UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

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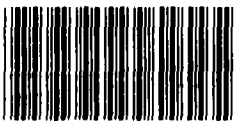
PROCUREMENT, LOGISTICS, AND READINESS DIVISION



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B-208937

NOVEMBER 1, 1982

The Honorable Gerald P. Carmen
Administrator of General Services

Dear Mr. Carmen:

Subject: Use of Escalation Clauses in GSA Leases (GAO/PLRD-83-8)

We have reviewed the use of escalation clauses in General Services Administration (GSA) leases. GSA has used the Consumer Price Index (CPI) since 1978 as a basis for making annual adjustments to rent payments to cover increases in lessors' operating costs.

In our November 1978 report (LCD-78-340), we expressed concern about GSA's use of changes in the CPI as a basis for annually adjusting rent for increases in operating costs. We pointed out that the CPI is a composite figure comprised of various consumer items that do not necessarily reflect those items that determine building operating costs. We recommended that, among other things, GSA cancel the April 1978 instruction requiring use of the CPI for calculating annual operating cost adjustments in all new or superseding leases. At that time, GSA disagreed with our recommendation and stated that to rescind the annual escalation clause would be a step backward because the private sector used an annual escalation clause.

Only about 9 percent of the GSA leases in effect in 1978 contained various operating cost escalation clauses. These clauses did not include the CPI as a basis for determining escalation. Since then there has been a dramatic increase in the use of escalation clauses. As of March 1982, 3,695 leases, or about 69 percent of all GSA leases, contained escalation clauses--2,764 of these had CPI escalation clauses. Operating cost subject to escalation based on changes in the CPI is about $62 million. If the annual increase in the CPI is 5 percent, GSA's rent will increase automatically by about $3 million. At 10 percent, the rent will increase by about $6 million.

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After using the CPI clause for almost 4 years, GSA decided, in December 1981, to eliminate the mandatory requirement for its use. GSA made this change because it believed there should not be a mandatory requirement to use the CPI clause and it would be more cost beneficial to the Government to use another approach. Under a new procedure implemented in December 1981, solicitations for offers to lease allow offerors an option to submit proposals with or without a CPI escalation clause. GSA is to evaluate offers and accept the one with the lowest cost. Although this change in approach does not rescind the CPI escalation clause, it is consistent with our 1978 recommendation.

Since GSA's decision to eliminate the mandatory requirement for using a CPI escalation clause was relatively recent, we could not determine whether the new approach would be more cost effective and would result in fewer CPI escalation clauses. However, our limited survey at two GSA regions--National Capital and Chicago--indicated that most offers still include the CPI escalation clauses.

Our observations, which are based on a limited survey made in accordance with generally accepted Government audit standards, are summarized below. Briefly, we found that:

--The new approach has not resulted in offers without the CPI escalation clause. Both regions included the new option in recent solicitations but did not receive any offers without the CPI clause. In all cases, the leases were being negotiated with single offerors. We believe that a lessor has no incentive to eliminate the CPI escalation clause GSA previously institutionalized and will be reluctant to do so when adequate competition does not exist.

--There is no assurance that the operating cost base established in leases for future rent adjustment is reasonable and is based on actual costs, where applicable. The base is arrived at through negotiations between the contracting officer and the lessor. The contracting officer considers the lessor's annual cost statement, appraisals, the market, and other sources of information. However, the lessor is not required to certify the appropriateness and accuracy of the costs and few audits are made of lessor proposals to assist the contracting officer in negotiating a reasonable operating cost base. We noted that as a result of two GSA audits made before lease awards, one operating cost base was reduced by $16,046 and another was reduced by $7,738. We found that, except for the lessor's operating cost statement, the files did not contain detailed cost and price data indicating how the projected base was determined. (See the enclosure for additional information on our findings.)

We previously reported on the issue of GSA's negotiating reasonable contract amounts in noncompetitive situations. In a September 14, 1978, report (LCD-78-338), we reported on various deficiencies in GSA's contracting for alterations to leased space. GSA awarded sole-source alteration contracts in many cases in the same amount as the lessors' offers. The lump-sum offers did not contain sufficient detail to enable the contracting officer to evaluate the reasonableness of price. We recommended that GSA obtain certificates of current cost and pricing data for negotiated lease alteration contracts over $100,000 from lessors. GSA agreed with the recommendation and revised its leasing handbook accordingly.

Concerning the negotiations for the operating cost base, we noted that the regional offices did not obtain certificates of current cost and pricing data from lessors for cost bases over $100,000 in leases because GSA's leasing handbook did not include the Federal Procurement Regulation (FPR) requirement for the furnishing and certification of cost and pricing data. FPR 1-3.807-3 provides that for any negotiated contract over $100,000, contractors are to submit written cost or pricing data and certify that, to the best of their knowledge and belief, the data submitted is accurate, complete, and current. The regulations give the Government the right to audit such data as certified, and if inaccurate, incomplete, or not current, the Government is entitled to an adjustment of negotiated price. GSA has adopted many of the FPR provisions in its leasing handbook to encourage competition and acquisition of lease space to the best advantage of the Government. However, the GSA handbook does not contain the FPR provision relating to the submission of cost and pricing data.

CONCLUSIONS

We believe that negotiations of a reasonable base year operating cost are necessary to prevent unwarranted escalation in those cases where leases are awarded on a sole-source basis. In such cases, there is no price competition; therefore, a lessor can inflate its base cost. Also, the contracting officer must negotiate the base with the lessor using the lessor's proposal and any other available information.

We also believe that GSA needs to consider various alternatives, or combinations of alternatives, to assist the contracting officer in negotiating a reasonable base cost in such cases. One alternative is to make more audits of the cost bases. These audits could be made before or after the award of leases. If the audits are made after award, such leases should stipulate that the Government is entitled to an adjustment of the costs. Another alternative is to require a lessor to furnish the contracting officer with detailed cost and pricing data supporting the lessor's annual cost statement.

RECOMMENDATION

When leases are negotiated on a sole-source basis, the Administrator of General Services should require contracting officers to ensure that the operating cost bases that are subject to CPI escalation are reasonable. This could be accomplished by making more audits or analyses, either before or after lease awards, of lessors' proposed base costs.

AGENCY COMMENTS

In September 1982 we requested oral comments from GSA on the matters discussed in this report. We met with GSA Public Buildings Service representatives and they generally agreed with our conclusions and recommendations.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget, and to congressional committees.

Sincerely yours,

Donald J. Horan

Donald J. Horan
Director

Enclosure

ENCLOSURE

ESCALATION CLAUSES FOR OPERATING COSTS IN GSA LEASES

BACKGROUND

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 an 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 utilities, maintenance, and janitorial services.

In April 1978 GSA implemented a new escalation clause that provided for annual escalation of all new or superseding leases. The new clause provided for an annual adjustment of lease operating costs based on changes in the national revised CPI. This policy resulted from the recommendations of a committee from the private sector selected by the Administrator to examine GSA's leasing procedures. The panel believed that GSA's policy of granting escalation only on a 3- to 5-year basis prevented owners from offering space. When the owners decided to submit an offer, the panel believed that the offers would be padded to eliminate the risk of future inflation. The panel concluded that GSA's escalation clause was in direct conflict with the private sector's practice of using annual escalation clauses.

Recently, GSA eliminated the mandatory requirement for the inclusion of the CPI escalation clause in lease contracts. On December 23, 1981, the Commissioner, Public Buildings Service, notified all regional administrators that solicitations for offers for leased space would be amended to allow offerors to submit proposals with or without the CPI escalation clause or with alternate offers under both options. A Public Buildings Service official told us that GSA made this change because it believed there should not be a mandatory requirement to use the CPI clause and it would be more cost beneficial to the Government to use another approach.

Leases with escalation clauses have increased significantly over the past 4 years. According to GSA data, the number of leases with escalation clauses has increased from 9 percent of the total leases in effect as of May 1978 to 69 percent of the total leases in effect as of March 1982.

ENCLOSURE

Total GSA leases			Leases with escalation clauses			
No. of leases	Annual rental	Net usable sq. ft. leased	No. of leases	Annual rental	Net usable sq. ft. leased	Percent of total leases
	----(000 omitted)-----			----(000 omitted)-----		
a/7,024	$445,210	84,984	636	$201,405	35,993	9.1
b/c/5,340	623,851	85,657	3,695	510,968	69,574	69.2

a/Data in our report LCD-78-340, as of May 1, 1978, p. 1.

b/Data was provided by GSA as of March 17, 1982.

c/In 1979 about 1,500 recruiting office leases were transferred from GSA to the Corps of Engineers.

The March 1982 leases included the CPI escalation clause and other escalation clauses implemented by GSA in November 1973. At our request, GSA provided us with data identifying the number of leases with CPI escalation clauses as of April 1982. This data indicated that 2,764 leases, or 52 percent of the total 5,348 in effect, had CPI escalation clauses. The data also indicated that the cost base subject to escalation based on the CPI was over $62 million.

COST BASE USED FOR ESCALATION

GSA's handbook on the acquisition of leasehold interests in real property provides that a operating cost base for future escalation must be established before award and that such cost should be stated in the basic lease document. This cost base is to be arrived at through discussions between the contracting officer and the prospective lessor during the overall negotiations. The handbook also calls for the submission of a lessor's annual cost statement for services and utilities to assist the contracting officer in determining the basis for cost escalation. The contracting officer uses this statement, an appraisal estimate, the market, or any other available information to negotiate the cost base. The record of negotiations should reflect all of these factors; the trade-offs that were made, if any; and all pertinent details leading to the agreement on the base.

We reviewed the files for 21 leases with negotiated operating cost bases over $100,000 at the National Capital Region (NCR) and Chicago regional offices to determine the (1) type of CPI escalation clause used for annual adjustments and (2) extent of documentation supporting the cost base arrived through negotiations. The following excerpt describes the methodology GSA uses to adjust operating costs.

"Beginning with the second year of the lease and each year after, GSA shall pay adjusted rent for changes in costs for cleaning services, supplies, and materials, maintenance, trash removal, landscaping, water, sewer charges, heating, electricity, and administrative expenses.

"The amount shall be determined by multiplying the total first year's estimated costs of these items, as negotiated and established prior to the lease award, by the percent of change in the cost of living index from the base figure. The base figure shall be the index figure published for the month prior to the lease commencement date. The percent change shall be computed by comparing the base figure with the index figure published for the month prior to the commencement of the lease year for which the adjustment is to be measured by the U.S. Department of Labor revised consumer price index for wage earners and clerical workers, U.S. city average, all items figure, (1967=100) published by the Bureau of Labor Statistics. The lease year shall be the 12-month period beginning the first day of the lease term. Payment shall be made with the monthly installment of fixed rent.

"Applicable costs listed on GSA Form 1217 when negotiated and agreed upon shall be used to determine the bases for the tax adjustment and operating cost adjustment."

The following table summarizes the increase in rent for the 21 leases that were based on changes in the CPI for making annual adjustments of operating costs.

Region	Leases	Initial rental	Operating cost base	Percentage of initial rental	Increase in operating costs Cost (note a)	Increase in operating costs Percent
NCR	16	$21,872,940	$4,377,315	20.01	$542,983	12.40
Chicago	5	2,666,096	703,538	26.39	14,300	2.03

a/Four of the 16 leases at NCR and 4 of the 5 leases at Chicago did not have an increase in operating costs because they were in the first year of the lease.

Our review of the supporting documentation, in the lease files, for the negotiated operating cost bases disclosed that lessors provided annual statements of estimated operating costs but not detailed cost and pricing data indicating how the projected negotiated operating cost bases were determined. Also, the record of negotiations indicated that in some leasing actions, lessors had provided bills or cost data during negotiations. However, in none of the leasing actions we reviewed were audits made of the operating cost base.

We requested GSA's Office of Inspector General to provide us with copies of all audits relating to the evaluation of operating cost bases for CPI escalation clauses. As of March 1982, nationwide, the office had made only four audits of lessors' operating cost proposals. Two of these audits pertained to the NCR and Chicago regional offices. The NCR audit resulted in decreasing the lessor's proposed operating costs by $7,738, from $267,841 to $260,103. The Chicago audit resulted in decreasing the lessor's proposed operating costs by $16,046, from $151,824 to $135,778.

We also found that GSA's January 1982 policy on referring leases to the regional Inspector General's Office was being interpreted inconsistently at the two regional offices. Under this policy, regional offices notify the regional Inspector General's Office before award of all leases with a rental exceeding $200,000 annually. An award will be made unless the Inspector General's Office notifies a region within a specified time frame that the award must be delayed. The Chicago regional office refers only those leases with CPI operating cost bases of $200,000, not the total rent, while NCR refers leases with a total rent of over $200,000.

We believe that more audits should be made of these bases in noncompetitive situations. The data GSA provided to us indicates that about 115 of the 2,764 leases with the CPI escalation clauses had cost bases exceeding $100,000. At the minimum, GSA should establish criteria for selecting those leases with a large cost base for audit when adequate competition is not obtained.

NEW ESCALATION CLAUSE FOR OPERATING COSTS

Under the new procedure implemented in December 1981, the solicitations for offers allow offerors to submit proposals with or without the CPI escalation clause or alternate offers under both options. The new clause requires an evaluation of competing offers to determine the lowest offer over the initial term of the proposed lease.

We could not determine the extent lessors will submit offers without the CPI escalation clause since the requirement was only recently established. However, NCR and Chicago regional officials said that lessors will more likely submit offers with the CPI escalation clause. We also noted that, in March 1982, NCR had 128 leases with CPI escalation clauses, of which 125 were awarded on the basis of a single offer. Since most leases are negotiated with single offerors, there is no assurance that GSA's new procedure will induce lessors to consider submitting offers without the escalation clause.

During our survey, the NCR and Chicago regional offices sent solicitations to prospective offerors giving them the option to submit proposals with or without the CPI escalation clause. In all cases, the leases were being negotiated with single offerors and all lessors submitted their offers with the CPI escalation clause.

COST CERTIFICATION NOT REQUIRED OF LESSORS

In our November 13, 1978, report (LCD-78-340), we recommended that GSA redraft a standard escalation clause which would require a lessor to certify the appropriateness and accuracy of operating costs. In its response to our report, GSA stated that its leasing specialists review the operating cost bases and approve them before award. Any rental adjustment thereafter will be based on the CPI, thus obviating the need for any certification.

The Federal Property and Administrative Services Act of 1949 (40 U.S.C. 471 et seq.) created GSA. As required by the 1949 act, GSA has developed FPRs which are primarily directed to acquiring personal property and nonpersonal services and only have limited application to the leasing of real property. The regulations contain standard lease clauses, such as the Economy Act limitation, failure in performance, and maintenance of premises, but do not provide specific guidance on soliciting offers, obtaining competition, negotiating prices, and administering leases. Nevertheless, GSA has adopted many of the regulations' provisions in its leasing handbook to encourage competition and the acquisition of lease space to the best advantage of the Government.

However, GSA's leasing handbook does not include the FPR requirement for the furnishing and certification of cost and pricing data for the operating cost bases in leases. FPR 1-3.807-3 provides that for any negotiated contract over $100,000, contractors are to submit written cost or pricing data and to certify that, to the best of their knowledge and belief, the data submitted is accurate, complete, and current. The regulations give the Government the right to audit such data as certified, and if inaccurate, incomplete, or not current, the Government is entitled to an adjustment of the negotiated price. Since this provision does not apply to the operating cost base contracted for in leased buildings, the NCR and Chicago regional offices did not request the certificates of cost and pricing data from lessors.