



State of Washington

Real Estate Policies Study

Recommendations to the Legislature

Section 1085 of the Enacted 2013–15 Capital Budget
(Engrossed Substitute Senate Bill 5035)

Office of Financial Management
Facilities Oversight
February 2015

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SUMMARY

The state of Washington owns and leases more than 10,500 facilities for use by state agencies. Of these, approximately 1,300 facilities, totaling 13.5 million square feet, are leased. These leases obligate the state to pay more than \$261 million a year in rent alone, plus an estimated \$35 million in operating expenses. Sixty-five percent of the state's leased facilities are offices and related support facilities leased by the Department of Enterprise Services (DES) on behalf of state agencies.

The 2013 Legislature directed the Office of Financial Management (OFM), through section 1085 of the 2013–15 enacted capital budget, to review and recommend real estate policies and practices that are financially advantageous for the state. Consistent with the proviso, OFM considered lease renewals, the process of acquiring real estate, the use of cancellation clauses, and the state's backfill policies and practices.

This report contains a summary of the current policies and practices, OFM's findings, and OFM's policy and procedure recommendation. OFM's recommendations are largely directed to the DES. While specific recommendations are contained throughout the report, they are summarized by the following key points.

OFM recommends that DES:

- » Create a policy and transparent procedures to support its updated lease renewal practices. Some refinements of the lease renewal practices are needed to scale the process to the size of a transaction and to consider the state's fiscal cycle.
- » Update its policies and procedures for acquiring real estate to increase potential lessor participation, reduce the cost to potential lessors of submitting a proposal to the state, and more carefully consider community infrastructure and transportation impacts.
- » Continue to use situational cancellation clauses where programmatically or fiscally advantageous.
- » Incorporate a standard nonappropriation clause in all lease renewals and, where financially advantageous, new leases, with a requirement that OFM must certify that the state does not have sufficient appropriations to make the required lease payments.
- » Improve communication with stakeholders and increase transparency of all its new and updated policies and practices. This should include publishing all these documents to its public website and hosting trainings.
- » Abolish its policies related to backfilling state facilities after OFM establishes broader statewide policies.

Consistent with the final bullet above, OFM recommends that the Legislature establish authority in statute for the development and enforcement of a backfill policy that aligns with the responsibility to inventory, plan and budget for state-obligated facilities. Since each of these duties now resides in OFM, OFM should also be responsible for making policy and enforcing the backfill of state-obligated facilities.

PURPOSE

Section 1085 of the enacted 2013–15 capital budget (Engrossed Substitute Senate Bill 5035) requires OFM to review and recommend real estate policies related to lease renewals, requests for proposals, cancellation clauses, backfill policies and other related items. The study must document improvements to the state’s real estate policies that ensure that cancellation clauses are used in a financially advantageous way and renewal practices minimize unnecessary relocation costs.

APPROACH

In fall 2013, OFM consulted with DES and legislative staff to establish the study approach. From fall 2013 to summer 2014, OFM took the following actions to prepare this study:

- » identified and reviewed current policies and practices
- » conducted best practice research
- » surveyed other states and Washington stakeholders
- » hosted open forums
- » analyzed and documented findings
- » drafted a report

Tools used to conduct research and communicate with stakeholders included phone conversations, email, a project LISTSERV, a project web page, an online national survey of state facilities administrators, four in-state surveys and three policy forums. National and in-state surveys were conducted using SurveyMonkey™.

National survey results are available at

http://www.ofm.wa.gov/budget/facilities/documents/real_estate_survey_20140420.pdf.

In-state survey results are available at

http://www.ofm.wa.gov/budget/facilities/documents/instate_real_estate_survey.pdf.

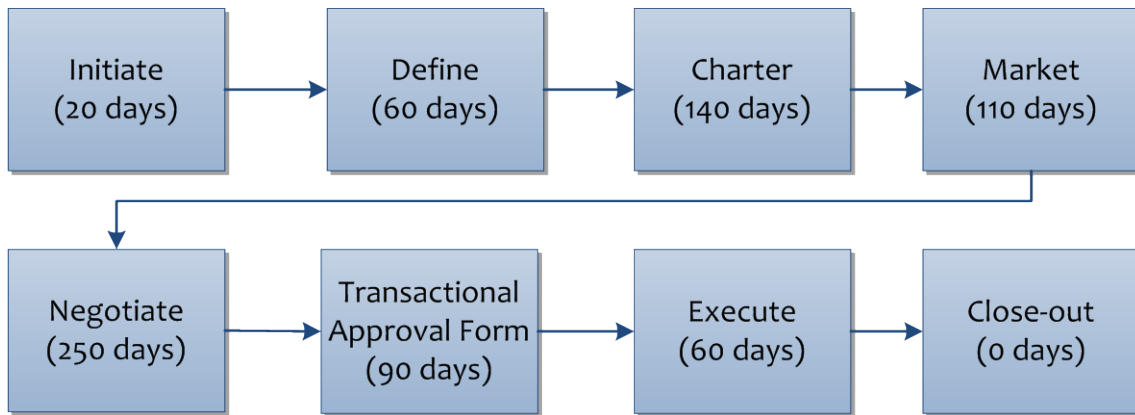
Meeting minutes from forums are available upon request.

LEASE RENEWAL

Current Lease Renewal Policy

Washington does not have a lease renewal policy. Therefore, the lease renewal survey addressed the DES lease renewal process. DES, higher education institutions and agencies with delegated real estate authority have procedures guiding lease renewals.

DES' renewal transaction process workflow was revised in January 2013. This new 24-month process identifies project scope, budget and timeline in a more consistent, transparent and collaborative manner with state agencies. The process occurs across eight phases, as illustrated in this flowchart:



Below is a summary of the primary objective of each phase:

1. *Initiate*: DES prepares for the transaction and contacts the agency, OFM and other relevant stakeholders to initiate the renewal process.
2. *Define*: DES, in cooperation with agency tenants, conducts the define meetings and begins to identify and confirm critical needs, constraints, budget and other project requirements.
3. *Charter*: Memorialize key data from the define meeting in a framework for the transaction.
4. *Market*: Seek market data for comparison and negotiation purposes using comparable leases.
5. *Negotiate*: Negotiate and finalize agreed-upon lease terms with the lessor.
6. *Transaction Approval Form (TAF)*: DES uses the TAF to verify that key terms from the charter were satisfied and drafts the initial lease containing final terms of the negotiations. Where necessary, this includes approval by OFM.
7. *Execute*: DES executes the lease agreement between the state and the lessor.
8. *Close-out*: DES closes out the lease renewal transaction and verifies the financial model using the TAF to confirm that key terms from the charter have been met to the agency's satisfaction.

Survey questions were designed to gauge awareness and familiarity with this new work flow.

Lease Renewal Findings

Below are OFM's key findings from the research conducted.

National Survey Findings

- » Sixty-four percent of states that responded to OFM's survey have written policies on lease renewal. Eighty-five percent of states have written procedures related to renewing leases.
- » Washington is the only state that uses a formal charter process. However, most states acknowledge that it is a best practice to plan for the transaction before entering into negotiations. Most states use a renewal request form.
- » The average renewal schedule in other states is six months in duration.

Washington Stakeholder Findings

- » DES' process is new, and many stakeholder responses suggested confusion about it. The state agency contacts who have had the greatest exposure to the process demonstrate a clearer understanding than those who haven't.
- » Many stakeholders expressed concern that the lease renewal process always has to begin 24 months in advance.
- » In some cases, this process is in conflict with the state's fiscal cycle. Some stakeholders expressed concerns that they cannot make decisions as early as expected by DES due to pending policy or budget decisions.
- » DES does not have a modern technology solution to manage lease renewal transactions. It has said that development of these tools is critical to establishing consistent implementation and communication in this process.

Recommendations

DES has developed an improved standard work process that is designed to leverage the marketplace to obtain the best lease renewal value for state agencies.

Based on the findings above, OFM recommends that DES:

- » Establish a written policy documenting the lease renewal practice of the state and define best value. The definition of a best value lease renewal should consider, but may not be limited to, the following criteria:
 - › agency business need
 - › condition and efficiency of the facilities and space within it
 - › the state's sustainability and energy goals
 - › lessor performance
 - › market conditions
- » Adapt its business process to scale the timeline to the size of the facility and anticipated complexity of the lease renewal. This should reduce the time frame for smaller transactions and may increase the time frame for very large facilities. Lease renewals need to consider the fiscal cycle.
- » Improve communication with state agencies and lessors during the renewal process. This may include establishing a database to monitor transactions. This should include offering annual training on the process to stakeholders.
- » Publish the lease renewal process and forms for stakeholders on its public website.

REQUEST FOR PROPOSALS/SOLICITATION

Current Solicitation Policy

DES uses a solicitation process to acquire privately owned space for leasing to state agencies. According to Policy-120: Seeking Space to Lease, DES separates solicitations into “small space requests” for less than 5,000 square feet and “regular space requests” for greater than 5,000 square feet.

A different solicitation tool may be used for each category. The most common tools are:

1. **Requests for proposals (RFP):** a formal document or package of documents to elicit competitive bids or proposals from possible vendors. They are advertised in print media and on the DES website. Solicitations proceed in the following sequence unless there is a waiver of the process or the RFP is being issued in Thurston County: a) existing space; b) space under construction; and c) planned space. A formal site selection and evaluation process is required.

If an RFP for existing space produces no acceptable proposals, DES may: a) re-advertise for existing space; b) conduct a market search to secure existing space; or c) with the written approval of the real estate services manager or designee, advertise for space under construction or planned space.

2. **Market search:** a physical search of the area specified in the original advertisement and/or in the agency’s program requirements, as well as contact with building owners, lessors, developers and real estate brokers by the joint DES and agency project team. When a suitable space has been located, the project team evaluates the site. No formal site selection and evaluation process is required.

In Thurston County, existing space, space under construction and planned space may be solicited concurrently. DES considers requests for waivers to solicit for all space types outside of Thurston County on a case-by-case basis.

DES has made many modifications to its solicitation process in the past four years. Most notable are:

- » Additional explanation of the state’s requirements in request for proposal documents.
- » Expanded submittal requirements for potential lessors.
- » Additional process steps to include best-and-final offers, and in some cases, blocking-and-stacking exercises to ensure the proposed program will fit appropriately within the building.
- » Replacement of scoring tools with a best value evaluation process.

Findings

Below are OFM’s key findings from the research conducted.

National Survey Findings

- » A formal solicitation/RFP process is a widely accepted practice of states. Many states have recently updated their processes and tools to streamline and clarify their processes.
- » National best practice indicates that solicitations are most successful when they are specific to the business requirements and scaled to the size and type of space that is being acquired.

Washington Stakeholder Findings

- » Potential lessors have indicated that the documentation required by the state is burdensome and can be costly to produce.
- » Potential lessors have indicated that the state's leased space requirements are difficult to understand and challenging to comply with.
- » Some state agencies are not seen as a high-value tenant in some marketplaces.
- » The evaluation process for selecting an apparent successful proposer is unclear.
- » Both state agencies and potential lessors feel that communication during the process is inadequate.
- » State agencies feel that the response rate from potential lessors is low in some marketplaces.
- » The process consumes a large amount of time, especially when no adequate existing space is available in the marketplace.
- » Community stakeholders have expressed a continued interest in having the state carefully consider its impacts on the community and local infrastructure.

Recommendations

To address the findings above, OFM recommends that DES:

- » Update its policy on soliciting for space. The policy should allow for solicitation of all space (both new and under construction) while placing an emphasis on considering existing space first in the evaluation process. The same process should exist in all jurisdictions for acquiring space.
- » Refine its solicitation process so that it is scalable with transparent evaluation criteria that comply with applicable state laws. The process should be scalable, too, based on the size of the request and type of space needed.
- » Identify and implement methods for increasing the size of the candidate pool for a solicitation.
- » Update its evaluation process to strengthen the consideration of:
 - › existing space over new space
 - › community impacts, including infrastructure and transportation
 - › reuse of infrastructure and investments made in buildings previously occupied by the state
- » Conduct additional outreach and education on an ongoing basis to increase potential lessor engagement in the solicitation process.
- » Publish the solicitation process for state agencies and potential lessors on its public website.
- » Publish an abbreviated explanation of the lease space requirements that is targeted to real estate brokers or property managers who may not have extensive building system knowledge to demystify these requirements.
- » Improve communication during a solicitation to state agencies and the lessor community.

CANCELLATION CLAUSES

Current Cancellation Clause Policy

Cancellation clauses are terms in a lease agreement used to terminate a lease or change the amount of space leased. Cancellation clauses take a variety of forms which can be general or specific, such as the ability to cancel all or part of a lease due to nonappropriation or the opportunity to collocate. DES does not have real estate policies or guidelines for cancellation of leases. The DES practice is to include cancellation clauses in certain leases to address specific needs such as the loss of federal program funding. The in-state cancellation clause survey asked questions similar to those on the national survey to solicit comments for partial cancellations, nonappropriation language and cancellation to take advantage of an opportunity to collocate.

Additional Research

Historical Experience

In 2003, the Department of General Administration (GA) began using a nonappropriation clause in state leases after discussions with the Office of the State Treasurer and OFM led to the conclusion that long-term leases created financial risk to the state. In 2004, the Legislature directed through the 2004 supplemental capital budget, section 906, that RCW 43.82.010 be amended to state that “for the 2003–05 biennium, any lease entered into after the effective date of this section with a term of ten years or less shall not contain a nonappropriation clause.” While the language was retained in statute, Governor Gary Locke also directed GA, through his veto message, to “work with stakeholders to develop cancellation language for operating and capital leases. This language will provide the state flexibility to respond to funding changes that necessitate termination of leases. This will properly protect the Legislature and state agencies and is a complement [to] section 906.”

GA then worked with stakeholders to develop what is commonly referred to as term adjustment language. The majority of stakeholders recall the state’s use of this standard lease term in the mid-2000s, and both state agencies and lessors indicated it was problematic. Term-adjustment language allowed the state to modify the terms of the lease or buy out the lease using a complex methodology. This language was difficult to explain to both brokers and lenders, and in some cases, dissuaded new developers from doing business with the state. When the state attempted to exercise the language in at least one case, it proved very complex to implement and eventually was dropped from the standard lease.

Legal Requirements

Feedback from stakeholders suggested that state law may require the use of termination language due to lack of funding in leases. OFM conducted a review of the statute and was unable to identify a specific state law or constitutional provision that asserted this as a requirement. However, the state constitution does prohibit the current legislature from binding a future legislature. Therefore, while a lease is permitted to be negotiated for a longer period of time, the state could face a situation in which, due to a lack of funding, the state would no longer be able to fulfill its contractual obligation. The current state lease has no specific termination language. Absent specific nonappropriation or alternative termination language, the state may be liable for both remaining payments and damages.

Findings

Below are OFM's key findings from the research conducted.

National Survey Findings

- » All states indicated that they use cancellation clause in their leases at least some of the time.
- » The majority of states indicated that they had policies and procedures on cancellation clauses. The actual cancellation clause terms vary widely. Criteria described included cancellation for the following reasons:
 - › reduction in federal or state funding
 - › need to backfill other state-obligated space
 - › lessor found guilty of criminal activity
 - › lessor default on financing of a building
 - › agency consolidation or reductions in staffing resulting in surplus space
- » Most states indicated that there was some correlation between cancellation clauses and other lease terms, especially lease rate.
- » Seventy-nine percent of respondents have nonappropriation clauses. Some states' nonappropriation terms are defined in statute, some are defined in administrative rules and some are defined only in the lease document itself.
- » Some states negotiate one to two year leases in lieu of nonappropriation terms.
- » Most states separate the duties related to nonappropriation clauses, requiring someone other than the state agency to declare that funding for the lease is not appropriated.

Washington Stakeholder Findings

- » Most in-state stakeholders indicated that cancellation clauses are necessary in at least some cases. The majority suggested that cancellation clauses are currently based on business need and that the specific terms should be tailored to the circumstances. Circumstances include:
 - › being strategic in leasing
 - › providing flexibility
 - › responding to decreased funding
 - › responding to changing program needs
 - › allowing the state to vacate a building in poor conditions
 - › allowing parties to exit the lease for other specific reasons
- » Lessors and developers indicated that cancellation clauses increase risk of loss of a tenant, and that because of this risk, they may need to increase ongoing lease costs. Most suggested that this would be a requirement of the financial institutions carrying the building financing.
- » Lessors expressed concerns and provided opinions from financial institutions on nonappropriation language that suggests that the inclusion of this term in a lease would increase costs and risks in the lending process. These opinions are available upon request.
- » Some stakeholders indicated that the state's build-out requirements require firm lease terms so that the lessor or developer can recover build-out costs.

Recommendations

To address the findings above, OFM recommends that:

- » DES continues to work with state agencies, and as needed, with the Attorney General's Office, to develop situational cancellation clauses on a per-transaction basis to meet individual state agency business needs. Situational cancellation clauses would allow an agency to respond to changes in program and organizational requirements, when needed.

- » State agencies identify locations where cancellation may be necessary when working with OFM to develop the Six-Year Facilities Plan. This may allow the state to backfill a facility in lieu of exercising a cancellation clause.
- » DES works with Attorney General's Office to modify the terms in the standard lease to ensure the state has the right to terminate a lease in the event a lessor is not responsive, does not uphold the terms of the contract or is convicted of criminal activity.
- » DES works with the Attorney General's Office and OFM to develop standard nonappropriation language for leases renewals. To provide appropriate protections for the state and reduce risk to lessors, the language developed should include a requirement that OFM certify that the state does not have sufficient appropriations to make the required lease payments. State agencies would not be able to exercise this provision absent this certification. Nonappropriation language should also be used in new leases when DES determines it is financially advantageous for the state for this term to be included.

BACKFILL

Current Backfill Policy

Backfill is the act of filling an obligated vacant space previously occupied by one tenant with another tenant. The state has two backfill policies developed and published by DES: Policy 126: Establishing Priorities for Leasing Space relates to the process and order for backfilling space that applies statewide, and Policy 125: Priority Leasing in Thurston County provides lessors with a priority for backfilling space.

DES priorities for backfilling space are in the following order: a) space owned by DES; b) space owned by other state agencies, boards, commissions and departments; c) privately owned vacant space still under lease to other state agencies, boards, commissions and departments; and d) space that is vacant as a result of a major consolidation and where such vacancy creates an adverse economic impact on the local community and multiple lessors. Priority D applies only in Thurston County.

After these categories have been considered and the requesting agency has provided a compelling reason for not backfilling available space, then privately owned space available to be leased may be considered.

Present backfill policies do not take into consideration space condition or state's total financial obligation for that space.

Additional Research

Recent Backfill Solutions

Although state law does not define the role of developing or administering a backfill policy, OFM, since 2007, has played the primary role in identifying and negotiating backfill solutions. While DES maintains the policy described above, most backfill solutions implemented in the past six years have been as a result of coordination by OFM and were not necessarily consistent with the current policy. Most backfill solutions have been negotiated during the development of the state's Six-Year Facilities Plan or when an agency is seeking approval for new space from OFM. A key consideration in developing successfully implemented backfill solutions has been the ability to identify and negotiate financial means for implementation by aligning these efforts with the state's budget process.

Findings

Below are OFM's key findings from the research conducted:

National Survey Findings

- » Just more than half the states have a documented policy related to backfill. Generally these states prioritize backfills into two categories: state-owned space and obligated private space.
- » Some states have explicit statutory requirements to fill state-owned space first. Those states have the greatest success keeping state-owned space occupied.
- » Ninety-two percent of all respondents indicated that having and implementing a backfill policy is financially advantageous.
- » In many cases, states indicated that funding for facilities improvements was needed to implement a backfill solution.

Washington Stakeholder Findings

- » The state currently owns or leases more than 110 million square feet. The facilities in the portfolio are not always used to their maximum potential. However, there is sometimes a lack of transparency about where vacant space is available for backfill.
- » Many stakeholders are confused about the application of the current policy.
- » State agencies that have independent real estate authority assume the DES policy does not apply to them or their facilities.
- » Many stakeholders suggested that the backfill list was difficult to locate, incomplete and inaccurate.
- » Some successful and unsuccessful backfills were identified by stakeholders. For state agencies, the primary considerations in whether a backfill was considered successful were suitability for location, agency business needs and building conditions.
- » Some stakeholders acknowledged that the statewide financial perspective needed to be a consideration while others stated there was too much emphasis being placed on financial considerations.
- » Lessors focused on the policy that requires state agencies to consider space previously occupied by the state before going to the marketplace. Generally the lessors participating in the surveys and forums believed it is important to maintain this policy.

Recommendations

To address the findings above, OFM recommends that:

- » DES abolish policies related to backfill.
- » DES add criteria in the evaluation of proposals during the solicitation process that consider infrastructure and investments made by the state in privately leased space previously occupied by the state.
- » OFM be given statutory authority to develop and enforce a statewide backfill policy. OFM has broader and complementary authorities that allow the agency to define and negotiate backfill solutions. DES will continue to be responsible for successful and timely implementation of backfill solutions. A statewide policy established by OFM would:
 - › Apply to all state agencies, boards and commissions.
 - › Establish updated criteria for determining if a backfill is suitable.
 - › Create a consistent and predictable process and tools for conducting an evaluation of potential backfills that is integrated in current requests for new space.
 - › Require agencies to post space available for backfill in the state's facilities inventory system.

OTHER FINDINGS AND RECOMMENDATIONS

Stakeholders introduced several other concepts for consideration through this process. Three real estate practices were consistently mentioned. Each of these concepts is documented briefly below.

Access to Policies and Procedures

There is limited information available on the DES website about the policies, procedures and tools referenced in this report. A common theme emerged throughout the process that the state could do more to make these documents available to stakeholders.

OFM recommends that the state, led by DES in consultation with OFM and agencies, develop and maintain a centrally located public portal for real estate policies, procedures, tools and general information. This portal should be available to all state agencies, lessors and stakeholders. All documents should be posted in formats that meet statewide accessibility standards.

Preferred Leasing Areas

The Capitol Campus Master Plan Policy 3.1 states that “the state shall concentrate state office in medium-to-high density locations that are well served by public transportation. To this end, the state will build to own in preferred development areas (PDAs) and lease facilities in preferred leasing areas (PLAs).”

The PLA, designed by GA with the advice of Capitol Campus Design Advisory Committee and the approval of the State Capital Committee, is designed to support growth management principles, transportation demand management objectives and the comprehensive plan goals of the cities of Lacey, Olympia and Tumwater, as well as Thurston County.

Several stakeholders raised concerns with this policy and expressed other concerns that the PLA:

- » May not be being applied consistently by DES.
- » May not allow for consideration of a facility previously occupied by the state if the building is outside of the current PLA.
- » May limit competition in the community.
- » May not provide space that is in suitable condition for use by state agencies.

OFM understand that DES is evaluating the preferred leasing area policy as a part of the update to the Capitol Campus Master Plan. DES should consider this input when updating this policy.

DES Real Estate Services

Several state agencies made suggestions that DES should consider realigning and enhancing services provided to them, including:

- » There should be a single point of contact at DES for the lease renewal process.
- » The state should use private sector services (brokerages and space planning) to augment and expedite the work of DES Real Estate Services.

OFM understands that DES will continue to evaluate how to best align its staff to serve the needs of state agencies.

In February 2014, in accordance with RCW 43.19.008(5), OFM recommended that DES conduct a competitive procurement process to obtain bids from the private sector for real estate leasing services for new leases and renewals. The results of the procurement process will continue to assist the state in determining whether a program or service may be performed by the private sector in a more cost-efficient and effective manner than by being performed by the department.


OFM understands that this process will address the suggestion made by stakeholders to consider private sector services.



STATE OF WASHINGTON
DEPARTMENT OF ENTERPRISE SERVICES
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February 23, 2015

TO: Amy McMahan, Senior Facilities Oversight Manager
Office of Financial Management

FROM: Bob Covington, Deputy Director 

SUBJECT: **Response and Acknowledgement to Office of Financial Management Policy Survey**

This memo is a response and acknowledgement by the Department of Enterprise Services (DES) regarding the recommendations set forth in the Real Estate Lease Policies Report conducted and issued February 2015 by the Office of Financial Management (OFM).

I want to thank you and your staff for conducting and preparing the study, which has generated a number of valuable insights into the views of both internal and external stakeholders. I realize and appreciate the significant amount of work and time that was dedicated to this study.

DES is thoroughly evaluating every recommendation as we continuously review and improve our internal processes covered by the four policy focus areas included in the study – as well as other areas of opportunity. Many of the recommendations are quite timely and in some instances, mirror changes we have already put in place that are yielding dramatic results for our staff, client agencies, external stakeholders and ultimately the state taxpayer.

For example, the report's recommendation to characterize a best value lease renewal by clearly defining agency business need and market conditions closely mirrors our current approach, which is a product of recently completed lean initiatives. As a result of these new work processes and other improvements, state agencies have avoided more than \$8.1 million in costs over five years as a result of DES negotiating under-market lease rental rates. This clearly suggests that these and other recommendations from the report could lead to greater success.

While OFM's report outlined a number of other recommendations for changes and improvements to DES policies and processes that haven't been put in place, we are evaluating all of them in detail as part of our larger continuous improvement efforts. I anticipate that our staff will work and consult closely with OFM as we make changes that incorporate recommendations from this report.

Again, thank you and we look forward to further collaboration as we improve the management and delivery of real estate services.

cc: Nona Snell, OFM
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