

## *Why the Budget Scoring Rules Make Sense*

by Patrick J. Keogh, President, AMV LLC

It seems the one thing Federal real estate professionals agree on is that the budget scoring rules are the devil's handiwork. The rules are blamed for all the ills experienced in dealing with the marketplace. Build-to-suit procurements have to be cancelled. Why? Because of the scoring rules! The government procures its lease construction projects in a way no one else does. Why? It's the scoring rules! Financing rates are high on build-to-suits, or financing isn't available. Why? Again, it must be due to the scoring rules!

There may be good reason not to like the scoring rules. The truth is that on a privately financed build-to-suit the government through its lease pays for the building. Virtually all of GSA's lease construction projects are financed with 100% debt based on the lease income. There usually is no equity in the deal (this is not a bad thing, as equity requires a higher return and using equity means more lease dollars that do not go into the building). Why shouldn't the government own the building and what possible sense can it make for the government to pay for the building—only to have someone else own it? Explaining all that is the purpose of this article.

Hi, I'm Pat, and I'm a recovering capital leasing guy. It all started for me 37 years ago with the passage of the Public Building Amendments Act of 1972. That law authorized GSA for a period of three years to enter into purchase contracts to develop approved projects. You see, the administration back then had failed to secure appropriations to build some 68 public buildings for which prospectuses had been approved. Most of the money was going to the war in Vietnam. I was the financial manager of that program and in three years we contracted for all those projects, thereby adding about 12 million square feet to the GSA inventory. Although we first tried to bundle the financing with the development, it did

not work out well. Although there was significant resistance to change we soon tested separating the financing procurement. The results were so compelling that all subsequent deals involved separately procuring the financing in the capital markets. The Office of Management and Budget (OMB) felt GSA had found a way around the traditional budgetary process and thereafter refused to process prospectuses unless the administration was prepared to request construction funding. OMB did not want to let a "backlog" accumulate that would be an incentive for creating back door financing.

About the same time the Federal Financing Bank was formed as a unit of the Treasury Department to buy agency "obligations" like those represented by GSA's purchase contracts. Both Treasury and OMB believed it to be bad public policy to have agencies in the capital markets with debt-like obligations. Also, managing the government's overall debt should be the job of the President (through OMB) and his Treasury Department, not individual agencies like GSA.

### **The Seeds are Sown for the Budget Scoring Rules - Archives II**

The dam held for some time. And then about 1987, with funding going to fight the Cold War, Congress started to pass individual laws empowering GSA and others to enter into lease-purchase arrangements to build about 12 major Federal buildings comprising another 12 million square feet. There were no prospectuses involved because OMB had stopped the prospectus/approval process, but legislation obviated the need for the kind of prior authorization afforded by a prospectus.

These projects included the Ronald Reagan building in downtown Washington, DC, the one-million square foot Foley Square Federal Office Building in New York City, the adjoining one million square foot Foley Square Court-

house, the Oakland CA Federal Building, the Metcalfe Federal Building in Chicago, the Atlanta Federal Office Building, the Judiciary Office Building in Washington, DC, and a number of others. They were all big projects, and this time I was appointed program manager for lease development.

Prior to this program, a "lease" procurement involved bundling all design, construction, financing operations and everything else to make a building work into a single procurement. As in earlier efforts, it did not work well. And then came Archives II, a \$305 million deal to be located on land donated by the University of Maryland. In 1988 we decided to go about the financing in a different way and the first securitized lease financing for Archives II was placed in the capital markets at low rates not seen before. The result was that all subsequent projects involved separate procurement of the lease financing. It worked well and all the projects were successfully completed. Archives II proved a number of other very important principles. That project showed conclusively that there was no one single process for doing a leased build-to-suit or arranging financing when acquiring leased space. The financing was handled as a separate transaction and less dollars were spent on funding costs as a result.

The lease procurement process as implemented by GSA today involves the bundling or aggregation of all related transactions. There are those within GSA that assert that this is the only way to meet the scoring rules though the scoring rules make no mention of the procurement process. If properly disaggregated, the various transactions could each individually be structured so that project risks are more efficiently assigned and managed. *The more efficient each transaction component is, the less costly the overall transaction, and hence the lower the lease*

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rate. In the end, the transaction may be documented and look very much like the deal done in the conventional form, but the process for getting there is different and the risk assignments internal to the deal are different.

There came a day not too long after Archives II had spawned a continuing series of successes in the financing and development of the remaining projects, that I realized there was a larger problem. Controlling a large amount of public financings, I was constantly being called upon for help by other agencies and individuals in structuring development deals that had been stalled by a lack of appropriated funds.. They wanted me to help them “beat the system”. It was then that I knew we had a larger problem and, fortunately, so did the very smart people at OMB. Archives II and the subsequent leased build-to-suit projects were done the right way for their time. You may consider that self-serving because they were my deals, but I believe that to be the case. We placed the financings at the best possible rates and we structured the development procurements in the best possible ways. Eventually, the leases were seen as obligations qualifying for Federal Financing Bank investment. Previously, the FFB had been stuck in their thinking that a lease by its nature did not qualify as an “obligation.” That view changed with Archives II, and as a result the FFB bought many of the remaining leases, so that was indeed the right solution. But the experience came to convince me that Federal development agencies, and GSA in particular, had the capacity for unlimited development and “debt” creation unless checked by some external force. *That external force came, thankfully, by way of OMB and the scoring rules.*

### **The Scoring Rules**

The scoring rules classify a capital lease as one in which one or more of the

following terms is met:

1. *The lease transfers ownership of the property to the lessee by the end of the lease term.*
2. *The lease contains a bargain purchase option.*
3. *The lease term is equal to 75% or more of the estimated economic life of the leased property.*
4. *The present value at the beginning of the lease term of the minimum lease payments...equals or exceeds 90% of the excess of the fair market value of the leased property to the lessor at the inception of the lease...*

No, wait a minute! Those are the scoring rules for the Financial Accounting Standards Board Rule 13. I knew they looked familiar. You see, private accounting standards are fundamentally the same as the Federal budget scoring rules. And that makes sense. It's not strange that the federal government now has budget scoring rules. What is peculiar is that the feds were alone for so long in not having scoring rules. Cities, counties, states and corporations all have scoring rules patterned on FASB 13. Why should the feds be different?

If a corporate executive enters into a capital lease, then his company must reflect that obligation as a debt on his balance sheet. He will show an asset representing the value of the building but also reflect an offsetting liability in the form of the “capital lease” as a liability or debt obligation. A corporate CEO would not think to dispute FASB 13 with the SEC. Can you imagine the CEO saying “if only you let me enter into a capital lease but not account for the liability my balance sheet would look a lot better”? But Federal agency executives have been disputing the wisdom of the scoring rules since their inception. The unique nature of the Federal Budget process explains why the issue arises.

### **Government lacks the Discipline of Commercial Accountability**

We all know the feds do not have a balance sheet. The largest single enter-

prise in the world is managed mostly on the basis of cash accounting. Cash comes in from a variety of sources and cash goes out as appropriated for a vast array of purposes. If expenses exceed income the government borrows the difference. As we all know, the U.S. government has a huge and growing debt. It is appropriately a cause of great concern. Do we really want Federal agencies entering into obligations that are effectively more debt, albeit out of the public eye?

Largely because the government does not have a balance sheet it lacks the kind of incentive to be strategic about its real estate investments. You never hear the feds talking about “improving shareholder value by repositioning their assets.” Lacking a commercial accounting structure, there would never be the incentive to act like the retailer that sold the downtown Chicago Sears Tower to take advantage of market values. “Value” has far less meaning to the feds than to corporate real estate owners. Take as an extreme case on that point the Defense Department and how it handles its assets. When no longer needed, DoD often pays to dispose of its property through the BRAC process, priding itself when it minimizes the cost of disposition—virtually never thinking to capture the best return for its assets (admittedly, DoD has begun to rethink this in recent years). When no longer needed as a military tool DoD properties become problems not assets.

### **Is Government a Smart Owner and Asset Manager?**

So the federal government, from a strategic standpoint and from a return on investment perspective, might not be the best asset manager. Real estate for government is more a tool than an asset. Federal real estate professionals tend more toward a facilities management than an asset management view.

Looking at real estate as a tool then, the argument typically goes that the government should own its facilities to

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meet its long term requirements. That might make sense but what are the government's real long-term requirements? Take Archives II, for example. The government did that deal in 1988 and will own the property free and clear in 2020. The technology of records retention was fundamentally different in the mid 1980s when the building was designed than it is today. The personal computer was coming into popular use and the age of the Internet was just dawning. Who knows where the state-of-the-art will be in 2020? There are even competitive sources for archival services today that did not exist back then. Owning is not always a good thing as real estate investors are painfully learning today.

### **The Current System Encourages Developers to Advocate Capital Lease Structures**

We think there are ways for the government to harvest the intrinsic value of ownership, mitigate the long-term risks associated with ownership and do it in strict compliance with the budget scoring rules. But to do so requires a fundamental change in the way government procures its space and structures its business relationships. Again, let's focus on GSA's lease-construction practices as the example that proves the point. GSA's standard build-to-suit procurement structure involves soliciting for a developer to design, build, finance, operate and own a building to meet the Federal government's performance requirements.

There are lots of problems with this "package" approach but let's focus on the financing. The current approach requires the developer to engage an advisor to structure the financing. Financing being the largest component of the developer's cost, the lower the cost of financing, the more competitive the developer's proposal, and the more the developer will make. The more the financing is structured as the Archives-type "debt" lease financing the better

from the developer's perspective. It is the easiest way to sharpen the price and so the pressure builds on the government client to permit a capital lease structure. In the current structure, developers and their advisors are natural allies with the government in criticizing the scoring rules. Even after they get the deal, a developer's incentive is to seek changes to the financing terms so as to lower his cost and improve the project's return. It's just a natural consequence of the current aggregated procurement approach. Everyone tends to point the finger at OMB instead of creatively working within the rules to accomplish the government's wider range of objectives.

### **Financing on the Government Side Changes the Incentives**

Now let's look at the disaggregated approach that was used in Archives II. That approach is best and most recently illustrated by the NIH Bayview Research Center in Baltimore, MD. The Bayview project has been extensively discussed in recent issues of GLN. It was a \$200 million lease financing. But in the case of Bayview, the financial advisor was separately selected by the government. In that case, the financial advisor's responsibility was to work for the government and structure the deal to get the best deal for their public client—and to do this within the authorization limit imposed by OMB and Congress and comply with all Federal budgetary and financial regulations including the scoring rules. The strategy then is to mitigate the cost and comply fully with the rules rather than seek to avoid the rules and maximize the profit. It's a fundamentally different dynamic that has achieved better results for the government lessee. And, let's face it, lending conditions in the current market do not suggest that the status quo is going to result in many completed deals.

### **The Government Does Not Own But Gleans the Value of Ownership**

Under the Bayview structure, NIH

will never own the building. To start with, Bayview is largely a research facility with a heavy concentration of laboratories for conducting NIH's "intramural" research activities. Most of NIH's research is done "extramurally." Intramural simply means that the research is done internally by government employees. Extramural means that the research is done under NIH grants to universities, private research institutes and the like. Who really knows what the state-of-the-art in laboratories will be in 20 or 30 years? Who knows whether there will even be an intramural program? In owning Bayview, NIH would effectively assume those future risks.

Working with the development team, NIH's financial advisor structured the financing and ownership to bring the project in under the budgetary limitations and in conformance with the scoring rules. To get NIH what they wanted in the facility the lease was structured to amortize 60 percent of the project cost over the 20-year term of the lease. An insurer was paid a premium to place residual value insurance on the property for the remaining 40 percent. NIH has the right to walk away from the property in 20 years and the insurer retains the risk that the building cannot be re-leased or sold to pay off the unamortized loan balance.

*But look at what NIH received in addition:* By being active in the structuring of the financing, NIH was able to get more building within the authorization limit. In effect then, NIH captured the value of future ownership during the initial term. NIH's financial advisor arranged to "sell" the residual value to get more current value for the NIH tenant. They used the ownership as an additional source of capital. That is a sophisticated and beneficial solution that would be an inconceivable result in the current procurement practice.

What is important to remember about Bayview is not the result so much as the process. Markets have changed and the specific structure used at Bayview

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would not likely work today. But another structure would. By putting the financial advisory talent on the government's side of the table the incentives were created to tailor the financing to the government's needs from both a business and regulatory perspective.

### **A Proposal for Going Forward**

So what should managers in the GSA lease-construction program do? First, in recognition of how important the financing is relative to the total cost of the lease, engage a financial advisor to structure the financing to the best advantage of the government. With its financial advisor at the table the government will always know where it stands relative to the authorized limit thereby vastly reducing any prospect for a "busted" procurement. That's how NIH did it at Bayview and that is how the GSA did it for Archives II.

Finally, we should ask ourselves the "but for" question regarding the scoring rules. "But for" the scoring rules what would be different about the procure-

ment process for lease-construction deals? GSA would continue to use the same cumbersome procurement which inefficiently assigns virtually all project risks. Such inefficiencies require loading the pricing with pricing premiums to cover the risks. The system requires developers to incur enormous pursuit costs over protracted procurement period often only to have a "busted" procurement terminated.

The second recommendation is to make the process between developer selection and funding a collaborative effort; more of a public-private partnership allowing more disaggregation of the development's components. In this way, the rate risk inherent in the process can be, to a certain degree, managed, and increases and decreases in funding rates can be reflected in scope revisions instead of busted deals.

"But for" the scoring rules, I suggest, nothing significant would change and deals would still not be completed. In today's market, fewer developers will even risk the cost of preparing a re-

sponse to a solicitation given lending conditions. Projects will only proceed and work well when GSA tests the disaggregation approach. Only GSA, among major credit tenants, uses a package approach to procuring large build-to-suits. Disaggregation is what the rest of the market does and it is what GSA has done before. It's what GSA needs to do now.

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Asset Management Ventures (AMV) offers a one-day workshop on alternative lease construction methods for your project team, at your site, on how to design an acquisition strategy that works for your build-to-suit projects. Why spend time and money on a strategy that fails?

For GSA and its client agencies we will assist in team building as an integral part of a business plan that will permit successful execution of your procurements.

We understand public procurements, financing and development. Our team has a long and proven track record of successfully planning and implementing government real estate projects. We can be readily accessed off our GSA schedule contract detailed at [www.amv-llc.com](http://www.amv-llc.com).

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