency played the role of unabashed cheerleader. For example, in 2004, RDA reported that the incubators were generating over $1.2 million annually in tax revenue to the City of San José, a number *six times higher* than the estimate provided by independent consultants in 2009, who found the RDA's estimate indefensible.

In short, the time has long since passed for the Council to utilize the services of its own independent auditor.