BUILD OR LEASE

A Report Prepared for the
Legislative Finance Committee

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LFD
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INTRODUCTION

This report will provide an overview of the laws related to providing new space through either a build or lease option, provide a historic view of how the state's owned and leased space have changed over time, and review the build versus lease model used in the Montana Capitol Complex Masterplan, with the end goal of providing an increased understanding for the case of build or lease.

DOA is charged with the provision of state space, either through building or leasing. The Architecture and Engineering Division (A&E) provides administrative services for the construction of state buildings and the General Services Division (GSD) provides administrative services for leased space (these functions are not exclusive).

PRESSURES FOR NEW SPACE

Pressures for new state space can impact the efficient functioning of state government and the state's financial resources. As discussed in the Legislative Fiscal Division's (LFC) December infrastructure report, the reasons for various pressures are numerous. In the December report, the pressures were referred to as "drivers" of new space. For state government, these included:

1) Agency growth (growth in the workforce),
2) New programs (growth in the population served and changes in the provision of services),
3) Facility obsolescence,
4) Replacement of leased space, and
5) Consolidation of personnel and function.

To demonstrate how pressures drive the need for new space, an example of the pressures at play was apparent in the 2015 Legislature's decision to provide space for the Eastern Montana forensic lab. Pressures for that new space included increased staffing levels (1) and increased level of workload, given the growth in forensic analysis needs (2). The 2015 Legislature decided that the new space should be leased rather than built as state owned space and provided general fund support for the costs of the lease.

The University System experiences similar pressures with the additions of the following:

6) Growth in student populations, and
7) Availability of donations for new buildings.

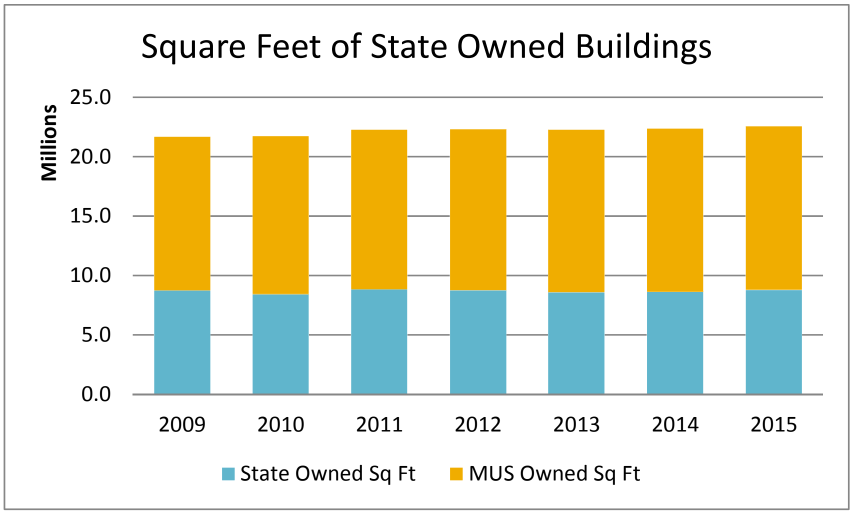
An example of clearly visible pressures at the Montana University System (MUS) was the authorization for the construction of new state-owned space in Hamilton for the Bitterroot College, approved by the 2015 Legislature. Pressures for new space included expected increases in the number of students (6) and the potential for the addition of functions (2) at the college. Furthermore, the project would replace leased space with state-owned space (4) and would be financed with of non-state monies (7). The decision of whether to build or lease is made easier when financial pressures are not involved.

THE BUILD OPTION

For the construction of a new building or an addition to an existing building, the agency must request the project in the Long-Range Building Program (LRBP). Statute directs that the construction of buildings, specifically buildings constructed or purchased with state money; at a state institutions; owned or to be owned by a state agency; or constructed for the use or benefit of the state with federal or private money, with costs greater than $150,000 be approved by the legislature (18-2-102, MCA). State buildings may be constructed through the approval of the Governor's office or the Board of Regents under certain circumstances. After approval is provided, A&E is tasked with supervising the project including:

- o Solicitation, selection, and procurement of design services
- o Reviewing and accepting all plans, specifications, and cost estimates
- o Approving all financial arrangements and supervising and approving the expenditures
- o Soliciting, accepting, and rejecting bids and awarding contracts
- o Monitoring construction and inspection operations
- o Reviewing and approving change orders
- o Accepting the building when completed

The relevant Montana codes for constructing state buildings are included in Appendix A of this report.



As shown in the figure to the right, state owned space has remained relatively flat over the past six years, growing by 4.1%. Most of the new building construction, 92.6%, has occurred at the Montana University System (MUS) campuses. The campuses have the unique characteristic of needing to keep their buildings in close proximity, therein being less able to consider a leased space option than other state agencies.

Between 2009 and 2015, the number of square feet in state government (non-University) buildings increased by 64,992 square feet[1], or growth of 0.7%, while the number of square feet in University space has increased by 884,550 square feet, or growth of 6.3%. The 64,992 square feet of new state government space is net of (reduced by) buildings that were eliminated from the insurance rolls such as those demolished or sold. Of the new governmental space added, the largest additions of square footage were facilities under the Department of Military Affairs and storage/equipment buildings statewide under the Department of Transportation. Over that time period, State Fund also added a significant amount of square footage with the construction of their new building in Helena. It is expected that the square feet of MUS space will increase substantially in the next few years as new buildings authorized in the 2013 and 2015 Legislative sessions are added to the insurance rolls.

From 2009 to 2015 the building projects administered by A&E have been primarily in the University System, and are not strictly office space. Costs for new buildings has ranged between $163.32 per square foot (Butte Justice Center completed in 2014) to $355.56 per square foot (Education Building Addition, Missoula completed in 2009). Prices can vary significantly dependent on the quality, functions, and amenities of the space. In this period, the average construction cost for new space construction administered by the state was $299.93 per square foot. As reported by the Turner Building Cost Index, the total growth in building costs for the U.S. between 2009 and 2015 was 13% and the average annual rate of building construction inflation was 2.1%. The growth between 2014 and 2015 was 4.5%.

THE LEASE OPTION

The second option available when new space is needed is for the agency to lease space. State agency leases, with the exception of the Montana University System, are administered by the GSD.

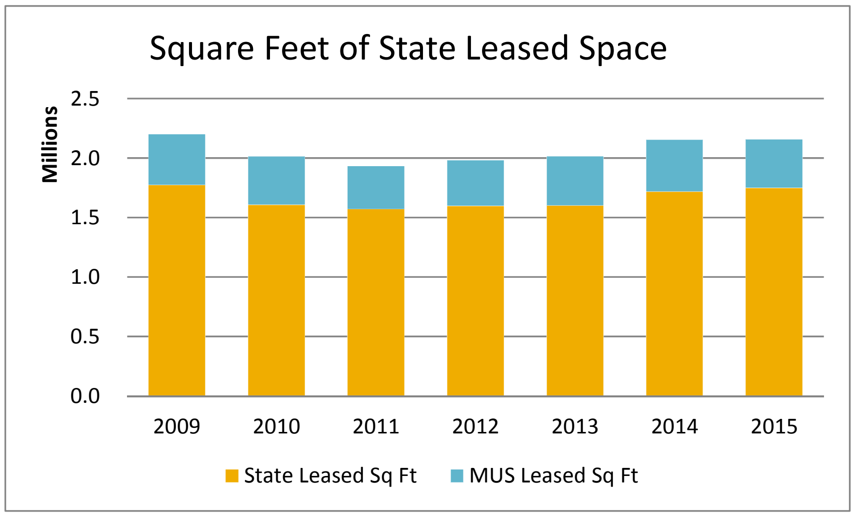
[1] The data used in this analysis is compiled by the Risk Management and Tort Division (RMTD) for insurance purposes. The information is not strictly gathered as a measure of the space owned in state buildings.

The authority to enter into leased space is given in law to GSD. The exception to this authority is that leases of more than 40,000 square feet or a term exceeding 20 years must be submitted for legislative approval through the Long-Range Building Program. In addition to assuring that agencies have the space they need to function efficiently, statute (2-17-101, MCA) tasks GSD with the following:

- Locating new space or entering into a build to lease agreement for the space.
- Approving leases, rentals, or the purchase of real property
- Consolidating offices of state agencies when it would result in cost savings while providing sufficient space and facilities

The relevant Montana codes for leasing state space are included in the appendix to this report.

As shown in the figure to the right, between 2009 and 2015, the total square footage of space leased by the state (including the university system) has remained relatively flat, declining by 2.1%. During this period, state government leases accounted for an average of 80.4% of all of the state and university leases. Over time, state government leased space declined by 25,631 square feet, or 1.4%, while university-leased space declined by 21,108 square feet[2].



The costs of leases has increased slowly over time. Between 2009 and 2015, office space lease rates have increased by $1.27 per square foot, 9.5%, or an annual average growth of 1.5%. In 2015 the average office lease rate was $14.69. Of the leases entered into in 2016, the rate per square foot has varied between $7.50, office space in Libby, to $29.95, group home in Galen.

BUILD VS. LEASE MODEL

The factors that might be considered when making the decision to build or lease are numerous and may be complex. The information used to complete such an analysis is spread throughout the state government. In the findings of the final 2011 Capital Complex Master Plan, a build-lease analysis considering only mathematical inputs concluded: "Individually, most factors have little effect on the outcome; however, the greatest impact can be made by altering the period of the lease. Generally, the longer the lease period (30 year) the more cost effective it is to lease space rather than to construct a new facility. Conversely, the quick payback period for a renewed short-term lease (5 years) advances the argument in favor of constructing and owning a new facility."[3]

In reaching their conclusion, analysts modeling the costs of build versus lease for the master plan used the following inputs in their model:

- The costs to design and construct a building with associated parking
- State lease rates
- State lease trends – annual increase (10+ years of data preferred)
- Private lease rates

[2] The state government lease data is provided by GSD, while the MUS lease data was provided by RMTD.

[3] *Montana Capitol Complex Master Plan.* CTA Architects Engineers, Bozeman, MT and SRG Partnership, Inc., Portland, OR. 2011. Pp. 66

- Private lease trends – annual increase (10+ years of data preferred)
- Private lease term
- Annual yearly private lease increase within term
- Interest rate and term for bonds including insurance and fees

The following assumptions (summarized here) were used in the modeling:

- The cost of land is excluded
- Parking reductions allowed by the City of Helena are not applied
- The proposed office building is constructed of a quality equal to the Lee Metcalf Building
- Annual lease rates increase for both the state and private landlords in a linear fashion
- 1.51% of the building value (construction cost) is added annually for maintenance and repair
- The value of money over time is adjusted using a discount factor of: $DF=1/(1+i)^n$ where i=interest rate n=number of years
- Building average of 300 gross square-feet per FTE (full-time equivalent)

LFD review of the master plan conclusions confirms there is no golden rule regarding whether it is always best to build or lease, and if only based upon financial considerations the two are often close in cost in the long-term. The best choice depends upon a number of factors, financial and other, and is likely a decision that is unique for each new space request. Factors that commonly favor lease include: short-term needs, quick space acquisition, low capital requirement, reduced maintenance obligations, and the ability to walk away at the end of a lease term. Disadvantages may include: lack of suitable space, limited location choices, limited attribute choices, fracturing of agencies or public services (with small leases), and unknown market increases upon renewal (particularly with short-term leases).

Factors that commonly favor the choice to build include the ability to: build-to-suit agency needs and functional requirements, customize for unique functions or services, customize building and site security for critical facilities, designing for future expansion, build at a specific location, and provide space proximal to existing state buildings or functions. Disadvantages may include: uncertainty of the legislative outcome of a building request, large cash outlays or long-term debt, 1-4 years to design and construct, and additional ownership responsibilities (custodial, maintenance, repairs).

Additional factors have the potential to favor one or the other option at any point in time including current lease market, local economic trends, inflation, bond rates, availability of state-owned land, and local construction market.

For those legislators interested in understanding more about current lease and build costs, and how various factors mentioned in this report and the Capitol Campus Master Plan influence long-term costs to the state LFD staff has an updated and functional version of the master plan model available to demonstrate at your convenience.

CONCLUSION

When the pressures associated with the need for new state space become sufficient, there are many considerations that must be addressed in making the decision of whether to build or lease. Laws generally require legislative involvement when the decision is to build (in cases where costs are greater than $150,000), while DOA has the administrative authority to approve new leased space (if the square feet needed is less than 40,000 or the lease term is no greater than 20 years). In recent years, there has been little growth in state government space either built or leased while the University system has constructed new buildings, many funded with non-state resources. For any new space needs a number of factors, financial and other, must be taken into consideration in order to determine in each instance whether to build or lease is the best course of action.

APPENDIX

RELEVANT STATE BUILDING CONSTRUCTION CODES

Title 18 – Public Contracts / Part 2 – Construction Contracts

18-2-101. Definitions of building, costs, and construction. In part 1 of this chapter, with the exception of 18-2-104, 18-2-107, 18-2-113, 18-2-114, 18-2-122, and 18-2-123, the following definitions apply:

(1) (a) "Building" includes a building, facility, or structure:

(i) constructed or purchased wholly or in part with state money;

(ii) at a state institution;

(iii) owned or to be owned by a state agency, including the department of transportation; or

(iv) constructed for the use or benefit of the state with federal or private money as provided in 18-2-102(2)(d).

(b) "Building" does not include a building, facility, or structure:

(i) owned or to be owned by a county, city, town, school district, or special improvement district;

(ii) used as a component part of an environmental remediation or abandoned mine land reclamation project, a highway, or a water conservation project, unless the building will require a continuing state general fund financial obligation after the environmental remediation or abandoned mine land reclamation project is completed; or

(iii) leased or to be leased by a state agency.

(2) (a) "Construction" includes the construction, alteration, repair, maintenance, and remodeling of a building and the equipping and furnishing of a building during construction, alteration, repair, maintenance, and remodeling.

(b) "Construction" does not include work performed under an energy performance contract entered into pursuant to Title 90, chapter 4, part 11.

(3) "Costs" means those expenses defined in 17-5-801.

Note: References to “the department” means the Department of Administration.

18-2-102. Authority to construct buildings. (1) Except as provided in 22-3-1003 (historic renovation projects through the MT Heritage Commission) and subsection (2) of this section, a building costing more than $150,000 may not be constructed without the consent of the legislature. Legislative approval of repair and maintenance costs as part of an agency's operating budget constitutes the legislature's consent. When a building costing more than $150,000 is to be financed in a manner that does not require legislative appropriation of money, the consent may be in the form of a joint resolution.

(2) (a) The governor may authorize the emergency repair or alteration of a building and is authorized to transfer funds and authority as necessary to accomplish the project. Transfers may not be made from the funds for an uncompleted capital project unless the project is under the supervision of the same agency.

(b) The regents of the Montana university system may authorize the construction of revenue-producing facilities referred to in 20-25-302 (revenue producing facilities) if they are to be financed wholly from the revenue from the facility.

(c) The regents of the Montana university system, with the consent of the governor, may authorize the construction of a building that is financed wholly with federal or private money if the construction of the building will not result in any new programs.

(d) The regents of the Montana university system may authorize the construction of facilities as provided in 20-25-309 (constructing or renovating athletic facilities).

(e) The department of military affairs, with the consent of the governor, may authorize the construction of a building that is financed wholly with federal or private money on federal land for the use or benefit of the state.

18-2-103. Supervision of construction of buildings. (1) For the construction of a building costing more than $150,000, the department shall:

(a) review and accept all plans, specifications, and cost estimates prepared by architects or consulting engineers;

(b) approve all bond issues or other financial arrangements and supervise and approve the expenditure of all money;

(c) solicit, accept, and reject bids and, except as provided in Title 18, chapter 2, part 5, award all contracts to the lowest qualified bidder considering conformity with specifications and terms and reasonableness of the bid amount;

(d) review and approve all change orders; and

(e) accept the building when completed according to accepted plans and specifications.

(2) The department may delegate on a project-by-project basis any powers and duties under subsection (1) to other state agencies, including units of the Montana university system, upon terms and conditions specified by the department.

(3) Before a contract under subsection (1) is awarded, two formal bids must have been received, if reasonably available.

(4) The department need not require the provisions of Montana law relating to advertising, bidding, or supervision when proposed construction costs are $75,000 or less. However, with respect to a project having a proposed cost of $75,000 or less but more than $25,000, the agency awarding the contract shall procure at least three informal bids from contractors registered in Montana, if reasonably available.

(5) For the construction of buildings owned or to be owned by a school district, the department shall, upon request, provide inspection to ensure compliance with the plans and specifications for the construction of the buildings. "Construction" includes construction, repair, alteration, equipping, and furnishing during construction, repair, or alteration. These services must be provided at a cost to be contracted for between the department and the school district, with the receipts to be deposited in the department's construction regulation account in a state special revenue fund.

(6) It is the intent of the legislature that student housing and other facilities constructed under the authority of the regents of the university system are subject to the provisions of subsections (1) through (3).

(7) The department of military affairs may act as the contracting agency for buildings constructed under the authority of 18-2-102(2)(d). However, the department of administration may agree to act as the contracting agency on behalf of the department of military affairs. Montana law applies to any controversy involving a contract.

18-2-104. Scheduling of state building program. The department of administration shall, by careful advance planning, ordering of construction priorities, consultation with architects, and timing of bid lettings, direct the building program of the state in such a manner as to reduce to a minimum the effects of weather on construction and to stabilize as far as possible the work opportunities of the construction labor force.

18-2-105. General powers and duties of department of administration. In carrying out powers relating to the construction of buildings, the department of administration may:

(1) inspect buildings not under construction;

(2) contract with the federal government for advance planning funds;

(3) transfer funds and authority to agencies and accept funds and authority from agencies;

(4) subject to 2-17-135, purchase, lease, and acquire by exchange or otherwise, land and buildings in Lewis and Clark County and equipment and furnishings for the buildings;

(5) issue and sell bonds and other securities;
(6) maintain an inventory of all buildings;
(7) appoint a project representative to supervise architects' and consulting engineers' inspection of construction of buildings to ensure that all construction is in accordance with the contracts, plans, and specifications. The cost of supervision may be charged against money available for construction.
(8) negotiate deductive changes, not to exceed 7% of the total cost of a project, with the lowest responsible bidder when the lowest responsible bid causes the project cost to exceed the appropriation or with the lowest responsible bidders, if multiple contracts will be awarded on the project, when the total of the lowest responsible bids causes the project cost to exceed the appropriation. A bidder is not required to negotiate a bid but is required to honor the bid for the time specified in the bidding documents. The department may terminate negotiations at any time.

18-2-111. Policy regarding practice of architecture -- preparation of working drawings by department limited.

(1) It is the policy of the state not to engage in the practice of architecture. However, this policy may not be construed as prohibiting the department of administration from:
(a) engaging in preplanning functions necessary to prepare a building program for presentation to the legislature;
(b) supervising construction as provided in 18-2-105(7); or
(c) preparing working drawings for minor projects.
(2) The department of administration may not prepare working drawings for the construction of a building, with the exception of repair or maintenance projects, when the total cost of the construction will exceed $75,000.

Relevant State Leasing Codes

Title 2 – Government Structure and Administration / Chapter 17 – Property Systems Development and Management

2-17-101. Allocation of space -- leasing -- definition.

(1) The department of administration shall determine the space required by state agencies other than the university system and shall allocate space in buildings owned or leased by the state, based on each agency's need. To efficiently and effectively allocate space, the department shall identify the amount, location, and nature of space used by each agency, including summary information on average cost per square foot for each municipality, and report this to the office of budget and program planning and to the legislative fiscal analyst by September 1 of each even-numbered year. The report must be provided in an electronic format.
(2) An agency requiring additional space shall notify the department. The department, in consultation with the agency, shall determine the amount and nature of the space needed and locate space within a building owned or leased by the state, including buildings in Helena and in other areas, to meet the agency's requirements. If space is not available in a building owned or leased by the state, the department shall locate space to be leased in an appropriate existing building or a build-to-lease building, including buildings in Helena and in other areas, or recommend alternatives to leasing, such as remodeling or exchanging space with another agency. A state agency may not lease, rent, or purchase real property without prior approval of the department.
(3) (a) The location of the chambers for the house of representatives must be determined in the sole discretion of the house of representatives. The location of the chambers for the senate must be determined in the sole discretion of the senate.

(b) Subject to 2-17-108, the department, with the advice of the legislative council, shall allocate other space for the use of the legislature, including but not limited to space for committee rooms and legislative offices.

(4) The department shall consolidate the offices of state agencies in a single, central location within a municipality whenever the consolidation would result in a cost savings to the state while permitting sufficient space and facilities for the agencies. The department may purchase, lease, or acquire, by exchange or otherwise, land and buildings in a municipality to achieve consolidation. Offices of the law enforcement services division and motor vehicle division of the department of justice are exempted from consolidation.

(5) Any lease for more than 40,000 square feet or for a term of more than 20 years must be submitted as part of the long-range building program and approved by the legislature before the department of administration may proceed with the lease. Multiple leases in the same building entered into within any 60-day period are to be aggregated for purposes of this threshold calculation. When immediate relocation of agency employees is required due to a public exigency, the requirements of this subsection do not apply, but the new lease must be reported as required by subsection (1).

(6) The department shall include language in every lease providing that if funds are not appropriated or otherwise made available to support continued performance of the lease in subsequent fiscal periods, the lease must be canceled.

(7) "Public exigency" means that due to unforeseen circumstances a facility occupied by state employees is uninhabitable due to immediate conditions that adversely impact the health or safety of the occupants of the facility.

Title 15 – Taxation / Chapter 8 – Assessment Procedure

15-8-102. County to furnish office space -- allowable charge.

The county commissioners of each county shall provide existing office space in the county courthouse or other county building for use by the department's staff, if space is reasonably available. A county may charge the department a rate that does not exceed the rental rate that the department of administration charges state agencies for space in state buildings. If space is not reasonably available in the courthouse or other county building, the department may contract for the procurement of suitable space. For purposes of this section, "county building" includes a city-county building or a building maintained by a consolidated government.

Title 18 – Public Contracts / Chapter 3 – State Building Leases

18-3-101. Authority to lease with option to purchase.

When authorized by a vote of two-thirds of the members of each house of the legislature, the department of administration may, as part of the long-range building program, enter into a lease contract that provides an option to purchase a building to be used by the state or any department of state government.

18-3-105. Location of building.

A building authorized pursuant to 18-3-101 must be located as determined by the terms of the request for proposals. If a contract entered into pursuant to this chapter requires the sale or lease of any interest in state lands, the contract must have prior approval of the board of land commissioners.