September 29, 2009

TOM A. SAMRA
VICE PRESIDENT, FACILITIES

SUBJECT: Audit Report – Postal Service Lease Process
(Report Number SA-AR-09-006)

This report presents the results of our audit of the U.S. Postal Service's Lease Process (Project Number 09YG005SA000). Our objective was to determine whether current lease processes and procedures are economically beneficial to the Postal Service.[1] We conducted this self-initiated audit based on the operational and financial risks associated with leases. See Appendix A for additional information about this audit.

## Conclusion

Our audit of lease processes and procedures found that the Postal Service could enhance their procedures to ensure leases are more economically beneficial to the Postal Service. We found that responsible Facilities personnel were adhering to established policies and procedures; however, the Facilities Service Offices (FSOs) could improve internal controls with regard to the following:

- Termination Language
- Cost and Income Analyses
- Negotiating with National Lessors
- Leases under $25,000

We plan to do additional audit work to quantify the impact of these issues to the Postal Service.

### Termination Language

Sixty-nine percent of the leases we reviewed did not include termination language. According to Facilities personnel, FSOs are beginning to require termination language in leases, but there is no formal policy. When the Postal Service excludes termination language from leases, it is locked into long-term lease agreements that prohibit it from

[1] The original objective included determining whether the Postal Service was paying above market lease rates. We separated that phase of the audit and will complete it in future audit work.

effectively managing its real estate needs and from responding to economic downturns or opportunities for optimization. See Appendix B for our detailed analysis of this topic.

We recommend the Vice President, Facilities:

1. Develop and implement policies and procedures that require termination language in all leases. The policy should include a requirement for written justification and approval for exceptions to this policy.

## Cost and Income Analysis

Real Estate Specialists (RESs) are required to perform value analyses for leases of $10,000 or more. RESs did not document or support the methodology used for estimated variables included in their calculations of Fair Annual Rent on the Cost and Income (C&I) Analysis. The estimates used in the calculations were subjective and based on the RES's experience in the region, and there were no requirements to document or support their methodology.

Estimates based on prior RES experience increase the Postal Service's risk of paying above market rent because there is no assurance the RES is considering changes in the real estate market. See Appendix B for our detailed analysis of this topic.

We recommend the Vice President, Facilities:

2. Require Real Estate Specialists to document and support their methodology when they establish estimated variables used in the calculation of Fair Annual Rent on the Cost and Income Analysis.

## Negotiating with National Lessors

Facilities does not leverage its relationships with national lessors to negotiate lease rates, terms, and conditions. According to Facilities management, leveraging the volume of leases with national lessors to negotiate discounts is not necessary. Furthermore, there is no Postal Service policy that requires Facilities management to negotiate discounted lease rates with national lessors. We also found that leases with national lessors are spread across the country and negotiated by multiple FSOs. In addition, large national lessors develop subsidiaries that also lease property to the Postal Service under different business names. As a result, lease terms and conditions are not consistent, and the Postal Service is not realizing potential savings that could result from negotiated volume discounts. Facilities management stated they were implementing a National Lessors Program to address inconsistencies in lease negotiations with national lessors. However, management has reduced the initial staffing approved for the program by approximately 50 percent, resulting in discontinuation of program implementation.

See Appendix B for our detailed analysis of this topic.

We recommend the Vice President, Facilities:

3. Implement the National Lessors Program to ensure consistent lease terms and conditions with national lessors and include a process for negotiating volume discounts.

## Internal Controls for Leases Under $25,000

RESs negotiated and approved leases in 15 of 87 sampled leases we reviewed. This occurred because there is no requirement for independent review or approval of leases under $25,000. Therefore, there is no segregation of duties and the Postal Service is exposed to an increased risk of fraud and errors. See Appendix B for our detailed analysis of this topic.

We recommend the Vice President, Facilities:

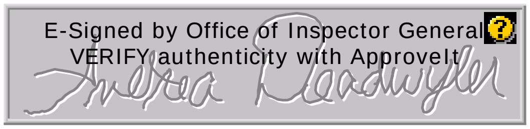
4. Implement internal controls, such as periodic reviews, for leases under $25,000, to ensure the integrity of the process and reduce risk exposure.

## Management's Comments

Management partially agreed with recommendation 1 and stated that termination clauses are valuable tools that can offer the Postal Service flexibility. However, they proposed issuing guidelines for determining the need for termination language in Level 1 and 2 leases, rather than instituting a national policy mandating documentation of reasons for not including termination language in their renewals. Management agreed with recommendation 2 indicating they would ensure adequate policies, procedures, and criteria for performing value analysis for leases of $10,000 or more. In response to recommendation 3, management agreed and proposed a re-examination of the National Lessors program in 2010, and an effort to legally determine what can be done to centrally manage each national lessor as a single entity. Lastly, management indicated they would be implementing increased internal controls to reduce risk in response to recommendation 4. In supplemental correspondence dated September 22, 2009, management stated they would take corrective action for these recommendations in November 2009 (recommendations 1 and 2), January 2010 (recommendation 3), and March 2010 (recommendation 4). See Appendix C for management's comments, in their entirety.

## Evaluation of Management's Comments

The OIG considers management's comments responsive to the recommendations and corrective actions should resolve the issues identified in the report.
We appreciate the cooperation and courtesies provided by your staff. We appreciate the cooperation and courtesies provided by your staff during the review. If you have any questions, please contact Stephen Chow, Acting Director, Inspection Service and Facilities, or me at (703) 248-2100.




Andrea L. Deadwyler
Acting Deputy Assistant Inspector General
for Support Operations

Attachments

cc: Steven Forte
Steven C. Roth
Michael R. New
All Area FSO Managers
Tim J. Perez
Bill Harris

# APPENDIX A: ADDITIONAL INFORMATION

## BACKGROUND

Facilities is an enabling organization within the Postal Service whose primary mission is to (1) provide quality real estate and facilities products and services to meet present and future needs of Postal Service organizations and (2) realize optimum value from facilities assets and transactions. Facilities is headquartered in Arlington, VA, and has eight FSOs throughout the country. Facilities' responsibilities include administration of approximately 25,240 leases that represent approximately $973 million in annual rent. The Postal Service has various levels of approval and decision analysis based on the nature of the lease. The lease approval levels depend on the lease amount and whether the Postal Service is entering into a new lease or exercising the renewal option of a current lease.

## OBJECTIVE, SCOPE, AND METHODOLOGY

Our objective was to determine whether current lease processes and procedures are economically beneficial to the Postal Service. The OIG contracted with Dr. Anthony Yezer, Professor of Economics at George Washington University, to perform a statistical analysis of Postal Service leases and identify leases that appear to be higher than market rate. Dr. Yezer performed a statistical analysis of 25,240 Postal Service leases. Dr. Yezer identified an initial set of 117 leases that appeared to be above rates typically paid by the Postal Service in each of the nine Postal Service areas. We judgmentally selected 87 of the 117 leases for our audit. Our original objective included determining whether the Postal Service was paying above market lease rates based on Dr. Yezer's analysis. However, we segregated this phase of the audit and will complete it in a subsequent audit.

We reviewed lease policies and procedures to determine whether the Postal Service was complying with them and making timely lease decisions. We reviewed 87 leases to determine whether the Postal Service leverages its business relationship with landlords by requiring them to provide them with lease incentives that are economically beneficial. The audit team also reviewed Fair Annual Rent calculations and corresponding lease documentation as well as Postal Service lease data to determine if there were justifications for the lease amounts. In addition, we interviewed personnel responsible for entering into and renewing leases and reviewed applicable policies and procedures governing the lease process.

Policies and procedures from the following Postal Service publications govern the lease process:

- Handbook RE-1[2]
- *Administrative Support Manual* (ASM) 13[3]
- Handbook F-66A[4]
- Handbook F-66C[5]

We conducted this performance audit from November 2008 through August 2009 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 objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. We discussed our observations and conclusions with management officials on August 6, 2009, and included their comments where appropriate.

We used computer generated data from the Postal Service's electronic Facilities Management System (eFMS) and data provided by Dr. Yezer. We verified the validity and reliability of eFMS and Dr. Yezer's data by comparing it to actual lease documentation.

## PRIOR AUDIT COVERAGE

We did not identify any OIG or Government Accountability Office reports related to Postal Service leases within the past 3 years.

[2] *U.S. Postal Service Facilities Guide to Real Property Acquisitions and Related Services,* Section 333.1, October 2008.
[3] *Administrative Support Manual* 13, Sections 512 and 513, Issue July 13, 1999, updated through January 1, 2009.
[4] *Investment Policies and Procedures - Major Facilities,* Chapters 2 and 3, January 2006.
[5] *Field Investment Policies and Procedures,* Chapters 2 and 3, March 2006, updated through April 13, 2006.

# APPENDIX B: DETAILED ANALYSIS

## Termination Language

Sixty of the 87 Postal Service leases we reviewed did not include early termination language. This occurred because Postal Service policy does not require termination language in leases. Early termination options give the Postal Service the ability to terminate leases if the current lease is not advantageous either operationally or financially. Lessors typically insist on excluding termination clauses in leases because they eliminate the guarantee of a long-term revenue stream. In addition, RESs exclude termination language from leases if they believe inclusion will result in a higher rent.

The Optimization team, led by the Eastern Area FSO, has identified approximately 140 Level 3[6] leases that had termination clauses and is in the process of determining if management can consolidate operations within these facilities. The Optimization team has recognized the importance of including termination language in leases and the Eastern Area FSO requires justification and approval for leases without termination language.[7]

## Cost and Income Analysis

Handbook RE 1, requires performance of a value analysis before every purchase, sale, or lease of real property that is valued at $10,000 or more.

We reviewed cost and income analysis performed by the RESs for the 87 leases included in our audit to determine Fair Annual Rent. Cost and income analyses typically contain the following four cost approaches for calculating Fair Annual Rent:

1) A Cost Approach that takes into account the estimated useful life of the building, the replacement cost of the building, land value and landlord expenses, and rates of return.

2) A Present Annual Contract Rent Approach based on the current rent multiplied by a projected annual rent percentage increase and lease term.

3) A Marshall and Swift (MS) Approach that uses national MS cost estimates to determine annual rent.

4) A Comparable Area ZIP Code Average Approach that calculates the average rent for similar Postal Service facilities in the same ZIP Code.

[6] Leases with annual rent above $150,000.
[7] Although the Eastern Area FSO requires justification before a lease is approved without termination language, this is not a national practice.

Our audit found that estimates RESs use in these valuations are primarily based on their experience in the region. RESs did not document or support the methodology they used to calculate Fair Annual Rent on the Cost and Income Analyses. In all of the cost and income calculations reviewed in our sample there were one or more variables critical to Fair Annual Rent determination that were primarily based on RES experience with no support for the methodology. Furthermore, facilities does not have a policy that requires them to document or support their methodology. Estimates based on prior RES experience increase the Postal Service's risk of paying above market rent because there is no assurance that changes in the real estate market are being considered.

## Negotiating with National Lessors

In our review of lease documentation, we concluded that Facilities does not leverage its relationships with national lessors when negotiating lease rates and other terms and conditions. National lessors are landlords who have multiple leases with the Postal Service across the country. We identified two national lessors in our sample that, combined, have approximately 961 active leases with the Postal Service. Per discussion with a manager at one area FSO, lessors use the Postal Service's inability to move to their advantage during lease negotiations.

We also found that leases with national lessors are spread across the country and are negotiated by multiple FSOs. In addition, large national lessors develop subsidiaries that also lease property to the Postal Service under different business names. As a result, the Postal Service has not established consistency in the terms and conditions included in leases with national lessors and lessors use favorable terms negotiated in one area as leverage when negotiating with another. Facilities was in the process of establishing a national lessors program intended to address this issue by creating consistency in lease terms and conditions with national lessors; however, management reduced initial staffing approved for the program by approximately 50 percent, resulting in discontinuation of program implementation.

## Internal Controls for Leases Under $25,000

We reviewed a sample of 87 leases and identified 38 that were under $25,000. Fifteen of the 38 leases under $25,000 were negotiated and approved by the RES. According to Standard Operating Procedures, the RES conducts lease negotiations with the lessor and the Contracting Officer (CO) reviews and approves the signed lease. After the CO approves the lease the district approves it. However, through interviews with FSO management, we found that RESs typically have contracting authority for leases of up to $25,000 annual rent. We also found in our review of lease approval documents that some leases were negotiated and approved by the same individual. In one of the 15 exceptions noted, an RES negotiated and approved a lease that was identified as above market on the lease negotiation summary. Because there was no segregation of duties, the RES was the only person aware of this above market rent negotiation. A weak control environment results in undetected errors, above market rents, and an increased risk of fraud.

The U.S. Government Accountability Office's *Standards for Internal Control in the Federal Government* requires adequate segregation of duties related to approval processes. The Eastern Area FSO developed local policies that do not allow a RES to negotiate and approve the same lease; however, this is not the policy nationwide. Facilities does not have a national policy that prohibits an RES from negotiating and approving the same lease.

# APPENDIX C: MANAGEMENT'S COMMENTS

TOM A. SAMRA
VICE PRESIDENT, FACILITIES

UNITED STATES
POSTAL SERVICE

September 15, 2009

LUCINE M. WILLIS
DIRECTOR, AUDIT OPERATIONS

SUBJECT: Transmittal of Draft Audit Report—Postal Service's Lease Process (Report Number SA-AR-08-DRAFT)

This is in response to the Draft Audit Report Number SA-AR-08-Draft, Transmittal of Draft Audit Report—Postal Service's Lease Process.

**Termination Language**

Recommendation 1:
The Office of Inspector General (OIG) recommendation is to require termination language in all leases. The OIG cites the Eastern Area as requiring termination language in all its leases and believes this area policy should be nationalized in order to ensure maximum operational and financial flexibility.

Response 1:
While Facilities agrees with the premise that termination clauses are valuable tools that can offer the United States Postal Service (USPS) flexibility, we disagree that a national policy mandating Facilities Service Offices (FSOs) document the reasons for not including termination language in their renewals. We believe a more practical and efficient approach is for the optimization teams to provide this guidance to their Real Estate Specialists (RESs) based on the need (or lack thereof) for the facility. The OIG cites this observation in their assessment noting "the Optimization teams have recognized the importance of including termination language in leases and…".

Facilities also believe financial and operational flexibility can be achieved in ways other than the inclusion of termination language in lease renewals. Depending on external and internal factors, short term lease extensions, month-to-month or year-to-year leases and even holdover language offer ways to achieve the same operational and financial flexibility objectives at a lower cost and with less time and effort. In short, the tool to achieve the desired result should be determined by the situation rather than by national "one size fits all" policy. A lease renewal strategy can then be established in the context of all available options.

Facilities propose the issuance of guidelines on how the FSO management team should work closely together in order to determine the need for termination language in its Level 2 and Level 1 leases. This approach is already employed for Level 3 leases. The Facilities Vice President, Realty Asset and Lease Management Manager, National Optimization Manager and FSO Managers have a bi-weekly telecom to discuss lease renewal strategy. Similar discussions would occur for Level 2 and Level 1 leases. Such an approach will emphasize what the RESs should

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be doing and give them greater insight and engagement into the when and why lease termination clauses should be used. This approach, coupled with OIG recommendation 3, which we agree with will, we believe, achieve the same objective of operational and financial flexibility in a more effective and efficient way.

**Cost and Income Analysis**

Recommendation 2:
The OIG recommendation is to require RESs to perform value analyses for leases of $10,000 or greater so as to eliminate subjectivity and provide documented support for their thought process.

Response 2:
We agree with this recommendation and will review our internal procedures and make sure that there are adequate policies, procedures, and criteria in place to perform value analyses for leases of $10,000 or greater so as to eliminate subjectivity and provide documented support for their thought process. Please see "Determining Annual Rent" section A3.3.3. attached as exhibit A. Negotiating with National Lessors

**Negotiating with National Lessors**

Recommendation 3:
The OIG recommendation is for Facilities to follow through on an earlier initiative to form a National Lessors Group in order to ensure consistent lease terms and conditions with National Lessors and include a process for negotiating "volume" discounts.

Response 3:
Facilities concurs in concept with the objective of this recommendation. We also noted that there are several legal and operational hurdles that must first be overcome in order for such a group to be effective. The OIG Audit Report was correct in recognizing these obstacles. The first and foremost obstacle is the varied ownership structures national lessors have established. Such structures make it legally impossible for the USPS to leverage a national lessor's extensive holdings to our advantage. One example is our inability to deduct the cost of deferred maintenance the landlord is responsible for from other facilities the same landlord owns. Facilities, in conjunction with Legal, have already decided to undertake a joint performance objective in fiscal year (FY) 2010 to rectify this situation.

The OIG also correctly recognizes that negotiations with national lessors, while consistent within an FSO, are not necessarily consistent across FSOs. Regardless of whether or not there is an organization change, Facilities concurs that policy and procedure guidance when dealing with a national lessor must be consistent. Step 1 is to be able to flag and run national lessor lease expiration reports. Facilities is working to correct this situation within eFMS. Concurrent with this initiative National Real Estate will review policy in order to determine which lease terms and conditions, and well as approval levels, must be changed in order to get consistency across the entire portfolio. As the OIG noted in recommendation #1, termination clauses are but one example of where a national lessor will aggressively push to exclude lease language that is not in their best interest.

Finally, the OIG correctly recognized the subsequent elimination of 50 percent of the positions targeted for the National Lessors Group. Without reinstatement of these positions such a group will be unable to perform this work. Facilities proposes, concurrent with the above noted initiatives, a re-examination in FY2010 regarding the formation of a National Lessors Group against other options such as a matrixes structure, outsourcing, etc. Based upon this re-examination, a proposal for review and discussion can be integrated with what can legally be done to centrally manage each national lessor as a single entity rather than hundreds of separate entities.

**Internal Controls for Leases under $25,000**

Recommendation 4:
The OIG recommendation is to implement internal controls so as to ensure the integrity and reduce risks with the process. Specifically, change the Standard Operating Procedures so that the RES who conducts the lease negotiations cannot also be the Contracting Officer, thereby reviewing and approving his or her own negotiated transaction.

Response 4:
We agree with this recommendation and will review our internal procedures and make sure that there are adequate policies, procedures, and criteria in place and change Standard Operating Procedures so that the RES who conducts the lease negotiations cannot also be the Contracting Officer.

In conclusion, we appreciate the efforts of the OIG audit team in the review of the Postal Service's Lease Process.

TN

Tom A. Samra

Attachment

cc: Bill Harris
Manager, Realty Asset and Lease Management
Manager, Program Support

# EXHIBIT "A"

4. *Land Leases Exceeding $25,000 Per Annum*
   Leases (or Ground Leases) for unimproved property (land only) with an annual rent exceeding $25,000 and currently occupied/used by the Postal Service may be renewed and executed by the contracting officer following the initial, first-time written approval of the USPS Law Department ethics official and the National Manager, Realty Asset and Lease Management.

   Leases (or Ground Leases) for unimproved property (land only), *not previously occupied by the Postal Service*, with an annual rent exceeding $25,000 may be executed by the contracting officer with written concurrence from the USPS Law Department ethics official and the National Manager, Realty Asset and Lease Management.

   > ***Note:*** Once an approval is obtained, future contract renewals of any type may be executed by the CO as long as there is no change affecting the ownership.

A3.3.3 Determining Annual Rent

*Annual Rent $25,000 or Less*

While it is always preferable to conduct negotiations with the landlord in person, this is often impractical and not cost-effective. For leases with annual rents of $25,000 or less, it is acceptable to prepare the lease contract and send it to the landlord via mail or e-mail without preliminary contact. This process is often referred to as the "cold-call" process.

Leases with an annual rent of $10,000 or less may be prepared relying on general knowledge of real estate values in the facility's geographic area. No formal "determination of value" is required to estimate the annual rent. Most, if not all, leases in this category are sent to the landlord using the cold-call process.

Leases with an annual rent between $10,000 and $25,000 require a "determination of value" before beginning negotiations or preparing a cold-call lease. Use the Average Rent in the 3-digit ZIP Code report in *e-RECS* to determine the average rent for post offices in this area. If the proposed rental rate is less than or equal to the average rate in the report, no additional calculation is required. However, many RES's and CO's still prefer to make an additional determination or justification of value, using one or more of the following formats: a cost and income approach; a Marshall and Swift cost valuation analysis; rental comparables, if available; or other documentation as required by the Real Estate Contracting Officer, FSO.

Cold-call leases are sent to the landlord requesting that the landlord review the proposed contract thoroughly as the contract documents have most likely changed since the last contract was executed. The transmittal letter or e-mail must include the following language:

> *All owners of record are advised to read the lease thoroughly to ensure that each party is in total agreement with the terms and conditions of this document. Although the terms and conditions may generally be the same, some changes may have been made. Do not assume that this document is identical to our existing contract with you.*