Audit of PBS Rent Pricing
Report Number A040104/P/R/R05001

December 29, 2004
Date: December 29, 2004

Reply to Regional Inspector General for Auditing
Attn of: Real Property Audit Office (JA-R)

Subject: Audit of PBS Rent Pricing
Report Number A040104/P/R/R05001

To: F. Joseph Moravec
Commissioner, Public Buildings Service (P)

This report presents the results of our audit of the Public Buildings Service’s (PBS) actions to effectively implement its rent pricing methodology. Primarily, the audit assessed whether the current pricing methodology is implemented consistently and in accordance with PBS’s rent pricing strategy. Our audit disclosed that, while basic tenant rent rates are generally established in accordance with PBS’s pricing strategy, improvements could be made to strengthen the integrity of the rent data. One improvement is having Regional Appraisers maintain sufficient information to support the origin of the rent rates in owned buildings. Secondly, although PBS is placing more emphasis on monitoring the financial performance of leased properties, additional efforts would enhance lease profitability. Finally, resolution of customer questions could be improved by more detailed information in the property files, rent bills, and inventory database.

If you have any questions regarding this report, please contact me or Regina O’Brien, Regional Inspector General for Auditing, Real Property Audit Office, on (202) 219-0088.

Susan P. Hall
Audit Manager
Real Property Audit Office (JA-R)
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EXECUTIVE SUMMARY

Purpose
The audit focused on determining if the current pricing methodology is implemented consistently and in accordance with the Public Buildings Service’s (PBS) rent pricing strategy as it relates to the basic pricing structure.

Background
PBS designs, builds, leases, secures and manages about 340 million square feet of space to house federal tenants in approximately 8,700 buildings across the United States. The rent rates PBS charges to the tenant agencies must approximate commercial charges for comparable space and services. PBS redesigned its policy for charging rent to customer agencies in fiscal year (FY) 1997. Under the new pricing policy, the basis for rent in government owned space is an appraisal that is performed every five years and in leased space is the lease contract costs plus a PBS service charge so that this space is essentially revenue neutral. The core cost is for shell rent, which is the rate charged for space that includes no services or operating costs, tenant improvements or alterations.

PBS uses Funds From Operations (FFO) as its main indicator of financial performance. FFO is the net income that remains after deducting operating, security, and administrative expenses as well as repair and alterations (capital costs) from total income but before deducting depreciation. While overall FFO is increasing, the leased portfolio has only generated positive FFO the last two fiscal years.

Results-in-Brief
Generally, tenant shell rent rates are being established in accordance with PBS’s rent pricing strategy. We did, however, note three areas where improvements could be made to strengthen the integrity of the rent data. First, Regional Appraisers’ changes to contract appraisal rates need to be better supported. This was highlighted by variances in the shell rent rates recorded in three key PBS databases. Secondly, while PBS is placing more emphasis on monitoring the financial performance of leased properties, increased efforts, including consistent recovery of GSA funded repair and alterations, would enhance lease FFO. Lastly, PBS’s resolution of customer questions could also be improved through more detailed information in the property files, rent bills and the System for Tracking and Administering Real Property (STAR).
Recommendations

We recommend that the Commissioner of the Public Buildings Service take steps to ensure that PBS’s rent pricing strategy is effectively implemented by: including sufficient documentation in regional files to support the source of rent rates for owned properties; billing the tenant appropriately for GSA funded leasehold improvements, and including guidance for developing special case rates. Additionally, populating more fields in STAR would promote accurate and timely research into billing questions by customers.
INTRODUCTION

Background

The Public Buildings Service (PBS) designs, builds, leases, secures and manages about 340 million square feet of space to house federal tenants in approximately 8,700 buildings across the United States. The rent rates PBS charges to the tenant agencies must approximate commercial charges for comparable space and services. Owned inventory consisted of about 1,600 properties and the leased inventory includes more than 8,000 leases in over 7,000 locations.

PBS redesigned its policy for charging rent to customer agencies in fiscal year (FY) 1997. Under the new pricing policy the basis for rent in government owned space is an appraisal that is performed every five years, and in leased space is the lease contract costs, a PBS service charge, and a security charge, resulting in space that is essentially revenue neutral. The core cost is for shell rent, which is the rate charged for space that includes no services or operating costs, tenant improvements or alterations.

PBS uses Funds From Operations (FFO) as its main indicator of financial performance. FFO is the net income that remains after deducting operating, security, and administrative expenses as well as repair and alterations (capital costs) from total income but before deducting depreciation. While overall FFO is increasing, the leased portfolio has only generated positive FFO the last two fiscal years. However, in FY 2003, lease profitability dropped considerably, even though over 5 million rentable square feet was added to the inventory.

Objective, Scope, and Methodology

The objective of this review was to determine if the current pricing methodology is implemented consistently and in accordance with the PBS rent pricing strategy as it relates to the basic pricing structure. For owned property, this meant we reviewed the basis for shell rent (the appraisal). In leased properties, because we recently reported on a comparison of billed lease rates to actual leases, we focused on indicators that leases may not be revenue neutral. We performed audit work in the National Office and in three Regions: National Capital (Region 11), Greater Southwest (Region 7), and Pacific Rim (Region 9). We reviewed:

- Key controls over the rent data;

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• The appraisal process as the basis for owned property rent rates from contractor or staff appraisal through tenant rent bills; and
• Leased properties financial performance as an indicator that the basic rates are a pass through of contract costs.

To accomplish our objective, we spoke with cognizant Regional and National Office associates regarding rent pricing and associated methodologies. We also reviewed applicable PBS policies and desk guides as well as studies commissioned by PBS such as the review of its service fee and PBS’s efforts to aid customer satisfaction with the clarity of the rent bills. Our sample of properties for in-depth review was selected from FY 2003 income and expense information and building detail reports. For 76 owned buildings, we reviewed the appraisal files and compared the rates in the appraisals to the inventory and billing databases. These 76 buildings were judgmentally selected based on building size, having a total of over 39 million rentable square feet, with limited vacant space. We reviewed a sample of 138 leased buildings, based on building profitability. This sample focused on buildings with either a negative FFO over $100,000 or a positive FFO that was well beyond what the PBS fee would have generated. We also looked at capitalized projects of approximately $18 million in 32 leased buildings judgmentally selected from leased properties with depreciation expense.

Fieldwork was conducted between April and August 2004. The audit was performed in accordance with generally accepted Government auditing standards.
RESULTS OF AUDIT

Generally, tenant shell rent rates are being established in accordance with PBS’s rent pricing strategy. We did, however, note three areas where improvements could be made to strengthen the integrity of the rent data. First, Regional Appraisers’ changes to contract appraisal rates need to be better supported. This was highlighted by variances in the shell rent rates recorded in three key PBS databases. Secondly, while PBS is placing more emphasis on monitoring the financial performance of leased properties, increased efforts, including consistent recovery of GSA funded repair and alterations, would enhance lease FFO. Lastly, PBS resolution of customer questions could also be improved through more detailed information in the property files, rent bills and the System for Tracking and Administering Real Property (STAR).

Support for Shell Rent Rates for Owned Space Needs Improvement

A review of 76 appraisal files highlighted differences among the three regions with regards to how appraised rates are developed and supported. Further, in comparing the shell rate in the appraisals to the Appraisal Data System (ADS) information, the financial portion of the Occupancy Agreements (OA), and tenant billings we found several instances of variance among these rates. Agency files should include sufficient documentation to support rent rates for owned properties and substantiate GSA’s position in the event of a rent dispute.

PBS policy is that shell rent rates in federally owned properties be based upon a Fair Annual Rent (FAR) as determined by contractor-generated or GSA staff appraisals. According to the Pricing Guide, an appraisal by an independent contractor provides, “...a clear and forthright means to establish a fair and reasonable Rent by a disinterested third party”. The Pricing Guide further states that customer agencies can request a review of the appraisal prior to filing a rent appeal and that PBS is responsible for sharing information from the appraisal to demonstrate that the rent rate is correct and adequately supported. Rates are set for five-year periods for existing tenants. For new assignments commencing in a year other than the year for which the appraisal was commissioned, there is a table of values in the appraisal to assist realty practitioners in establishing an initial shell rental rate. The Regional Appraisers enter the rent rate data from the FAR appraisal in to ADS, the official national web-based database. To commence billing, the Regions load STAR with the appropriate rent rates from ADS.

The Regional Appraisers varied in their approach to using contract appraisals. In setting the initial rate for a building, the Regional Appraisers used a contract appraisal. Our review disclosed that all contractor prepared appraisals were
performed in accordance with PBS technical guidance. However, we found that in one region, the Regional Appraiser used contractor recommended shell rates as a starting point, but adjusted the rates. Our sample of 25 appraisals in this region disclosed that the Regional Appraiser had adjusted the contractor recommended shell rate in 10 instances, 9 of these upward. The rationale for the adjustments was documented in the appraisal files. In two regions, the Regional Appraiser rarely adjusted contractors’ rates. These Appraisers discussed rate related concerns with the contractor. If no agreement was reached, they ordered a new appraisal. Appraisal files did not include information as to why certain appraisals were rejected and others ordered. Appraisal files in these two regions generally did not contain information other than the appraisals themselves.

Further, adherence to National Office guidance varies among the regions. Although we found that Regional Appraisers are signing off on contractor-generated appraisals signifying concurrence with recommended rates, two out of the three Regions reviewed were not completing the PBS mandated Reviewer’s Appraisal Analysis checklist, where applicable. This form provides a standardized method for determining if an appraisal meets prescribed specifications, and is required for all Rent Estimate appraisals effective from FY 2005 forward. It could also be used as a method for providing rationale for why certain appraisals are rejected. Only one region rotates appraisal contractors as suggested by PBS National Office guidance. This guidance advised that reusing the same contract appraisers in successive years “may not yield optimal results.” The other two regions cited the uniqueness of Government requirements and the rural location of many properties as reasons for non-rotation.

Different approaches were used for establishing rent rates for new tenancies in buildings, which commenced after the initial appraisal. None of the Regional Appraisers relied on the table of values provided in the initial appraisal, rather each one established his own methodology. In one Region, because of a volatile real estate market, the Appraiser stated he adjusts shell rates quarterly using web-based and local market information. However, there was no documentation to support how the rates were developed, which violates PBS’s pricing policy. Additionally, these quarterly updated rates are not posted in the ADS, the official database for appraisal based rent rates. Instead, they are stored in an internal regional shared drive. The ADS was developed to provide an up-to-date, web enabled record for appraisal-based information. Maintaining information outside of ADS hinders the functionality of the system. Another Regional Appraiser often escalated the prior years’ FAR rate to provide rates he thought better reflected current market conditions. While the appraisal files we reviewed did not contain an official record showing how these rates were developed, the Regional Appraiser is currently compiling a master file detailing how trend factors used in the development of escalated rates are determined. Alternatively, he sometimes orders a new FAR appraisal based on factors such as the square footage of the new tenant and changes in local markets. The third Regional Appraiser generally orders an entirely new FAR appraisal. He stated he does so because he encountered numerous tenant challenges to his regionally escalated rates.
In the course of our review we discovered some instances where the Regional Appraiser developed special rates for storage space. The current space classifications do not provide a category for storage space. Space used as storage is to be charged as office space. It is less expensive than regular office space because there are no tenant improvement costs. We found, however, that in instances where space was deemed substandard, the Regional Appraisers, based on their expertise, devised a storage facility rate. Only one of the regions included written support for these special rates in the appraisal files.

We performed an analysis of the shell rent rates in our sample of 76 buildings to compare rates in the ADS, the OAs, and the customers’ rent bills. We found discrepancies in 39 buildings. Several differences were due to space re-measurements, which were virtually never documented in the appraisal files. Five of the differences were due to data entry errors. Nine were due to the use of the updated quarterly rates instead of the ADS rates, which violates PBS’s pricing policy. The difficulty in matching appraised shell rates to rent bills reinforces the need that official files contain enough information to support the origin of billed rates and GSA’s position in a rent dispute. Only Region 11 requires that the Regional Appraiser verify the accuracy of the OA rent rate prior to billing.

In summary, we found varying degrees of support for shell rates. The PBS pricing guide notes customer agencies can request a review of the appraisal. PBS is responsible for sharing this information. All Regional Appraisal offices should maintain sufficient information to sustain GSA’s actions during a rent appeal, or readily respond to rate based questions from other sources.

**Monitoring of Leased Properties Financial Performance Needs Improvement**

While leased space was envisioned to be revenue neutral, a review of the profitability of the FY 2003 lease inventory shows this is often not the case. While the lease inventory has generated positive FFO overall the last two years, approximately 2,000 leased buildings had a negative FFO in FY 2003. Our review of buildings with significant negative or positive FFO surfaced numerous reasons for this inconsistency; including not recapturing the cost of PBS funded leasehold improvements.

An analysis of 138 leased buildings disclosed a variety of reasons contributing to the FFO issue. Primarily, these relate to: adjustments due to errors when billing the tenant; vacant space; cross-year timing of revenue and expenses; accounting errors; overpayments to lessors; and general and administrative expenses. Many of the discrepancies were attributable to human error. For example, in one instance, PBS received six months free rent (totaling $180,000) from a landlord, but did not pass this along to the tenant. In another, a lessor repaid GSA by check for $416,600 for an unused tenant improvement allowance. The entire credit to

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2 Rent is a pass-through of the underlying PBS contract rent, plus: (1) any conventional operating costs not performed through the lease; (2) the PBS fee; (3) security charges; and (4) in limited cases, a charge for PBS funded leasehold improvements.
rental of space was recorded, but the customer was not provided a rent credit. Thus, these properties registered a high positive FFO during this particular fiscal year.

National Office and the Regions are currently focusing resources on leases showing high negative FFO. There has also been a shift to manage the leased portfolio as PBS currently does the owned property. Additionally, one region was preparing a financial plan annually at the building level and variances are examined regularly. The focus, however, has been on variances of $250,000 or more. As part of the increased emphasis on leased assets in FY 2004, PBS developed a Leased Business Plan tool to monitor their largest leases, and expanded the data accuracy performance measure to include all leases in the inventory. During our audit, we saw evidence of additional review of financial and billing data by asset managers, financial management staffs, and the single point of entry groups. With the emphasis on managing the entire portfolio, greater scrutiny should be focused on properties exhibiting both positive and negative variances.

Positive income generated in leased properties should result from the PBS fee, which is comprised of three components; (1) contract risk; (2) brokerage services; and (3) property management. We did not perform an in-depth analysis of the sufficiency of the fee since PBS engaged the Logistic Management Institute (LMI) to: (1) identify and recommend the cost elements that should be recovered by the fee; (2) assess the adequacy of the fee to recover costs; and (3) recommend if PBS should refine its lease fee pricing methodology and offer different approaches for consideration.

LMI concluded the sufficiency of the 8 percent would be impacted by PBS’ indirect cost allocation method. In a related study, LMI also assessed PBS’ current and a proposed indirect cost allocation method. According to LMI, the PBS fee was barely sufficient under the current indirect cost allocation method and was insufficient under the proposed methodology. LMI recommended that PBS consider refining its current lease fee pricing methodology. Prior Office of Inspector General (OIG) reports and an Office of Management and Budget study also recommended changes in this area. PBS recently engaged LMI to obtain information on commercial indirect cost allocation practices.

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3 Asset Managers have been monitoring the performance of each individual owned property in the PBS inventory through creation of Asset Business Plans (ABP). The ABP describes the asset’s physical attributes, as well as its financial performance, including FFO. PBS is moving towards the same level of analysis for its leased properties.

4 The method PBS uses to allocate indirect costs (general & administrative and overhead) to direct costs is critical because it produces cost information needed to support decision making at all levels. PBS senior management is concerned that its current indirect cost allocation method does not accurately support such decision-making.
PBS Funded Leasehold Improvements Are Not Consistently Recaptured

Not recapturing the costs of PBS funded leasehold improvements can negatively impact a lease’s profitability, as was the case with six buildings we examined. In limited circumstances, PBS will fund building improvements in leased space using Budget Activity 54 (Basic Repairs and Alterations) funds. For projects over $10,000, the costs are capitalized and depreciated in PBS financial records, and PBS’s policy is to collect an annual rental charge for these improvements over the lease term. We reviewed a sample of projects capitalized after October 1, 1997 (valued at approximately $18 million in 32 leased buildings), to determine if PBS is indeed recapturing these costs from the tenant. We identified almost $700,000 in project costs that apparently were not appropriately billed to tenant agencies.

Recently, Region 11 expanded the quality assurance plan it uses to monitor the BA 54 work item inventory. It added a standard for tracking work items in leased buildings. This standard requires that costs be passed on to the tenant, where appropriate.

From this same sample we found that the regions, in certain instances, made a business decision not to bill customers for projects that totaled approximately $5.4 million. The majority of these were for security enhancements completed prior to the March 1, 2003 effective transfer of security responsibilities to the Department of Homeland Security. The Pricing Desk Guide states that capital items installed after FY 98 are to be charged to the customer agencies. We were advised that, after the Oklahoma City bombing (April 19, 1995) and the September 11, 2001 terrorist attacks, a conscious business decision was made not to bill tenants for security upgrades. A basis for these decisions included PBS interim guidance on how to treat protection costs in FY 2002. Yet, some projects in our sample were for security enhancements where project costs were recouped.

Regional personnel conceded that, while STAR or the lease files might contain information as to whether charges were passed on to the tenants, the rationale for the business decision not to bill the customer might not be formally captured. Better use of the STAR Remarks section and improved file documentation would alleviate this problem.

PBS Customers Desire More Descriptive Rent Bills

Fairness, simplicity and cost predictability were key goals of PBS’s revised rent pricing strategy. The intent was to insulate customers from wide annual rent fluctuations, and provide a bill that was easier to understand. PBS performed a customer satisfaction survey in April 2003, of all rent-on-the-web users. The two major issues uncovered were that clients were unhappy with: (1) unexpected changes, and (2) unexplained charges to their bill. In the survey, customers felt the main thing GSA could do to improve the rent bill would be to "Explain changes on each bill in more descriptive language". OIG discussions in the regions support this opinion. Additionally, PBS employees repeatedly suggested that the STAR remarks area provide more descriptive detail when property related adjustments
are made. PBS is in the process of shifting customer billing from STAR to the OA Tool\(^5\). According to PBS, the billing information generated by the OA Tool will contain a “remarks section”. In fact, the new billing process will require an explanation whenever changes are made to the rent bill.

Faster resolution of customer inquiries would also improve customer satisfaction. Often the remarks section in STAR is unpopulated or contains limited information. Better use of this capability would allow the Realty Specialist or others to readily research and respond to customer inquiries. This would also be helpful to those researching formal billing challenges lodged through PBS National Office. The National Office does not track individual informal miscellaneous billing adjustments made by the regions. A key control for ensuring that the customer does not receive duplicate rent credits by disputing rent bills informally through the regions, then filing a formal rent dispute with the National Office, is the research performed by regional personnel into rent protests lodged with National Office. Detailed information on the basis for rent credits granted by the region would reduce the risk that PBS would give duplicate credits to its customers.

**Conclusion**

Many of the variances we observed resulted from inconsistencies in Regional practices in implementing the policy, ensuring the accuracy of the rent data, and supporting the rent pricing decisions in official records.

**Recommendations**

We recommend that the Commissioner of the Public Buildings Service take steps to ensure that PBS’s rent pricing strategy is effectively implemented by:

a. Including sufficient documentation in appraisal and Realty Specialist files to support the source of rent rates for owned properties.

b. Including guidance for developing special case rates such as basement storage in PBS’s Pricing Desk Guide.

c. Ensuring that the tenant is billed in accordance with the rent pricing policy, when Budget Activity 54 money is spent in leased property.

d. Ensuring the remark sections in STAR and/or the OA Tool are complete and populated when assignment changes are made to enable accurate and timely research into billing questions by customers.

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\(^5\) The OA Tool automates the process of documenting the mutual understanding between GSA and the tenant agency as to the financial terms, space, tenant improvement, contractual conditions and timing of the tenant’s occupancy
Management Comments

The PBS Commissioner has provided comments to this report, which we have included in their entirety as Appendix A. Management’s response indicates concurrence with the report recommendations. Changes were made to this report to incorporate points made in Management’s comments.

Management Controls

As discussed in the Objective, Scope and Methodology section of this report, the audit focused on aspects of rent pricing. Related management control issues are discussed in the context of the audit findings and addressed by the recommendations provided above.
APPENDICES
APPENDIX A

Audit of PBS Rent Pricing
Report Number A040104/P/R/R05001

Management's Response To Draft Report

MEMORANDUM FOR REGINA O'BRIEN
REGIONAL INSPECTOR GENERAL FOR AUDITING
REAL PROPERTY AUDIT OFFICE -JA-R

FROM: F. JOSEPH MORAVES
COMMISSIONER - P

SUBJECT: Audit of PBS Rent Pricing
Report Number A040104

DEC 27 2004

For your consideration, we are providing the following comments on the draft report,
Audit of PBS Rent Pricing, report number A040104. We appreciate the opportunity
to provide comments and feedback.

Page 4, second paragraph, the second sentence is misleading: “This form provides a
standardized method for determining if an appraisal meets prescribed specifications,
and is required for all Rent Estimate appraisals completed from FY 2003 forward.” This
form was not required for FAR Appraisals with an effective date prior to FY2005. The
report states that the Reviewers Checklist was missing from appraisals reviewed in two
regions. Were the appraisals effective prior to FY2005? Our quality control review for
FAR appraisals prepared in FY2004 and prior relied on standard appraisal industry
practice review standards. When our quality control efforts showed that we were
lacking in this area, we implemented the Reviewers Checklist with the FY2005 Rent
Estimate process.

Page 5, first paragraph, second sentence: “While the Pricing Guide Companion
Document allows for flexibility for setting rates for space located in basements, the
current space classifications do not provide a category for storage space.” At the time
this audit commenced, the Pricing Companion Document was in effect. Pricing Policy
Clarification #16, effective October 1, 2004, deleted the Pricing Companion Document
in its entirety. The Companion Document had become out of date due to the issuance
of numerous clarifications and modifications to the pricing policy. There is no reference
to pricing of basement storage space in the Pricing Desk Guide. A clarification to the
Pricing Desk Guide will be made.

Should you have any questions, please contact William H. Matthews, Assistant
APPENDIX B

Audit of PBS Rent Pricing
Report Number A040104/P/R/R05001

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| Regional Administrator, National Capital Region (11A) | 1 |
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