

## *Lease Construction: It's Either New Tools or New Money*

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The elevator speech on GSA's Public Building Service goes something like this. PBS is in the business of acquiring and managing space and services for federal agencies. It has two main ways to acquire space: by direct construction and by leasing. "Direct construction" as used by PBS means the project is publicly funded and owned. A direct construction project is delivered by contracting with the private sector using a number of variants on the basic design-bid-build-operate delivery system. Leased space is also delivered by private owners with ownership remaining with a private owner. Leased space is delivered using a single solicitation for a lessor.

As PBS was merged into the new GSA in 1949 things might have seemed simple. More permanent, larger and perhaps unique requirements of government would be delivered by direct construction. Smaller and perhaps more uncertain requirements would be leased in the market. It makes sense, but would it were that simple.

As every public real estate professional knows, funding for capital improvements is the first thing to go when competition for public funds intensifies. As was discussed in our previous article on GSA's Lease Construction Program that appeared in *Government Leasing News* [Fall 2008, Vol. 4, No. 3], that is exactly what happened as a result of the Korean War, Viet Nam War, the Cold War, and now during the War on Terror. As backlogs of directly funded projects grew during those times GSA devised a series of methods for privately financing and owning its projects intended for direct construction.

Things changed in the early 1990s with the advent of the budget scoring rules. Those rules were installed at least partially in response to GSA's use of these methods for privately financing owned facilities. The nature of the scoring rules is not the subject of this article. We will deal with that in a later

piece. Suffice it to say that the scoring rules effectively dictated that GSA could not own any leased property built to suit GSA's requirements.

GSA is unique among federal agencies in that it has multiyear real property leasing authority. In fact, GSA has leasing authority for terms as long as 20 years. Most other federal agencies, like governments generally, are limited to annual authority. Legislatures like our own Congress are very particular about not tying the budgetary hands of future legislatures.

So here's where GSA is in 2008. Budget pressures from the War in Iraq, the War on Terror, and other challenges have limited the funding for direct construction. GSA has agencies clamoring for facilities that in more normal times would be directly funded and as a result GSA is mostly limited to its basic leasing authority for delivery. Budget pressures cannot reasonably be expected to be reduced any time soon. So the "more money option" is nowhere on the horizon.

Let's talk a bit about the leasing delivery system. The authority to enter into a lease of any significant size originates with a congressionally approved prospectus. That prospectus limits the amount that may be spent to satisfy the requirement. That limit is usually set at GSA's estimate of rents in the market where the space is to be procured. GSA has historically used a single solicitation for the turnkey delivery of space subject to the terms of the GSA lease and the prospectus cost limitation. Lease offerors are required to tailor their space to the public tenant's needs, and the lessor usually operates the space for the term of the lease. This is common enough and usually works where existing space is to be leased.

But now consider the current challenge. GSA is being asked to provide larger and more complex projects and is essentially limited to leasing. In response, GSA has attempted to use its

standard lease solicitation approach to define the relationship with a developer-lessee. The space requirements are such that the lessor must undertake a build-to-suit in order to meet the project requirements. This may involve providing the site, designing, constructing, financing, operating and owning the completed facility. And all this for a fixed rental rate set several years prior based on anticipated market rates.

"The largest purchase we make in our lifetimes is usually our home." We hear that said so often we tend to accept it as fact. The truth usually is that the largest purchase any of us make is the mortgage necessary to purchase our home. This holds just as true for GSA's leased build-to-suits or what is also referred to as lease construction projects. The lessor must arrange financing in order to fund the delivery of the facility—and financing is often the largest component of cost. The risks involved in fixing a construction cost, particularly based on anything less than detailed plans and specs, are tough enough. Just imagine trying to fix the financing rate months ahead of when the financing is required? That's what the current approach to lease construction projects requires.

Let's pursue the financing issue a little further. As we are all aware, rates change over time. GSA lease construction projects are often priced as spreads over Treasury rates. After all, a long-term GSA lease represents a federal agency obligation and pegging rates to Treasuries makes sense. The problem is that Treasuries vary over time and spreads also change over time. Spreads vary as a function of a variety of factors, including the specific nature of the risks associated with a particular lease. But rates vary depending on the vagaries of the market as well. This is especially apparent at this writing as the capital markets experience an unprecedented flight to quality best represented

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by Treasuries but where spreads have widened significantly. In some cases, there simply is no credit available to fund certain obligations.

So what is one to do? The current system of burdening the offerors with taking all the rate risk is to ignore the basic issues. If rates go up, the successful offeror will either seek changes in the lease to cover the additional cost or will attempt to abandon the deal. If rates go down, the lessor reaps a windfall profit. We have seen lessors walk away from closing with very large checks. The government can't win under the current system. There are, of course, financial market tools for hedging rate fluctuations. But they are expensive and it is impractical to burden offerors with yet another pursuit cost. To hedge rates would also require a date certain for funding and GSA's procurement process does not lend itself to committing to such a fixed schedule. Accepting a variable rate would also undermine GSA's assurance that the deal can be completed at the approved rental rate.

GSA's standard lease solicitation tools work reasonably well for procuring smaller increments of space in existing buildings. Under the best of circumstances for larger lease construction projects, it works poorly even under stable circumstances. In current markets it is largely unusable. That is the reason that private enterprise never uses the GSA approach to its privately financed build-to-suits.

Nowhere in the Federal Acquisition Regulations is GSA required to use the current procurement system for build-to-suits. The FAR is often blamed when the government deals in a ham-handed manner with private markets. It may be of surprise that the FAR in 1.102(d) states:

*The role of each member of the Acquisition Team is to exercise personal initiative and sound business judgment in providing the best value product or service to meet the customer's needs. In*

*exercising initiative, Government members of the Acquisition Team may assume if a specific strategy, practice, policy or procedure is in the best interests of the Government and is not addressed in the FAR, nor prohibited by law, Executive order or other regulation, that the strategy, practice, policy or procedure is a permissible exercise of authority.*

Is this a great country or not? The FAR simply says if there is no law against it and it looks like a good idea, then give it a try. Interestingly, elsewhere in the FAR the Acquisition Team is defined to include "... the customers they serve, and the contractors who provide the products and services." GSA is to be commended for its recent lease construction roundtable that was held on June 11, 2008, soliciting agency and industry input.

So GSA needs new tools. The existing system does not work well and current markets may have rendered it unusable. Our earlier article in Government Leasing News [Summer 2008, Vol. 4, No. 2] detailed the system used at the National Institutes of Health Bayview Research Center in Baltimore. The procurement structure there was patterned somewhat on the delivery system employed by GSA in the \$300 million Archives II project in College Park, Maryland, in the late 1980s.

Although Archives II was accomplished before the scoring rules, both projects were privately financed. Most importantly, both projects borrowed their delivery system largely from the standard direct construction design-bid-build-operate model. After all, *these were really privately financed public building developments.* The fact that the final form of the transaction had to be a lease does not alter that fact. Using a more direct construction approach, both projects were designed and built to the budget. At the risk of oversimplifying, the "budget" in both cases was the amount available at prevailing rates to fund the project. Using this delivery

method the budget for a lease construction project will be more dynamic than a direct construction project because of fluctuating rates. Dynamic in the sense that construction plans and financing structures must be readily changeable as rates and requirements change. That's the environment in which the private world must and does operate. The new tools must be based, not on rigid prescribed procurement systems, but on the kind of public-private partnering and relationships that was at the center of both Archives II and Bayview.

The public-private partnering model is the long-term answer to the government's challenge for the best tool for meeting its current backlog. More immediate benefits can be achieved by modifying current solicitations to provide the government with the opportunity to provide its own financing. It is a principle of economic efficiency that the entities causing the risks should manage the risk and sustain the cost or benefits of their own actions. The risks associated with the financing and the resulting rates are almost exclusively within the government's control. To the extent the government causes rates to increase, it should incur those costs. Similarly, any lower rate advantage achieved from improving the deal should accrue to the government. As described in our Fall 2008 article on GSA's Lease Construction Program, this is an approach used during a transition period in a prior program of private financing of public buildings.

We all know that in the options of new tools or new money, it really is a Hobson's choice. There will be no new money for public buildings development for a very long time. So to get the job done we need new and better tools. The tools are there and they have been used successfully before in government. The tools are also based on the best private sector practices. And if there is no law against the new tools and they make sense, the FAR tells us to give them a go.