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HOW DOES THE FEDERAL GOVERNMENT LEASE NEEDED SPACE?

HEARING

BEFORE THE

FEDERAL FINANCIAL MANAGEMENT, GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

OCTOBER 6, 2005

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CONTENTS

	Page
Opening statements:	
Senator Coburn	1

WITNESSES

THURSDAY, OCTOBER 6, 2005

Robert L. Neary, Jr., Acting Chief Facilities Management Officer, U.S. Department of Veterans Affairs	7
William H. Matthews, Assistant Commissioner, Office of Real Property Asset Management, Public Buildings Service, U.S. General Services Administration	9
Mark L. Goldstein, Director, Physical Infrastructure Issues, U.S. Government Accountability Office	12

ALPHABETICAL LIST OF WITNESSES

Goldstein, Mark L.:	
Testimony	12
Prepared statement	39
Questions and responses for the Record	49
Matthews, William H.:	
Testimony	9
Prepared statement	31
Neary, Robert L., Jr.:	
Testimony	7
Prepared statement	28

APPENDIX

Chart entitled "Construction vs. Operating Leases," submitted by Senator Coburn	27

HOW DOES THE FEDERAL GOVERNMENT LEASE NEEDED SPACE?

THURSDAY, OCTOBER 6, 2005

U.S. SENATE,
SUBCOMMITTEE ON FEDERAL FINANCIAL MANAGEMENT,
GOVERNMENT INFORMATION, AND INTERNATIONAL SECURITY,
OF THE COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:30 p.m., in room 562, Dirksen Senate Office Building, Hon. Tom Coburn, Chairman of the Subcommittee, presiding.

Present: Senators Coburn and Carper.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. The Subcommittee hearing will come to order. Senator Carper has advised me he will be late, so we will begin without him to honor your time and our commitment to be on time.

Our goal is to figure out how the lease operations and billing operations work in the Federal Government. To cover the Federal Government's current promised payouts, Americans will have to fork over more than 90 percent of their net worth. To pay the current debt of this country would work out to over $350,000 for each full-time worker. The political will to tackle the problem won't grow until we come clean with the Americans about the scope of the problem at every area in the Federal Government. That is what this hearing is about, increasing transparency about our obligations, our assets, our liabilities, and expenditures.

A few weeks ago, we held a hearing on the financial mismanagement at the Securities and Exchange Commission. One of the findings was that the SEC was involved in an unnecessarily expensive leasing arrangement to acquire new buildings. I would note their leasehold improvements are financed at 9 percent. Once these buildings are built, the SEC won't even own them. What we find is the SEC is not the only agency that operates that way.

What is more, last week, this Subcommittee learned that no one in the Federal Government keeps an inventory of what we buy and at what price. Today, we discovered that this data vacuum extends for inventory in real Federal property assets.

Each year, $5.5 billion goes to pay rent on federally-used properties. We are renting space for facilities while at the same time we already have a vast portfolio of facilities that we are trying to get rid of. GAO estimates that more than 30 Federal agencies control about $328 billion in real property assets worldwide. Many of

these assets and structures are either not needed, not aligned with agencies' missions, or in an alarming state of deterioration. However, no comprehensive number of government-wide real property assets exists.

Not only do we not know what we are renting, but we don't know what we own. I draw your attention to the poster over there, "Construction vs. Operating Leases." [1] The following five examples show that operating leases are almost always more costly than purchase, lease-purchase, or construction. In 1995, GAO reported that GSA had entered into 55 operating leases for long-term needs that were estimated to cost $700 million more than had we constructed them and owned them. In 1999, GAO reported for nine major operating lease acquisitions GSA had proposed, construction would have been the least costly option in eight cases and would have saved $126 million for the taxpayer. A lease-to-purchase option would have saved an estimated $107 million.

The Patent and Trademark Office in Northern Virginia entered into an operating lease that was estimated to be $48 million more than construction and $38 million more than lease-purchase. The Department of Transportation headquarters reduced the term of a 20-year lease to a 15-year lease so that it could meet the definition of an operating lease. GSA's fiscal year 1999 prospectus for constructing a new facility for this need showed the cost of construction was estimated to be $190 million less than the operating lease. SEC used the same approach by reducing the terms of their lease from a 20-year lease to a 14-year lease in order to fit OMB's criteria for an operating lease.

The Administration has acknowledged the problem, and for that, I commend them. OMB has begun to look at some, if not all, of the problems with property asset management. This is a critical first step to managing the government's real property portfolio, but OMB isn't specifically focused on the increasing use of costly leasing arrangements.

The problem is serious and has long been ignored. GAO has been reporting for over 6 years that the government's reliance on costly leasing instead of ownership or lease-purchase poses liabilities in an unknown proportion on the American Government. GAO reports that agencies change lease terms in order to avoid higher up-front costs. Reliance on the lease changes creates huge liabilities on the Federal Government of an unknown amount.

The Federal deficit figures do not reflect these liabilities, but budget scorekeeping rules, altered in 1990, are mainly to blame because they do not require most leases to be counted against an agency's annual appropriation. This encourages agencies to rent space to meet their needs because only a portion of the cash is needed up front.

Congress is part of the problem. Rather than requiring agencies to plan and budget for their facilities needs, we refuse to let them cut in other areas to appropriately invest in construction projects that could save us money. We encourage the government to operate

[1] The chart entitled "Construction vs. Operating Leases," submitted by Senator Coburn appears in the Appendix on page 27.

in some alternative universe rather than the way normal American families and business operate.

When a renter in Oklahoma wants to buy his first home, he and his family scrimp and save until they have enough for a down payment. They understand that owning a house may be more difficult up front, but it is much better for their long-term financial health.

Congress doesn't let agencies do the same when they need a new building. Congress is so beholden to special interests that we can't allow agencies to set priorities and cut program budgets in order to find money for down payments on new buildings.

And what about when a home-owning family or business is growing and needs more space? They sell their existing facility and use the profit to invest in the bigger facility. What they don't do is keep their existing facility in perpetuity while arranging outrageous terms on short-term lease for the building they will never own.

When Congress does so-called oversight on agency budgets, those hearings often amount to nothing more than agencies getting spanked for trying to cut spending in certain programs. After the hearing, appropriators just go add that spending right back in. What choice does an agency have but to engage in costly leasing schemes that look on paper like budgets are unaffected, but which gouge the taxpayer, our children, and our grandchildren over the long run?

Today, I look forward to hearing about the way the Federal Government obtains needed space, the reason agencies have chosen certain options. I am also interested to hear what the long-term implications for the American taxpayer are under the current budget scoring rules. We will hear from key players in the leasing process, the U.S. Government Accountability Office, the Government Services Administration, and the Department of Veterans Affairs.

I also would make the statement, and I do this—I am not picking on you all—because the notice of this hearing was quite some time ago. We got VA's testimony at 2:30 p.m. yesterday and 9 a.m., GSA's, and GAO was on time. So it tells us there is a problem. I recognize your testimony has to go through OMB, but we have talked with OMB about that.

My first predilection was to cancel the hearing so we can enforce some discipline in terms of us being able to do our job. I chose not to do that, but I am sending the message to OMB, the next hearing we have where the testimonies are not here on time, we will cancel the hearing, but we will not tell you at which time we will cancel the hearing, so we will waste your time and our time, just like ours has been wasted by not having the appropriate material in front of us in a timely manner.

With that said, let me smile and welcome each of you here. Let me thank you for your service to our country. Each of you provides and does a job that is needed. We understand that. What we want to do is have the information to how we can help you to do that job better. We want to create a climate where we lessen the costs in the long-term for the Federal Government, and we look forward to having your testimony and your thoughts along with that.

[The prepared statement of Senator Coburn follows:]

Chairman's Statement
"How Does the Federal Government Lease Needed Space?"

October 6, 2005

To cover the Federal government's *current* promised pay-outs, Americans would have to fork over more than 90 percent of their net worth. To pay the current debt of this country would work out to over $350,000 (GAO analysis) for each full-time worker. Political will to tackle the problem won't grow until we come clean with Americans about the scope of the problem. That's what this hearing is about - increasing transparency about our obligations, assets, liabilities, and expenditures.

A few months ago, we held a hearing on the financial mismanagement at the Securities and Exchange Commission (SEC). One of the findings that day was that the SEC is involved in an unnecessarily expensive leasing arrangement to acquire new buildings. Once these buildings are built, the SEC won't even own them. I was surprised to learn that SEC is not the only agency that operates this way.

What's more, last week this subcommittee learned that no one in the Federal government keeps an inventory of what we buy and at what price. Today, we discover that this data vacuum extends to our inventory of real federal property assets. Each year, five and a half billion dollars (GSA) goes to pay rent on Federally-used properties. We're renting space for these facilities, while at the same time, we already have a vast portfolio of facilities that we're trying to get rid of. GAO estimates that more than 30 federal agencies control about $328 billion in real property assets worldwide. Many of these assets and structures are either not needed, not aligned with agencies' missions, or in an alarming state of deterioration—however –no comprehensive number of government-wide real property assets exits. Not only do we not know what we're renting, but we don't know what we own.

The following five examples show that operating leases are almost always more costly than purchase or construction:

- In 1995, GAO reported that GSA had entered into 55 operating leases for long-term needs that were estimated to cost $700 million more than construction.

- In 1999, GAO reported that for nine major operating lease acquisitions GSA had proposed, construction would have been the least-cost option in eight cases and would have saved an estimated $126 million. A lease to purchase option would have saved an estimated $107 million.

- The Patent and Trademark Office (Northern VA) entered into an operating lease that was estimated to be $48 million more than construction and $38 million more than lease-purchase.

- Department of Transportation headquarters reduced the term of a 20 year lease to a 15 year lease so that it could meet the definition of an operating lease. GSA's FY 1999 prospectus for constructing a new facility for this need showed the cost of construction was estimated to be $190 million less than an operating lease.

- SEC used the same approach by reducing the terms of their lease from a 20-year lease to a 14-year lease, in order to fit OMB's criteria for "operating lease."

The Administration has acknowledged a problem, and for that I commend them. OMB has begun to look at some, if not all, of the problems with property asset management. This is a critical first step to managing the government's real property portfolio, but OMB isn't specifically focused on the increasing use of costly leasing arrangements.

And the problem is serious and has long been ignored. GAO has been reporting for ***over six years*** that the government's reliance on costly leasing--instead of ownership—poses liabilities of an unknown proportion on the American government.

GAO reports that agencies change lease terms in order to avoid higher up-front costs. Reliance on these leases creates huge liabilities on the federal government-of an unknown amount. The federal deficit figures do not reflect these liabilities. Budget scorekeeping rules altered in 1990 are mainly to blame because they do not require most leases to be counted against each agency's annual appropriation. This encourages agencies to rent space to meet their needs, because only a portion of cash is needed up front.

Congress is part of the problem. Rather than requiring agencies to plan and budget for their facilities needs, we refuse to let them cut in other areas in order to appropriately invest in construction projects. We encourage the government operate in some alternate universe rather than the way normal American families and businesses operate. When a renter in Oklahoma wants to buy his first home, he and his family scrimp and save until they have enough for a down payment. They understand that owning a house may be more difficult up front, but is much better for their long-term financial health. Congress doesn't let agencies do the same when they need a new building. Congress is so beholden to special interests that we can't allow agencies to set priorities and cut program budgets in order to find money for down payments on new buildings.

And what about when a home-owning family or business is growing and needs more space? They sell their existing facility, and use the profit to invest in the bigger facility. What they ***don't*** do is keep their existing facility in perpetuity, while arranging outrageous terms on a short-term lease for a building they will never own.

You see, when Congress does so-called oversight on agency budgets, those hearings often amount to nothing more than agencies getting spanked for trying to cut spending in certain programs. After the hearing, appropriators just go add that spending right back in. What choice does an agency have but to engage in costly leasing schemes that look - ***on paper*** - like current budgets are unaffected, but which gouge the taxpayer over the long haul?

Today I look forward to hearing about the way the federal government obtains needed space and the reasons agencies have chosen certain options. I am also interested to hear what the long-term implications are for the American taxpayer under current budget scoring rules. We will hear from key players in the leasing process: the U.S. General Accounting Office, the Government Services Administration, and the Department of Veterans Affairs.

I want to thank our witnesses for their time and preparation.

Senator COBURN. As I said, Senator Carper will be here in about 15 minutes, so we will go on and start.

Our first witness is Mark Goldstein. He is the Director of Physical Infrastructure Issues at the U.S. Government Accountability Office. He is responsible for the agency's reviews, audits, and investigations in Federal property, telecommunications, and special products.

Bill Matthews is Assistant Commissioner of the Office of Real Property Asset Management at the U.S. General Service Administration. In that capacity, Mr. Matthews is responsible for asset management and the continuous financial improvement for a nationwide portfolio of over 1,500 federally-owned properties which generate almost $7.3 billion in revenue. He also is responsible for capital planning and investment portfolio strategy, policy and analysis, and disposal.

And finally, Robert Neary is Acting Chief Facilities Management Officer of the Veterans Health Administration at the Department of Veterans Affairs. He is responsible for managing many of the Department of Veterans Affairs' capital asset programs, including major construction, minor construction, real property management, leasing, enhanced use leasing, architectural, engineering, and policy advice.

Welcome, and I think we will start with you, Mr. Neary, and go down the row. You will have 5 minutes plus if you would like to do that. Your written statements will be made a part of the record. Feel free to take the time that you need.

TESTIMONY OF ROBERT L. NEARY, JR.,[1] ACTING CHIEF FACILITIES MANAGEMENT OFFICER, U.S. DEPARTMENT OF VETERANS AFFAIRS

Mr. NEARY. Thank you, Mr. Chairman. Let me say I am pleased to be here this afternoon to present an overview of VA's leasing programs, and I will start by apologizing for our testimony being tardy. We will do everything we can not to let that happen again.

Senator COBURN. The Senators are late all the time, but that doesn't give us an excuse. If we waste your time, we should be chastised for it, and vice-versa. That is why we started this hearing on time, and we do things on time because your time is just as valuable or more valuable than my time.

Mr. NEARY. Thank you, sir. I appreciate that.

Senator COBURN. Please continue.

Mr. NEARY. The Department of Veterans Affairs is the owner and operator of the largest real estate health care-related portfolio in the United States. VA also maintains facilities for our Veterns Benefits Administration (VBA), which handles veterans' benefits other than the health care program, and for most of the national cemeteries in the United States.

We own and operate over 5,000 buildings, comprising approximately 144 million square feet, and about 7 percent or 7.5 percent of that is acquired through lease. We use our leasing authority for multiple purposes, including space for community-based outpatient

[1] The prepared statement of Mr. Neary appears in the Appendix on page 28.

clinics, VBA regional offices, and space to support the Department's research and information technology missions, to name a few.

The need for space is identified in the strategic planning processes of each of the administrations. The proposed acquisition of leased space exceeding the threshold levels established by Congress is evaluated as part of the Department's capital investment application process. Smaller amounts of space are approved at appropriate levels within the Department.

We operate our leasing program under a delegation from the General Service Administration. We were initially granted a delegation in 1983 focusing on medically-related activities. That delegation expanded over time, through and including GSA's broader delegation in 1996 under the program known as "Can't Beat GSA Leasing" to lease general purpose office space for periods of up to 20 years.

Federal agencies must adhere to all of the laws and regulations when acquiring and utilizing space, and therefore we follow the same rules, regulations, and laws as does GSA. We must first notify GSA of proposed actions to be sure that there is not available space in the Federal inventory that would meet our needs. VA also reports semi-annually to the GSA on our leasing delegation activity.

We are mandated by Congress with certain authorization and appropriation requirements. If the annual cost of a rent of a lease is greater than $600,000, we are required to have an authorization from the Congress. In addition, we must notify the Congress of our intent to award a lease if it exceeds $300,000 or if the cost will exceed by 10 percent that which was authorized in law.

Within the VA, the Secretary has delegated various authorities. My office is responsible for the majority of leasing actions that go on throughout the United States. If facility wishes to lease, needs to lease space, less than 10,000 square feet and less than $300,000 in annual rent, they have the authority to do that. Above that, it is necessary for them to come to the Washington headquarters for approval, up to and including the involvement of the Congress if it is greater than $600,000.

All of our leasing actions are negotiated procurements based on a methodology colloquially known as best value. We seek competition to the fullest extent possible when acquiring space and establish evaluation criteria specific to each procurement. Offers are evaluated for both technical qualifications and price and a contracting officer establishes a competitive range and negotiates with those in the range and makes a decision on the best value to the government.

Under the budget scorekeeping rules, we evaluate the price in present value terms to determine if the lease needs to be scored for budget purposes or whether it can be considered an operating lease and paid in annual rent.

Our Real Property Service has a small staff of 15 individuals who manage the large leases from Washington and from our field office in Silver Spring, Maryland, and we conduct training for VA employees throughout the United States in conjunction with the VA's Office of Acquisition and Material Management to ensure that our leasing program is effective and provides quality execution.

I want to close with a mention of our enhanced use leasing program. In addition to traditional leasing programs, VA also has been granted EU leasing authority. This unique asset management tool, managed jointed by the Office of Asset Enterprise Management and the Office of Facilities Management, is an innovative process to partner with the private sector to maximize return from underutilized capital assets. Currently, VA can out-lease property to other parties for up to 75 years for fair consideration, and the fair consideration can be in the form of cash, services, space, or other in-kind consideration.

The law was originally authorized in 1991 and recently modified and reauthorized until 2011. We have successfully developed projects giving veterans access preferences and discounts for the usage of assisted living, traditional transitional homeless housing, and homeless services facilities without the use of appropriated funds. The program results include significant cost savings compared to construction and leasing, substantial private investment in the Department's capital facilities and infrastructure, and new long-term sources of revenue.

Mr. Chairman, that concludes my opening statement. I will be pleased to answer questions at the appropriate time.

Senator COBURN. Thank you very much.

Chairman COBURN. Would you like to do your opening statement, Senator Carper.

Senator CARPER. I don't have an opening statement that I want to give. I just want to say welcome to our witnesses. We are delighted that you are here and look forward to your testimony and the chance to ask you some questions.

Thanks, Mr. Chairman.

Senator COBURN. Thank you. Mr. Matthews, it is good to see you again.

TESTIMONY OF WILLIAM H. MATTHEWS,[1] ASSISTANT COMMISSIONER, OFFICE OF REAL PROPERTY ASSET MANAGEMENT, PUBLIC BUILDINGS SERVICE, U.S. GENERAL SERVICES ADMINISTRATION

Mr. MATTHEWS. Good to see you again, sir. Let me first start by also apologizing for the tardy submission of our testimony. We will endeavor not to let that happen to us again.

Senator COBURN. Can I ask you a question about that? The delay is not you, correct?

Mr. MATTHEWS. I am certain we contributed to that delay.

Senator COBURN. But most of the time, getting it cleared through OMB is the problem, is that right?

Mr. MATTHEWS. I would be reluctant to say it was solely the fault of OMB that we were late.

Senator COBURN. All right.

Senator CARPER. I just thought that was a gracious response.

Mr. MATTHEWS. We were the ones called. It is our job to get it on time, and I apologize for the tardiness.

My name is Bill Matthews. I am the Assistant Commissioner for the Office of Real Property Asset Management for the GSA and I

[1] The prepared statement of Mr. Matthews appears in the Appendix on page 31.

am pleased to talk about and provide an overview of our leasing process.

GSA is among the Nation's largest public real estate organizations, providing a work space for more than 1.1 million Federal workers in almost every Federal agency, the judiciary, and for some parts of Congress.

We are a real estate services delivery organization. We support our customer agencies in their mission of service to the American people, and as such, it is our mission to provide a quality workplace for the Federal worker at a superior value.

Our agency customers are required to use existing vacant federally-controlled space when that space is available and suitable to meet their mission requirements and in a location where their mission is appropriately carried out. When suitable Federal space is not available, we can lease space from the private sector.

Approximately half of our customers' workforce is housed in over 1,500 buildings owned by the Federal Government and held in custody and control of GSA. The other half is located in over 7,300 buildings that we lease from the private sector in over 2,000 communities across the United States and its territories. These leased buildings together comprise over 167 million square feet out of our total portfolio, which is in excess of 340 million square feet. Our annual rent bill for leases with private landlords is approximately $3.8 billion per year.

We lease space in both large cities and small towns when leasing is the only practical answer to meeting Federal space needs. More than 50 percent of our leases by number are for increments of 10,000 feet or less. The size of a lease can range from literally a single room to an entire building or group of buildings.

We lease all types of space for our diverse Federal clientele, primarily office space. Eighty-five percent of our portfolio is for commercial office space. But we also lease laboratories, warehouses, clinics, and border stations. We locate them according to the customer's mission requirements in urban, suburban, and rural areas in accordance with established Federal location and security polices.

We execute many single-tenant leases, but also many multi-tenant leases with agencies which are consolidated for economies of scale. Other GSA leases meet tenant leases for storefront locations in high public access. These are in contrast with other leases for customers who require limited access to and control of their buildings for security purposes.

When the existing inventory of buildings in the local market cannot meet our customers' requirements and where Federal construction is not an option, we solicit the construction of a new building, which is built to meet our customers' specifications and leased by us on the customer's behalf. All of our lease assets are held in GSA's name and not passed forward to our customers.

Our principal authority to lease real property for use by Federal agencies is derived from the former Federal Property and Administrative Services Act of 1949. That authority is now codified in Title 40 of the U.S. Code, Section 585, which authorizes GSA to enter into space leases on behalf of Federal agencies for terms up to 20 years.

In terms of our tenants, we strive to keep leasing costs at or below market levels and have developed a comprehensive strategy to do so. We use standard industry benchmarks and market surveys to assure that we are getting the best value for our customers. We use published market sources to gain a better understanding of area markets. Our standard lease forms try to balance the interest of the government against the interest of private landlords to achieve a cost-effective contract term.

Because lease often acquires large blocks of space to meet the needs of multiple Federal agencies, we are often able to leverage our market position to get more favorable rent rates and lease terms for the taxpayer. Also, the creditworthiness of the Federal Government can be used as an important consideration in obtaining more competitive rent rates.

Additionally, this year, we have awarded a national broker contract. This effort consolidated our private leasing support services among four commercial real estate service firms. The award is the largest single contract of its type in the history of GSA's Public Buildings Service and will enable us to leverage the expertise of private sector brokerage firms and increase our capacity to achieve market value in the marketplace. It will also assist us in our efforts to standardize leasing practices nationwide and provide more support to our customers.

Another important consideration in measuring the value of real estate that is leased is the cost of holding vacant leased space. The vacant leased space in our inventory is down to 1.3 percent, which is a historic record low and a figure well below industry averages.

Not surprisingly, the increased need for security in many agencies does have an effect on GSA's leasing process and on lease cost. The need for greater building setbacks, blast resistance, building access requirements, and restrictions on who can be co-located within our space all affect lease procurement and the cost of space we lease.

Our leasing process is conducted within a framework of procedures that comply with a comprehensive list of laws and Executive Orders. These include the Competition in Contracting Act, the Small Business Act, energy, environmental, and historic preservation laws, and other Executive Orders.

Leases with an annual cost that exceeds a specific dollar threshold, $2.41 million for fiscal year 2006, require explicit Congressional authorization. For this purpose, GSA submits prospectuses to the Senate Committee on Environment and Public Works and the House Committee on Transportation and Infrastructure for their approval.

For most of our leasing activities, we follow a fairly standard process which starts with customer involvement in defining workplace requirements that is highly variable. Some customers have a very sophisticated, well-developed and repetitive set, and in other cases, they have to be developed from scratch and the agency requires a great deal of assistance.

In determining those requirements, we conduct a series of meetings, and once our customer requirements are established, we document the amount and types of space and technical requirements in an interagency agreement called an occupancy agreement. At this

stage, we review the availability of Federal space to meet the needs, and if none is available, we study the market against the customer requirements and develop and present various leased housing options. And finally, we redocument after that market survey with a progressive occupancy agreement that reflects the additional information we have.

We try to maximize competition through advertising on the Federal Business Opportunities Web page to ensure increased exposure of our request for offers.

Once initial bids are received, we generally conduct negotiations with all offerors to assure they understand the requirements and can better prepare their final proposals. We conduct multiple scoring analysis throughout this process, before we enter the market, and during negotiations. When final proposals are received, we evaluate them and make an award, usually on the basis of lowest price, but for more complex and longer-term requirements, we consider source selection procurements where a higher weighted qualitative proposal may prevail over a lower-rated, lower-priced proposal. In these cases, a determination has to be made and justified that the technical superiority justifies the cost differential.

We give the successful offeror an adequate time to build out the space. We inspect and accept the space, assist our tenants in move-in, and then start the rent process.

GSA's lease responsibilities do not stop as we hold the lease. We continue to service it with escalations and adjustments in lease administration activity throughout the life of the lease term. Typically, unless GSA has delegated operational responsibility, we will continue these activities throughout most of the 7,500 leases we service.

Also, under a program called "Can't Beat GSA Leasing," GSA delegated its leasing authority to other Federal agencies. It was our intention to end our monopoly provider status and enter into a provider of choice relationship with most of our Federal agencies and most of them have chosen to stay with us at this point.

Mr. Chairman, this is the approach we use to identify and meet our customer agencies' mission requests for leased space. Meeting our customer requirements in an efficient and cost-effective manner is our agency's highest priority. I thank you for the opportunity to testify before your Subcommittee and I will be happy to answer any questions you might have.

Senator COBURN. Thank you very much, Mr. Matthews. Mr. Goldstein.

TESTIMONY OF MARK L. GOLDSTEIN,[1] DIRECTOR, PHYSICAL INFRASTRUCTURE ISSUES, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. GOLDSTEIN. Thank you, Mr. Chairman and Senator Carper. Thank you for the opportunity to testify today on our work related to Federal real property, and in particular, the government's reliance on space leased from the private sector.

As you know, at the start of each new Congress since 1999, we have issued a special series of reports entitled, "Performance and

[1] The prepared statement of Mr. Goldstein appears in the Appendix on page 39.

Accountability Series: Major Management Challenges and Program Risks." In January 2003, we designated Federal real property a high-risk area as part of this series and we issued an update on this area in January 2005.

We identified the government's reliance on costly leased space as one of the major reasons for this high-risk designation. Other reasons included excess and deteriorated property, unreliable real property data, and the challenges associated with protecting those assets from terrorism. My testimony today will discuss our designation of Federal real property as a high-risk area and focus specifically on the government's reliance on costly leased space.

According to available data, the Federal Government owns and leases about 3.3 billion square feet of building floor area worldwide in roughly a half-a-million buildings. About 380 million square feet of this space is leased.

My testimony today will highlight the following points. One, the conditions that led to our January 2003 high-risk designation still exist. Many of the assets in the government's vast and diverse portfolio of real property are not effectively aligned with or responsive to agencies' changing missions. Furthermore, many assets are in an alarming state of deterioration. Agencies have estimated restoration and repair needs to be in the tens of billions of dollars.

Compounding these problems are the lack of reliable government-wide data for strategic asset management and the cost and challenge of protecting these assets against terrorism. Additionally, a heavy reliance on costly leasing instead of ownership to meet new space needs is a pervasive and ongoing problem.

The Administration has acknowledged the problems in this area. In February 2004, the President added the Federal Asset Management Initiative to the President's Management Agenda and signed an Executive Order on real property management reform. These and other efforts are positive steps, but it is too early to judge whether the administration's focus on this area will have lasting impact.

In addition, we continue to believe that a comprehensive and integrated transformation strategy is needed to address the problems and underlying obstacles to reform, which include competing stakeholder interests, various funding and budgetary disincentives, and the need for improved capital planning among agencies.

Two, as a general rule, building ownership options through construction or purchase are the least-expensive ways to meet agencies' long-term and recurring requirements for space. Lease-purchases, under which payments are spread over time and ownership of the assets is eventually transferred to the government, are generally less costly than using ordinary operating leases to meet long-term space needs, but are more costly than other ownership options. However, over the last decade, we have reported that the General Service Administration, as the central leasing agent for most agencies, relies heavily on operating leases to meet new long-term needs because it lacks funds to pursue ownership.

While we have no recent work in this area, in 1995, we reported that GSA had entered into 55 operating leases for long-term needs that were estimated to cost $700 million more than construction. In 1999, we reported that for nine major operating lease acquisi-

tions GSA proposed, construction would have been the least-cost option in eight cases and would have saved an estimated $126 million. Lease-purchase would have saved an estimated $107 million compared with operating leases, but would have cost $19 million more than construction.

A prime example of this problem was the Patent and Trademark Office's long-term requirements in Northern Virginia, where the cost of meeting this need with an operating lease was estimated to be $48 million more than construction and $38 million more than lease-purchase. In August 2001, we also reported that GSA reduced the term of a proposed 20-year lease for the Department of Transportation headquarters building to 15 years so that it could meet the definition of an operating lease. GSA's fiscal year 1999 prospectus for constructing a new facility for this need showed the cost of construction was estimated to be $190 million less than an operating lease.

The Securities and Exchange Commission used a similar approach by reducing the terms of a proposed 20-year lease for its facility to 14 years.

Although most of our work in this area has focused on GSA-controlled space, other real property holding agencies with leasing authority, such as the Department of State and Veterans Affairs, also face the same obstacles to ownership. Operating leases have become an attractive option, in part because they generally look cheaper in any given year, even though they are generally most costly over time. Budget scorekeeping rules allow budget authority for some of these operating leases to be spread out over the term of the lease. In contrast, budget authority for ownership options, according to the scorekeeping rules, are recorded fully up-front in the budget to appropriately reflect the government's commitment.

As a result, this situation has encouraged an over-reliance on operating leases for satisfying long-term space needs. Resolving this problem has been difficult. However, change is needed because the current practice of relying on costly leasing to meet long-term space needs results in excessive cost to taxpayers and does not reflect a sensible or economically rational approach to capital asset management.

Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions that you or Members of the Subcommittee have. Thank you.

Senator COBURN. Thank you very much. I thank all of you. Senator Carper, do you want to start?

Senator CARPER. Thanks, Mr. Chairman.

Mr. Matthews, you just heard a litany there of, I guess, criticism and questions from Mr. Goldstein. Let me just ask you to take a minute or two and respond to some of them. Do you agree?

Mr. MATTHEWS. I always agree with GAO. [Laughter.]

Senator COBURN. That could be dangerous. I don't.

Mr. MATTHEWS. The general observation that our leased inventory is growing is quite correct. In 1964, our leased inventory was under 50 million square feet, and as the government grew, it grew faster than our ability to fund new construction, and today you heard me testify that it was up to 167 million square feet.

Generally, I would agree with the observations that we have grown very dependent on operating leases. Over the last 40 years, we have seen our leased inventory at GSA grow from under 50 million to over 167 million square feet. During that same period of time, the amount of direct Federal construction, the amount of the owned inventory that GSA has under its custody control has remained fairly stable. There has not been a growth spurt. We have disposed of assets that no longer meet Federal needs or they are in the wrong locations, they are archaic designs that no longer fit the typical Federal user.

The bottom line is that we have basically a lack of alternatives to leasing and we have some built-in incentives because of the scoring rules to write operating leases. There are also some arguments for leases.

Senator CARPER. Talk about the issue a little bit more, please.

Mr. MATTHEWS. About the advantages of leasing?

Senator CARPER. Yes. How are you incentivized to do that? You mentioned the word scoring.

Mr. MATTHEWS. Well, the very first point is one made by my colleague from GAO, that the first year costs of leasing are much lower than the first year costs of direct Federal construction by a very significant margin, and we have done every year a good deal of Federal construction. We have reached the point where we, for general purpose office space, the attractiveness of the commercial market is better.

But I would also like to make a point that for many of our customers, leasing is a preferred option. There are rapidly changing organizational and program mandates that the Federal agencies are facing that cause them to want to stay in a somewhat fluid situation. There are changes in technology. Some of our larger customers are, and this is not for the very largest, but for the medium-sized leases, they are very sensitive to geographic location near the people for whom they are providing services.

For example, the Social Security Administration likes to be in the middle—in fact, I think this is even embedded in their authorization—in the middle of the service area where the beneficiaries reside. IRS now tracks in a geographic basis where people are for whom they are providing services or are involved in enforcement actions. We feel these are very legitimate reasons to want to stay fluid because these things shift.

As we study closely through Core Net and BOMA and other professional organizations, we see our colleagues in the private sector also have moved heavily toward—during this same 4-year period, there has been an increased tendency in the private sector to enter into shorter-term leases to remain flexible, to adjust to changing market conditions, technology, service issues of the type I just described in the Federal sector.

On the other hand, we have told GAO, and I think this remains our position, that for situations where we have a demonstrated long-term need, a large requirement, and large is somewhat subjective, but I would say 100,000 square feet or more, and in markets where we have other activities where we could backfill if we encountered vacant space, it does make all the sense in the world to own rather than lease if you have the resources.

Senator CARPER. Mr. Goldstein, we will come back to you and the point that Mr. Matthews raises about their movement toward long-term leases, operating leases, sort of mirrors what is going on in the private sector. I would just ask if you find that to be the case, and if so, say so, and if not, explain your difference.

Mr. GOLDSTEIN. I think it probably does. We haven't done a lot of work to look at what is occurring in the private sector. I would agree with Mr. Matthews that there are certainly times when it behooves the Federal Government to be flexible in leasing depending on how the needs of the government are changing. In fact, it is also the case based on many of the reports that we have issued. That is, while we have talked about the fact that construction is frequently the better course for the taxpayer when it comes to the dollar, it is also the case that for leasing, there are always situations where it is going to make more sense. It may be in rural areas. It may be in certain kinds of space, certainly in temporary space when the government is refurbishing permanent space. So, there are certainly times where leasing makes sense.

We don't say that in every instance, construction and purchase of a building are going to be cheaper. That is not the case. But overall, that clearly is where we would like to see GSA go.

Senator CARPER. Thanks. Mr. Chairman, thanks very much. Will we have time to ask some more questions, as well?

Senator COBURN. Yes.

Senator CARPER. Good. Thank you.

Senator COBURN. I want to go to Mr. Neary here first, and I will just kind of go down the line. You have delegation rights from GSA to do certain things. What is the total number of buildings that you all have? How many are owned, how many are leased, and how many are lease-purchased?

Mr. NEARY. We have about 5,300 buildings. I don't know the specific number that is leased. In terms of square footage, approximately 7.5 percent of the space is leased and the rest is owned. The bulk of that is in the health care system. The majority of office space that the Veterans Benefits Administration uses is acquired through GSA.

Senator COBURN. Would you agree that most often, a lease-purchase would be better for us than a lease?

Mr. NEARY. In terms of the economics, I think that probably would be correct.

Senator COBURN. What percentage are lease-purchase in the VA?

Mr. NEARY. I don't believe we have any lease-purchases in the VA.

Senator COBURN. So my question is, why not?

Mr. NEARY. I think, as Mr. Matthews said, in locating space and acquiring space to accomplish our mission, there are various options available to us. Probably no agency would say that we receive the amount of capital that we would like or that we feel that we need. Most of our leases are smaller leases and I think they are appropriate to be done as an operating lease. They are short-term requirements, or they are small spaces, rural areas, kind of things. We have a number of leases, large clinics, for example, that probably meet the characterization of Mr. Goldstein that you need to make a business choice. In some of those cases, we have obviously

constructed a lot. We have a large construction program. But in some cases, we have chosen to lease.

Senator COBURN. I am still having trouble with this lack of lease-purchase, because, first of all, we are the best payer in the country. We have the best credit rating, as Mr. Matthews testified. We lose—even in lease-purchase, what is the internal rate of return you all allow to the people you lease from? I mean, do you look at their internal rate of return to make a decision of whether or not this is a good lease?

Mr. NEARY. I don't know the answer to that. We could provide that to the Subcommittee.

Senator COBURN. OK. I think that is really important, because being in the commercial real estate business to a very small degree myself, we make all our decisions based on what the internal rate of return is going to be. It would seem to me that there has not been enough emphasis on lease-purchase, because lease-purchase gets us around the budget rules to a certain extent, but a lease-purchase allows us to gain equity. And even though we might lose on some because of the smallness or the geographical location, if you look at commercial real estate appreciation as a whole in this country, there has been a significant increase in it in the last 10 years.

The American taxpayer got no benefit out of that equity appreciation except for an increase in the lease rate as the property increased in value, if it is based on any type of internal rate of return. I would love for you all to tell us the criteria that you all use in terms of internal rate of return when you look at a lease and also to break it down.

If you have no true lease-purchase, what is it in the budget accounting that Senator Carper and I can do to help you all with the budget scoring rules to make this a better deal for the American public? Off the top of your head, do you know what we need to do to help you in terms of budget scoring?

Mr. NEARY. I am probably not one who is in a position to really respond to that. I am not an economist or particularly knowledgeable about economics.

Regarding lease-purchase, under the current budget scoring rules, if we were to enter into a lease-purchase agreement, that would be scored as a capital lease and that is the primary reason we have not done that.

Senator COBURN. So the whole cost of that lease would be scored——

Mr. NEARY. Present value.

Senator COBURN. So that is something we could change. So we end up losing equity gain by having the budget scoring rules that way, correct? This is an opportunity cost lost because we didn't go lease-purchase because we are going to score it as a capital cost for the total cost of the lease over the life of the lease, correct? Is that what you are saying?

Mr. NEARY. That is correct.

Senator COBURN. So that is something that hinders you from making the best decision for the American taxpayer, is that right?

Mr. NEARY. Well, Senator——

Senator COBURN. Under the budget scoring?

Mr. NEARY. I am here representing the Administration in some sense, I guess, and we in VA are required to follow the existing budget scoring rules.

Senator COBURN. Oh, I understand that. The whole purpose of this hearing—there are two or three. One is to figure out what you are doing and how you are doing it. The other is if there are things that we can change to save the American taxpayer money, we need to be doing that, and when we handicap your ability to make the best equitable deal for the country, and it may not always be a capital purchase. It may be smarter for us to do a lease-purchase.

But if you have a hand tied behind your back and you have lease versus purchase, most of the time, you are going to lease because of the way it is scored. So if it is a lease-purchase and it is scored just like a capitalization of a new building, then we are going to have problems ever getting you to the point to make good lease-purchase agreements. My medical building at home was a lease-purchase. It has been a great deal. As the building has appreciated, a portion of my rent has gone towards equity, and so I have gained in that equity.

Bill, do you have any comments on that?

Mr. MATTHEWS. It is a difficult issue for us to talk about. It is hard to argue that we are not disadvantaged by not having more opportunities to take an equity position where, as I said, you have criteria for very long-term large requirements where the flexibility of leasing is not as important to you. I don't think the Budget Enforcement Act was written around my program area, so it is hard for me to understand fully what Congress' objectives and intents were there.

Senator COBURN. I guess the thing I would like to get from you is a commitment to help us figure out what we can change in terms of the Budget Act that will make your job more likely to be successful in capturing equity growth and lowering overall cost and ending up with real assets, even though we may turn around and sell them. We all know that a lease, a 15-year lease which expires, all you got was the space to use, whereas if it is a lease-purchase agreement, you got the space and a portion of the equity. I know those aren't always going to be good, because you may not be able to negotiate the best deal to get us them.

But I just would like a commitment from you to give this Subcommittee what you think needs to be changed in the Budget Act so we can make those—or at least we can argue for those changes when we come to the next Congress, or change the Budget Act, because I see a real loss. In reading GAO's report, $700 million here, $129 million here.

The SEC obviously would have done a whole lot better had they been doing the GSA Best Buy program than doing it on their own, based on the mistakes they made and the fact that they forgot to include leasehold improvements in their lease when they bought it. That tells you that not all agencies have the capability to do what you do.

I would also say, I don't have any argument with how you all are running what you are running. What I want to do is get us more value, know what we have got, know what we need to get rid of, and use those assets to leverage other assets and to create a way

for, if you have a building that is not out there and you can say, well, I can sell this building. We don't have a need for it. I can use that money to lease-purchase four other buildings the same size and offset the budget rules to be able to get there. What I am trying to do is help you save us money for our grandkids.

So I would just like that commitment from you, if you will, or maybe the Administration won't let you do that, I don't know.

Mr. MATTHEWS. Well, as my colleague said, not being an attorney or an economist, it is difficult for us to fully respond to that. I think we are committed to looking for additional tools. GSA supported reform legislation that you may be aware of in previous years, asking for more leeway to do something closer to enhanced use leasing that involved redevelopment of underutilized Federal assets. We have some limited authorities in that respect and we are trying to find ways to use those to get closer to sharing an equity position and still remaining on the right side of the operating lease problem.

I can commit to sharing our previous thoughts on reform legislation with the Subcommittee separately.

Senator COBURN. OK. Good enough.

Let me ask you the same question that I asked Mr. Neary. Total number of buildings, total number owned, total number leased, total number lease-purchased.

Mr. MATTHEWS. May we submit those separately?

Senator COBURN. Do we know them?

Mr. MATTHEWS. Yes, we have very detailed records.

Senator COBURN. And you can give us by numbers as well as by square footage?

Mr. MATTHEWS. Absolutely. Owned, leased, and square footage.

Senator COBURN. And lease-purchased. We do have some lease-purchases going on.

Mr. MATTHEWS. We have some transactions from prescoring years that might qualify as lease-purchases, but we haven't done any since about 1990, when that legislation went into effect.

Senator COBURN. Let me ask you another question. Is the problem not having enhanced use leasing authority, or is the problem the budget scoring rules? Which is it?

Mr. MATTHEWS. I would be inclined to say the first. The principal problem is the Budget Enforcement Act requirement for scoring capital leases.

Senator COBURN. So it is the scoring rules, it is not the enhanced leasing authority?

Mr. MATTHEWS. Having the additional tools would make it easier, as well.

Senator COBURN. But if we changed the scoring rules, you would have an open door to make the best equity decision for the country, is that correct?

Mr. MATTHEWS. We would be in a better position than we are today.

Senator COBURN. OK, then I will ask it another way. What would put you in the best position to make the best equity decision for the people of this country?

Mr. MATTHEWS. I believe if we could make those decisions without having to be concerned about scoring as a capital lease, we could come closer to getting the best equity position.

Senator COBURN. OK. You said the same thing. I will go back to you, and I will come back and finish up.

Senator CARPER. Mr. Matthews, you mentioned, I believe, some earlier reform efforts that had been undertaken along these lines. I would just ask you to go back in time to sort of recall, if you will, the genesis of those efforts, what came of them, what was accomplished, what was left on the table.

Mr. MATTHEWS. Well, at this point, nothing has come of them. The principal provisions, GSA supported legislation that would have allowed all agencies to retain proceeds from the sale of underutilized property and would have allowed public-private partnerships for the development of a kind of enhanced use lease on government property with underlying ownership remaining with the government. There were some other provisions that I can't recall at this point. I wasn't directly involved with that legislation. None of those moved beyond Committee that I am aware of.

Senator CARPER. When were those ideas proposed? Just roughly, was it the 1990s or the 1980s?

Mr. MATTHEWS. It was in the last Congress and the one before that, as well, I believe.

Senator CARPER. Do you know what the genesis was? Was it something that you all came up with yourselves, or was it proposed by others? Was it some of GAO's doing?

Mr. MATTHEWS. Part of the genesis was our move toward increased asset management. Most land-holding agencies are analyzing the existing inventory we have for the very reasons that you have mentioned in your opening remarks. We are looking for ways to realize some value from those assets or to dispose of them in the most expeditious way and perhaps use the equity for reinvestment in assets we retain, or to exchange them for something else that supports our program requirements. GSA is not the only agency that has a fairly passionate desire to try to be able to do that, egged on by our friends at GAO, who have documented some of the problems we have because we have not as rapidly dealt with underutilized and deteriorated assets as perhaps we should.

Senator CARPER. If you will, and this might be for you, Mr. Matthews, or it might be for one of our other witnesses, but just sort of walk us through the scoring under current law for operating leases, for lease-purchases, and also just for outright purchases.

Mr. MATTHEWS. I would prefer to submit something in writing on that, with your permission. I can review with you the six principal tests for scoring, and these are OMB's interpretation in OMB Circular A–11 of how to comply with the law.

Ownership of the asset remains with the lessor during the term of the lease and is not transferred at or shortly after the end of the lease period. The lease does not contain a bargain price purchase option. The lease term does not exceed 75 percent of the estimated economic lifetime of the asset. The present value of the minimum lease payments over the life of the lease does not exceed 90 percent of fair market value at the beginning of the lease term. The asset

is a general purpose asset rather than a special, unique government asset. And there is a private sector market for the asset.

These rules are intended to work together. If you trip one, that is the end of the discussion, and the one that is most often tripped in GSA's experience is the 90 percent of fair market value rule.

Senator CARPER. Again, maybe one last question for each of you. If you were in our shoes, if you were the junior Senator from Oklahoma or the junior Senator from Delaware and you were serving on this Subcommittee, what would you do about this? Mr. Goldstein, do you want to go first?

Mr. GOLDSTEIN. I think there would be a couple of things, Senator. I was tempted—GAO has been writing about this issue—this is a report from 1980. We have basically been saying the same thing for 25 years.

Senator CARPER. You are consistent.

Mr. GOLDSTEIN. For better or worse, I suspect we are. It is a very complex issue. It is among the reasons that we put Federal property, the government's portfolio, on our high-risk list in 2003 and why it remains there today. It is a very complex issue. There are a number of issues that must be dealt with.

We think there are a couple of things that really could be done. For example, we made a recommendation in 2003 in our high-risk report that there be a transformation strategy developed by the Administration, something that would bring together the variety of stakeholders that have a role in trying to figure out how to deal with these issues, and it is not just the leasing issue. It includes the issues we have talked about already, about dealing with vacant and underutilized property, dealing with having space that we can't fix. The Interior Department IG has said that Interior has a repair and meaintenance backlog of between $8 and $11 billion. It is dealing with, in today's world, the security needs that obviously government property has to have to ensure the safety of the people and the facilities, things like that.

There really does need to be, in our opinion, a transformation strategy that would help get us to the next place that we have to be instead of having to write all these reports for all these years, frankly.

We do think, additionally, that—and we have said this in a number of our reports—that it would be important to have a budget transparency or budget neutrality, if you will, for all of the various options, whether it is ownership or whether it is purchase, whether it is lease-purchase, capital lease, or an operating lease, so that folks like yourselves, so that Congress and other stakeholders can make better informed decisions where everything is recognized up front in the budget so you can determine across the board what is the best deal for the government and the taxpayer. And yes, obviously, there are other issues that would have to be dealt with, but at least you would be understanding the commitment that the government is going to make across the board and you would be able to confront it.

The concern we have, obviously, is that there are things that would have to be fixed. The Budget Enforcement Act caps would have to be altered in some fashion. Additionally, you would have to understand, probably in much more detail and for a longer pe-

riod of time, what the government's space needs are if you are going to actually use that approach. So we think that would be important.

And then we would ask that there be a re-emphasis on eliminating vacant and underutilized space because one agency alone, the Department of Defense, for instance, has said that it costs between $3 and $4 billion annually for it to maintain space that it doesn't need. Well, that would have paid for quite a large amount of re-investment in the real property portfolio. So there are other ways. There are some ways that you could move this forward, I think.

Senator CARPER. All right, thanks.

Mr. Matthews, just quickly, if you could respond. If you were in our shoes——

Mr. MATTHEWS. I might ask if the original intent of the Budget Enforcement Act was originally intended to apply to routine real estate leasing transactions. I have heard people through the year ask if that really was part of the intent to cover. We certainly in no way question the scoring rules. We have learned to live with them and make them work the best we can. The idea of budget neutrality would go a long way toward allowing us to make the most efficient business judgment and have it out there. I am not sure if that is going to change the government's ability to fund all the proposals that would legitimately be put forward as the best option.

Senator CARPER. OK. Mr. Neary, last word.

Mr. NEARY. In VA, we have recently completed a major study of our infrastructure and our health care programs across the United States, known as Capital Asset Realignment for Enhanced Services. It grew out of a report from GAO that recognizes that the nature of health care had changed considerably over the years and all of these large hospitals out there were no longer needed for that purpose. The Congress has been very supportive of our implementation of some of those recommendations to help us eliminate unused space. I would ask that you would continue to support that.

In terms of the budget scorekeeping rules, from a purely—executing a real estate program, as Mr. Matthews said, we want to have as many tools and as much flexibility available to us to make the best deals to, at the same time, accomplish our mission.

Senator CARPER. All right, thanks. Thanks to each of you.

Senator COBURN. A couple of moments ago, I think Mr. Matthews said that anything above $2.41 million has to come back and get specific authorization. Is that right?

Mr. MATTHEWS. That is correct. That is the fiscal year 2006 prospectus threshold.

Senator COBURN. So on the SEC debacle, they got authority to do their own leases, which were far in excess of that. Did they have to come check with somebody?

Mr. MATTHEWS. I am sorry, I can't answer that question, sir.

Senator COBURN. It went to, what, $60 million on the SEC leases? It was $60 or $70 million. Here is the thing I am trying to find out, is if you allow somebody to go away from GSA's Best Buy program—I am convinced GSA is the best buy. VA, you have done a good job, but you go back to them anyhow in terms of the guide-

lines. But if you allow them to go away, how do those limitations and requirements—or let them go independently—how do they apply to them? How did SEC get away with doing a lease that was far greater than this threshold with nobody in Congress knowing it was a mess until we discovered that it was a mess?

Mr. MATTHEWS. I can tell you that it is not our policy to delegate prospectus-level leases. I am not familiar with the timing of when that was done and whether it was done strictly on SEC's own authority, but it is not our policy to grant under our delegation program the authority to do prospectus-level——

Senator COBURN. So you don't really know how SEC got that authority?

Mr. MATTHEWS. No, sir, I do not.

Senator COBURN. Well, they didn't do it very well, so there is a star in your all's crown.

You have a national broker contract right now. What does that cost?

Mr. MATTHEWS. It doesn't really cost anything. We don't pay them. They take a commission out of the transaction.

Senator COBURN. OK, but we pay them, because that transaction fee is added back in to the cost of the lease. What is the average cost of that when we utilize these broker contracts?

Mr. MATTHEWS. I am sorry, we are only now deploying it. I couldn't tell you what the annual cost of those——

Senator COBURN. That is an important thing for you to know, because if they are really going to supply you a service, and there is a charge for it, some of it may be borne by the property owner but we are certainly going to pay a cost of that commission, that broker fee, is to know what are you getting for that money. I mean, they are not doing it for free and the property owner isn't going to absorb all that, so we as taxpayers are paying a portion of that. I think it is real important for us to look at that.

And my question to follow up, as you utilize them, because they are in regional areas and they are better—I guess the presumption is they know the local real estate markets better. They can help you execute better. How has that been cost saving inside GSA? Now you have got four national broker contracts out there. Their whole purpose is to help you be more efficient, get you to the right buildings at the right prices at the right time. What has it done to save work on the inside, because it obviously is an added cost. Is there a cost-benefit analysis looked at for, one, why you went that way, and two, do you have plans to do a cost-benefit analysis to see if it was the right decision?

Mr. MATTHEWS. There has been, but I am not prepared to speak to it.

Senator COBURN. Well, you can send that to us.

Mr. MATTHEWS. Yes, sir.

Senator COBURN. And are there plans to do a cost-benefit analysis to look at this at the end of the year to see if it has been beneficial?

Mr. MATTHEWS. I am sure there will be an intent to review the performance at the end of the first year.

Mr. GOLDSTEIN. The GAO is currently doing a review for a House Committee on this topic.

Senator COBURN. Wonderful. So our Subcommittee would certainly like to have a copy of that review?

Mr. GOLDSTEIN. Yes, sir.

Senator COBURN. Thank you. I would like one also, Mr. Goldstein. So you will know, we are planning a hearing in this Subcommittee on the buildings that need to be disposed of in this country and that will be coming up before the end of the year. So we will probably have you back as well as GSA as well as DOD as well as a whole lot of other people. That is going to happen.

Mr. GOLDSTEIN. We would be happy to, sir.

Senator COBURN. Let me ask you something, Mr. Goldstein. Does GAO look at internal rate of returns on leases that GSA has done?

Mr. GOLDSTEIN. Not recently. We haven't done, in fact, much work in this area in probably 5, 6, or 7 years now. What we have tended to do when we have examined some of the kinds of issues that you have put up here, we have looked at the economic analyses and the prospectuses that have been done by GSA and made determinations based on that. We haven't necessarily looked at the internal rates.

Senator COBURN. OK. In your testimony, Mr. Matthews, you talked about when you consider a proposal at a higher price, and I want you to have that authority. There is no question there are going to be times when the lowest bid isn't the best deal for you. I understand that. Can you tell us what guidelines you use to make those determinations? What are the policy guidelines that say, OK, we are in one of these situations where we think the lowest price is not the best deal for us. What are the guidelines that your people follow to make that decision?

Mr. MATTHEWS. Well, there is a whole web of Federal Acquisition Regulations that help with that, but for a source selection-type procurement, there would be a source selection plan at which GSA, with some input from the customer for whom we are acting, would identify those factors that are most important and they would bear—in some cases, they might be location-specific, like access to a Metro stop or other public transportation. They might have to do with additional efficiencies in operating costs. There is no standard answer. In some cases, security would be a big driver. Are we able to get the full set back or other security-enhancing features in a building within the competitive range.

Senator COBURN. So there are guidelines, but what is the thing to protect us from not buying the higher-priced lease when it is really not needed? What is in there to protect us from influence peddling in the lease procurement, when somebody says, hey, I have got a deal here? In other words, how can somebody skirt right along the edge of those rules and still advantage themselves with GSA and not really have been qualified? What are the procedures that are there?

Mr. MATTHEWS. Generally, you have a contracting officer and a group of people who write the plan, develop criteria to apply to the different offers which have to be reduced in some detail in writing. It would be difficult for me to imagine, short of——

Senator COBURN. So it is at a contractor level, I mean, a contracting officer level?

Mr. MATTHEWS. Yes. A contracting officer would oversee that. There would be a source selection committee with a chairman. They would have written the plan and developed criteria to apply before they ever saw the offers. They would have to evaluate each one in writing, technically and price. And then if they elected to go for other than the low price, they would have to write the justification and explain how, in their evaluation of the criteria, it was justified.

Senator COBURN. So it is not a single individual decision. You have got a safeguard in there with backup?

Mr. MATTHEWS. Yes.

Senator COBURN. So I think, and correct me if I am wrong, basically, what GSA is doing now is leasing buildings.

Mr. MATTHEWS. Yes. Those are the two overwhelmingly predominant tools we have available to us.

Senator COBURN. Leasing or purchasing?

Mr. MATTHEWS. Leasing or direct Federal construction.

Senator COBURN. Right.

Mr. MATTHEWS. Those are the two options.

Senator COBURN. But that square footage, you said, hasn't significantly changed and the leasing square footage has, so basically what we have been doing the last few years is the vast majority of the space that we have been taking, we have been leasing?

Mr. MATTHEWS. Yes. Prior to the scoring rules, we were occasionally given access to the Federal Finance Bank, where we were able to do a form of purchase contract, where we were able to borrow the money to construct the building and then pay it back as if it were a lease over a period of time.

Senator COBURN. Do you find it odd that the SEC would sign a lease for leasehold improvements at 9 percent cost for the leasehold improvements on top of the lease?

Mr. MATTHEWS. Without reviewing the whole offer, I would be reluctant to comment on that.

Senator COBURN. OK. I take it from your testimony, you would be in favor of more public-private partnerships in terms of real estate transactions to help us leverage our dollars?

Mr. MATTHEWS. I would be in favor of having more options on the table for us other than——

Senator COBURN. Of which one of those is that?

The 2002 Defense authorization bill gave DOD the authority to do enhanced use leasing. That law also exempted DOD from having to report any of its leases. Has GAO studied this or found that to be problematic, Mr. Goldstein?

Mr. GOLDSTEIN. I am not aware that we have studied this. We will get an answer for you for the record——

Senator COBURN. OK.

Mr. GOLDSTEIN [continuing]. To the extent to which we are able to determine if it has been problematic.

Senator COBURN. What is the long-term commitment, Mr. Matthews, on the commitment to the national broker contracts that you have signed? What is the length of the term with those?

Mr. MATTHEWS. Excuse me just one second. I believe I have that answer here. A 5-year commitment with options for renewal.

Senator COBURN. OK. Was an RFP put out for that, or——

Mr. MATTHEWS. Yes, it was.

Senator COBURN. This went through the regular process and then you chose down based on what you thought would give us the best broad experience and exposure and regionalization?

Mr. MATTHEWS. Yes, sir, and we chose four. I don't know if I made that clear.

Senator COBURN. Yes.

Mr. MATTHEWS. There were four large companies and they subcontract, so it is an extensive network of resources.

Senator COBURN. Have you all been used at all during the response to Hurricanes Katrina and Rita in terms of leasing?

Mr. MATTHEWS. I am not aware that the broker contract has yet been used, although I heard that discussed just this week.

Senator COBURN. All right. First of all, you guys have all been great. Thank you. There are several questions we have had for you.

I want to change what needs to be changed so that you can do the best job for our grandkids. I came to Congress, again, reluctantly, because I want the same future for all of our grandkids that has been created as an opportunity for us. When we are spending maybe $1 billion or $2 billion more a year in leases when we could be having that same money go towards equity assets and equity appreciation, that is money we could use to pay for Katrina, that is money we could pay for raises for Federal employees, enhanced benefits. I mean, there are all sorts of things.

So my commitment is sincere and I would love to have each of your help. How do we fix it to make it to where you can do your job in a better financial way that gets us a better return, smarter investments, and in the long run protects all of our security, our financial security? I am not worried about our international security from terrorism. The bigger threat we have is financial. We are on an absolutely unsustainable course, and if we can find a couple of billion here by reforming this—I have no lack of confidence in what you all do, but if we can give you the tools to allow you to save us the money, then we ought to be about doing that.

If you don't want to talk as a member of the Administration, if you want to call me on my cell phone and say, here are some ideas for you, I am happy to take that, too. I understand the rules of procedure in terms of working in the Administration. But there have got to be ways we can do it better and I want to take the handcuffs off of you and let you do it.

I appreciate your service. I appreciate you coming and I thank you for your testimony.

The hearing is adjourned.

[Whereupon, at 3:40 p.m., the Subcommittee was adjourned.]

APPENDIX

Construction vs. Operating Leases

- In 1995, GAO reported that GSA had entered into 55 operating leases for long-term needs that were estimated to cost $700 million more than construction.
- In 1999, GAO reported that for nine major operating lease acquisitions GSA had proposed, construction would have been the least-cost option in eight cases and would have saved an estimated $126 million.
- The Patent and Trademark Office (Northern VA) entered into an operating lease that was estimated to be $48 million more than construction and $38 million more than lease-purchase.
- Department of Transportation headquarters reduced the term of a 20 year lease to a 15 year lease so that it could meet the definition of an operating lease. GSA's FY 1999 prospectus for constructing a new facility for this need showed the cost of construction was estimated to be $190 million less than an operating lease.

Construction Would Have Saved Taxpayers Over $1 Billion

Statement of
Robert L. Neary, Jr.
Acting Chief Facilities Management Officer
Department of Veterans Affairs
Before the
Committee on Homeland Security and Governmental Affairs, Subcommittee on Federal Financial Management, Government Information, and International Security
Hearing on
"How Does the Federal Government Lease Needed Space?"
United States Senate
October 6, 2005

Mr. Chairman and members of the subcommittee, I am pleased to appear before you this afternoon to provide you with an overview of the Department of Veterans Affairs' (VA) leasing program, with a primary emphasis on VA's leasing processes and the reasons VA enters into leasing arrangements.

The Department of Veterans Affairs (VA) is the owner, tenant and operator of one of the largest health care related real estate portfolios in the United States. The Department also maintains facilities for the Veterans Benefit Administration (VBA) and most of the Nation's national cemeteries under management of VA's National Cemetery Administration (NCA). Overall, VA owns and leases over 5,000 buildings comprising over 144M square feet of space. Approximately, 10.5M square feet of this space has been acquired through over 1,000 leases. VA uses its leasing authority for multiple purposes including acquiring space for Community Based Outpatient Clinics, Regional Offices, and space to support the Department's research and information technology missions, to name only a few.

The need for space to support mission accomplishment is identified in the strategic planning processes of the Administrations. The proposed acquisition of leased space exceeding the threshold levels established by Congress is evaluated as part of the Department's capital investment application process. The acquisition of smaller amounts of space is approved at the appropriate levels within the Department. Before the Department enters the market to acquire leased space, VA first notifies the General Services Administration (GSA) to determine if any suitable space is available in their inventory that will meet VA needs.

VA's Delegated Leasing Authority

VA operates its lease acquisition program under a Delegation of Leasing Authority from GSA. The initial delegation, granted in September 1983, allows VA to assume responsibility for all leasing of outpatient and medically related activities throughout the country, with authority for firm term leases up to 20

years. In February 1995, the delegation was expanded to include general purpose office and related space to provide administrative and functional support to the medical facilities. Further, under GSA's 1996 "Can't Beat GSA Leasing" program, the Administrator of General Services delegated GSA's authority to lease general purpose office space for periods up to 20 years to all Federal agencies. Under the Can't Beat GSA Leasing program, as well as with all delegations of GSA leasing authority, Federal agencies must adhere to all applicable laws and regulations when acquiring and utilizing space. Therefore, VA follows all the same rules, regulations and laws required including, but not limited to, the Competition in Contracting Act, Executive Orders 12072 and 13006, Davis Bacon Act, the lease prospectus-approval requirements of 40 U.S.C. § 3307, and the General Services Administration Acquisition Regulations. Also, with respect to our lease procurements under GSA's "Can't Beat GSA Leasing" Delegation, VA must first notify GSA of the proposed action, to be sure other Federal space is not available, and to ensure that our lease procurement is compatible with GSA's community housing plans. The VA must also semi-annually notify GSA of its leasing activities under all GSA leasing delegations.

VA is legislatively mandated by Congress with certain authorization and appropriation requirements including dollar thresholds for reporting lease acquisitions. Congressional authorization is required of all leasing actions when the annual base rent is $600,000 or greater. In addition, VA must notify Congress before obligating funds for any lease (1) when the annual rent exceeds $300,000, or (2) if the rental amount exceeds by more than ten percent that which was previously authorized by legislation.

VA's Delegated Leases

By VA Directive, the Secretary of Veterans Affairs has granted delegations of authority within VA. The Real Property Service within VHA's Office of Facilities Management (OFM) is responsible for all leasing actions throughout the country. Small leases under 10,000 square feet and under $300,000 in annual rent may be acquired at the local level by the Director of each VA Medical Center through their contracting activity. Some instances may arise where it is advantageous to obtain space through GSA. VBA which operates VA benefits programs acquires most of its space through GSA assignment and often utilizes Federally-owned space to house veterans' benefits offices.

Best Value Contracting

All leasing actions are negotiated procurements and are based on a methodology colloquially known as "best value" contracting. VA seeks competition to the fullest extent possible when acquiring space and establishes evaluation criteria specific to each procurement. Offers are evaluated for both technical qualifications and price, and the Contracting Officer establishes a

competitive range of those offerors that are the most highly qualified. Negotiations are held with the offerors within the competitive range and final revised proposals are reevaluated. The total rental price of a lease over its term is then discounted to its present value. That present value is then evaluated, along with other factors, under the budget scorekeeping criteria of the Budget Enforcement Act, and OMB's lease scoring guidelines in OMB Circular A-11, to determine if the lease cost should be scored against the agency's budget as an operating lease or a capital lease. Capital leases are required, for budget purposes, to be recorded at their full cost at the time of lease award, while operating leases are allowed to be recorded on an annual rent basis.

Staffing and Training

OFM's Real Property Service is comprised of a staff of 15 realty specialists, contracting officers and administrative support personnel. To ensure that VA maintains an effective leasing program, OFM in conjunction with VA's Office of Acquisition & Materiel Management (OAM&M) conducts periodic training of VA staff involved in leasing activities. Specialists and contracting officers are also required to have training in accordance with GSA guidelines. Field specialists and contracting officers are required to have lease training before they are allowed to acquire space and administer leases. Training includes formal classes and on-the-job training. OFM has recently completed a Lease Design Guide that can be found on OFM's Technical Information Library at the office's website. In addition, Real Property Service also has a Lease Handbook that can be found on the Real Property Webpage. The Lease Handbook is a step-by-step guide to acquiring space through the simplified or standard lease acquisition processes.

Enhanced Use-Leasing

In addition to these traditional leasing programs, VA also has been granted Enhanced-Use Leasing authority. This unique asset management tool, managed jointly by the Office of Asset Enterprise Management (OAEM) and OFM, provides VA an innovative process to partner with the private sector to maximize return from underutilized capital assets. Currently, VA can outlease property to other parties for up to 75 years for "fair consideration." The fair consideration can be in the form of cash, services, space or other in-kind consideration. The program was authorized by law in 1991 (38 U.S.C. § 8161, et seq), and was recently modified and re-authorized until 2011. VA has successfully developed projects giving veterans access preference and discounts for the usage of Assisted Living, Transitional Homeless Housing and Homeless Services facilities without the use of appropriated funds. The program results included significant cost savings compared to construction and leasing; substantial private investment in the Department's capital facilities and infrastructure; and, new long-term sources of revenues.

Mr. Chairman, this concludes my opening statement and I would be pleased to answer any questions you or the members of the Committee may have.

STATEMENT OF

WILLIAM H. MATTHEWS
ASSISTANT COMMISSIONER

OFFICE OF REAL PROPERTY ASSET MANAGEMENT
PUBLIC BUILDINGS SERVICE

U.S. GENERAL SERVICES ADMINISTRATION

BEFORE THE

COMMITTEE ON HOMELAND SECURITY
AND GOVERNMENTAL AFFAIRS

SUBCOMMITTEE ON FEDERAL FINANCIAL
MANAGEMENT, GOVERNMENT INFORMATION, AND
INTERNATIONAL SECURITY

UNITED STATES SENATE

OCTOBER 6, 2005

Good morning Mr. Chairman and Members of the Subcommittee. My name is William Matthews, Assistant Commissioner, Office of Real Property Asset Management, and Public Buildings Service (PBS) of the General Services Administration (GSA). I am pleased to appear before you to discuss how GSA leases space and answer any of your questions.

GSA is the nation's largest public real estate organization, providing workspace for more than 1.1 million Federal workers. We are a real estate services delivery organization – supporting our customer agencies in their mission of service to the American people. As such, it is *our* mission to provide a superior workplace for the Federal worker and a superior value for the taxpayer.

Our Agency Customers are required to use existing, vacant, Federally-controlled space when that space is available and suitable to meet their mission requirements. When suitable Federal space is not available, we can lease space from the private sector...

Approximately half of our customers' workforce is housed in about 1600 buildings owned by the Federal Government through GSA. The other half are located in over 7,300 buildings that we lease from the private sector in over 2,000 American communities across the United States and its territories. These leased buildings

together comprise over 167 million square feet of our total portfolio of approximately 340 million square feet. Our annual rent bill for leases with private landlords is about $3.8 billion.

We lease space in both large cities and small towns when leasing is the only practical answer to meeting Federal space needs. More than 50 percent of our leases (by number) are for 10,000 square feet or less. The size of a lease can range from a single room to an entire building.

We lease all types of space for most Federal agencies, including offices, laboratories, warehouses, clinics, and border stations. We locate them according to the customer's mission requirements in urban, suburban, and rural areas and in accordance with established location and security policies. We execute many single tenant leases, but also many multi-tenant leases with agencies consolidated for economy of scale. Other GSA leases meet tenant's needs for store-front locations and high public access. These are in contrast with other leases for customers who require limited access to and control of their buildings for security purposes. As I said, GSA leases all types of space for Federal agencies.

When the existing inventory of buildings in the local market cannot meet our customer's requirements, and where Federal construction is not an option, we solicit the construction of a new building, which is built to meet our customer's specifications and leased by us on the customer's behalf.

Our principal authority to lease real property for use by Federal agencies is derived from the former Federal Property and Administrative Services Act of 1949 and Reorganization Plan No. 18 of 1950. That authority is now codified in Title 40 of the United States Code, Section 585, which authorizes GSA to enter into space leases on behalf of Federal agencies for terms up to 20 years.

In terms of cost to our tenants, we strive to keep leasing costs at or below market levels and have developed comprehensive strategies to do so. We use standard industry benchmarks and market surveys to assure that we get the best value for our customers. We use published market sources to gain a better understanding of area markets. Our standard lease forms balance the interests of the Government against the interests of private landlords to achieve cost-effective contract terms. Because GSA often acquires large blocks of space to meet the needs of multiple Federal agencies, we are often able to leverage our market position to get more favorable rent rates and lease terms for the Federal taxpayer. Also, the credit worthiness of the Federal Government can serve as an important consideration in obtaining competitive or below-market rent rates.

Additionally, this year we awarded a National Broker Contract. This effort consolidated our private sector leasing support services among four commercial real estate service firms. This award is the largest single contract of its type in the history of GSA's Public Buildings Service and will enable us to leverage the expertise of private sector brokers

and increase our capacity to achieve the best value in the market place. It will also assist us in our efforts to standardize leasing practices nationwide and provide more support to our customers.

Another important consideration in measuring value in the real estate arena is the cost of having vacant space. The vacant space within our leased inventory is only 1.3 percent - a figure well below the national industry average of 14.5 percent according to Torto Wheaton Research.

Security

Not surprising the ever increasing need for security does have an effect on GSA's leasing process and on GSA's leases. The need for greater building setbacks, blast resistance, building access requirements and who can be co-located within our space all affect our lease procurement and the cost of the space we lease.

Laws and Regulations

Our leasing process is conducted within a framework of procedures that comply with a comprehensive list of laws and Executive orders that apply to Government contracts. These include the Competition in Contracting Act; the Small Business Act; and energy, environmental, and historic preservation laws and orders.

Leases with an annual cost that exceeds a specific dollar threshold amount ($2,410,000 in fiscal year 2006) require explicit congressional authorization. For this purpose GSA submits prospectuses to the Senate Committee on Environment and Public Works and the House Committee on Transportation and Infrastructure for their approval.

Leasing Process

For all of our leasing activities we follow a fairly standard process. This process starts with our customer agencies approaching us with their workplace requirements. Some customers come to us with a complete requirements package developed in accordance with professional space planning models. For other customers, we need to work closely with them to document their specific requirements.

In determining the actual requirements of our customers, we conduct a series of meetings with the customer to review and confirm their general requirements. Once our customer's space requirements are better established, we memorialize the amount and types of space they need, and the expected duration of the lease, in an interagency agreement called an Occupancy Agreement. At this stage, we review the availability of Federally-controlled space that may meet the agency's requirements. If none is available, we then study the market against the customer's requirements and develop

and present various leased housing options. When we agree with our customers on the best approach, we then formalize the requirements for our Solicitation for Offers. At this stage, we also document our proposed arrangement with the agency customer.

We advertise requirements for space in local newspapers and/or the Federal business opportunities webpage at www.fedbizopps.gov to ensure that we get the maximum amount of competition from the private sector.

Once initial bids are received, we generally conduct negotiations with all Offerors to assure that they understand the requirements and can better prepare their final proposals. When final proposals are received, we evaluate them and make an award to the responsible Offeror whose proposal represents the best value to the Government considering price and other factors. Most leases are awarded to the Offeror who meets the Government's minimum requirements at the lowest price. For more complex requirements, however, we sometimes conduct "source selection" procurements where a higher-rated qualitative proposal may prevail over a lower-rated and lower-priced proposal. These cases require a determination that the technical superiority offered by the higher priced proposal is worth the cost differential.

We give the successful Offeror an adequate time to build out the space according to the lease requirements; we inspect and accept the space; we assist our tenants in occupying the space; and then start the rent paying process.

GSA's lease responsibilities do not stop when the customer occupies the space. Typically, unless GSA has delegated operational responsibility to our customer agency, GSA is responsible for the administration of the lease throughout the term. Also, under a program called "Can't Beat GSA Leasing", GSA delegated its leasing authority to other Federal agencies. It was our intention to make GSA a provider of choice for our Federal agency customers; and I am pleased to say that almost all of our customers chose to stay with GSA because of the service and value we provide.

Mr. Chairman, this is the approach we use to identify and meet our customer agency's mission requests for work space. Meeting our customer's requirements in an efficient and cost effective manner is our Agency's highest priority. Customer service and customer satisfaction together with achieving superior value for the American taxpayer are at the core of the GSA mission.

Mr. Chairman, thank you for the opportunity to testify before your Subcommittee. I will be happy to answer any questions you or Members of the Subcommittee may have.

United States Government Accountability Office

GAO

Testimony

Before the Subcommittee on Federal Financial Management, Government Information, and International Security, Senate Committee on Homeland Security and Governmental Affairs

For Release on Delivery
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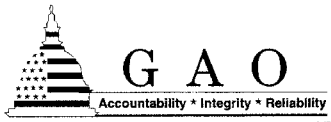
FEDERAL REAL PROPERTY

Reliance on Costly Leasing to Meet New Space Needs Is an Ongoing Problem

Statement of Mark L. Goldstein, Director



GAO-06-136T

GAO
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Highlights

Highlights of GAO-06-136T, a testimony for the Subcommittee on Federal Financial Management, Government Information, and International Security, Committee on Homeland Security and Governmental Affairs, U.S. Senate

Why GAO Did This Study

In January 2003, GAO designated federal real property a high-risk area and issued an update on this area in January 2005. GAO identified the government's reliance on costly leased space as one of the major reasons for the high-risk designation. Other reasons included excess and deteriorated property, unreliable real property data, and the challenges associated with protecting these assets from terrorism.

This testimony discusses GAO's designation of federal real property as a high-risk area and focuses specifically on the government's reliance on costly leased space.

What GAO Recommends

GAO continues to believe that a comprehensive and integrated transformation strategy is needed to address several underlying obstacles to real property reform. These obstacles include competing stakeholder interests, various funding and budgetary disincentives, and the need for improved capital planning among agencies.

Alternatives to costly operating leases for long-term space needs should be considered because the current practice results in excessive costs to taxpayers and does not reflect a sensible and economically rational approach to capital asset management.

www.gao.gov/cgi-bin/getrpt?GAO-06-136T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Mark L. Goldstein at (202) 512-2834 or GoldsteinM@gao.gov.

October 6, 2005

FEDERAL REAL PROPERTY

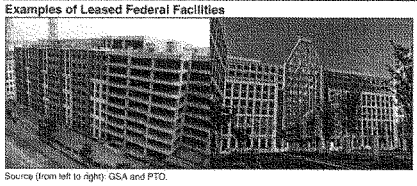
Reliance on Costly Leasing to Meet New Space Needs Is an Ongoing Problem

What GAO Found

The underlying conditions and related obstacles that led to GAO's designation of federal real property as high risk still exist. Many of the assets in the government's vast and diverse portfolio of real property are not effectively aligned with, or responsive to, agencies' changing missions. Furthermore, many assets are in an alarming state of deterioration; agencies have estimated restoration and repair needs to be in the tens of billions of dollars. Compounding these problems are the lack of reliable governmentwide data for strategic asset management and the cost and challenge of protecting these assets against terrorism. Additionally, a heavy reliance on costly leasing, instead of ownership, to meet new space needs is a pervasive and ongoing problem. Since GAO's designation of this area as high risk in January 2003, some important efforts to address these problems have been initiated, but it is too early to judge whether the administration's focus on this area will have a lasting impact.

The federal government owns and leases about 3.3 billion square feet of building floor area in roughly a half-million buildings worldwide, of which more than 380 million square feet are leased. Building ownership options through construction or purchase and lease-purchase are generally less costly than using operating leases to meet long-term space needs. However, as GAO reported over the last decade, the General Services Administration relies heavily on operating leases to meet new long-term space needs because it lacks funds to pursue ownership. Operating leases have become an attractive option, in part because budget scorekeeping rules allow budget authority for some operating leases to be spread out over the term of the lease and "look cheaper" in any given year, even though they are generally more costly over time. In contrast, budget authority for ownership options is recorded fully up front in the budget to appropriately reflect the government's commitment. As a result, this situation has encouraged an overreliance on operating leases for satisfying long-term space needs. For example, the Patent and Trademark Office's (PTO) operating lease for long-term space needs was estimated to cost $48 million more than construction and $38 million more than lease-purchase.

Examples of Leased Federal Facilities



Source (from left to right): GSA and PTO.

From left to right: Department of Transportation Headquarters Building (under construction), Washington, D.C. and Main PTO Building, Alexandria, VA.

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to testify today on our work related to federal real property and, in particular, the government's reliance on space leased from the private sector. As you know, at the start of each new Congress since 1999, we have issued a special series of reports entitled the *Performance and Accountability Series: Major Management Challenges and Program Risks*. In January 2003, we designated federal real property a high-risk area as part of this series, and we issued an update on this area in January 2005.[1] We identified the government's reliance on costly leased space as one of the major reasons for the high-risk designation. Other reasons included excess and deteriorated property, unreliable real property data, and the challenges associated with protecting these assets from terrorism. My testimony today will (1) discuss our designation of federal real property as a high-risk area and (2) focus specifically on the government's reliance on costly leased space.

According to available data, the federal government owns and leases about 3.3 billion square feet of building floor area worldwide in roughly a half-million buildings. About 380 million square feet of this space is leased. My testimony today will highlight the following points:

- The conditions that led to our January 2003 high-risk designation still exist. Many of the assets in the government's vast and diverse portfolio of real property are not effectively aligned with, or responsive to, agencies' changing missions. Furthermore, many assets are in an alarming state of deterioration; agencies have estimated restoration and repair needs to be in the tens of billions of dollars. Compounding these problems are the lack of reliable governmentwide data for strategic asset management and the cost and challenge of protecting these assets against terrorism. Additionally, a heavy reliance on costly leasing, instead of ownership, to meet new space needs, is a pervasive and ongoing problem. The administration has acknowledged the problems in this area; in February 2004, the President added the Federal Asset Management Initiative to the President's Management Agenda and signed an executive order on real property management reform.[2] These and other efforts are positive steps, but it is too early to judge whether the administration's focus on this area

[1]GAO, *High-Risk Series: Federal Real Property*, GAO-03-122 (Washington, D.C.; Jan. 2003); GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.; Jan. 2005).

[2]Presidential Executive Order 13327, Feb. 4, 2004.

will have a lasting impact. In addition, we continue to believe that a comprehensive and integrated transformation strategy is needed to address the problems and several underlying obstacles to reform, which include competing stakeholder interests, various funding and budgetary disincentives, and the need for improved capital planning among agencies.

- As a general rule, building ownership options through construction or purchase are the least expensive ways to meet agencies' long-term and recurring requirements for space. Lease-purchases—under which payments are spread over time and ownership of the assets is eventually transferred to the government—are generally less costly than using ordinary operating leases to meet long-term space needs but are more costly than other ownership options. However, over the last decade, we have reported that the General Services Administration (GSA)—as the central leasing agent for most agencies—relies heavily on operating leases to meet new long-term needs because it lacks funds to pursue ownership. Operating leases have become an attractive option in part because they generally "look cheaper" in any given year, even though they are generally more costly over time. Budget scorekeeping rules allow budget authority for some of these costly operating leases to be spread out over the term of the lease. In contrast, budget authority for ownership options, according to the scorekeeping rules, are recorded fully up-front in the budget to appropriately reflect the government's commitment. As a result, this situation has encouraged an overreliance on operating leases for satisfying long-term space needs. Resolving this problem has been difficult; however, change is needed because the current practice of relying on costly leasing to meet long-term space needs results in excessive costs to taxpayers and does not reflect a sensible or economically rational approach to capital asset management.

Federal Real Property: A High-Risk Area

Over 30 federal agencies control hundreds of thousands of real property assets—including both facilities and land—in the United States and abroad. These assets are worth hundreds of billions of dollars. Unfortunately, much of this vast and valuable asset portfolio presents significant management challenges and reflects an infrastructure based on the business model and technological environment of the 1950s. Many assets are no longer effectively aligned with, or responsive to, agencies' changing missions and are therefore no longer needed. Our high-risk reports highlighted problems with excess and underutilized property at several agencies, including the Departments of Defense, Veterans Affairs (VA), Energy, and State; the U.S. Postal Service (USPS); and GSA. Furthermore, many assets are in an alarming state of deterioration; agencies have estimated restoration, repair, and maintenance needs to be

in the tens of billions of dollars. For example, we reported in 2003 that the Department of the Interior had a maintenance backlog of between $8 billion and $11 billion. Compounding these problems are the lack of reliable governmentwide data for strategic asset management, a heavy reliance on costly leasing instead of ownership to meet new space needs, and the cost and challenge of protecting these assets against potential terrorism. The problems facing the federal portfolio have been exacerbated by a number of factors, including competing stakeholder interests in real property decisions, various legal and budget-related disincentives to businesslike outcomes, and the need for better capital planning among real property-holding agencies.

More specifically:

- *Competing Stakeholder Interests* - In addition to Congress, the Office of Management and Budget (OMB), and the real property-holding agencies themselves, several other stakeholders have an interest in how the federal government carries out its real property acquisition, management, and disposal practices. These include foreign and local governments; business interests in the communities where the assets are located; private sector construction and leasing firms; historic preservation organizations; various advocacy groups; and the public in general, which often views the facilities as the physical face of the federal government in local communities. As a result of competing stakeholder interests, decisions about real property often do not reflect the most cost-effective or efficient alternative that is in the interests of the agency or the government as a whole, but instead reflect other priorities.

- *Legal and Budgetary Disincentives* -The complex legal and budgetary environment in which real property managers operate has a significant impact on real property decisionmaking and often does not lead to economically rational and businesslike outcomes. For example, we have reported that public-private partnerships might be a viable option for redeveloping obsolete federal property when they provide the best economic value for the government, compared with other options, such as federal financing through appropriations or sale of the property. Resource limitations, in general, often prevent agencies from addressing real property needs from a strategic portfolio perspective. When available funds for capital investment are limited, Congress must weigh the need for new, modern facilities with the need for renovation, maintenance, and disposal of existing facilities, the latter of which often gets deferred. In disposing of excess property, agencies also need to consider a range of laws intended to address other objectives—such as historic preservation

and environmental remediation.

- *Need for Improved Capital Planning* - Over the years, we have reported that prudent capital planning can help agencies to make the most of limited resources, and failure to make timely and effective capital acquisitions can result in increased long-term costs. GAO, Congress, and OMB have identified the need to improve federal decisionmaking regarding capital investment. Our Executive Guide,[3] OMB's Capital Programming Guide, and OMB's revisions to Circular A-11[4] have attempted to provide guidance to agencies for making capital investment decisions. However, agencies are not required to use the guidance. Furthermore, agencies have not always developed overall goals and strategies for implementing capital investment decisions, nor has the federal government generally planned or budgeted for capital assets over the long term.

Since our designation of this area as high risk in January 2003, some important efforts to address these problems have been initiated by the administration and executive agencies, including the addition of the Federal Asset Management Initiative to the President's Management Agenda and an executive order on real property management reform which led to the development of guiding principles for real property asset management. The executive order requires the establishment of senior real property officers at most executive branch departments and agencies that, among other things, prioritize actions needed to improve the operational and financial management of the agency's real property inventory. The order also established a Federal Real Property Council, with representation from major real property-holding agencies. The council has developed guiding principles for real property asset management and is also developing performance measures, a real property inventory database, and an agency asset management planning process. The executive order is clearly a positive step. However, it has not been fully implemented, and further actions are necessary to address the underlying problems and related obstacles to reform. Despite these efforts and the sincerity with which the federal real property community has embraced the need for reform, the problems have persisted. We continue to believe that a comprehensive and integrated transformation strategy for real

[3]GAO, *Executive Guide: Leading Practices in Capital Decision-making*, GAO/AIMD-99-32 (Washington, D.C.: Dec. 1998).

[4]OMB, *Circular No. A-11, Appendix B.*

property is needed to build on the executive order. More specifically, the additional step of developing a transformation strategy would provide decisionmakers with a road map of actions for addressing the underlying obstacles, assessing progress governmentwide, and enhancing accountability for related actions. As an example, OMB and other stakeholders could look to the USPS Transformation Plan and related progress reports, which GAO has supported for guiding postal reform.[5]

If actions resulting from the transformation strategy and other efforts to address the long-standing problems are effectively implemented, agencies will be better able to recover asset values, reduce operating costs, improve facility conditions, enhance security and safety, recruit and retain employees, and achieve mission effectiveness. Realigning the government's real property, taking into consideration the future federal role, likely organizational structure, geographic presence, and workplace needs, will be critical to improving the government's performance and ensuring accountability within expected resource limits.

Reliance on Costly Leasing

One of the major reasons for our high-risk designation was the pervasive problem of over reliance on costly leased space to meet new space needs. As a general rule, building ownership options through construction or purchase are the least expensive ways to meet agencies' long-term requirements. Lease-purchases—in which payments are spread out over time and ownership of the asset is eventually transferred to the government— are generally more expensive than purchase or construction but are generally less costly than using ordinary operating leases to meet long-term space needs. However, over the last decade we have reported that GSA—as the central leasing agent for most agencies—relies heavily on operating leases to meet new long-term needs because it lacks funds to pursue ownership. In 1995, we reported that GSA had entered into 55 operating leases for long-term needs that were estimated to cost $700 million more than construction.[6] In 1999, we reported that for 9 major operating lease acquisitions GSA had proposed, construction would have been the least-cost option in 8 cases and would have saved an estimated $126 million. Lease-purchase would have saved an estimated

[5]U.S. Postal Service, *Transformation Plan* (Washington, D.C.: Apr. 2002); U.S. Postal Service, *Progress Report* (Washington, D.C.: Nov. 2004).

[6]GAO, *General Services Administration: Opportunities for Cost Savings in the Public Buildings Area*, GAO/T-GGD-95-149 (Washington, D.C.: July 13, 1995).

$107 million compared with operating leases but would have cost $19 million more than construction.[7]

A prime example of this problem was the Patent and Trademark Office's (PTO) long-term requirements in northern Virginia, where the cost of meeting this need with an operating lease was estimated to be $48 million more than construction and $38 million more than lease-purchase. In August 2001, we also reported that GSA reduced the term of a proposed 20-year lease for the Department of Transportation (DOT) headquarters building to 15 years so that it could meet the definition of an operating lease. GSA's fiscal year 1999 prospectus for constructing a new facility for this need showed the cost of construction was estimated to be $190 million less than an operating lease. The Securities and Exchange Commission used a similar approach by reducing the terms of a proposed 20-year lease for its facility to 14 years.[8] Although most of our work in this area has focused on GSA-controlled leases, other real property-holding agencies with leasing authority—such as the Departments of State and Veterans Affairs—also face the same obstacles to ownership. USPS officials have told us that they do not believe that USPS is overly reliant on operating leases. Figure 1 shows the main PTO building and construction of the DOT headquarters building, both of which are being leased by the government.

[7]GAO, *General Services Administration: Comparison of Space Acquisition Alternatives—Leasing to Lease-Purchase and Leasing to Construction*, GAO/GGD-99-49R (Washington, D.C.: Mar. 12, 1999).

[8]GAO, *Budget Scoring: Budget Scoring Affects Some Lease Terms but Full Extent Is Uncertain*, GAO-01-929 (Washington, D.C.: Aug. 31, 2001).

Figure 1: The DOT Headquarters Building and Main PTO Building, which are Being Leased By the Federal Government.

Source (from left to right): GSA and PTO.

Operating leases—in which periodic lease payments are made over the specified length of the lease—have become an attractive option in part because they generally "look cheaper" in any given year. Pursuant to the scoring rules adopted as a result of the Budget Enforcement Act of 1990, the budget authority to meet the government's real property needs is to be scored—meaning recorded in the budget—in an amount equal to the government's total legal commitment. For example, for lease-purchase arrangements, the net present value of the government's legal obligations over the life of the contract is to be scored in the budget in the first year. For construction or purchase, the budget authority for the full construction costs or purchase price is to be scored in the first year. However, for many of the government's operating leases—including GSA leases, which, according to GSA, account for over 70 percent of the government's leasing expenditures and are self-insured in the event of cancellation—only the budget authority to cover the government's commitment for an annual lease payment is required to be scored in the budget.[9] Given this, while operating leases are generally more costly over

[9]According to the scoring rules (OMB *Circular No. A-11, app. B)*, in cases where the operating lease does not have a cancellation clause or is not paid for by funds that are self-insuring, budget authority to cover the total costs expected over the life of the lease is to be scored in the first year of the lease.

time, compared with other options, they add much less to a single year's appropriation total than these other arrangements, making operating leases a more attractive option from the agency's budget perspective. This is particularly evident when funds for ownership are not available in an era of constrained budgetary resources. While the requirement for "up-front funding" provides for congressional control over the full costs to which the government is committing itself, the budget scorekeeping rules for self-insuring funds like GSA's Federal Buildings Fund allow costly operating leases to "look cheaper" in the short term and have encouraged an overreliance on them for satisfying long-term space needs.

Decisionmakers have struggled with this matter since the scoring rules were established and the tendency for agencies with self-insuring funds to choose operating leases instead of ownership became apparent. We have suggested the alternative of scoring the budget authority for all operating leases up front on the basis of the underlying time requirement for the space so that all options are treated equally.[10] Although this could be viable, there would be implementation challenges if this were pursued, including the need to evaluate the validity of agencies' stated space requirements. Finding a solution for this problem has been difficult; however, change is needed because the current practice of relying on costly leasing to meet long-term space needs results in excessive costs to taxpayers and does not reflect a sensible or economically rational approach to capital asset management. To address this and other complex problems related to federal real property, we continue to believe that a comprehensive and integrated transformation strategy is needed.

Scope and Methodology

We conducted our work for this testimony in September 2005 in accordance with generally accepted government auditing standards. The work is based on our past reports on federal real property and, specifically, leasing issues.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the Subcommittee may have at this time.

[10]GAO, *Supporting Congressional Oversight: Budgetary Implications of Selected GAO Work for Fiscal Year 2003*, GAO-02-576 (Washington, D.C.: Apr. 26, 2002).

Questions and Responses for the Record from
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U.S. Government Accountability Office

Hearing Title: How Does the Federal Government Lease Needed Space?

Subcommittee on Federal Financial Management, Government Information, and International Security

Question: Please discuss changes to reporting requirements for DOD leases that were in the Department of Defense 2002 authorization? If possible, please provide GAO's position on these changes.

Answer: The reporting requirements in question were associated with leasing authority available to the Department of Defense (DOD) under 10 USC 2667. This statute provides authority for the secretaries of the military departments to lease real property not declared excess but currently not needed for mission requirements to help reduce infrastructure and base operating costs. 10 USC 2667(d)(1) requires that all money rentals received pursuant to leases entered into by the Secretary of a military department (except for DOD-furnished utilities and services or sums from agricultural or grazing leases, in general, or from BRAC leases) must be deposited in a special account in the Treasury. The sums deposited in these accounts are available for service-wide facility maintenance and repair, restoration, construction, operations support, or for facility leases, while reserving at least 50% of the sums received for these activities at the military installation where the lease proceeds are derived. An additional restriction on the use of sums received from DOD leases is that the Secretary may not expend more than $500k at a single installation until 30 days after submitting a report to the congressional defense committees on the facts of the proposed expenditure.

The Bob Stump National Defense Authorization Act for Fiscal Year 2003 (Public Law 107-314, Section 1041 (December 2, 2002), amended 10 USC 2667(d) by striking paragraph (3), which had up to that point required the "Secretary of Defense - - to submit as part of the DOD request for authorizations of appropriations submitted to Congress for each fiscal year - - an accounting of the receipt and use of all money rentals that were deposited and expended under this subsection during the fiscal year preceding the fiscal year in which the request was made; and a detailed explanation of each lease entered into, and of each amendment made to existing leases, during such preceding fiscal year." This change was part of an effort to provide DOD with "relief" from numerous reporting requirements.

Notwithstanding the legislative repeal of the annual reporting requirements, some elements of Congressional reporting remain. Specifically, 10 USC 2667(c)(4) still prevents DOD from entering into a lease that generates over $500,000 of in-kind consideration until 30 days after the military service secretary reports on the facts of the lease to the congressional defense committees, and 10 USC 2667(d)(1)(E) prevents the expenditure of money rental sums above $500,000 at a single installation until the military service secretary reports the proposed expenditure to the congressional defense committees. DOD's congressional reporting requirements were not addressed in our 2002 report on use of DOD's leasing authority (GAO-02-475). At the same time, problems identified in that report, such as the absence of a strong program emphasis and inadequate accounting for lease revenues, existed at a time when the previous annual reporting requirements were in place. This could suggest the need for a different type of congressional oversight depending on congressional expectations for the program.

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