OFFICE OF
INSPECTOR
GENERAL
UNITED STATES POSTAL SERVICE

Lease Purchase Options for Postal Service Facilities

Audit Report

September 18, 2012

Report Number DA-AR-12-002

OFFICE OF INSPECTOR GENERAL
UNITED STATES POSTAL SERVICE

HIGHLIGHTS

September 18, 2012

Lease Purchase Options for Postal Service Facilities

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BACKGROUND

The U.S. Postal Service administers over 24,000 leases, representing about $820 million in annual rent. About 2,252 leases have purchase options, which enable lessees to purchase leased properties. The Facility Service Office is responsible for negotiating, executing, and tracking leases and headquarters decides whether to execute the lease purchase option. Our objective was to determine whether or not the Postal Service is exercising lease purchase options that provide adequate cost benefits to the Postal Service.

WHAT THE OIG FOUND:

While the Postal Service generally exercised favorable purchase options, opportunities exist for improving the process. Of the 195 leases reviewed, six had options that were economically favorable but were not exercised. By not exercising these favorable purchase options, the Postal Service incurred about $1.3 million in additional cash outlays for long-term lease obligations. In addition, management did not use its ability to assign lease purchase options to third parties in the real estate market to its economic advantage. Twenty-one leases, which are scheduled for termination or identified as potential terminations, have options the Postal Service could assign to third parties to generate about $936,000 in revenue. The Postal Service did not always perform the required analysis for potentially favorable purchase options, which can result in missed opportunities. Finally, the Postal Service did not consider exercising purchase options for leased property occupying less than 6,500 square feet (SF). Five leases, each for properties of less than 6,500 SF, contained purchase options of $1 that, if exercised, would have represented about $134,657 in cash savings to the Postal Service. Reviewing purchase options based on building size alone could lead to missed purchase option opportunities.

WHAT THE OIG RECOMMENDED:

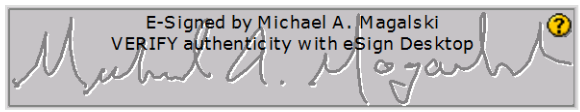
We recommended that management develop an objective methodology to quantify and prioritize opportunities for favorable purchase option exercises, establish procedures for assigning lease purchase options to third parties in the real estate market, reiterate the importance of performing the required analysis on potentially favorable purchase options, and revise procedures to evaluate lease purchase options for leases occupying less than 6,500 SF.

Link to review the entire report.

OFFICE OF INSPECTOR GENERAL
UNITED STATES POSTAL SERVICE

September 18, 2012

MEMORANDUM FOR: TOM A. SAMRA
VICE PRESIDENT, FACILITIES



FROM: Michael A. Magalski
Deputy Assistant Inspector General
for Support Operations

SUBJECT: Audit Report – Lease Purchase Options for Postal Service Facilities (Report Number DA-AR-12-002)

This report presents the results of our audit of the U.S. Postal Service's Lease Purchase Options for Postal Service Facilities (Project Number 11YG038DA000).

We appreciate the cooperation and courtesies provided by your staff. If you have any questions or need additional information, please contact Monique P. Colter, director, Facilities, Environmental and Sustainability, or me at 703-248-2100.

Attachments

cc: Megan Brennan
Mary Anne Gibbons
Corporate Audit and Response Management

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Introduction

This report presents the results of our audit of the U.S. Postal Service's lease purchase option program for Postal Service facilities (Project Number 11YG038DA000). The objective was to determine whether the Postal Service exercised lease purchase options that provided adequate cost benefits to the Postal Service. This audit was self-initiated and addresses financial risks. See Appendix A for additional information about this audit.

Postal Service Facilities administers over 24,000 leases, representing about $820 million in annual rent. About 2,252 leases have lease purchase options, 18 of which the Postal Service exercised in fiscal year (FY) 2011. Each Facilities Service Office (FSO) has Real Estate specialists on staff who are responsible for negotiating, executing, and tracking leases. Facilities Headquarters makes the final decision on whether or not to exercise the lease purchase option based on the information the Facilities Service Offices provide. The Pacific Area FSO has considered the assignment of leases[1] and purchase options[2] as a potential stream of revenue, but has not executed any assignment to a third party.

Conclusion

While the Postal Service generally exercised favorable purchase options, opportunities exist for improving the process. Of the 195 leases reviewed, six contained options that were economically favorable but which the Postal Service did not exercise. In addition, management did not use its ability to potentially assign lease purchase options to third parties in the real estate market to its economic advantage. The Postal Service leased 57 properties planned for termination that could generate additional revenue if the Postal Service assigned the rights to these leases to third parties.

Facilities officials did not perform Purchase Existing Building (PEB) analyses[3] on eight of 195 sampled leases that included potentially favorable purchase options. Finally, the Postal Service did not consider exercising purchase options for leased properties occupying less than 6,500 square feet (SF). By not exercising favorable purchase options, leveraging options via lease assignment, performing required PEB analyses, and considering leases occupying less than 6,500 SF for option exercise, the Postal Service missed the economic benefits these lease options may provide.

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[1] Lease assignment occurs when the lessee markets the lease and finds a third party to assume it.
[2] Purchase option assignment relates solely to purchasing the option for exercise. In this scenario, the lessee identifies third parties prior to lease termination and charges the third party an assignment fee for the rights to the purchase option at the end of the lease. This will allow the third party to assume ownership for the property or resale it as investment property to a subsequent buyer.
[3] PEB analyses are performed by Real Estate specialists to assist with determining whether leasing or purchasing a building is in the best financial interest of the Postal Service. These analyses involve 10-year cash flow projections based on relocation of services, continuance of lease, and exercise of purchase option.

Favorable Purchase Options Not Exercised

While the Postal Service generally exercised favorable purchase options, opportunities exist to improve the process. Of the 195 leases reviewed, six (or 3 percent) contained options that were economically favorable but were not exercised. These six options would have resulted in about $1.3 million in cash savings had officials exercised the options. We based these cash savings on a 2-year average of a projected 10-year cash flow comparing purchase option exercise versus lease continuance.

Due to Postal Service Headquarters Finance's direction, Facilities officials primarily focused on purchase options with a 2-year payback. Very few lease purchase options met this requirement. Despite a focus on lease purchase options with a 2-year payback, we observed the exercise of six purchase options with more than a 2-year payback during our audit. Management denied three of the six lease options representing $424,109 in cash savings to the Postal Service because they did not yield a 2-year rent to option price payback.[4] However, these leases were within Facilities' historical standard of a 10-year rent to option price payback.[5]

Facilities Headquarters officials denied the remaining three leases representing $893,131 in cash savings to the Postal Service due to better opportunities that were not quantified. These leases were within Facilities' historical 10-year payback measurement but did not meet 2-year payback requirements; however, when the new annual rents were negotiated they did meet the 2-year payback requirement. Furthermore, the new lease terms do not include purchase options. The following is a detailed explanation of these three leases:

- **Baraboo, WI –** A 6,569 SF facility with a purchase option of $80,000 and a current market value of $1.2 million. The Postal Service was transitioning from a 40-year lease with the expectation of a higher annual rent in future lease terms. Subsequently, the Postal Service entered a lease that increased the annual rent from $10,894 to $39,954. Based on the new negotiated annual rent, the purchase option meets the 2-year payback status required by Finance. The new lease does not include a purchase option.

- **Stevens Point, WI –** A 17,291 SF facility with a purchase option of $200,000 and a current market value of $1,660,000. The Postal Service was transitioning from a 40-year lease set to expire in November 2011. As of December 2011, there was no negotiated annual rent in the system because the lessor insisted the Postal Service assume all maintenance responsibility. The lessor requested an increase in annual rent to $166,226, to include the Postal Service assuming all maintenance. There was also an escalation in rent to $185,782 to begin in 2014. The prior annual rent

[4] Two-year payback calculations are performed by multiplying the annual rent by two and comparing that to the option price. If the option price is less than the 2-year rent calculation, the purchase option exercise is determined to be potentially favorable and requires further analysis.
[5] Ten-year payback calculations are performed by multiplying the annual rent by 10 and comparing that to the option price. If the option price is less than the 10-year rent calculation, the purchase option exercise is determined to be potentially favorable and requires further analysis.

was $17,438. The new annual rent exceeded Finance's 2-year payback requirement. By exercising this favorable purchase option, the Postal Service could have avoided the long lease negotiation with the lessor.

- **Kirksville, MO –** A 9,974 SF facility with a purchase option of $200,000 and a current market value of $320,000. The Postal Service was transitioning from a 50-year lease with an expected current rent in excess of $100,000 a year.

These six option exercise opportunities were missed because there is no financial measurement or criteria to support why certain option exercises are approved and others are not. Officials stated they denied the purchase option due to limited capital funding and greater return on other projects. However, there were no specific criteria to support why options exercised with more than a 2-year payback were approved and others were denied. The decision to deny or approve an option exercise at the Facilities Headquarters level was subjective and focused on one lease at a time instead of taking into account the economic benefits of all leases subject to exercise in a given fiscal year. Not exercising favorable purchase options could result in additional cash outlays for long-term lease obligations.

Third-Party Assignment of Lease Purchase Options

Postal Service officials had opportunities to generate revenue from assigning purchase options for 57 leases which were subject to termination. Twenty-one of the 57 leases, which are scheduled for termination or identified as potential terminations, contain options that could be assigned to third parties to generate revenue, while the remaining 36 leases opportunities ceased because the terminations were cancelled.

The Postal Service did not use its ability to assign purchase options to third parties in the real estate market to its economic advantage because standard operating procedures (SOP) did not require Facilities personnel to consider the assignment of leases or purchase options. However, the Postal Service could create an additional revenue stream of $986,000 by assigning options of 21 leases identified for termination to interested third parties. The Postal Service could have generated about $1.4 million in revenue for the 36 leases that were initially subject to termination and consolidation efforts. See Appendix B for additional information on leases that potentially qualify for third-party lease assignment.

There are legal considerations to take into account before assigning purchase options to third parties. Generally, lease purchase options are assignable without the consent of the lessor; however, there are two possible limitations on assignment of a lease purchase option. First, a provision of the contract might explicitly prohibit assignment, or require the lessor to consent to any assignment. Second, many state statutes permit lessees to assign option contracts; however, at least one state (Texas) prohibits the assignment of leases without the lessor's approval. Three of the 57 leases reviewed related to properties in Texas. Because the provisions of each lease purchase option will vary by state, the Postal Service must avoid assigning a lease purchase option when they are prohibited from doing so, or prohibited from doing so without the lessor's consent.

Purchase Existing Building Analyses Not Performed

Facilities officials did not perform PEB analysis on eight of 195 leases reviewed that included potentially favorable purchase options. SOP require Real Estate specialists to perform an analysis to determine the viability of purchase option exercises. In six of the eight leases, Facilities personnel indicated that PEB analyses were not performed due to future opportunities to exercise options. In two of the eight leases, exercise opportunities were missed and the new leases no longer have a purchase option. We determined these leases had favorable options by performing the preliminary 10-year payback analysis as well as the cash flow analysis typically performed by the Real Estate specialists. These leases in total represent a potential $252,889 in cash savings to the Postal Service if the options were exercised. Not performing required PEB analysis for favorable purchase options results in missed opportunities for exercising purchase options and negative cash flow corresponding to long-term lease obligations in subsequent years.

Purchase Options for Leased Properties of Less Than 6,500 Square Feet

Leased properties of less than 6,500 SF were not considered for option exercise, even when the options were economically favorable to the Postal Service. SOP did not require the Postal Service to review or perform an analysis for leased properties of less than 6,500 SF. Facilities officials asserted that there was minimal cost benefit related to the option exercise of these leases. However, as a best practice, the Great Lakes Area FSO reviewed purchase options for leased properties of less than 6,500 SF. Facilities officials approved an option submitted by the Great Lakes FSO for a 2,002 SF facility in Blanchardville, WI, with a purchase option of $1 and a current market value of $215,000. The exercise of the purchase option resulted in a positive cash flow to the Postal Service of $357,037.

Five leases reviewed, each for properties of less than 6,500 SF, contained purchase options of $1 that, if exercised, would have represented about $134,657 in cash savings to the Postal Service. Not reviewing purchase options based on building size alone could lead to missed purchase option exercise opportunities.

Recommendations

We recommend the vice president, Facilities:

1. Develop an objective methodology to quantify and prioritize opportunities for favorable purchase option exercises.

2. Establish procedures for assigning lease purchase options to third parties in the real estate market.

3. Reiterate the importance of performing the required analysis on potentially favorable purchase options despite future opportunities to exercise.

4. Revise procedures to evaluate lease purchase options for leases occupying less than 6,500 square feet.

Management's Comments

Management generally agreed with all the recommendations but disagreed with the analysis related to the economic benefits the Postal Service lost by failing to exercise or assign purchase options and disagreed with the associated monetary impact. Management stated that we oversimplified the analysis required before exercising a purchase option by failing to consider the facility and property condition.

Regarding recommendation 1, management agreed to clarify the methodology used to quantify and prioritize favorable purchase options, which includes a reasonable timeline for completing each step, by October 31, 2012. For recommendation 2, management agreed to update procedures by December 31, 2012. For recommendations 3 and 4, management agreed to send a memorandum to Facilities staff to reiterate the importance of performing required analysis of all purchase options, regardless of facility size, by September 30, 2012.

Management agreed that $424,109 and $893,131 represent opportunities that could have been captured if the Postal Service had the capital available to exercise favorable purchase options. However, in response to ongoing financial challenges, Finance has implemented a revised payback requirement equal to 2 years. This, coupled with other factors, were the basis for declining these purchase options.

Management disagreed with $986,000 in additional revenue that could have been generated by assigning 21 leases with purchase options to third parties whereby the Postal Service intends to terminate such leases. Additionally, management disagreed that $1,456.509 in revenue was lost based on 36 leases no longer having assignment opportunities due to the cancellation of the termination. Management stated that, without the Postal Service as a tenant generating cash flow, the value an investor would be willing to pay is significantly reduced.

Management disagreed with the assumption that the Postal Service could earn an assignment fee equal to a percentage of the purchase option fee. Management stated that the correct analysis would assume that if there were interested parties, the option would be sold competitively on the open market based on the arbitrage that could be created between the market value of the property and the purchase option fee. Management did acknowledge the current lack of a formal procedure for assignment of purchase options.

Lastly, management stated that we assumed that for every property for which the Postal Service did not exercise the option, there was a market for assigning the option. They stated that the commercial real estate market has been relatively flat and the length of time that a property is on the market has increased in most areas. As such, assuming that every purchase option is readily or easily assignable is tenuous. See Appendix D for management's comments in their entirety.

Evaluation of Management's Comments

The U.S. Postal Service Office of Inspector General (OIG) considers management's comments responsive to the recommendations and corrective actions should resolve the issues identified in the report.

In response to management's statement that we failed to consider facility and property conditions and other factors in our analysis of favorable options, we used Facilities' staff present value calculations as well as market valuations to determine monetary impacts. Our calculations agreed without exception to the Facilities lease files reviewed and there were no significant facility condition or maintenance issues noted in the files.

Management opposed the third-party assignment of lease purchase options. They stated that, without the Postal Service as a tenant generating cash flow, the value of the property would be borne by the investor. Our analysis took into consideration the fact that the Postal Service would no longer have tenancy at the property and assumed investors would purchase the property based on their ability to identify tenants that would pay rent no less than the current Postal Service rate. The rent estimate is conservative because most Postal Service long-term lease agreements are below fair market value. We performed net present value calculations with conservative rates of return as low as 1 percent for real estate and investor rates of return. Based on these assumptions, 57 of 1,538 leases resulted in a positive investor cash flow. We did not consider an investor's ability to obtain the property and sell as opposed to leasing, which would have yielded significantly higher results, due to the complexities of this type of analysis. This further supports our conservative approach to identifying investor opportunities and our efforts not to oversimplify the nature of this transaction.

Management also disagreed that the Postal Service could earn an assignment fee equal to a percentage of the purchase option fee. Our research on the lease assignment process noted examples of lease assignment and commissions or fees corresponding to these transactions. We do agree that lease assignment based on a percentage of the option price is not the only way to increase revenue; however, it represents our most conservative estimate. For example, estimates associated with fair market values would yield greater results and be more difficult to quantify given real estate market trends.

Management further stated that we assumed that for every property for which the Postal Service did not exercise the option, there was a market for assigning the option. The intent of the audit was to identify third-party lease assignment opportunities to assist the Postal Service with its revenue-generating efforts. We considered the legality of the assignment of lease purchase options and eliminated leases in Texas where we noted specific restrictions. We do, however, agree that there may be some difficulty assigning all of the lease purchase options we identified.

The OIG considers recommendations 1 through 3 significant, and therefore requires OIG concurrence before closure. Consequently, the OIG requests written confirmation when corrective actions are completed. These recommendations should not be closed in the Postal Service's follow-up tracking system until the OIG provides written confirmation that the recommendations can be closed.

Appendix A: Additional Information

Background

Postal Service Facilities officials administer over 24,000 leases representing about $820 million in annual rent. Each FSO has Real Estate specialists who are responsible for negotiating, executing, and tracking leases. The Postal Service has about 2,252 leases with purchase options recorded in the electronic Facilities Management System (eFMS). With regard to lease purchase options, the FSO performs lease versus buy analyses to determine the cost benefit of either renewing a lease or purchasing the existing building.

On June 11, 2010, Facilities officials implemented SOP to assist in tracking and executing lease purchase options. The procedures require the review of all leases for properties larger than 6,500 SF and exercisable within 18 months, as a result. Leases for properties of less than 6,500 SF do not require a purchase option review. Prior to implementing SOP, specialists did not perform a detailed review of purchase options and were more focused on lease renewals resulting in the continuance of annual rent.

The lease purchase option process consists of a specialist verifying future facility requirements and determining the condition of the structure. The postal operations analyst prepares a preliminary lease versus buy analysis to determine whether the purchase of the facility would be beneficial to the Postal Service. If the preliminary analysis indicates the purchase would be advantageous, the specialist conducts the required due diligence, including submittal of an environmental and intergovernmental notice.[6]

The specialist may obtain an appraisal of the property to determine its value and, after gathering the final cost information (offer price, maintenance expenses, and leased fee value), the analyst, with input furnished by the specialist, makes a lease versus buy determination. If the determination is favorable, a recommendation to purchase the existing building is submitted to headquarters for review and then to the Funds Investment Committee (FIC)[7] for approval. The purchase option exercise can be denied at the headquarters level prior to submission to the FIC. Upon FIC approval, the property is recorded as an owned facility in the database and the old leased property record is terminated.

[6] Real Estate specialists conduct due diligence by submitting a request for an appraisal of a property and performing a detailed financial analysis related to the benefits of leasing versus buying. Due diligence also requires an environmental review that involves the determination of any potential hazards that may preclude the Postal Service from purchasing the property. During due diligence local government agencies are notified of the Postal Service's intent to purchase the property. The cost of due diligence is roughly $20,000 per lease.
[7] Postal Service approving officials may select one or more of the following types of review committees to review a capital purchase: work group, functional review team, FIC, or performance cluster. Facilities officials use the FIC to review capital projects and, after review, the FIC recommends whether or not the project should be approved.

Objective, Scope, and Methodology

Our objective was to determine whether the Postal Service exercised lease purchase options that provided an adequate cost benefit to the Postal Service. To accomplish our objective we:

- Identified and reviewed 195 leases subject to exercise 18 months past their termination dates and 18 months before their termination dates to determine whether favorable lease purchase options were identified and exercised according to SOP. Procedures require review of all lease options at facilities occupying more than 6,500 SF and exercisable within 18 months. These leases represent annual rents of $19,064,463 and purchase options of $219,051,701.

- Identified 2,252 leases with purchase options in eFMS. About 1,538 of these leases contained options that could be exercised in the next 5 years. These leases represent cumulative annual rents of $13,747,047 and purchase options of $790,592,810. We reviewed all leases exercisable within 5 years to determine whether the leases were potential third-party assignment opportunities.

- Identified 1,051 leases representing $437 million in purchase options and $39 million in annual rent for properties of less than 6,500 SF. Based on the Great Lakes best practice of reviewing these leases we reviewed all purchase options less than 6,500 SF with purchase options of $1 for potential cash savings.

- Reviewed scanned copies of original leases and purchase option details recorded in eFMS to determine whether the Postal Service was adhering to its policies and procedures. We used Postal Service criteria to support our conclusions.[8]

- Interviewed Postal Service personnel to gain further understanding of the lease purchase option process. In addition, we performed on-site reviews of 103 leases at Postal Service facilities. We conducted interviews and lease reviews at the following locations:

  - Facilities Headquarters, Washington, D.C. (48 leases reviewed — 32 in the Western Facility Service Office and 16 in the Pacific Facility Service Office).

  - Southern FSO, Dallas, TX (23 leases reviewed).

  - Great Lakes FSO, Bloomingdale, IL (32 leases reviewed).

[8] The following Postal Service criteria was used to support our conclusions: Handbook RE-1, *U.S. Postal Service Facilities Guide to Real Property Acquisitions and Related Services*; Handbook F-66 Series, *General Investment Policies and Procedures and Interim Purchase Existing Building Standard Operating Procedures* (June 11, 2010).

  - Eastern and Northeast FSOs (92 leases reviewed via desk audit and email correspondence).

- Reviewed PEB analysis and other supporting documentation to determine the cost effectiveness of Postal Service lease purchase options and related purchase decisions. We further identified best practices within Postal Service FSOs as well as industry-wide applicable to real estate purchase option exercises.

We conducted this performance audit from July 2011 through September 2012[9] in accordance with generally accepted government auditing standards and included such tests of internal controls as we considered necessary under the circumstances. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We discussed our observations and conclusions with management on July 24 and 31, 2012, and included their comments where appropriate.

We assessed the reliability of computer-generated data by running a query of lease purchase options and comparing the results of our query to data in Facilities' databases. We reviewed discrepancies and determined they were a result of timing differences related to the date the reports were generated. There were no significant deviations between our report and data from the Facilities' databases. In addition, we compared information related to purchase options to the scanned leased documentation in the eFMS. We determined that the data was sufficiently reliable for the purposes of this report.

Prior Audit Coverage

Our report titled *The Postal Service Lease Process* (Report Number SA-AR-09-006, dated September 29, 2009) concluded that the Postal Service could enhance procedures for ensuring that leases are more economically beneficial by improving internal controls related to lease processing. Facilities personnel adhered to established policies and procedures; however, FSOs could improve internal controls with regard to termination language, cost and income analyses, negotiations with national lessors, and leases under $25,000. Management partially agreed with our recommendation related to termination clauses and agreed to the remaining recommendations in their entirety.

[9] The milestones for this audit were increased from 9 to 12 months due to an increase in the scope of the audit corresponding to our findings for leased properties occupying less than 6,500 SF and third-party option assignments. Additional audit work to support these findings required analysis and review of an additional 2,589 leases.

Appendix B: Leases Subject to Third-Party Assignment

We based potential revenue estimates on the assignment fees of 2 and 4 percent in the contractual agreement between the Postal Service and CB Richard Ellis (CBRE)[10]. Our estimate did not account for individual real estate market trends; therefore, we were conservative by not using estimated fair market values and perceived buyer benefits such as location and other selling points that cannot be easily quantified. Table 1 and Table 2 illustrate the monetary impact of 21 leases that are viable assignment opportunities and 36 leases that no longer represent assignment opportunities.

[10] Commission rates per the CBRE contract for disposition of property is 4 percent. We used a conservative estimate of 2 percent for Level III leases with annual rents greater than $500,000 because the fixed purchase option prices were significantly higher for these leases. The 2 percent rate is the standard CBRE uses to negotiate leases on behalf of the Postal Service.

Table 1. Potential Additional Revenue Stream for 21 Leases

Post Office Name	Option Rent	Purchase Option Amount	Assignment Rate[11]	Assignment Fee
Algona	$9,400	$125,000.00	4%	$5,000
Atlanta	$436,800	$5,300,000	4%	212,000
Ballwin	$109,590	$1,400,000.00	4%	56,000
Bellevue	$34,250	$300,000	4%	12,000
Boston	$32,000	$125,000.00	4%	5,000
Brooklyn	$394,200	$4,891,153.00	4%	195,646
Burlington	$40,872	$550,000.00	4%	22,000
Chapel Hill	$44,261	$600,000.00	4%	24,000
Detroit (Northwestern Station)	$50,700	$450,000	4%	18,000
Detroit (Harper Station)	$198,000	$1,820,000	4%	72,800
Dothan	$51,521	$303,811.00	4%	12,152
Eau Claire	$42,840	$350,000	4%	14,000
Everett	$56,700	$775,000	4%	31,000
Fort Madison	$27,500	$225,000.00	4%	9,000
Glen Carbon	$70,000	$520,000.00	4%	20,800
Haddam	$46,309	$490,000.00	4%	19,600
Lanark	$10,554	$140,000.00	4%	5,600
Maryville	$18,024	$205,000.00	4%	8,200
Miles	$6,600	$49,000.00	4%	1,960
New York	$819,450	$12,000,000.00	2%	240,000
Osco	$6,300	$50,000.00	4%	2,000
Total	**Potential Revenue Stream**			**$986,759**

[11] The assignment rate is the percentage the Postal Service would charge the third party for the rights to the lease and purchase options. The rates per the table are applied as follows: Level I and II leases - 4 percent; and Level III leases - 2 percent.

Table 2. 36 Leases No Longer Representing Assignment Opportunities

Post Office Name	Option Rent	Purchase Option Amount	Assignment Rate	Assignment Fee
Brayton	$8,639	$55,000.00	4%	$2,200
Cainsville	$10,903	$98,762.00	4%	3,950
Candler	$127,414	$950,000	4%	38,000
Collinsville	$13,750	$180,000	4%	7,200
Columbus	$600,000	$8,000,000.00	2%	160,000
Commerce	$32,338	$350,000	4%	14,000
Debary	$88,660	$1,000,000.00	4%	40,000
Effingham	$26,027	$185,866.00	4%	7,435
Ellensburg	$20,850	$200,000.00	4%	8,000
Escanaba	$35,989	$380,000.00	4%	15,200
Farmville	$10,000	$100,000.00	4%	4,000
Fayetteville	$123,705	$1,340,000	4%	53,600
Franklin	$37,000	$230,000.00	4%	9,200
Huntsville	$256,874	$2,650,000	4%	106,000
Johnson City	$157,870	$1,600,000.00	4%	64,000
Lawrence	$57,300	$650,000.00	4%	26,000
Lithia Springs	$181,342	$1,500,000.00	4%	60,000
Lowell	$92,000	$1,130,000	4%	45,200
McLeansville	$46,770	$607,770.00	4%	24,311
Metairie	$17,953	$230,000	4%	9,200
Milwaukee	$45,000	$450,000	4%	18,000
Muncie	$45,000	$450,000.00	4%	18,000
Mystic	$6,889	$89,603.00	4%	3,584
Newport	$138,600	$1,440,000.00	4%	57,600
Osceola	$17,000	$200,000	4%	8,000
Ridgeley	$11,230	$117,791.00	4%	4,712
Riverdale	$209,304	$2,900,000.00	4%	116,000
Rocky Mountain	$232,236	$2,554,560	4%	102,182
Russellville	$100,000	$850,000	4%	34,000
Sandersville	$10,870	$100,000	4%	4,000
Smithfield	$17,676	$240,000	4%	9,600
San Juan	$300,000	$4,000,000	4%	160,000
Talco	$28,200	$285,000.00	4%	11,400
Trion	$80,904	$939,000.00	4%	37,560
Waco	$333,819	$3,500,000.00	4%	140,000
Wyckoff	$224,500	$859,375.00	4%	34,375
Total	**Potential Revenue Stream**			**$1,456,509**

Appendix C: Monetary Impacts

Recommendation	Impact Category	10-Year Cash Savings Calculation[12] 10-Year Cash Flow	OIG Reporting Requirement 2-Year Cash Savings Maximum[13]
1	Unrecoverable Questioned Costs[14]	$6,586,201	$1,317,240
2	Recoverable Revenue Loss[15]	986,759	986,759
2	Unrecoverable Revenue Loss[16]	1,456,509	1,456,509
3	Unrecoverable Questioned Costs	1,264,446	252,889
4	Unrecoverable Questioned Costs	673,286	134,657
Total		**$10,967,201**	**$4,148,054**

[12] Initially, we calculated cash flow projections over a 10-year period beginning in FY 2012 and ending in FY 2021.
[13] Cash flow savings are based on a 2-year average over a 10-year cash flow period in compliance with the OIG policy of maximum monetary impact projections with the exception of the finding related to third party lease assignment that was not projected based on cash flow savings.
[14] Unrecoverable questioned costs are questioned as unnecessary, unreasonable, or unsupported due to an alleged violation of law, regulation, or contract or not properly supported. Questioned costs can include lease payments which were generally in excess of market levels in the economy. This finding corresponds to lease payments since the exercise of purchase options would have avoided additional lease payments. It is determined unrecoverable because the action needed to be taken within a predetermined period of time.
[15] Revenue loss relates to revenue not realized due to policies, procedures, agreements or requirements that were lacking or not followed. Twenty-one of 57 leases are considered recoverable because they relate to leases currently subject to termination or potential termination due to active Postal Service consolidation efforts and can be assigned to third parties in the real estate market.
[16] Thirty-six of 57 leases are considered unrecoverable revenue loss because they no longer represent leases subject to termination or active Postal Service consolidation efforts and, as a result, can no longer be assigned to third parties in the real estate market.

Appendix D: Management's Comments

TOM A. SAMRA
VICE PRESIDENT, FACILITIES

UNITED STATES POSTAL SERVICE

September 4, 2012

Lucine M. Willis, Director – Audit Operations
Office of Inspector General, United States Postal Service
1734 North Lynn Street
Arlington, VA 22209-2020

SUBJECT: Lease Option Process for Postal Service Facilities
Draft Audit Report (Report Number DA-AR-12-DRAFT)

Thank you for the opportunity to review and comment on the subject draft audit report. Management appreciates the efforts the Office of Inspector General (OIG) has taken in regards to the Lease Purchase Option Process. The following is in response to the above subject audit and management's comments with respect to the findings of such audit.

Overall, management disagrees with the analysis related to the economic benefits lost by the Postal Service in failing to exercise or assign purchase options. In many cases, the Audit oversimplifies the analysis required before exercising a purchase option by failing to consider the facility and property condition, the condition of title, and the cost of due diligence to determine market value. The need for major structural or roofing repairs, the assumption of on-going maintenance of the facility, property environmental issues, and clouds on the title can significantly impact the economic benefit of ownership of a property, and as such, should be part of the analysis along with the appraised value and the purchase option price. For example, recently Facilities reviewed a $7.1M purchase option in Rochester, New York that on the surface appeared to make sense, given an annual market lease rate equal to $1.7M plus $522k for maintenance/janitorial reimbursements. However, the detailed financial analysis quickly indicated that once deferred maintenance of $1.6M and ongoing maintenance responsibilities associated with a purchase equal to $1.9M were added, the calculated net present value favored renewing the lease.

Additionally, the Audit also tends to oversimplify the analysis required of each purchase option by failing to recognize the terms of each lease, whether or not the purchase option is in fact assignable, the market value of the asset and whether or not the overall market conditions are conducive to selling/assigning such option.

Facilities management disagrees with the monetary impacts stated in the Audit as follows:

Favorable Purchase Options Not Exercised. Facilities agrees that $424,109 represents opportunity that could have been captured if the Postal Service had the capital available. However, in response to ongoing financial challenges, Finance has implemented a revised payback requirement equal to 2 years.

475 L'ENFANT PLAZA SW
WASHINGTON, DC 20260-1861
TEL: 202-268-3389
FAX: 202-268-6038
www.usps.com

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This coupled with other factors, including the cost of deferred maintenance, the cost of ongoing maintenance responsibilities and market value in relation to the purchase option strike price, were the basis for declining these purchase options.

Again Facilities agrees that $893,131 represents opportunity that could have been capture if the Postal Service had the capital available as follows:

> **Baraboo, WI:** At the time of the analysis the purchase option did not meet the 2-year payback requirement, and therefore was declined. Though the audit states the lease subsequently increased to a point whereby the 2-year payback test would have been met, the relinquishment of the purchase option was used to negotiate a below market rent.
>
> **Stevens Point, WI:** Though the analysis appeared somewhat favorable management stated that "since there is limited capital available and we are seeing much greater return on other projects, we are not going to pursue at this time."
>
> **Kirksville, MO:** At the time of the analysis the purchase option did not meet the 2-year payback requirement, and therefore was declined.

Third Party Assignment of Lease Purchase Options: Management strongly disagrees with the $986,000 in additional revenue that the audit reports could have been generated by assigning 21 leases with purchase options to third parties whereby the Postal Service intends to terminate such leases. Please note, without the Postal Service as a tenant generating cash flow, the value of the property would be reduced greatly because the risk and cost associated with re-tenanting the property would be borne by the investor.

For example, the audit report indicates the Postal Service could generate $212,000 for the assignment of the Atlanta facility lease. The Postal Service currently pays $436,800 in annual rent. Assuming a commercially reasonable capitalization rate equal to 10 percent, the estimated market value would be $4.4M. The Purchase Option Price is $5.3M, therefore, no one would be interested in paying any amount for a $5.3M option for an asset only worth $4.4M. And since the assumption is that the Postal Service is terminating, the cash flow would not be guaranteed, and hence, the value would be significantly less.

Additionally, management does not agree that $1,456,509 in revenue was lost based on 36 leases no longer having assignment opportunities due to the cancellation of the terminations. Again, as previously stated above, without the Postal Service as a tenant generating cash flow, the value an investor is willing to pay is reduced significantly. Unless there is considerable upside, there would be no market for assigning or selling the rights to the option.

Also, management disagrees with the assumption that the Postal Service could earn an assignment fee equal to a percentage of the Purchase Option Fee. This assumption is not commercially appropriate. The correct analysis would assume that if there were interested parties, the option would be sold competitively on the open market based on the arbitrage that could be created between the market value of the property and the Purchase Option Fee.

For example, given a hypothetical scenario whereby the Postal Service was remaining as the tenant with annual rent for the next 5 years equal to $200,000, the Postal Service did not have the capital to exercise the Purchase Option itself, the Purchase Option Price was set at $1M and assuming a market capitalization rate equal to 10 percent, estimated market value is $2M, then it would be reasonable to assume there would be interested parties willing to pay the Postal Service a premium for the right assume the Purchase Option. This premium would be in the range of 50 percent of the delta equal to approximately $500k for the assignment in order to capitalize on the arbitrage created between the option price and the market value.

Management does recognize the current lack of a formal procedure for assignment of purchase options. However, there are a number of factors that will need to be reviewed on a case-by-case basis to determine whether a particular purchase option is assignable and whether assignment will ultimately benefit the Postal Service. Management will consider adding a step to its current policies and procedures that advises responsible employees that assignment of purchase options should be considered where the Postal Service has determined that it does not wish to exercise the option itself, where the Landlord is unwilling to give the Postal Service any rent concessions or other benefits in exchange for relinquishing the purchase option, and/or where such an assignment would be in the best interest of the Postal Service.

Please note the language of each purchase option will control whether the purchase option can be assigned. If a lease is transferable, a purchase option included therein is generally transferable. Upon assignment of a lease, the assignee has the right to exercise the purchase option contained therein. If only a portion of the lease is assigned, no such right passes to the assignee. If a lease prohibits assignment or subleasing, a purchase option included therein is generally not transferable, but a covenant against assignment of the lease will neither prevent an assignment of the option after, nor invalidate an agreement by the tenant, made prior to the exercise of the option, to convey the property to a third party.

Additionally, the OIG assumes that for every property for which the Postal Service did not exercise the option, there was a market for assigning the option. The commercial real estate market has been relatively flat and the length of time that a property is on the market has increased in most areas. As such, assuming that every purchase option is readily or easily assignable is tenuous.

Purchase Existing Building Analyses Not Performed: Management agrees that an analysis should be completed on every purchase option, whether or not future opportunities to exercise the option exists. However, as previously requested and until the OIG identifies which 2 purchase options Facilities missed, and therefore, created a lost opportunity in the amount of $252,889 in cash savings, Management cannot respond to this monetary finding appropriately.

Purchase Options for Leased Properties of Less than 6,500 SF: Management agrees that an analysis should be completed on every purchase option.

Audit Recommendations. Management's comments with respect to the recommendations outlined in the audit report are noted below:

Recommendation 1: Develop an objective methodology to quantify and prioritize opportunities for favorable purchase option exercises.

Management Response/Action Plan: Management agrees that an objective methodology should be used to quantify and prioritize favorable purchase option opportunities. Management believes that the provisions contained in Implementing the RE-1, Chapter 5, subchapter B-55 and the November 9, 2011, version of the Purchase Existing Building – Standard Operating Procedure and related Lease Action Request/Purchase Existing Building form, contain an objective methodology. Currently, management is in process of clarifying the methodology that includes a reasonable timeline for completing each step within the process. RE-1 and all other related documents will be updated accordingly by October 31, 2012.

Recommendation 2: Establish procedures for the assignment of lease purchase options to third parties in the real estate market.

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Management Response/Action Plan: As previously stated, management acknowledges the lack of a formal procedure for assignment of purchase options and agrees to add a policy to RE-1 by December 31, 2012.

Recommendation 3: Reiterate the importance of performing the required analysis on potentially favorable purchase options despite future opportunities to exercise.

Management Response/Action Plan: Management agrees that purchase options should be analyzed regardless of whether future opportunities to exercise the option exists, but notes that the existence of such future opportunities is a relevant factor to be considered. Given the Postal Service's current financial condition, its limited personnel and resources, as well as the current condition of real estate market, management believes that in many cases it may be in the best interests of the Postal Service to defer the exercise or assignment of a purchase option to a later opportunity. Management agrees to send a memo to Facilities staff reiterating the importance of performing the required analysis on **ALL** purchase options despite future opportunities to exercise by September 30, 2012.

Recommendation 4: Revise procedures to evaluate lease purchase options for leases occupying less than 6,500 square feet.

Management Response/Action Plan: Management notes that current Facilities' policies and procedures found in Implementing the RE-1, Chapter 5, subchapter B-55, and the November 9, 2011, version of the Purchase Existing Building – Standard Operating Procedure, contain no directives limiting the evaluation of purchase options to facilities greater than 6,500 square feet, and as such, no formal revisions are necessary. Management acknowledges that as a result of the Postal Service-wide capital freeze, fiscal year 2011 training and goals included 6,500 square feet criteria as a factor to be considered in the prioritization and evaluation of purchase options. To the extent that responsible employees may have misinterpreted that factor as controlling, management agrees to issue a memo to Facilities staff by September 30, 2012, making it clear that size is merely one of several factors in the analysis and that all purchase options, regardless of facility size, should be analyzed to ensure that decisions related thereto are in the best interests of the Postal Service.

Please note, management does not believe that his report and management's responses contain information any proprietary or business information and may be disclosed pursuant to the Freedom of Information Act.

Tom Samra
Vice President
Facilities

cc: Sally K. Haring, Manager, Corporate Audit