

The Past is Prologue for GSA's Lease Construction Program

by Patrick Keogh, AMV LLC

With funding limited for GSA's capital investment program there is growing dependence on leasing to satisfy the government's space needs. Increasingly, GSA is relying on its lease construction approach to develop privately financed build-to-suits. The current structure of GSA's lease construction procurements involves a "package approach." The package approach is based on GSA's standard lease solicitation and requires the developer/lessor to provide all site, design, construction, financing, management, operations, and ownership responsibilities during the term of the lease. That system does not work very well. As the projects get larger procurements are increasingly failing because they can not be delivered within the cost limitations set by the Congress. GSA has experienced this before and in the past used other approaches to successfully complete large, privately financed public buildings projects.

It's Almost as Predictable as 17-Year Cicadas

Once each generation GSA builds up a backlog of capital projects. The shortage of capital funding is typically associated with a war. Funding for the war drains the funding that would otherwise go into the more capital intensive civilian programs such as development of new government-owned space. When we look at GSA's history we will find that almost 20 percent of the current inventory of owned space was financed by other than appropriated funds. It started with the end to the Korean War when Congress passed the Public Buildings Amendments of 1954. That law authorized GSA to enter into purchase contracts for a period of three years to develop the backlog of previously authorized but unfunded projects. At the time, GSA had the sites and designs for the authorized projects but was lacking the construction funds. To implement the authorization GSA designed the first package system for contractors to pro-

vide construction and financing. These purchase contracts were effectively installment sales and the government owned the buildings at the end of the lease term. The 1954 purchase contracting program was generally not thought to be successful, with about 15 small projects being completed during the three-year term. The authority was not extended.

The 1972 Vietnam Program

With the financial pressures of the protracted Vietnam War again creating a backlog of capital projects Congress passed the Public Buildings Amendments Act of 1972. That is the law that created the Federal Buildings Fund. The law also extended purchase contracting authority to GSA for another three years for all authorized but unfunded projects. Again, GSA applied the package system for soliciting contractors. Very soon into the implementation of this new authority, GSA undertook a test to separate the financing from the construction of the projects.

For a period of five days during a single week (referred to as "World Series Week"), GSA offered a different project for bidding on both the package system and a so-called dual system which allowed the government to separately solicit for and provide the necessary financing. On each of the five days the dual system won by substantial margins. *GSA never again used the package system during 1972-1975 for its purchase contracting procurements.* Instead, the capital markets created a securitized "trust participation certificate" structure for financing GSA's purchase contracting requirements. Within the three-year window GSA successfully contracted for all authorized and unfunded projects amounting to some 70 projects comprising about 20 million gross square feet. At the time, this program to privately finance the development of public buildings was considered to be an enormous success.

The 1988 Cold War Program

In the late 1980s, the Cold War was approaching a successful end. But the costs associated with President Reagan's rebuilding of the U.S. military had once more taken its toll in the funding available for civilian public works. There again was a backlog of required facilities. Under the very able leadership of the GSA Administrator, Terry Golden, the agency took a somewhat different approach to the backlog. A different approach was required for a number of reasons and chief among them was OMB's refusal after the 1972 legislation to process authorization requests ("prospectuses") unless it was certain that funds would be readily available for construction. As a result, there was a backlog of required facilities but no backlog of "authorized" projects.

Administrator Golden was a former principal in the Trammell Crow firm and well informed in all matters of real estate development and financing. Working with the Congress he secured enabling legislation for the "lease construction" of the most critically required facilities. He also created working relationships with local governments where, for example, the land required for the facilities was to be donated by the municipality. The enabling legislation came in individual bills rather than a single act authorizing a program as before. In this way, GSA was authorized to enter into long-term lease construction agreements for the development of a variety of buildings. These included, as examples, an office building in Chicago, a courthouse and separate office building at Foley Square in New York City, an office building in Oakland CA, a criminal justice facility in Miami, an archival facility ("Archives II") in College Park MD, the federal Ronald Reagan building in Washington DC, the adaptive reuse of the Tacoma WA Union Station to a courthouse, an IRS cen-

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ter in Memphis, the Atlanta Federal Center and a number of others. In all about 12 million square feet was to be included in the program.

The first solicitation issued under the Cold War program was for the 800,000 square foot Chicago Federal Building. A major difference between this program and the earlier 1972 effort was that, with the exception of Archives II, designs were not available for the projects. Despite the success of the Vietnam purchase contracting program, the solicitation used for Chicago was a package system approach. That is, the developer was to design, construct, finance and operate the completed facility.

Things changed after Archives II (A2). Technically, the authority for A2 was granted to the National Archives and Records Administration. Formerly a part of GSA, NARA was an independent agency by the time of A2. Though independent, NARA nevertheless turned to GSA to help get A2 developed. Because the Archives II project had been designed, NARA was particularly receptive to the separate financing of the project to reduce cost, increase government control and better insure the successful completion of the project.

In effect, NARA through its GSA representatives served as the developer of A2. That resulted in the first securitized or capital markets financing of a federal lease. And again the successful placement of the \$301 million "lease certificate of participation" financing for A2 had the effect of eliminating the package approach as a method of procuring all future projects. In fact, all outstanding package procurements on the street or in negotiations at the time of the A2 financing were restructured to provide for separate government financing. With the disaggregation of the financing the pace of the procurements accelerated. Within about three years all the specially authorized Cold War pro-

jects had been let and the program, like the Vietnam program before it, was considered to be an enormous success.

Enter the Office of Management and Budget and its budgetary scoring rules. No discussion of private financing of public building development or real property leasing can advance very far without some discussion of the scoring rules. In the early 1990's OMB promulgated its so-called "scoring rules." Many working in the field believe the scoring rules to be the end of reason in federal real estate practice. Some see the scoring rules as unduly burdensome in distinguishing between capital and operating leases.

Capital transactions, like the earlier GSA purchase contracting and lease construction transactions, were now required to be scored either entirely or mostly in the year in which the transaction was consummated. That meant any agency entering into such a transaction would need adequate budget authority before doing the deal. Operating leases, where the private market retained significant ownership risks, could continue to be scored annually as an operating expense. To many, it seemed illogical for the government to pay for a facility over time and not to own the property at the end of a lease.

The scoring rule is not peculiar to the federal government. The truth is just the opposite. Prior to federal adoption of the scoring rules every other enterprise including state and local government as well as private companies operated under a similar standard promulgated by the Financial Accounting Standards Board [Google "FASB Rule 13"]. What was extraordinary, in fact, was that the federal government had operated for so long without any scoring rules. The scoring rules make sense, reflect sound federal budgetary policy, and need to be a consideration in the design of any financing of a lease transaction.

It is also necessary to understand that the scoring rules do not necessarily re-

quire agencies to do dumb deals. As was discussed in our earlier article on the NIH Bayview project [Government Leasing News, Vol. 4, No. 2, Summer 2008], we believe the financing and ownership structures on that deal make good sense for the government and satisfy federal budgetary policy.

The Fourth Wave – The War on Terrorism

Today we find the federal budget stressed with the obligations to meet the global war on terrorism. The ongoing hostilities in both Afghanistan and Iraq are particularly draining on the Treasury. Predictably, this has led to the resulting backlog of required projects and the search for privately financed methods for providing the space. This time there will not likely be broad enabling legislation as in 1954 and 1972. Nor will there be any mass passage of legislation authorizing individual projects as in the Cold War program. Rather, GSA is reaching deep into its bag of basic tools and pulling out the Federal Property and Administrative Services Act of 1949.

In addition to creating GSA, the 1949 Property Act granted GSA leasing authority of up to 20 years for projects approved by prospectus submitted to special committees of both houses of Congress. In addition to being the only authority being available to develop build-to-suits the scoring rules dictate that a lease is the only form of transaction practically available.

That is where we are today. With limited funding for capital development, GSA is relying increasingly on its basic leasing authority to do build-to-suits. The projects are getting larger as time passes with limited funds forthcoming for construction of public buildings.

The very predictable result of this is that the procurement tool being used today is yet again the package approach. That is until the National Institutes of Health's Bayview Research Center was brought on line in 2008

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through the innovative development and financial arrangements described in our earlier article.

What's Wrong With The Package Approach?

Let's get a couple of misconceptions out of the way before we delve into the problems of the current form of the procurement approach being used for lease construction projects. Search as you might there is no section of the Federal Acquisition Regulations that tells you how to design a solicitation for a lease build-to-suit. It is just not there. GSA decided how to structure the transaction with no direction from the government's procurement regime.

Also, no one else does it the way GSA does it on a large build-to-suit. The package approach might work reasonably well for a 3,000 square foot retail post office. It might even work for an 8,000 square foot local Social Security office. For a 700,000 square foot Department of Justice facility it makes no sense. And it is for the same reasons as it made no sense in 1954, 1972 or 1988. The following are just some of the major reasons that no one else does it this way and why the package approach was abandoned in earlier programs:

1. Very High Pursuit Costs and Protracted Procurement Processes. It is not uncommon for each offeror to incur \$500,000 to \$1 million in direct costs to pursue a major GSA lease construction project. That does not include the opportunity costs involved in a one-year or longer procurement process. Given these kinds of costs it is no surprise that GSA gets protests. It also explains why the best developers tend to shy away from GSA lease construction deals.

2. No Reasonable Assurance of Success in Award. The rent limitation upon which GSA can make an award is often based on a market rate at the time the prospectus is drafted (often without sufficient consideration of the high in-

cremental cost of security features for mission-oriented agencies). Although there are inflationary adjustments the current system has no "design, build and finance to the budget" capacity. That is, the solicitation drafted defining the required facility is based on the government's requirements or wants and has no capacity for adjustment as market conditions change over the very protracted procurement process.

The current system is a "hope for the best" cost approach. That is, the solicitation is drafted with a program of requirements and the procurement process pursued with offers accepted "hoping for the best" outcome that the project will be bid within the prospectus limitation.

3. Financing Risks are Inefficiently Assigned. The single largest component of cost in a GSA lease construction project is the cost of financing. The package approach requires the offeror to assume the financing risk. That is, in creating his offer, the offeror must assume a financing rate at the time the financing is to be placed not knowing when it will get either the award or a notice to proceed. At all times the decisions are within the control of the government but all of the responsibility is that of the offerors.

4. Construction Cost Risks are Inefficiently Assigned. The next largest component of cost after financing is the construction cost. Offerors are effectively required to determine a fixed construction cost based only on conceptual drawings for the project. On a major facility the contingency required to cover the uncertainty of pricing between bidding and start of construction can be enormous. Only a more complete design can yield confident pricing.

5. You Never Get the "Dream Team." The current process forces the packaging of the team. One team may have the best contractor while another team has the best architect. A third team might have the best banker and financial solu-

tion while a fourth has the best developer. The package approach forces marriages of convenience. It is often about who is available; not who is best.

6. Everything About the Package Approach Tends to Create Either an Adversarial or Windfall Result. Take the financing as an example. If rates move up from the offerors estimate to the time of placing the financing offerors must attempt to get out of the deal or make up the loss elsewhere. That does not make for a cooperative relationship between offerors and their government tenants.

If rates go the other way, the contractor makes a windfall. We have seen contractors walk away from the closing table with very substantial checks simply reflecting the windfall from a favorable decline in rates. Favorable for the contractor, that is. So the government can virtually never win. The only way for the relationship to stay in balance is for the rate at time of estimating to be the same when the contractor places the financing. What's the probability of that happening?

The same happens on the construction side. As the selected contractor works with the government through the completion of the design process there is a constant question as to whether specifics are within the original concepts or not. Of course, the government will always try to get as much as possible and the contractor will try to give the least. The package approach does not make for a partnering relationship.

And Now There Is Bayview

As discussed in our earlier article, the NIH Bayview Research Center involved a separation or disaggregation of the financing. It is true that Bayview was not undertaken pursuant to the Property Act of 1949 authority. It was done under special legislation authorizing a long-term lease with a \$51 per square foot rental limitation. The business plan for Bayview included a prospectus but the Congress chose to bypass its own

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Government Leasing News is pleased to announce
a one-day professional seminar on
**Lease Construction and Alternative Methods
for Procuring Build-to-Suits**

Thursday, December 4, 2008
8:30 am – 4:00 pm

Naval Heritage Center, 701 Pennsylvania Ave., NW
Washington, DC 20004 202-380-0733

Note: This initial seminar is limited to employees of federal agencies and Congressional committee staff. A subsequent session will be open to all, including private-sector, build-to-suit developers.

PROGRAM

Session I: Assessment of the Current Situation

- Why today's lease construction deals aren't working
- Problems facing developers, lenders, procurement officials
- History of prior privately financed public buildings programs

Session II: Alternative Models

- The NIH Bayview Research Center Model
- The NARA Archives II Model

Session III: Critical Analysis of Alternative Approaches

- Real Estate vs. Capital Markets Financing
- Disaggregating the Financing
- A Public-Private Partnering Model
- Implications to Budgetary Scoring

Session IV: Perceived Benefits and Risks

- From the Perspective of the Developer
- From the Perspective of the Architect and Contractor
- From the Perspective of the Lender and Insurer

Session V: Advantages to the Government

- Simpler Procurement and Faster Delivery
- Greater Alignment with Budget Constraints
- Scoring Problems Virtually Eliminated

Session VI: Workshop

- Describe your Challenging Project(s)
- Team Design of a Procurement Strategy

SEMINAR STAFF

Dr. Dennis Eisen, *Editor-in-Chief, Government Leasing News*, will serve as moderator. He is a long-term consultant on cost-benefit and leasing analysis to GSA and other government agencies, and is author of the classic text, *Decision Making in Federal Real Estate*.

Patrick J. Keogh, *President, AMV, LLC*. Former financial manager of GSA's private financing development program in the 1970's and program manager of the 1980s lease construction program. Adviser to NIH on the agency's Bayview Research Center.

David Miller, *Partner, Pillsbury Winthrop Shaw Pittman*. Advisor to NIH on Bayview and other agencies on build to suits. Advisor to private developers on government and developments. Lawyer to the U.S. Postal Service on public-private development partnerships

Thomas Zarrilli, *Principal, CTL Capital LLC*. Expert in financing lease construction projects. Engineered the financial structure and placed the financing for Bayview and numerous other government projects.

Thomas Regan, *President, Regan Associates*. Private developer experienced in large lease construction projects. Former head of the Pennsylvania Avenue Development Corporation.

WHO SHOULD ATTEND

- Government contracting officers dealing with real property lease and lease construction projects
- Realty specialists dealing with leasing
- Officials responsible for processing and securing project authorizations
- Budgetary officials, particularly those dealing with scoring issues
- Agency strategists responsible for developing and meeting agency space requirements
- Government attorneys dealing with leasing and related matters

RESERVATIONS

The fee for this important one-day conference is \$495. The fee includes lunch. Payment can be by credit card by calling *Government Leasing News* at 301-762-1441, or by check for \$495 per person payable to Government Leasing News at 13408 Glen Lea Way, Rockville, MD 20850. If registering by mail, please complete the registration form on the next page for each person in your office planning to attend.

For more information, contact Dr. Dennis Eisen at 301.762.1441 or DennisE@aol.com, or Pat Keogh at 703.790.8471 or pkeogh@amc-llc.com.

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process by writing special authority into other NIH legislation. Suffice it to say that had Bayview been authorized under the 1949 Act we would have done nothing differently. The structure was not undertaken because of the nature of the authorization but rather because it made sense and got NIH more building for the money available.

We think of Bayview as potentially the equivalent of World Series Week in the 1972 program or Archives II in the 1988 Cold War program. It shows that significant savings can be achieved from the government facilitating the separate procurement of the financing.

More than that, Bayview demonstrates that a more complete disaggregation of responsibilities can reduce cost, more efficiently align responsibilities, and accelerate the process. Bayview is an industry standard approach to a privately financed credit tenant lease for a build-to-suit. Bayview, as a strictly FAR compliant system of procurements, shows that the federal procurement regime is actually flexible enough to empower the best commercial practices.

Bayview and Scoring

The scoring rules effectively eliminate the government's ability to do an installment sale-like transaction. So, any privately financed lease deal cannot

result in ownership. That's as it should be. *However, the scoring rules do not mean the government cannot harvest the value of the ownership created by its lease.* Bayview proves that. By separately procuring the financial advisory and engineering services and disaggregating the financing, NIH designed the structure so that it was NIH that decided what happened to the ownership. In that case, the ownership was used to get the most building within the authorized limit of \$51 per square foot. This was accomplished by arranging for an insurance company to guarantee a payment equal to 40 percent of the original financing in the event NIH failed to renew its lease at the end of the term. This meant that NIH's rent only had to amortize 60 percent of the financing during the lease. Such an intricate structure, designed to get the government the most value from its lease, would have been impossible in a package approach to the financing.

The Future

The pattern is compellingly clear. GSA has always reverted to a package approach to procuring privately financed development. That approach has never worked well and is not working well now. There has always been a defining event reflecting changes in procedures and we think Bayview can be regarded as that event in this cycle.

GSA should test a separate approach to arranging lease construction financing or delegate the leasing authority to its occupant agencies to test the approach. The test is simple: simply provide that the government reserves the right to provide its own financing for the development and then engage the talent necessary to structure the financing.

The longer term and better solution is to develop and deploy the more total disaggregation approach employed first in Archives II and most recently in Bayview. Such an approach offers agencies a state-of-the-art method for meeting its space requirements in an atmosphere where risks are well managed and outcomes more predictable. In addition, such an approach offers the industry a better, less costly way to pursue government business.

Patrick J. Keogh is the President of AMV, LLC which holds a GSA schedule contract for real estate, financial, development, asset management and legal services. AMV, together with its partners at CTL Capital and Pillsbury Winthrop Shaw Pittman, has advised NIH on a number of major deals including Bayview. Pat is the former financial manager of GSA's 1972 purchase contracting program and the program manager of the "Cold War" lease construction program. He can be contacted at pkeogh@amv-llc.com or 703.790.8471.

Registration Form

To register for the Lease Construction seminar by mail, please supply the information below for each individual and return it to the address below along with your check for \$495 per person payable to Government Leasing News

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