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Use of Escalation Clauses for Operating Costs on All GSA Leases. LCD-78-340; B-95136. November 13, 1978. 8 pp. + 2 appendices (8 pp.).

Report to Rep. Norman Y. Mineta, Chairman, House Committee on Public Works and Transportation: Public Buildings and Grounds Subcommittee; by Elmer B. Staats, Comptroller General.

Issue Area: Increase in the Amount of Govt. Leased Space Despite Congress' Emphasis on Federal Construction. (710).

Contact: Logistics and Communications Div.

Budget Function: General Government: General Property and Records Management (804).

Organization Concerned: General Services Administration.

Congressional Relevance: House Committee on Public Works and Transportation: Public Buildings and Grounds Subcommittee. Rep. Norman Y. Mineta.

Authority: OMB Circular A-109.

The General Services Administration (GSA) is responsible for locating suitable space to meet agency needs, negotiating and awarding leases, and ensuring that lease terms are met. In November 1973, because of increased inflation, GSA directed its regions to use escalation clauses for building operating costs in long-term leases of 5 years or more. The purpose of the clauses was not to reimburse lessors for actual building operating costs but to provide lessors, through the process of averaging cost increases, some protection against excessive increases in major costs such as real estate taxes, utilities, maintenance, and janitorial services.

Findings/Conclusions: The administration of escalator clauses is complicated by the variety of clauses, by different escalatable cost items, and by payment restrictions. The regional offices did not maintain current or accurate lists of leases with escalator clauses, rental readjustment dates, base years, or payment dates. The administration of escalation clauses is costly, involving additional negotiations and the collection, verification, and analysis of the lessors' cost information. The best guarantee of a fair and reasonable rental rate, with or without escalation clauses, is adequate competition by landlords with space suitable for GSA's needs. Escalation clauses should be limited to space requirements that are: for leases not drawing much competition, for lease periods of at least 3 years or more, and of sufficient size to justify additional administrative costs. The Consumer Price Index is not an appropriate standard for determining adjustments to building operating costs. Recommendations: The Administrator of GSA should direct the Public Buildings Service to: cancel April 1978 instructions requiring use of the Consumer Price Index for calculating annual operating cost adjustments, reconsider the circumstances under which escalation clauses may benefit the

Government when negotiating fair and reasonable rental rates, redraft a standard escalation clause for use under specified circumstances, and monitor the regions' implementation of escalation clause instructions in order to minimize the effects that result from noncompliance or unallowed deviations from basic instructions. The Administrator should also direct the Regional Administrators to maintain adequate control over escalation clauses included in all leases in order to eliminate the necessity to rely on the memory of the realty specialist or to wait for lessors to initiate escalation procedures. (RRS)

REPORT BY THE

# Comptroller General

OF THE UNITED STATES

8298

Released 11-24-78

## Use Of Escalation Clauses For Operating Costs On All GSA Leases

Since November 1973 GSA has used escalation clauses for building operating costs in long-term leases of 5 years or more, or 5 years with the option to renew.

In April 1978, GSA implemented a new escalation clause which provides for annual escalation on all new or superseding leases. Potentially the clause will apply to 7,024 active leases on May 1, 1978. GSA has suggested the use of changes in the Consumer Price Index as a basis for making annual adjustments of lease operating costs.

GAO believes escalation clauses should be used sparingly in GSA leases and certainly should not be required for all leases. GAO does not consider the Consumer Price Index to be an appropriate standard for determining adjustments to building operating costs.





COMPTROLLER GENERAL OF THE UNITED STATES  
WASHINGTON, D.C. 20548

B-95136

The Honorable Norman Y. Mineta  
Chairman, Subcommittee on Public  
Buildings and Grounds  
Committee on Public Works and  
Transportation  
House of Representatives

Dear Mr. Chairman:

In your letter of January 26, 1978, you asked us to study the General Services Administration's (GSA's) use of various clauses that provide for escalation of operating costs in leases and to estimate which clause best protects the Government's interests.

GSA is responsible for locating suitable space to meet agency needs, negotiating and awarding leases, and ensuring that lease terms are met. In this connection, GSA is authorized to enter into leases, not to exceed 20 years, in existing buildings or in those to be erected by lessors.

As of May 1, 1978, GSA reported 7,024 leases in effect for about 85 million square feet of net usable space at gross annual rentals of \$445 million. The net or base rentals accounted for about \$331 million of the total. The remaining \$114 million represents operating costs such as utilities and janitorial services. At that time 636 leases had escalation clauses. Although they comprised only 9 percent of all GSA leases, the total annual rent is about \$201 million. (See app. II.)

In November 1973, because of increased inflation, GSA directed its regions to use escalation clauses for building operating costs in long-term leases of 5 years or more, or 5 years with the option to renew. The purpose of the clauses was not to reimburse lessors for actual building operating costs, but to provide lessors, through the process of averaging cost increases, some protection against excessive increases in major costs, such as real estate taxes and utilities, maintenance, and janitorial services.

In November 1973, the GSA central office specified that the adjustment intervals for operating costs should be 5 years. Regional offices were permitted to change the adjustment interval on a case-by-case basis. The changes could be made if (1) the rental adjustment interval was not less than 3 years and (2) the lease file showed that significant rental savings would have accrued to the Government from such changes. Unless they received prior written approval from the central office, the regions were required to use the standard escalation clause contained in the guidance. Yet the regional offices received no substantial guidance on how or when to award and administer leases containing escalation clauses.

We reviewed leases issued after November 1973 in GSA's Atlanta (region 4), Chicago (region 5), and Washington (region 3) regions, where many different types of escalation clauses were used. Some regions revised the standard clause issued by the central office and, in many cases, used escalator clauses which differed considerably from the standard. The extent of deviation from the standard clause varied from 1 out of 65 leases used in region 5, to all cases in region 4. In most cases where nonstandard escalation clauses were used, the region did not receive the required central office approval. The regional realty specialists gave different reasons for not using the standard clause. Some disagreed with provisions of the standard clause, some added provisions that better protected the Government's interest, and others changed the clause based on lessors' demands.

The administration of escalator clauses was complicated by (1) a variety of clauses, (2) different escalatable cost items, and (3) payment restrictions. The regional offices did not maintain current or accurate lists of leases with escalator clauses, rental adjustment dates, base years, or payment dates. While some of these problems were reported by GSA's internal audit office, the central office did not monitor the situation or enforce corrective action. Thus, some unique clauses were still included in leases and resultant administrative problems continued.

Although we did not analyze the favorable or unfavorable impact of each nonstandard clause, the differences generally seemed to favor the lessor. For instance, the standard clause provided for a 5-year base period to compute the rent adjustment for the succeeding period with a 3-year adjustment provision at the option of the Government. The nonstandard clauses generally contained provisions for annual adjustments, which decreased the lessor's risk.

However, in one situation the provisions of a nonstandard clause apparently protected the Government's interest better than the standard clause. (See app. I for further discussion.)

In February 1978, during our examination, the Administrator selected a committee from the private sector to examine GSA's leasing procedures and to recommend improvements in GSA's opportunities for acquiring additional space from private lessors. On April 3, 1978, the committee submitted its final report with recommendations to the Administrator. The committee considered its most important recommendation to be that GSA should include in leases an escalator clause which provides for an annual rent adjustment for increases in a building's operating expenses.

Effective April 28, 1978, GSA implemented a new escalation clause which provides for annual escalation of all new or superseding leases. The new clause could apply to all 7,024 active leases rather than only to the 636 leases currently containing escalation clauses. The new clause provides for an annual adjustment of lease operating costs based on changes in the national revised Consumer Price Index. The GSA central office suggested the use of the Consumer Price Index.

It seems impractical to require an escalation clause in all leases. Of the 7,024 leases in effect as of May 1, 1978, 1,333 were for 1 year or less and 2,579 were for 1 to 3 years. Thus, less than half of GSA's leases are for periods long enough to be suitable for escalation clauses.

There is no assurance, particularly on shorter leases, that GSA's proposed escalation clause would induce landlords to consider reducing their rent offers commensurate with the reduced risk of price inflation, or even to reducing their offers at all. GSA in region 3 recently attempted to negotiate a reduction in one lessor's offer by adding the escalation clause, but the lessor refused. Since most leases are negotiated with single offerors, the above example may be typical. In a January 1978 report to the Congress (LCD-78-354) on GSA practices in awarding and administering leases, we noted that 55 percent of new lease awards and 95 percent of follow-on lease actions involved negotiations with only one offeror. In that report we recommended that GSA should insure that competition is obtained to the maximum practical extent for new leases and follow-on leases.

An escalation clause serves little purpose when the Government provides most of the services. For example, one GSA region 5 lease requires the lessor to furnish only janitorial services while the Government pays directly for all other operating costs. In such cases inflation affecting operating costs will have little impact on the lessor.

We are concerned about the use of changes in the Consumer Price Index as a basis for making annual adjustments of lease operating costs, although we were unable to determine how this policy affects the Government's interest.

The Consumer Price Index is a composite figure comprised of various consumer items, such as food, clothing, and fuel, but does not necessarily reflect those items that determine building operating costs. Certain items, as well as different areas of the country, may experience a more rapid cost increase than others. For example, fuel price increases in 1973-74 were much greater than the overall Consumer Price Index increase. When operating costs exceed the Consumer Price Index, some lessors experience a loss while others may realize undue profit. In 1973 GSA advised the regional offices that the Consumer Price Index was an unacceptable basis for escalation because it did not correlate with building cost changes.

If rental adjustments for building operating costs are based on changes in the national Consumer Price Index, lessors have an incentive to overstate the portion of their total rent offer that represents such costs in order to apply the rate of the Consumer Price Index increase to as much of the total rent as possible. In some cases leases may not be awarded to the low offeror because GSA criteria for lease awards considers only the first year costs--not the total lease costs. The following hypothetical example of a 5-year lease for 10,000 square feet where operating costs escalate based on an 8-percent annual Consumer Price Index increase illustrates this point.

	<u>Offer A</u>	<u>Offer B</u>
Costs per square foot:		
Net rent	\$ 4.00	\$ 6.10
Operating costs	<u>4.00</u>	<u>2.00</u>
Gross rent	\$ <u>8.00</u>	\$ <u>8.10</u>
Annual rental (rounded):		
Year 1	\$ 80,000	\$ 81,000
Year 2	83,200	82,600
Year 3	86,700	84,300
Year 4	90,400	86,200
Year 5	<u>94,400</u>	<u>88,200</u>
Total lease cost	<u>\$434,700</u>	<u>\$422,300</u>

Under GSA award criteria, offer A would be accepted because the first-year rental is lower. The total rent paid under the lease, however, is \$12,400 more than would be paid under offer B.

Circular A-109 establishes policies to be followed in the acquisition of major systems. <sup>1/</sup> In it the Office of Management and Budget has defined Life cycle cost as the

" \* \* \* sum total of the direct, indirect, recurring, nonrecurring, and other related costs incurred, or estimated to be incurred, in the design, development, production, operation, maintenance and support of a major system over its anticipated useful life span."

Although Circular A-109 applies to major acquisitions, its principles seem appropriate for offers on all GSA leases containing escalation clauses in determining the low offeror. Also, many GSA leases will cost \$25 million or more over the lease life--such as in region 4's Marietta Tower lease with an average annual rental of \$2.55 million for 10 years at zero escalation.

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<sup>1/</sup>GSA considers \$25 million to be the dollar threshold for defining major acquisitions.



The negotiation of reasonable base year operating costs is the realty specialist's responsibility and is necessary to prevent unwarranted escalation. GSA has no internal or external training program in negotiation techniques for realty specialists. Realty specialists are expected to become proficient at negotiating through experience which can be costly to the Government.

Administrative costs, already high under the clause implemented in 1973, will be even higher under the new clause. Formerly, the lessor was required to submit an operating cost statement which was examined and, in some cases, audited by the regional audit division. Manual calculations were then necessary to determine the escalation amount during the follow-on lease period and to compute real estate tax escalation. Presently, however, less than 10 percent of the leases contain escalator clauses.

GSA will have to administer annual adjustments for many more leases with the new escalation clause. Moreover, leases are frequently changed to add or decrease space. The Consumer Price Index itself has various updates during the year. Thus, the lease data base will require frequent changes if correct payments are to be made. The real estate tax portion of rentals will be based on actual lessor payments which vary among leases.

## CONCLUSIONS

We believe escalation clauses should be used sparingly in GSA leases, and certainly should not be required for all leases. The extent of rental rate reductions that landlords are induced to offer cannot be determined from the removal of part of their price inflation risks. At the same time, the administration of escalation clauses is costly (additional negotiations and the collection, verification, and analyses of the lessors' cost information). The best guarantee of a fair and reasonable rental rate, with or without escalation clauses, is adequate competition by landlords with space suitable to GSA's needs. Since GSA does not always obtain that kind of competition, the escalation clause may be an appropriate pricing alternative to use in negotiations under certain circumstances.

Another alternative to the escalation clause is for GSA to pay directly for certain services rather than include them in the rent. Where practical, for example, GSA-rented space could be separately metered for electricity billing, and the

cleaning services could be provided by GSA. These are two of the largest building operating cost elements.

As a negotiating alternative, we believe that escalation clauses should be limited to those space requirements that are: (1) for leases not drawing much competition, (2) for lease periods of at least 3 years or more, and (3) of sufficient size to justify the additional administrative costs. For the reasons discussed on page 4, we do not consider the Consumer Price Index to be an appropriate standard for determining adjustments to building operating costs.

### RECOMMENDATIONS

We recommend that the Administrator of General Services direct the Commissioner of the Public Buildings Service to:

- Cancel the April 1978 instructions requiring use of the Consumer Price Index for calculating an annual operating cost adjustment in all new or superseding leases.
- Reconsider the circumstances under which escalation clauses may benefit the Government when negotiating fair and reasonable rental rates, including the possibility of GSA furnishing certain services, the length of lease periods, market conditions, and the size and costs of space requirements.
- Redraft a standard escalation clause for use under specified circumstances, which contains
  1. rent adjustments which are based on actual costs accurately reflecting real estate tax and operating expense changes,
  2. definitions which specifically identify operating costs and taxes considered for escalation,
  3. allocation of operating costs and taxes which is based on a percentage of the building occupied, but service which is based, when possible, on actual meter readings to more accurately reflect actual costs,
  4. certification which is made by the lessor attesting to the appropriateness and accuracy of operating cost and tax payments,

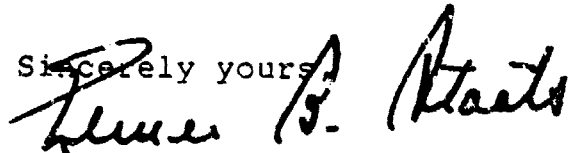
5. limitation of costs which is identified by GSA's estimate of the Government's cost for providing services, with a provision for Government take over of services insuring quality at reasonable prices, and
6. notification that the Economy Act rental limitation of 15 percent cannot be exceeded by adding a tax escalation clause.

--Monitor the regions' implementation of escalation clause instructions in order to minimize the effects that result from noncompliance or un-allowed deviations from the basic instructions.

We recommend that the Administrator also direct the GSA Regional Administrators to maintain adequate control over escalation clauses included in all leases in order to eliminate the necessity to rely on the memory of the realty specialist or to wait for lessors to initiate escalation procedures.

As you requested, we did not take the additional time to obtain written comments on a draft of this report. However, we discussed its contents with GSA officials. We are sending copies of this report to the Administrator of General Services. We will make no further distribution of this report for 10 days unless you publicly announce its contents or authorize its release before then.

Sincerely yours



Comptroller General  
of the United States

DETAILS OF REVIEW OF ESCALATION CLAUSESCOMPARISON OF ESCALATION  
CLAUSES USED WITH NOVEMBER  
1973 STANDARD CLAUSE

With one minor exception, Chicago (region 5) used the standard clause in all 65 leases with escalation clauses awarded after November 1973. However, region 5 did not negotiate base period operating costs for 19 of the 54 leases examined. In contrast, both regions 3 and 4 made substantial changes to the standard clause, or used clauses developed by local GSA personnel or the lessors.

Of the 47 clauses we reviewed in region 3:

- Seven were different and unique clauses, usually offered by the lessor with characteristics such as no rent reductions if building operating costs decline and annual adjustment in rents based on actual increases in costs.
- Four contained major variations to the standard clause, such as annual rent adjustments as opposed to the 3- to 5-year standard with no limit on rental increases, and no Government right to take over services.
- Thirty-six clauses contained minor variations, such as defining taxes and operating cost and work changes to prevent misinterpretation, with rental adjustment intervals of from 3 to 5 years.

In region 3 the standard clause with minor variations best protects the Government's interest.

Region 4 (Atlanta)

None of the 41 escalation clauses in our sample at region 4 were identical to the standard clause. The clauses used varied in length and content from one sentence stating "the Government is to pay increases in cost of utilities and janitorial services above the first year cost," to a very detailed 12-page clause. In five leases, GSA and the lessor agreed to predetermined annual rental increases.

The payments under one lease were:

1st year	\$5.25 a square foot
2d year	5.50 a square foot
3d year	5.75 a square foot

Although they generally contained some of the same features, most Region 4 clauses did not contain one or more of the protective features found in the standard clause, such as provisions for

- requiring supporting documentation for real estate tax increases,
- decreasing the rental rate, and
- taking over services (janitorial, maintenance, etc.) by the Government.

The clause used most often in region 4 had an annual adjustment interval with lump sum retroactive payment based on actual cost increases--that is, payment of actual costs. In contrast, GSA's standard clause provided for rental adjustment every 3 to 5 years. Under the standard clause an operating cost rate subject to escalation adjustment was negotiated at the beginning of the initial operating period. A new operating cost rate was negotiated at the end of that period for the succeeding period. The rental adjustment for the succeeding period was determined by comparing the new negotiated rate to the higher of the initial negotiated rate or the average actual costs during the initial period.

In region 4, various definitions were used for operating expenses and taxes subject to escalation. The most frequently used definition included such items as

- fire, casualty, and liability insurance and
- all taxes, whether sales, license, business, or franchise.

Depreciation of personal property and building administrative costs were allowed as operating expenses in at least one clause used by region 4. The standard clause did not include any of these questionable items.

Region 4's nonstandard clause with  
better than adequate protection of  
the Government's interest

One nonstandard escalation clause we reviewed in region 4 has many features found in the standard clause, such as

- 5-year adjustment interval for operating costs and real estate taxes,
- adjustments to operating costs based on actual costs,
- documentation required to support tax increases, and
- provision for rate decreases.

This particular clause additionally protects the Government by (1) requiring that rent increases be based on actual cost increases instead of negotiated increases as allowed in the standard clause and (2) requiring a certified statement from the lessor attesting to the accuracy and validity of operating costs and real estate taxes. Since rent increases are based on the differences between the actual average annual cost and base period operating cost rather than negotiated increases, the lessor shares more of the cost increases in the succeeding period. However, it is essential that the Government negotiate a realistic base period operating cost in order to preclude the lessor from benefiting from an unreasonable increase by using a low unrealistic base period operating cost.

The following schedule shows the increase in rent using the standard clause and the nonstandard clause at region 4. To illustrate, we assume a lease awarded with a gross \$8.00-a-square-foot rental rate and that the Government and lessor negotiate \$2.00 a square foot as the base period operating cost, subject to escalation for cost increases. We further assume that the escalation interval is 5 years; actual costs have increased each year, so that the operating cost at the end of the fifth year is \$3.75; an actual average annual cost of \$2.75 a square foot for the 5-year base period; and the Government and lessor have negotiated an operating cost rate of \$3.90 for the next 5-year escalation period.

The increase is computed as follows:

	<u>Standard clause</u>	<u>Nonstandard clause</u>
Negotiated operating cost for base period	\$2.00	\$2.00
Average actual annual cost	<u>2.75</u>	<u>2.75</u>
Bases for adjustment:		
Standard clause:		
New negotiated cost	\$3.90	
Less average actual costs	<u>2.75</u>	1.15
Nonstandard clause:		
Average actual costs	2.75	
Less original negotiated	<u>2.00</u>	.75
Gross rent for base period	<u>8.00</u>	<u>8.00</u>
Gross rent for succeeding period	<u>\$9.15</u>	<u>\$8.75</u>

Region 4 tax clauses

In addition to the operating expenses provisions, the real estate tax provisions of escalation clauses also varied. Four of the region 4 clauses we reviewed did not provide for real estate tax escalation. The standard clause defined real estate taxes as total taxes paid on property. In 21 clauses, however, region 4 more explicitly defined real estate taxes as

- ad valorem taxes attributable to buildings and land of which the premises are a part,
- any other tax in lieu of ad valorem taxes which shall be a tax on the value of the land and improvement, and
- assessments for improvements or benefits.

This definition specifically excluded water charges, sewer rent, profit taxes, income taxes, franchise taxes, and Government charges.

The most questionable definition of real estate taxes used in region 4 was "Real and personal property taxes or any tax levied wholly or partly in lieu of real or property taxes." A leasing official provided information specifically stating that personal property taxes should not be considered when computing real estate tax escalation.

### Administration of escalator clauses

GSA's control over the use of escalator clauses in long-term leases has been inadequate in several respects. The central office has issued only limited guidance concerning these clauses, and regional offices have not always fully complied with the guidance issued. In addition, without approval from the central office, the regions have altered the central office "standard" escalator clause. In several cases the regions have made improper escalation payments as a result of unclear clauses and poor administrative practices. Finally, the central office has not provided timely monitoring of the regions' procedures for awarding, administering, and controlling leases containing such clauses.

Both the nonstandard clauses and the standard clause added to the confusion surrounding the use and administration of the escalator provisions. Many clauses have unique payment requirements, include varying operating cost items as escalatable, and place special restrictions on payment schedules and amounts. All these variances complicate administration and cause the regional office problems when computing escalation payments. For example, in region 4 six of nine payments we reviewed contained some type of error in escalation payments. In region 3 one operating cost escalator payment contained an error of over \$24,000 in the lessor's favor. These errors were discussed and brought to the attention of GSA officials in the respective regional offices.

### Regional control

GSA regional offices do not maintain adequate control over escalator clauses included in long-term leases. They do not maintain current or accurate lists of leases with escalator clauses, rental adjustment dates, base years, or payment dates.



GSA personnel rely on their memory of particular leases or simply wait for lessors to initiate escalation procedures.

Some regions attempted to use an automated data processing system to identify leases with escalators, but this information was not completely accurate. An example of this problem occurred in region 4 when GSA personnel provided an informal list of 34 leases which were believed to include all leases containing escalator clauses in the region. To verify the accuracy of this list, we reviewed an additional sample of 37 leases and found that 12 of them also contained escalator clauses.

#### Monitoring by central office

Many of the problems found with the administration of escalator clauses by the regional offices can be attributed to poor monitoring by the central office. Central office instructions issued in November 1973 and December 1976 to implementing the standard clause were fairly explicit. However, without central office approval some regions deviated from these instructions, and in several cases apparently ignored them completely.

By failing to review the regions' implementation of escalation clause instructions, the central office in effect allowed noncompliance in many areas. Some regions avoided the use of escalation clauses whenever possible while others either wrote their own clauses or accepted clauses written by lessors.

#### OBSERVATIONS

Two of the three GSA regional offices we reviewed did not implement the November 1973 standard escalation clause as directed by the central office. Instead, the regions revised the standard clause and, in some cases, used escalator clauses not closely related to the standard clause. Generally, the nonstandard clauses were more costly to the Government due to provisions such as

- annual reimbursement to lessors for actual cost increases, whereas the standard clause provided for rent adjustment at 3- or 5-year intervals based on the difference between negotiated or actual costs, or

--more liberal definitions of real estate taxes to include personal property taxes which are not included in the standard clause.

The unique clauses devised by the regions, as well as the unclear and complicated standard clause resulted in administrative problems. Therefore realty specialists were often confused as to what operating cost items were escalatable and how to compute the escalation payments.

SUMMARY SCHEDULE OF LEASES

CONTAINING ESCALATION CLAUSES ON MAY 1, 1978

GSA region	Total GSA leases		Leases with escalator clause	
	Number of leases	Annual rent	Number of leases	Net usable area leased
		(000 omitted)		(000 omitted) (sq. ft.)
1	313	\$ 11,816	34	\$ 3,730
2	619	41,081	60	10,289
3 (note a)	946	178,239	236	122,193
4 (note a)	1,000	47,990	51	11,823
5 (note a)	1,024	31,814	70	9,476
6	344	14,159	13	4,044
7	809	31,372	54	10,685
8	528	19,472	36	5,673
9	930	49,081	63	19,885
10	511	20,186	19	3,607
GSA-wide	7,024	\$445,210	636	\$201,405

Percent 100.0 100.0 100.0 9.1 45.2 42.4

a/ Data for these regions determined by us, other data was provided by GSA.