GSA's Shift on Occupancy Agreements

By Norman Dong, Joe Delogu, and Chad Habeeb

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What Just Happened?

GSA's recently issued Asset Management Alert, which now requires Federal tenant agencies to sign non-cancellable Occupancy Agreements (OAs), is an unfortunate step in the wrong direction. Although the objective to mitigate the financial liability of vacant leased space makes sense, the Agency's course of action does not. This recent GSA policy change will increase leasing costs, decrease real estate values for Government-leased properties, and compromise the Agency's overall value proposition in managing the Federal real estate portfolio.

The GSA OA reflects the business terms governing the relationship between GSA and the tenant agency for a specific space assignment. It includes a description of the space and services, the financial terms, and the length of the tenancy. GSA has traditionally utilized a "cancellable" version of its OA, which allows tenant agencies to return unneeded space back to GSA with 120-days' notice. In contrast, GSA has reserved the use of "non-cancellable" OAs for more specialized Agency requirements where there is little chance that another agency or tenant would be able to use the space.

The cancellable OA has long been a central element of the Agency's value proposition. It allows GSA to provide a form of "insurance" by serving as a clearinghouse for unneeded space and mitigating the risk of any change in an agency's space requirements across the broader portfolio of Federally owned and leased assets. For decades, the cancellable OA has provided tenant agencies with the assurance to make thoughtful and deliberate decisions about their long-term space requirements knowing that should things change over time, GSA would have their back and allow them to return excess space that other Federal tenants might use.

The Unintended Impacts of the GSA Policy Change

The GSA Asset Management Alert issued in April 2023 suspends the concept of the cancellable OA and eliminates the ability for tenant agencies to return leased space back to the GSA portfolio. GSA issued this Alert in response to decreasing demand for general office space in a post-pandemic environment and its mounting financial liability as agencies exercise their right to return space. Clearly, GSA needed to take some action.

But the Agency is taking the wrong approach. The interim guidance, which sunsets at the end of FY2024, narrowly focuses on the potential problem of Agency space givebacks but disregards GSA's larger role in managing the Federal real property portfolio. This draconian policy change will create a multitude of problems in the short term that will far outweigh any future benefits that the Government may realize over the longer term.

As GSA shifts to non-cancellable OAs for all new leases, agencies will now opt for the shortest least term possible as they must now shoulder the economic burden of excess real property. Over the past decade, the Federal Government has embraced longer lease terms that maximize competition and allow landlords to secure lower financing costs, in turn, passing these savings onto tenant agencies in the form of lower leasing costs. As the Government reverts to shorter lease terms, these benefits will be lost.

The reduction in firm terms resulting from the recent GSA policy change will produce an immediate set of economic problems for the Government:

- **Increase in Financing Costs:** Shorter lease terms will lead to an increase in financing costs for building owners. The Government's reversion to shorter lease terms will create additional uncertainty and risk for building ownership because the cost of financing becomes much more expensive or potentially unavailable altogether. These increased costs will ultimately be passed on to tenant agencies as higher rent.

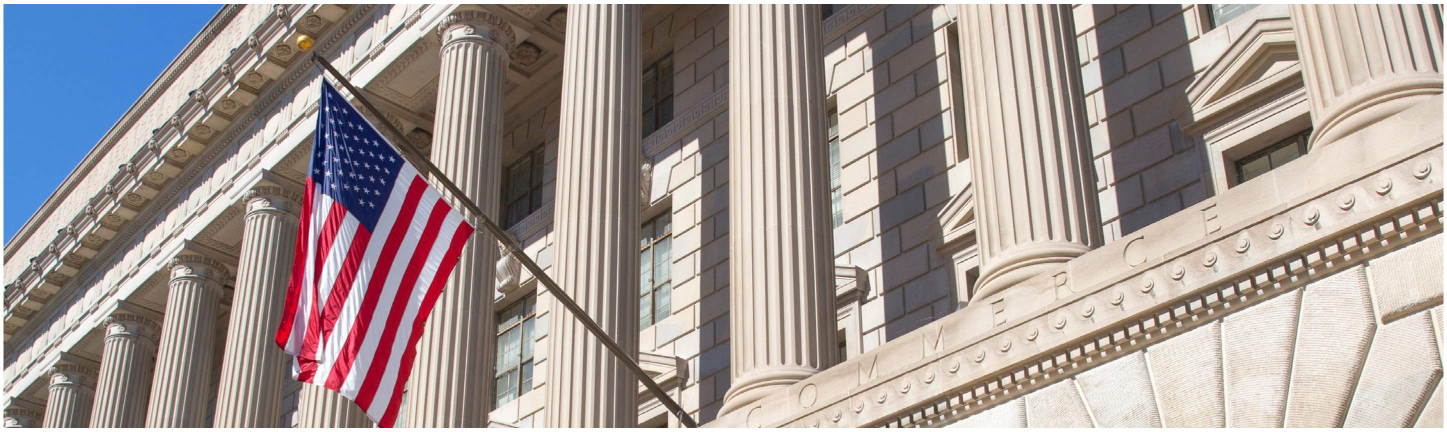
- **Reduced Competition:** With shorter lease-term commitments, we should expect to see a sharp reduction in competition for Federal leases. For new or replacement leases with a relatively short firm-term (e.g., five years instead of ten years), the Government is artificially constraining the amount of time for potential bidders to recoup their costs, effectively handing the incumbent lessor a significant home court advantage - decreased competition further results in higher costs to tenant agencies.

- **Hyper-Amortization Impact:** As the Government reverts to shorter lease terms, tenant improvement costs to prepare the space must now be capitalized over a shorter duration. This "hyper-amortization" of improvement costs will dramatically increase rents as tenant agencies pay considerably higher rent for essentially the same product.

Looking beyond the economic impact, the GSA policy shift will also generate significant management problems for the Government:

- **Compounding the GSA Workload:** With approximately 1000 leases expiring each year, GSA has struggled to keep up with the annual workload. As agencies reduce their lease terms, the annual caseload of expiring leases will skyrocket, and GSA will struggle to service its client agencies in a timely manner.

- **Shifting Portfolio Management Responsibility to Tenant Agencies:** The Federal Government will always have excess space in its leased portfolio as mission and facility requirements evolve over the course of time. By shifting to non-cancellable OAs, GSA is forcing tenant agencies to "fend for themselves" when space is no longer needed.



A More Effective Approach to Managing Risk

By adopting a one-size fits all non-cancellable OA policy for all new leases, GSA is abdicating its powerful insurance role in managing the Government's civilian real estate portfolio. The policy change begs the question of the Agency's value proposition in managing Federal real estate. Is the role of GSA to be the order-taker, acting simply as a pass-through between tenant agencies and private lessors? Or should GSA take a more proactive role that considers the needs of tenant agencies based on the owned and leased space under Government control?

If GSA intends to reduce the potential cost exposure of vacant lease space, far more effective approaches are already in use by other public and private sector organizations. These include:

- **Reassigning Vacant Space to Address Agency Requirements:** The Federal Property and Administrative Services Act of 1949 gives GSA with the authority "to assign and reassign space of all executive agencies in Government-owned and leased buildings." More effective portfolio planning would help enable the Government to utilize its space more efficiently by reassigning existing space to address agency requirements.

- **Sub-tenanting Vacant Space to the Private Sector:** In the private sector, sub-leasing space is a common tool for mitigating the financial liability of vacant leased space. GSA can also backfill vacant leased space to private-sector tenants but rarely exercises this authority. One exception was in December 2015, when GSA identified a private sector backfill tenant for a million-square-foot vacant warehouse in Burlington, NJ, for the full term of the remaining lease, saving taxpayers more than $23 million. There is no reason why GSA should not be fully using this standard real estate practice to mitigate its vacant lease liability.

- **Negotiating a Lease Buyout:** When a leased space is no longer needed, commercial tenants sometimes negotiate buyout arrangements to reduce future lease liability. In certain situations, the Government and the landlord may have a mutual interest in the Government exiting the lease early. As GSA looks to mitigate the risk of vacant leased space, the Agency should determine where the Government may have an economic advantage in buying out specific leases.

GSA must take a more thoughtful and strategic approach that utilizes the full set of tools at its disposal to manage the Government portfolio more effectively. The move to non-cancellable OAs reflects a blunt instrument approach that does little to stem the tide of current space givebacks and simply transfers the economic risk to the tenant agencies. GSA has a statutory mandate to consider the real estate needs of each Federal tenancy within the larger context of a Government-wide portfolio strategy. GSA must not disregard this mandate.

For questions about this white paper please contact:

Norman Dong
Managing Director
FD Stonewater
ndong@fdstonewater.com

www.fdstonewater.com