



STATE OF WASHINGTON
OFFICE OF FINANCIAL MANAGEMENT

Insurance Building, PO Box 43113 • Olympia, Washington 98504-3113 • (360) 902-0555

January 28, 2016

TO: Chris Liu, Director
Department of Enterprise Services

FROM: David Schumacher
Director

SUBJECT: OFM REVIEW OF PROGRAMS AND SERVICES AT DEPARTMENT OF ENTERPRISE SERVICES – REAL ESTATE LEASING SERVICES FOR NEW LEASES AND RENEWALS

RCW 43.19.008(5) directs the Office of Financial Management (OFM) to conduct a review of the programs and services performed by the Department of Enterprise Services (DES) to determine whether a program or service may be performed by the private sector in a more cost-efficient and effective manner than being performed by the department. Up to six activities and services may be selected by OFM each biennium under this review. In conducting its review, OFM is authorized to break programs into discrete services or activities or the programs may be reviewed as a whole. However, priority for selection shall be given to agency activities or services that are significant, ongoing functions.

In February 2014, OFM selected four activities for the 2013-15 biennium review, one of which was “real estate leasing services for new leases and renewals” (real estate leasing services). For each selected activity, DES must conduct a procurement process. If OFM determines through the results of the procurement process that the activity or service could be provided by the private sector at a reduced cost and with greater efficiency, DES may proceed with the contract.

Based on OFM’s analysis of DES real estate leasing services, which is attached for your reference, OFM cannot definitively conclude that the services can be provided at a reduced cost and with greater efficiency. However, based on what was learned through the procurement process and other related factors, the private sector may be able to provide the service at a reduced cost and with greater efficiency if done through an alternative structure. To confirm that conclusion, the use of convenience contracts established in specified metropolitan areas would need to be undertaken.

Although OFM does not recommend that DES contract out real estate leasing services based on the procurement process, OFM does recommend that DES begin to use its suite of convenience contracts with vendors in metropolitan real estate markets. A certain number of new leases and renewals can be performed by vendors with convenience contracts. A more detailed description of the pilot project is included in the analysis. This pilot project can help determine whether the service can be provided at both a reduced cost and with greater efficiency. DES will develop performance measures for this pilot project that measure cost and efficiency, as detailed in the analysis, for both vendors and DES employees. In that way, we can determine how these services can be provided at a reduced cost and with greater efficiency.



David Schumacher
January 28, 2016
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If you have any questions, please contact Roselyn Marcus, OFM Assistant Director for Legal and Legislative Affairs, at (360) 902-0434 or Roselyn.marcus@ofm.wa.gov or Cheri Keller, Senior Budget Assistant, at (360) 902-0563 or cheri.keller@ofm.wa.gov.

Attachment

cc: David Postman, Chief of Staff, Office of the Governor
Tracy Guerin, Deputy Director, OFM
Roselyn Marcus, Assistant Director for Legal and Legislative Affairs, OFM
Cheri Keller, Senior Budget Assistant, OFM



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January 27, 2016

TO: David Schumacher
Director

FROM: Roselyn Marcus *R. Marcus*
Assistant Director for Legal and Legislative Affairs

SUBJECT: REVIEW OF PROGRAMS AND SERVICES AT DEPARTMENT OF ENTERPRISE SERVICES – REAL ESTATE LEASING SERVICES FOR NEW LEASES AND RENEWALS

RCW 43.19.008(5) directs the Office of Financial Management (OFM) to conduct a review of the programs and services performed by the Department of Enterprise Services (DES) to determine whether a program or service may be performed by the private sector in a cost-effective and efficient manner than being performed by the department. Up to six activities and services may be selected by OFM each biennium under this review. In conducting its review, OFM is authorized to break programs into discrete services or activities or the programs may be reviewed as a whole. However, priority for selection shall be given to agency activities or services that are significant, ongoing functions.

In February 2014, OFM selected four activities for the 2013-15 biennium review, one of which was “real estate leasing services for new leases and renewals” (real estate leasing services). For each selected activity, DES must conduct a procurement process. If OFM determines through the results of the procurement process that the activity or service could be provided by the private sector at a reduced cost and with greater efficiency, DES may proceed with the contract.

Based on the analysis of the DES real estate leasing services procurement, I cannot definitively conclude that the services can be provided at a reduced cost and with greater efficiency. However, based on what was learned through the procurement process and other related factors, the private sector may be able to provide the service at a reduced cost and with greater efficiency if done through an alternative structure. To confirm that conclusion, the use of the convenience contracts established in specified metropolitan areas would need to be undertaken.

Although I do not recommend that DES contract out the real estate leasing services, I do recommend that DES begin to use its suite of convenience contracts with vendors in metropolitan real estate markets. A certain number of new leases and renewals can be performed by vendors with a convenience contract. This pilot project can help determine whether the service can be provided at both a reduced cost and with greater efficiency. In conducting this pilot project, DES should report on defined performance measures that measure the cost and efficiency, as detailed in the analysis, for both the vendors and DES employees. In that manner, we can determine whether and how these services can be provided at a reduced cost and greater efficiency.

Background

DES' Real Estate Services Division (RES) provides real estate services, including:

- Leasing services for new leases, renewals, extensions, and amendments to current leases.
- Acquisition and disposal of real property.
- Design, space planning, architectural services and construction supervision.
- Consulting and technical assistance including project planning and financial analysis.

The division's authority and duties are defined in RCW 43.82.010.

The above services are provided by three units and additional administrative and management staff. The leasing unit is responsible for procurement of space, lease negotiations, lease administration, and dispute resolution. The design unit is responsible for architectural and space design for leased facilities, construction project management, accessibility and energy assessment, and technical and programming assistance. A third unit manages the acquisition and disposal of real property through negotiations, appraisals, environmental studies, surveys, easements and title review.

DES is required to report annually to OFM and the fiscal committees of the Legislature on facility leases executed for all state agencies in the preceding year including lease terms and annual lease costs. RES is responsible for producing this report. To meet this reporting requirement, RES maintains a centralized database system.

Real Estate Leasing Services for New Leases and Renewals

Real estate leasing services conducts transactional management for over 15 million square feet with a monthly base rent of \$18.5 million, including DES-owned property. Services related to the procurement process were limited to the leased portfolio covering about 695 leases and approximately 10 million square feet of office, retail, warehouse, classrooms, land and other specialty space for \$13.4 million in monthly base rent. Located in 37 of 39 Washington counties, these leases serve the needs of 108 state agencies, boards, commissions and community colleges.

RES assists agencies in conducting market research and finding acceptable space, and negotiating new leases; amendments to current leases, and lease renewals. RES architects support the leasing agents and client agencies by developing floor plans and details that describe the built-out leased space. RES architects also may work with the building owner's architect, produce drawings, monitor construction progress, and look for compliance with state codes and statutes.

DES has a complicated set of fees for the various real estate services. Some fees are included in the central service model while other fees are charged per project. These fees are based on the following categories of services: leasing and design services for new leases, lease renewal services, cancellation fees, delegation fee, and other reimbursable services.

To receive assistance from RES, an agency may submit a request electronically through the DES website. An agency may also contact RES directly by email or phone number, both of which are listed on the DES website. RES maintains a bank of standard templates and forms related to real estate leases. However, pursuant to RCW 43.82.101(12), all leases must be approved as to form by the Attorney General's Office.

Real Estate Services Operations

RES has 22.75 FTEs to perform the work for all the above-referenced functions in the division. Most staff members are located at 1500 Jefferson Street, Olympia, Washington, except for a four-member team assigned to work with the Department of Social and Health Services (DSHS). Of that four-member team, one is based in the DSHS headquarters, and three are located in DSHS field offices.

RES has a biennial budget of \$7.2 million. It is funded by a combination of central service agency fees and one-time fees paid by state agencies that use its services.

DES Request for Proposals

DES conducted a competitive solicitation for real estate leasing services through the use of a Request for Proposals (RFP). The RFP was developed by DES staff from RES, Finance, and executive management. Although DES consulted with OFM during the development phase, OFM provided feedback that was not incorporated in the final solicitation document.

Services included in the RFP were those being performed by the leasing unit and design unit. The RFP required bidders to perform the duties in a similar manner as being performed by RES, with the oversight of RES. In addition, bidders were limited in the cost proposal to two set methods – fixed price and commission pricing. The RFP is very prescriptive as to the tasks and deliverables as DES saw this as a means to mitigate perceived risks identified in discussions with other states.

The RFP was issued via the Washington Electronic Business Solutions system (WEBS) on May 12, 2015. In addition, DES contacted a number of potential vendors directly. The solicitation was downloaded from WEBS by 18 vendors. Two amendments were posted to answer questions raised at the May 26, 2015, pre-bid conference and address issues raised later about the bid pricing worksheet. Responses were due on June 12, 2015. Despite this outreach, DES received responses from only four vendors: Royal Commercial Corp. (RCC), Jones Lang LaSalle (JLL), CBRE, Inc., and Cushman and Wakefield.

The responses were first screened for compliance with the administrative requirements. Two bids were disqualified for not providing the required firm price for services, despite the fact that this pricing scheme is not used in the private sector. (Although one vendor bid a different pricing scheme and the other provided an estimate of what a firm price would be, they were nonetheless disqualified.) That left two bids that were evaluated and scored by an evaluation team composed of representatives from RES and a representative from DSHS.

The responses were scored in two phases. A total of 100 points were available in Phase I. Phase I scoring considered the bidder's qualifications, approach and cost. The intent of Phase I was to advance the two highest-scoring bidders to Phase II. Both bidders were advanced.

Phase II was conducted as an interview. The intent of Phase II was to verify each proposal's alignment with the purpose and intent of the state, seek additional clarification where appropriate, and allow bidders an opportunity to refine their offer as a result of the interview. Following the interviews, both bidders were given an opportunity to submit a Best and Final Offer (BAFO).

RCC's BAFO provided that the pricing proposal was contingent upon a single award. This was inconsistent with the RFP, which allowed DES to make multiple awards. JLL's proposal was not so limited and was significantly less costly. JLL received the highest point total and would be the apparently successful vendor.

Overview of Procurement Process

In reviewing the market research, there is a large, mature statewide private market for this activity. More than 3,600 firms provide office building rental or leasing services. In addition, more than 1,500 firms provide real estate property management. There also are models from other states and municipalities that have contracted out all or part of these same services. It is concerning that only four vendors submitted bids and only two were ultimately evaluated. It would appear that work needs to be done to determine why more vendors did not respond to this RFP. Without additional research, I can only speculate as to why the response was so low. Potential reasons may be:

- The RFP provided a relatively short time between release and response due date. Only 30 days were provided to respond to this complex solicitation.
- Vendors may not have a presence throughout the state, but instead concentrate their services in one geographic area. The RFP called for a statewide response.
- The RFP did not appear to allow for much creativity in approach as to how services are to be provided. Although the strict task and delivery requirements were meant to limit risk, they might have limited the ability of vendors to bid in accordance with how they operate. In other words, vendors did not want to adopt the state method.
- The RFP was rigid in how the vendors submitted price proposals, requiring vendors to submit both fixed rate and commission-based pricing structures.
- DES had issued a similar RFP during the summer of 2015 to establish convenience contracts for brokerage services. From that process, 16 contracts were put into place. Those vendors may have thought they did not need to bid on this RFP since they were already awarded a convenience contract.

Evaluation of Efficiencies

Several ways of contracting for leasing services may offer efficiencies. They include:

- Completing projects in a shorter time period.
- Having greater knowledge or expertise in a geographic area, which allows for more location choices for agencies.
- These additional choices can provide competition for agency tenants, resulting in lower costs for leases or tenant improvements.
- Additional tools may provide more information and additional services that currently cannot be provided by RES.

The proposals suggest there may be opportunities to achieve some, if not all, of the above-listed efficiencies.

The timeline to complete projects may be shorter in duration. DES currently estimates a typical project will take 18–24 months from initiation to completion for lease renewals and new space. The two largest vendors, including the apparent successful vendor, Jones Lang LaSalle, estimated that their typical process would take roughly 13 months. Shortening the process time could reduce an agency's costs for implementation and reduce the risk of high-cost extensions or holdover terms if deals are not completed in a timely manner.

The proposals also indicated that additional resources are available. The three national vendors offered as many, if not more, resources than RES currently has to perform these activities. Each of these vendors identified that it would leverage local area brokers as well as existing management staff to perform these functions. Local brokers would be accessed on an as-needed basis, while the management structure would be dedicated. In addition, these vendors also identified tools and resources, such as proprietary lease forms and comparable databases, which would not otherwise be available to DES. Tools such as these are likely to reduce the cost of future transactions.

Although the proposals provided information that may lead to efficiencies, the data are limited. Based on the information from the procurement, I cannot make a definitive finding that there will be efficiencies if real estate leasing services were contracted out to the private sector.

Evaluation of Cost

The current costs for real estate services are roughly \$7.2 million with a total of 22.75 FTEs including administrative operations and acquisition and disposal services. A functional organizational chart is attached as Exhibit 1.

The RFP sought vendor proposals that would reduce the number of staff in RES by 13.8 FTEs and replace them with contracted staff for lease renewals and new space projects. DES would retain staff to conduct administrative operations and acquisition and disposal services. DES projects that if real estate services were to be contracted to the private sector, DES would reduce staffing and related costs by \$3.2 million each biennium.

The DES analysis indicates that to oversee the vendor's services and provide coordination with state agencies, DES would need to hire 6.4 staff in RES, including positions that would be assigned to work with the broker's staff. These new positions would result in a cost of \$1.5 million per biennium. These changes result in a net reduction of 7.6 FTEs and a reduced cost of \$1.7 million per biennium.

Vendors were asked to provide a commission structure bid and a fixed price bid. The two vendors who responded by providing both price structures were considered further.¹

The commission structure is typical in private sector real estate models, as opposed to the fixed price structure. However, these commissions are usually split between the lessor and lessee. The vendor responses appear to indicate that these fees would all be paid by the state and were evaluated as such. Final cost proposals from the vendors ranged from \$4.9 million, resulting from a fixed price model, to \$45 million for a commission model. These represent a biennial cost.

¹ Two other nationwide vendors did not provide fixed price structures and were eliminated from consideration.

The lowest cost proposal with DES's costs included would result in a biennial cost of approximately \$9.7 million, an increase of \$3.2 million a biennium. Because the costs were not bid by line of business or service, there is insufficient information to identify if the proposals could generate savings or be budget neutral with adjustments to the scope of services. It is also unknown whether a different price structure would result if the vendors were provided the opportunity to alter the manner in which the work is done.

It does not appear that DES made adjustments to its administrative operations as part of its cost analysis. The future-state proposal still includes approximately 6.75 staff to provide administrative functions. It is possible that redundant functions exist between the vendor and DES, and additional efficiency could be gained through contract negotiations resulting in cost savings, but based on the data supplied, a budget-neutral solution is unlikely.

Another potential avenue for achieving cost reductions relates to the results of the services provided, as opposed to the cost of the services. This could include, for example, the type of space that is found, what tenant improvements are included in the lease and their associated cost, and the cost of the leases negotiated. However, the RFP was not set up in a way to enable these types of comparisons to be made or to define the lease negotiations in which the vendor would be engaged. Therefore, while there may be savings incurred from leasing at a lower market rate than being negotiated by the state, we cannot confirm this as a definitive cost savings. However, it is possible there may be cost savings that can be added to the direct operational cost savings that would result in a reduced cost to the state. This would need to be tested before a final determination can be made.

Improvements to DES Real Estate Services

While the convenience contracts have not yet been used, RES has continued to make improvements to its business model to improve operational efficiencies. These include acquiring a new technology solution to monitor transactions and hiring new talent as opportunities arise.

DES is implementing a new lease management and tracking system. This tool will allow DES to track its turnaround times, monitor project status, and communicate more effectively with agency customers. It also provides the mechanisms for key performance indicators to be developed and tracked.

In addition, as staff members retire or accept new jobs, RES is making a concerted effort to hire new, highly-qualified talent. DES will continue to have the opportunity to strengthen the real estate services team and its skill sets in the next few years.

Convenience Contracts for Brokerage Services

During the same time period in which this procurement activity was to be conducted, DES issued a RFP dated December 15, 2014, to obtain real estate services on an as-needed basis. DES can then use any of these convenience contracts to engage the private sector to handle any particular project, but does not mandate usage. It appears that DES entered into convenience contracts with 13 vendors covering six counties.

Below is a list of the contracts with the counties covered in each contract.

- Black Commercial, Inc. dba NAI Black – Spokane County
- CBRE, Inc. – Benton, Clark, King, Pierce, Spokane and Thurston counties
- Chiles and Company – King County
- Commerce Real Estate Solutions, LLC – Benton, Clark, King, Pierce, Spokane and Thurston counties
- Flinn Ferguson Corporate Real Estate – King County
- Jones Lang LaSalle Americas, Inc. – King, Pierce and Thurston counties
- Kidder Mathews – Clark, King, Pierce, and Thurston counties
- Kinzer Real Estate Services – King County
- Madison Bay Co. LLC – Benton and Clark counties
- NAI Puget Sound Properties – Thurston County
- Omni Practice Group – King, Pierce, Spokane and Thurston counties
- Roland Resources, Inc. – King County
- Windermere Real Estate/TriCities – Benton County.

The contracts were executed in July and August 2015. They have not yet been used by DES for any real estate transactions. At this time, we do not have data on the cost savings, and no organizational changes have been made as a result of these contracts.

Recommendation

The statute provides that if OFM determines that the service can be provided by the private sector at a reduced cost and greater efficiency, OFM shall recommend that DES contract with one or more vendors to provide the service as a result of the procurement process. We are unable to confirm that contracting the real estate leasing services to the one apparently successful vendor will result in the service being provided at a reduced cost and with greater efficiency based on the information available through this procurement. However, the fact that DES entered into convenience contracts for services in specific metropolitan areas is evidence that the private sector can at a minimum provide these services at a reduced cost and greater efficiency for specific projects.

Therefore, I recommend that DES engage in a pilot project as described below, using the convenience contracts now in place. DES shall report on defined performance measures for the contractors and RES staff. DES should work towards changing its organizational structure to better align with the usage of the convenience contracts. At the end of the two-year period, DES should provide to OFM data related to the services provided by both the private sector and RES to determine if the contracts should continue, whether the contracts should continue with an expansion of markets, or change to mandatory use contracts.

Proposed Pilot Project

DES should use the convenience contracts on lease renewals and new space projects for this pilot project. It should attempt to negotiate service orders for at least 20 percent of real estate services

work performed in King, Clark, Thurston, Pierce and Spokane counties in the next two years. The service orders should have the following conditions:

- The fees for the broker's services must be paid by the lessor and not by the state agency.
- The broker's duties must include acting as the state's tenant broker for lease negotiations.

Consistent with the current DES charter process, before beginning any new transaction in these metropolitan areas, DES should define the estimated market range and the agency budget as targets to use in the negotiations by the broker or DES.

Every 12 months, DES should report the following results to OFM:

- The number of service orders
- The number and list of service orders that were successfully implemented.
- The number and list of service orders that could not be successfully negotiated along with a brief description of why.

For all completed transactions in these metropolitan areas, DES should provide, at a minimum:

- Whether the lease was negotiated by DES or a broker.
- The total annual cost and the cost per square foot of the negotiated transaction.
- How the cost per square foot compares to the established market range.
- How the cost per square foot compares to the agency budget.
- A list of any other financial incentives negotiated.
- The total number of months from the start of the transaction to the execution of the lease.

If negotiations result in higher lease costs to pay commission rates, these costs must be itemized in the lease agreement.

If you have questions, please feel free to contact Cheri Keller or me.

Attachments

cc: Tracy Guerin, Deputy Director, OFM
Jim Crawford, Assistant Director for Budget, OFM
Cheri Keller, Senior Budget Assistant, OFM

Current Functional Organization Chart

#1 - Existing

Department of Enterprise Services
Facilities Division
Real Estate Services
May 2015

