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# CAPITAL ASSETS CRISIS: MAINTAINING FEDERAL REAL ESTATE WITH THE DWINDLING FEDERAL BUILDING FUND

**(111–99)**

## HEARING

BEFORE THE

SUBCOMMITTEE ON
ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS, AND
EMERGENCY MANAGEMENT

OF THE

COMMITTEE ON
TRANSPORTATION AND
INFRASTRUCTURE
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

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# U.S. House of Representatives
## Committee on Transportation and Infrastructure
### Washington, DC 20515

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John L. Mica
Ranking Republican Member

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March 23, 2010

**SUMMARY OF SUBJECT MATTER**

**TO:** Members of the Subcommittee on Economic Development, Public Buildings, and Emergency Management

**FROM:** Subcommittee on Economic Development, Public Buildings, and Emergency Management Staff

**SUBJECT:** Hearing on "Capital Assets Crisis: Maintaining Federal Real Estate with the Dwindling Federal Building Fund"

**PURPOSE OF THE HEARING**

The Subcommittee will meet on Wednesday, March 24, 2010, at 2:00 p.m., in room 2167 of the Rayburn House Office Building for a hearing on "Capital Assets Crisis: Maintaining Federal Real Estate with the Dwindling Federal Building Fund." The hearing will focus on the financial viability of the Federal Building Fund (FBF) and whether the General Services Administration (GSA) is using its existing authorities to maintain its capital assets.

**BACKGROUND**

The GSA is the central asset management agency of the Federal Government. GSA was created in 1949, after the Hoover Commission recommended a central management entity for Federal personnel and real property activities, telecommunications, and automatic data processing equipment. Within GSA, the Public Building Service (PBS) has responsibility for more than 1,500 Federal buildings totaling 176.5 million rentable square feet of space. GSA leases 177.5 million rentable square feet of space in almost 7,100 leased properties. It also provides space in Federal buildings for child-care and telecommuting. The inventory ranges from 2,500-square-foot border crossing stations along the northern border to million square foot courthouses and office buildings located in major metropolitan areas.

PBS owns, operates, and constructs Federal buildings. PBS is responsible for the construction, repair, maintenance, alteration, and operation of United States courthouses and public

buildings of the Federal Government. Additionally, PBS leases privately owned space for Federal use.

**Federal Building Fund**

PBS activities are funded primarily through the FBF, an intra-governmental fund into which agencies pay rent to GSA for the space they occupy. Expenditures from the FBF are used to finance the operation and maintenance of existing Federally owned property, to acquire and pay for leased space, and construct and purchase buildings. Federal agencies are required to pay commercial equivalent prices into the FBF. The Public Buildings Amendments of 1972 (P.L. 92-313) authorized GSA to finance its real property management activities.[1] Using this authorization in 1975, the FBF replaced appropriations to GSA as the primary means of financing the operations and capital costs associated with the Federal space owned or managed by GSA. Income to the FBF is sometimes augmented by Federal appropriations when Federal construction needs out-strip the resources that can be provided by the FBF.

Congress exercises control over the FBF through the annual appropriations process by setting limits on how much of the fund can be expended for various activities. Section 3307 of title 40, United States Code, requires the Committee on Transportation and Infrastructure of the House of Representatives and the Committee on the Environment and Public Works of the Senate to pass resolutions authorizing the construction, repair, alteration, or leasing of space prior to an appropriation of funds. Title 40 also requires the Administrator of GSA to submit to the Committees a prospectus requesting authority for any project in excess of a certain dollar threshold, indexed to inflation. That threshold for Fiscal Year (FY) 2010 is $2.66 million. The prospectus must be approved by the Office of Management and Budget (OMB), and must detail the particular project, along with the cost, benefits, and plan for Federal occupancy.

Committee resolutions authorizing leases, new construction, or repair and alteration projects are usually approved and sent to the Committee on Appropriations prior to markup by the appropriate Appropriations subcommittee.

The Committee on Transportation and Infrastructure can also initiate building projects by passing a resolution in accordance with 40 U.S.C. § 3314(b), which allows Congress to direct the Administrator of GSA to conduct a study of Federal space needs in a community and report back to the Committee. These reports can serve as the basis to pass resolutions authorizing the appropriation of funds for the construction, acquisition, renovation, alteration, or leasing of space for Federal use.

**Financial Viability of the Federal Building Fund**

In January 2003, the Government Accountability Office (GAO) designated Federal real property an area of high risk, in part because of deteriorating facilities and an overreliance on "costly leasing".[2] In addition, the current PBS Commissioner has publicly expressed his concern about the ability of FBF to generate sufficient revenue to cover the repair costs of the current federally owned

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[1] GSA, *the Federal Buildings Fund and Rent System: A Business Approach to the Management of Federal Real Property* (April 1988).
[2] GAO, *High-Risk Series: Federal Real Property*, GAO-03-122 (Jan. 2003).

inventory.[3] Further, because the FBF has generated limited funding to finance construction of new Federal buildings, GSA has been forced to rely increasingly upon leases to meet the space growth needs of its Federal tenants. In most circumstances, the use of long-term leases to satisfy the need for Federal office space is not the best use of appropriated funds, because such leases are typically more expensive than Federal construction. The current guidelines for the budgetary treatment of leases require the full cost of a capital lease or lease-purchase to be scored up-front, whereas in the case of operating leases, only the first year's annual rent and the value of any cancelation provision is scored up-front. This scoring rule has had the unintended effect of forcing GSA into the use of long-term operating leases, which generally contain no ownership option, to meet Federal office space requirements.

Under current scoring rules and budget constraints, more cost-effective options, such as lease-purchase, cannot be considered; rather, GSA is left with just two options for meeting the Federal Government's office space needs – either direct appropriations for construction or long-term leases. Due to budget constraints, direct appropriations are often not a viable option, resulting in the inefficient use of long-term leases.[4] GAO determined that the decision to engage in leases that were often more costly than capital construction was driven by the fact that OMB scoring rules require that all capital purchases be fully appropriated initially.[5]

For capital expenditures, the FBF depends upon rent payments from agencies in government-owned space, which then allows GSA to construct, maintain, and repair buildings in the Federal inventory. Recent trends toward leasing buildings have led to a steady erosion in the proportion of the FBF that is available for capitalization. This, in turn, limits the Federal Government's ability not only to maintain its inventory of owned buildings and facilities, but also to generate funds for new Federal construction.

According to GAO, the current practice of relying on 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. In FY 2008, GSA reported for the first time ever that it was leasing more space than it owned.[6] If GSA's budget cannot be increased such that it can accommodate the up-front scoring required by current budget accounting rules while still meeting the space needs of the Federal Government, then GSA will have to examine its existing authorities to determine its ability to procure and maintain capital assets in a fiscally responsible manner.

The table below shows that $6.3 billion has been appropriated for FBF capital projects (e.g., repairs, modernizations, new construction, and building purchase) over the last five years, but this includes $1.6 billion in direct appropriations to the FBF. Thus, while the FBF has generated net income that is deployed towards capital projects, Congress has had to augment the FBF through direct appropriations for 25 percent of the total devoted to capital expenditures. One of the initial aims of the FBF was to provide an adequate source of capital to finance new construction, without the need for direct appropriations.

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[3] Tim Kauffman, *Old Buildings, dwindling rents: GSA faces financial crisis*, Federal Times (November 30, 2009).
[4] *Views and Estimates of the Committee on Transportation and Infrastructure for Fiscal Year 2011* (March 3, 2010), http://transportation.house.gov/pdf/ViewsEstimates.pdf.
[5] GAO, *Federal Real Property: An Update on High Risk Series*, GAO-09-901T (June 2009).
[6] *Id.*

Direct Appropriations Needed to Supplement FBF Revenues
(FBF Appropriations by Major Program Area FY 06-10 in millions of dollars)

| Program | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 | Totals |
|---|---|---|---|---|---|---|
| Rental of Space | 4,046 | CR | 4,316 | 4,642 | 4,805 | |
| Building Operations | 1,885 | CR | 2,105 | 2,197 | 2,290 | |
| Installment Acquisition Payments | 168 | CR | 156 | 150 | 141 | |
| Const. & Acquisition of Facilities | 792 | 397 | 306 | 746 | 894 | 3,135 |
| Repairs and Alterations | 861 | 465 | 722 | 692 | 414 | 3,155 |
| **Total** | **7,753** | **7,598** | **7,605** | **8,428** | **8,544** | 6,290 |
| Direct Appropriations to the FBF | **75** | **93** | **265** | **651** | **537** | 1,621 |

CR= Continuing Resolution

NB:

1. The Repair and Alterations figure for 2007 is the GSA request; appropriation detail in the CR is unavailable.
2. In the far right column, the total of $6.29 billion is the sum only of the two rows immediately above, i.e., the capital program categories of construction and acquisition, and repairs and alterations.

WITNESSES

**Mr. Robert Peck**
Public Buildings Service Commissioner
General Services Administration

**Mr. David Nash**
President, Dave Nash & Associates
National Academy of Sciences

**John Hentschel**
President, Hentschel Real Estate Services
Member, Counselors of Real Estate

**Mr. Kevin Stoklosa,**
Assistant Technical Director
Financial Accounting Standards Board

**Mr. Richard Greninger**
Managing Partner. Carr Services
Member, Building Owners and Managers Association

# CAPITAL ASSETS CRISIS: MAINTAINING FEDERAL REAL ESTATE WITH THE DWINDLING FEDERALBUILDING FUND

**Wednesday, March 24, 2010**

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS AND EMERGENCY MANAGEMENT,
COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE,
*Washington, DC.*

The Subcommittee met, pursuant to call, at 2:05 p.m., in Room 2167, Rayburn House Office Building, Hon. Eleanor Holmes Norton [Chair of the Subcommittee] presiding.

Ms. NORTON. Good afternoon, and welcome to today's hearing on the Federal Buildings Fund, or FBF.

Today we will examine whether the FBF offers the General Services Administration Public Buildings Service a viable tool for meeting its mandate of optimizing the use of Federal office space and providing a source of revenue to maintain existing buildings and to fund new construction.

The GSA owns more than 1,500 Federal buildings, totaling 176.5 million rentable square feet of space. It leases 177.5 million rentable square feet of space in almost 7,100 leased properties. However, in recent years the GSA construction program has essentially been reduced to land ports of entry and to courthouses, with few exceptions, and GSA increasingly relies on private commercial office space to meet its needs, straining the building fund and creating a growing crisis in meeting GSA's vital function.

The FBF was created in 1975 by Public Law 92-313 to provide a revolving fund that required agencies to pay for the space they occupied and to provide a revenue source for new Federal construction and upkeep of existing Federal buildings.

Today we will hear from witnesses across the spectrum to help us evaluate GSA's capital investment management strategies and to evaluate how GSA can manage Federal assets more effectively.

Our witnesses include two private sector witnesses with experience in maintaining and repairing buildings, from whom we hope to learn, and an expert on capital asset management. We also will hear from an official from the Financial Accounting Standards Board, who will discuss how new accounting rules may affect how the Federal Government will evaluate the Public Buildings Service's Capital Investment and Leasing Program.

The current guidelines for the budgetary treatment of leases require the full cost of a capital lease or lease purchase to be scored

up front rather than at only the first year's annual rent and the value of any cancellation provision as in the case of operating leases.

Of course, we will hear from Robert Peck, the PBS Commissioner, currently in his second tour of duty with GSA as the PBS Commissioner. We will want to focus on what it takes to properly maintain a capital assets portfolio and on the true costs of leasing versus owning Federal office space.

Since its inception, the building fund has struggled to meet its original mission. As early as 1981, the Government Accountability Office, or GAO, found that there was no evidence that the FBF had promoted a more efficient use of space or produced enough funds for new construction. Periodically since then the GAO has noted the inability of the FBF to fund the repair and maintenance of existing Federal assets. More importantly, the current head of the PBS has indicated that the Federal Buildings Fund is on an unsustainable course and will be unable to fund the proper maintenance of its Federal capital assets in the near future.

The Federal Buildings Fund recently received a much-needed infusion of cash of $5.5 billion provided by the American Recovery and Reinvestment Act. Even with this investment, there are public reports of a maintenance and repair backlog of almost $8.8 billion. Yet the PBS building portfolio has a replacement value of nearly $42 billion, which makes mandatory the development of a more effective approach for generating funds necessary to maintain our capital assets.

Two examples show that the government is beginning to recognize that it must right-size its Capital Investment and Leasing Program. The administration's fiscal year 2010 budget request included $100 million for the GSA to exercise the purchase option for the Columbia Plaza building located in Washington, D.C. In addition, the fiscal year 2011 Capital Investment and Leasing Program also includes a proposal to purchase an IRS building in Martinsburg, West Virginia, for $25 million.

We continue to applaud the efforts of the agency to parse through the purchase opportunities available to GSA and to exercise them whenever it is prudent to do so. The GSA had long leased the Columbia Plaza building, but finally purchased this much-needed asset housing State Department employees at nearly 50 percent of its 2006 appraised value. The building, close to the State Department headquarters, would otherwise have required another round of leasing and lost dollars to the building fund and to Federal taxpayers.

The Committee on Transportation and Infrastructure and this Subcommittee have repeatedly expressed concern about the expensive trend toward providing Federal office space through leasing and not Federal ownership, to the point that, for the first time, the Federal Government is now occupying more lease space than owned space in fiscal year 2008, according to a July 2009 GAO report. In almost every case, over the long term, leasing is more expensive than Federal ownership and deprives the Federal Buildings Fund of direct payments from agencies occupying government-owned space, which instead goes to developers.

The intended purpose of the FBF was to provide the resources to enable GSA to construct, maintain and repair buildings in the Federal inventory. That purpose is undermined by the steady shrinking of available funds to maintain Federal assets, much less to generate funds for new Federal construction. This skewed lease-to-own ratio trend presents a distressing portrait of the condition of Federal asset management, which is an essential function of government. We need to determine if the financial and managerial systems are in place for GSA to properly administer the FBF and maintain existing assets. We plan to address the assumptions used to justify the current capital asset management strategies.

Finally, and perhaps most importantly, this Subcommittee will examine whether GSA has existing statutory authority to address its needs and to maintain its own capital assets. We have pressed GSA to use all of the authority available to it, including section 412 of Public Law 108, which grants GSA the authority to enter into agreements that include selling, leasing, the exchanging of capital assets, and retaining the proceeds within the Federal Buildings Fund. When Congress granted this authority, it was contemplated that GSA would have a powerful tool at its disposal to enhance its ability to properly manage its capital assets portfolio and the Federal Buildings Fund as well. Instead, this authority has not been exercised as yet, and we are facing, perhaps, a looming crisis in managing our Nation's public buildings.

I very much look forward to hearing from today's witnesses, and I am pleased at this time to ask the full Ranking Member, shall we call him, of the Committee if he has any opening remarks. Mr. Mica.

Mr. MICA. Thank you.

I ask unanimous consent to participate in the Subcommittee hearing. I serve on all six Subcommittees, but I have to ask unanimous consent to fully participate. It is just a technical matter.

Ms. NORTON. So granted.

Mr. MICA. Thank you.

I am pleased to join you today, and I regret Mr. Diaz-Balart is delayed at another obligation and should be here later. But I appreciate the Chair's attention to this important matter of capital assets and maintaining Federal real estate with our dwindling Federal Buildings Fund and Federal resources.

I admire Ms. Norton not only for her tenacity on a number of issues and for her fine representation of the District, but she also gets into the weeds, which I think we need to do as Members of Congress, particularly when it comes to getting the best return for the taxpayers. Certainly GSA has an important responsibility, and so does she.

So it is a pleasure for me to be here. I have a personal interest, as she knows. Years ago I was in real estate development, and I enjoy making certain, as I tell some folks—the Federal Government has a great deal of public assets, and I always say we shouldn't be sitting on our assets, and that we should utilize them to the fullest and get the return, and that is what this hearing is about. So, again, thank you for convening it.

Let me just make a couple of points.

There is no better time than now, as you have heard me say before, to act. Now is the time we can lease and get the best deals for the Federal Government. This is the time when a wise real estate investor looks at acquiring properties, and certainly the Federal Government has one of the highest inventories.

You also have to look at the assets that we have within our inventories. Many of these assets—in fact, Mr. Nash, who, I think, is a later witness, is going to testify today that over half of the Federal buildings are more than 50 years old. Now, think about that. An old building, first of all, is going to be very costly to maintain. Anyone who has dealt with any property knows that an aging building is one of your highest assets to maintain. So we have this huge inventory of ancient buildings that are very costly to operate. This is the time to change out those properties to make the best deal.

Possibly, too, we could look at selling some of those assets and reinvesting that in properties that are less costly to own and to maintain, and we could probably get more net usable space for the taxpayers and increase our inventory. Again, it is aged just by having newer units.

The other thing that is so important today is when you have a 50-year old building, it isn't very friendly to the environment or very efficient.

So, on those two accounts, it is wise to acquire newer buildings and buildings that also have been built with more efficient systems. One of the most costly things to operate is energy utilization in those buildings, not to mention the high maintenance, but it is the high energy costs and low consideration and a high negative impact to the environment.

So, with every one of these deals that we are able to put forward at this time, again, we get greater value than we have ever gotten because the cost is down. We get greater efficiency in the operation as far as energy, and I think we do a big plus in helping the environment. Again, I think this is a very worthwhile hearing.

I think it is also important, as a leader of this T&I Committee, to look at the Federal Government's commitment to locating these properties, these new properties in particular, that we acquire close to public transportation. It is so important that that be a consideration because we do need to move people more efficiently. Again, the high amount of negative contamination to the atmosphere is done by transportation—by one person and one inefficient vehicle when one is getting to work or around the community. So I think we have an obligation to lead as far as also supporting transit-oriented development and acquisition as we move forward.

So I look forward to hearing from Mr. Peck. I think part of the problem that he deals with—and he has done a good job. First, he has to deal with the laws that Congress has already passed, and some of those may need some flexibility. Some of them, just like our capital assets inventory, may need some updating. Give him the flexibility to make these investments at this critical time when we have the money that is going to be spent—some stimulus, some other capital improvements—and give him the ability to be flexible in changing out aged assets. Maybe you could get more for the location. The building may not be that good, but in acquiring more en-

ergy-efficient transportation and an environmentally friendly property, we end up with a net plus for the taxpayer and the Federal Government.

So I look forward to hearing responses, commentary and also constructive suggestions from the witnesses today as to what laws or what approaches may be needed for the future, because we need to give them the tools to get this job done.

This is probably more than you wanted to hear, Ms. Norton, but since you have got me, those are my comments.

I yield back.

Ms. NORTON. I thank the Ranking Member for, really, very thoughtful comments, and I appreciate very much that he thinks deeply about this subject, too. This is a subject in need of leadership and in need of new ideas and new approaches, and I am sure we are going to get some of that from Mr. Peck, who I am pleased to welcome as our first witness.

**TESTIMONY OF ROBERT PECK, PUBLIC BUILDINGS SERVICE COMMISSIONER, GENERAL SERVICES ADMINISTRATION**

Mr. PECK. Thank you, Madam Chairperson and Ranking Member Mica. Thank you for inviting me here.

If I can step out of protocol a bit, I would also like to welcome both counsels, with whom we work very closely, and one who is new with you, Ms. Norton, who is a distinguished GSA alum, Mr. Kendall.

Actually, Madam Chair and Mr. Mica, you have pretty much made my statement. You have summarized, for the most part, how the fund is supposed to work, how it has worked, and some of the issues that I face, but I will go into a little bit of detail.

As you noted, the Federal Buildings Fund, which was established in 1972, was designed to provide a stable source of funding for both the operating needs of the building inventory and its capital needs. Rent revenues, which we get from Federal agencies whether we lease or own the buildings, are deposited into the fund and are made available to cover our activities, though, of course, we have to get an appropriation every year to spend them.

What is important to remember about the fund is that it is a revolving fund, which means that, not unlike some trust funds that we have in the government, we use current revenues to pay off liabilities that have accumulated over time, and that means that the age of our fund and the relative ratio of new buildings to old buildings is incredibly important.

I should also note while the initial intent was that the rent revenues going into the fund would cover both operating costs and capital needs, both new construction and renovation needs, within a very few years after the fund was set up, it was pretty clear that that was not going to be the case. The fund started collecting rent in 1975. By 1979, we were already receiving appropriated funds. We have in 8 of the last 10 years received appropriated funds to cover our capital needs.

As early as 1981, as you noted, the GAO reported that the fund was generating not enough revenues. In fact, they reported in 1981 that the fund was generating less revenue for new construction and other capital needs than Congress had been appropriating annually

into the fund before the fund was created. The GAO identified a number of factors contributing to that, including an increase in leased space, the high repair and alteration needs of an old building inventory, and a reduction in rental income due to administrative and legislative actions. It is interesting to note that, nearly 30 years later, we could say exactly the same thing.

From time to time, the administration and Congress have provided funding for a significant number of new buildings, including in 1983, partly in response to that GAO report of 1981, an opportunity purchase program under which GSA did go out and buy a number of existing buildings which were added to the inventory.

The most recent example of a significant boost in funding is, of course, the American Recovery and Reinvestment Act of 2009, which provided us with $5.5 billion for capital projects. Unlike previous building programs—and this is not a bad thing—not all of that money was directed to our direct capital needs for repairs and alterations, but rather a significant amount of it was intended to green our inventory. That is clearly a benefit to our inventory as a whole because it will, in the end, reduce our operating costs. It will also help us provide examples to the American building industry in general of what technologies and practices work.

I can also report, in response to Mr. Mica's note about the favorable investment climate, we are, in the Recovery Act, getting pretty low bids on construction. That is a good thing for us in a way. It is sort of a discouraging commentary in a way, however, on how soft the real estate market is out there, so we don't take undue satisfaction from that.

This infusion of capital from the Recovery Act will allow us to reduce the liability we have on some of our aging assets, and it will reduce the liability that we had which we had estimated a couple of years ago at about $7.3 billion in capital needs for significant alterations in our fund. I should note that the average age of our inventory, if you weight the square footage, is 46 years, and 31 percent of our square footage is older than GSA itself, which was founded in 1949.

In recent years we have met new space needs primarily through leasing buildings. There is nothing wrong with leasing per se, except that the income and outflow are exactly the same. We get rent from our agencies, and then we send it out a revolving door in lease payments to a private owner. It does not, in other words, contribute to the investment fund that we need to keep up our buildings. Without new government-owned facilities keeping up our income on the front end, because new facilities don't need repair and alterations and investments, funding for our reinvestment needs is reduced.

We will continue to look for ways to increase revenue and to reduce expenses. We are looking at ways to maximize utilization in our buildings, seeing if we can squeeze more people into less space. Our vacancy rate in our own buildings is already at around 2 percent, and the inventory as a whole, including the leased space, is only about 4 percent, but there still are ways, clearly, that we could get more people into less square footage.

I do want to note that Congress did give us the authority, under section 412 in an appropriations bill in fiscal 2005, I believe it was,

or in 2004, and the opportunity to retain the proceeds when we dispose of surplus properties, and we have, in fact, used that authority. We have in the previous 3 years earned about $198 million from selling off old properties.

We will also make sure that we collect rents in a timely way from our customer agencies, and we are looking at ways to reduce our own overhead, because with that, too, if we don't have the lowest possible overhead, we are eating into the net income that we need to maintain our buildings.

I should note that under section 412, we have from time to time, as I think you know, considered other financial mechanisms that would provide the means to own buildings, and we will continue to do so. Beginning this year also, I should note, just on the topic of trying to do better with the space we have, we will work with three major customer agencies to produce overall national strategic portfolio plans in an attempt to see if we can reduce the amount of space they need.

Finally, in response to Mr. Mica's comments about transit-oriented development, for which I thank you, I would note that, in October, President Obama signed Executive Order 13514, which, in ordering Federal agencies to pay much more attention to sustainable facilities, does say that, to the maximum extent we can, we should locate new Federal facilities in transit-oriented developmental locations, and we are developing guidance with the Department of Housing and Urban Development, the Department of Transportation and EPA to make that a reality.

That concludes my statement. I will say I look forward to hearing also from the other witnesses, but, of course, I am happy to answer your questions.

Ms. NORTON. Thank you very much, Mr. Peck.

Now, I think you said, for the record, something that is very important for this Subcommittee to note, which is that essentially—and correct me if I do not understand you—very soon after the Federal Buildings Fund was established, its premises appeared to be faulty in as much as it was assumed that the so-called ″rent″ from Federal agencies could cover new the construction and upkeep of the buildings.

So, this premise, was this a theoretical premise? Although you would have thought that somebody would have done some numbers on it. Was it shortly seen to be a flawed premise, and it is all you can do with inflow and outflow, simply with a diminishing building fund, to simply keep the fund going, and that it is not an investment fund?

Mr. PECK. Right.

Well, I want to say there were a couple of premises in the fund, and we are focused on one. There are a couple that are good. One: Still having agencies pay rent so that they realize the cost of occupying space and don't accept it as a free good, that is good.

Second: We do have a regular stream of income to do minor repairs and some of our capital expenses, and I think, compared to some other Federal agencies, we may even do better than they do in having some money to cover our capital investment needs.

However, you are absolutely right. I don't know what numbers they were looking at back then, given the age of the inventory,

which was an older inventory than most private investors would ever consider putting money into as an investment. If you consider the age of the fund, we just don't generate enough income. You are right. It seems that that was the case from the beginning.

Ms. NORTON. So, of course, I would add to this. This revolving fund notion, you say the agencies, you know, now understand there is nothing free in this world, and therefore, they are paying rent. But actually, the theory also is that the revolving fund is helping with the upkeep of the very buildings in which they are located. So the revolving fund notion is they really do get back the investment that comes from their so-called ″lease payments″; is that not the case?

Mr. PECK. That is. I always say I think I have the best job in American real estate. However, on a day-to-day basis, we get complaints, legitimate complaints, from the agencies we house that they are paying us fair market rents and are often not getting back the quality of building, if they are in an older building, that they would expect from those rents.

Ms. NORTON. Although the courts get more out of the fund than any other part of the Federal Government, they actually tried to get a waiver from their contribution to the Federal building. We could not believe the gall of any part of government believing that somehow somebody else—the taxpayers—ought to carry them, and that they should have nothing whatsoever to do with it. We were able to put that down, but there was a very concerted attempt to get that waiver in the last few years.

Now, you have got to make us understand the Department of Agriculture and its waiver. Would you describe its waiver and indicate what you have done to make sure that they are like every other agency of the Federal Government?

Mr. PECK. Well, at some point, I think it was—I have forgotten the number of years back, but I can provide that for the record. Within the last 10 years or so, we agreed to waiving all but operating expense rent for the Department of Agriculture. In other words, the basic rent was forgiven.

Ms. NORTON. They were supposed to keep the buildings up.

Mr. PECK. Correct, in return for, it seemed like, a reasonable arrangement, I have to say, that the Department of Agriculture would take that rent money and use it to renovate their buildings, which are also Depression-era buildings and need a lot of work. My understanding on the numbers to date is that the waived rent amounts to about $400 million, and Agriculture to date has put about $200 million into the buildings. We have had a discussion within——

Ms. NORTON. Just let me ask you: Since you are the leasing and construction arm of the Federal Government, one way to have controlled this would simply have been for you to take the money out of their appropriation and do the repairs as you would do for any other building. I mean, did you just say to them, You who have to do with Agriculture, you who are not in the construction and leasing building, you take your own money, and you fix your own building up?

Mr. PECK. That is it in essence. I mean, that is, in essence, what we said. We took the building out of the Federal Buildings Fund,

for all intents and purposes, and we said to Agriculture, You fix it up out of your own funding. That is the way that it was supposed to work, and they have put significant money into the building, although it looks like not as much as we have waived.

Ms. NORTON. How long is that arrangement supposed to last? Is there a letter from OMB that the Federal—we would like to see this letter from OMB. This says that the Federal Buildings Fund is not disadvantaged by the Department's not paying any rent.

What is the theory of that?

Mr. PECK. I am just checking to make sure. I think we did provide a letter to you either from OMB or——

Ms. NORTON. Would you describe to us the reasoning of OMB in that score?

Mr. PECK. Yes, ma'am.

Their view is that, while we no longer have the funds in the Federal Buildings Fund to fix up the building, neither do we anymore have the liability to fix up the building, and that that liability is on the Department of Agriculture.

Ms. NORTON. What did they say about the fact that they have only come up with $200 million of the $400 million they were supposed to come up with? I mean, I wish OMB were as forgiving in other respects as they seem to be here. How would they go and get the other money that has not come forward?

Mr. PECK. I think that—I can't really speak for them, but I believe that the view may be that eventually the Department of Agriculture will get around to fixing up the building.

Ms. NORTON. What have been your discussions with them, Mr. Peck? I mean, they are not going to eventually spend any money they don't have to spend, let us face it. But there are other things if you are the Department of Agriculture—that is why we make you, not the Department of Agriculture or HSS, the leasing and construction arm of the Federal Government. So they are not going to do it unless somehow the GSA Public Buildings Service comes forward with a formula that gives them an offer they can't refuse.

Mr. PECK. Well, thank you, because I obviously do have a concern, because if this established a precedent, eventually the Federal Buildings Fund would fall apart. We wouldn't have a revolving fund anymore. We would, in essence, have to create what people do in the private sector, which is to create a sinking fund. Every building would stand on its own and have a sinking fund. Somehow they would have to save money to fix up the building.

We have had some conversation with Agriculture. I know that they do intend to fix up the building.

Ms. NORTON. I am at a loss. Did Agriculture request this letter from OMB, or did you request the letter that came from OMB?

Mr. PECK. We requested the letter. It was partly in response, I believe, to yours and Mr. Oberstar's questions at a hearing sometime last year.

Ms. NORTON. Well, we are going to have—you know, as to the notion that OMB would not take into account past practice, whether or not, in fact, Agriculture had complied with its part of the agreement, was that addressed in the letter? If the agreement were a quid pro quo, the agreement is in violation.

Mr. PECK. I suspect if you—you know, again, I have spoken to the officials at the Department of Agriculture. Let me just say I think that the origin of this arrangement may have been, if memory serves me well, that Agriculture felt that they had waited a long time for their turn to come around in the revolving fund to get their building fixed up. So I think the argument was, I will tell you what. Forgive the rent. We will use the money, and we will start the project ourselves. We will step out of the queue for building renovations. At the time we were way behind on fixing up any of the 1930s-era buildings in Washington. I think that is the history of it.

The question of when they will finish the project I honestly can't address today. I can find out and provide it for you.

Ms. NORTON. I am going to have to ask you, Mr. Peck, if you would within 30 days get to the Committee a plan for assuring that the Department of Agriculture meet its agreement under—you don't sign an agreement and then go in violation and have nobody do anything about it. So, since you are the agency that is involved, the Committee is impatient with hearing about this, and even more impatient if OMB wants to let them off the hook since they rarely let anybody off the hook. We don't mind them saying there was originally a quid pro quo; we do mind them not saying that one party is in violation of the contract.

We ask you to submit within 30 days a plan for making sure that the Department of Agriculture meets its agreement under the contract.

Mr. PECK. I will be happy to do that.

Ms. NORTON. I very much would appreciate that.

I have a number questions, and I will ask one before I go to the Ranking Member, who is very practiced in this area.

I was interested in this 4 percent vacancy rate—that is the rate that we understood—compared to 16 percent in the private sector. I wondered if you were comparing the GSA rate to owner-occupied real estate portfolios or to general market vacancy rates.

Mr. PECK. It is to general market vacancy rates.

Ms. NORTON. So that is the appropriate comparison?

Mr. PECK. Not exactly, no. I just wanted to—we have not highlighted that in our testimony.

My point is as a benchmark, it is hard to get occupancy rates from owner-occupied inventories, but it is just by way of showing that a 2 percent rate in the owned inventory, for example, is about what you would want to hold because you have needs. If you need to shift people around in buildings, you need to keep a little bit of vacancy.

When people ask me that who are private sector owners, they say, Well, you know, we do, in the first instance, have the authority to order people to occupy our space. So it is not really a very fair comparison. On the other hand, we are very proud of the fact that even in the space where we lease, where agencies sometimes do move around, we manage to keep a pretty tight rate on inventory.

Ms. NORTON. Do you out-lease any federally owned space?

Mr. PECK. Do we out-lease?

Ms. NORTON. Yes.

Mr. PECK. We do some, but not very much.

Ms. NORTON. What kind of circumstance, given your needs, would be—do you have a building that is partially filled?

Mr. PECK. We have some authorities to occasionally—and I am not sure it is true anymore. We had buildings that were occupied by the VA in which veterans' organizations could lease space. We do have the ability under the Public Buildings Cooperative Use Act to lease ground floor and other space for retail purposes where that is appropriate.

In some cases, for example, the Hotel Monaco here is an out-leased building because it no longer served very efficiently as an office building, and we leased it to a hotel group that renovated it and turned it into a hotel, and we do get some rent back from that, but rarely do we lease out space otherwise. Section 412 did give us much more flexible authority to do that. It used to be we had to declare space surplus and go through a long process before we could lease it out to anyone else.

There was one case I know of in which we out-leased to a State court when we no longer needed a Federal building, but it is the exception.

Ms. NORTON. Mr. Mica.

Mr. MICA. Thank you for yielding.

Just a couple of quick questions.

As far as your funds to—right now, you know, everyone is talking about acquiring buildings and also about getting rid of, say, some buildings that are inefficient, and getting them off the rolls and replacing them with more efficient government-owned buildings. As far as dollars to accomplish that, what do you have on hand?

Mr. PECK. Well, as you know, and as, I think, Ms. Norton noted, we did in the President's budget this year propose acquiring two buildings that we already have under lease, the Columbia Plaza building here and the IRS building in Martinsburg, West Virginia, but we don't have any available funding at the moment——

Mr. MICA. Okay.

Mr. PECK. —to acquire existing buildings that are——

Mr. MICA. Out of this stimulus money, you can't acquire buildings, but could you build a building?

Mr. PECK. We are taking a couple of buildings that were already designed but had not been funded and are building them; for example, a new courthouse in Austin, Texas. The Recovery Act money was not allowed——

Mr. MICA. To acquire buildings?

Mr. PECK. It did not allow to us acquire buildings because it doesn't create jobs.

Mr. MICA. Is there any money available, or is all of that spoken for?

Mr. PECK. The Recovery Act money, all of it is committed to projects. We have a project list of more than 250 projects that are getting funding. Even, I have to say, we have realized some savings, as I noted, in some of our bids. Even those have been—because the Recovery Act funding said we had to put them into renovation projects or construction, we have clearly not allocated any of that to opportunity purchases either.

Mr. MICA. So, if you wanted to acquire new buildings, basically you are out of cash and out of authority?

Mr. PECK. That is correct.

Mr. MICA. Okay. So you would need that cash or authority by Congress, right?

Mr. PECK. That is correct. Of course, you can authorize via prospectus, obviously, but we would need to find the appropriations funding.

Mr. MICA. What about your legislative flexibility to accomplish some of these deals and maybe sell some properties that are inefficient, replace them, take those moneys and put them into other projects? Do you have enough authority to do that?

Mr. PECK. I think we do have the authority to do that at the moment. The one thing that sometimes gets in the way, which people forget, is that we rarely find that we have a building that is totally vacant. I mean, we manage better than that.

Where we find buildings that are only underutilized because they are inefficient or partially vacant, you need money up front to be able to move people out of those and put them into another space. It is kind of like what we discovered in the BRAC process. You need to put a lot more construction in Fort Belvoir, for example, to move out the people you are moving from other military bases that you are able to close down.

Mr. MICA. Do you keep an inventory of partially occupied Federal buildings?

Mr. PECK. We do. We have an inventory of what we call—the term of art in government is ″underutilized property,″ and we actually maintain that——

Mr. MICA. Right. If possible, could you share a copy with our staff? I would appreciate that. I would like to look at that.

If there are any impediments or lack of flexibility that would allow you to acquire properties, exchange properties, dispose of inefficient properties, again, with taking on newer, maybe more efficient, environmentally friendly, transit-located properties—if there is anything missing or lacking, I would like to know what authority you need.

Mr. PECK. I will.

We are, in fact, ourselves taking a look at our surplus property procedures because, as you know, there are a number of screening requirements that we have to go through once we have declared a property surplused before we can take it all the way to sale. There are certain procedures that we think we can do faster. On the other hand, some of the statutory requirements do make it more time-consuming than, I think, we might want. We may have some suggestions that we could send up to you.

Mr. MICA. All right. The only final thing would be if any of those deals that you said you have been obligated to fall through, could you also let us know on that account?

Mr. PECK. Yes, sir.

Mr. MICA. Thank you.

Mr. PECK. Can I add one other thing?

We were able with some of our Recovery Act funding to turn a couple of projects that would have been long-term leases for long-term government needs into constructed projects. I could just name

two. One Mr. Diaz-Balart may know as the FBI project in Miami. The second was a courthouse in Yuma, Arizona, both of which we changed from long-term leases, built-to-suit leases basically, into owned buildings.

Mr. MICA. Thank you.

I yield back, Madam Chair.

Ms. NORTON. Mr. Diaz-Balart.

Mr. DIAZ-BALART. Just one question. Thank you, Madam Chair.

With the stimulus money, obviously there were projects that went forward, or they had to be on the drawing board really quickly. So didn't that potentially free up some funding for you? I understand you can't use it for purchasing, but didn't it free up some money that you were looking for that you were already scheduled to do something else with?

Mr. PECK. The only money it would have freed up would have been the first-year lease cost of those buildings, and we do not actually have to pay the lease until the building is built. So, theoretically it is freed-up lease costs, say, 2 years from now that we won't have to pay in return for an upfront payment now to build the buildings.

Mr. DIAZ-BALART. It is not cash on hand?

Mr. PECK. Not significant, no. It would not be significant, but it is not cash on hand either. Yes, sir.

Mr. DIAZ-BALART. Thank you.

Ms. NORTON. Thank you, Mr. Diaz-Balart.

Now, I want to get at some of the efficiencies of the way you manage the portfolio. What is the industry pricing standard for managing a real estate portfolio expressed as a percentage of the value of the managed portfolio?

Mr. PECK. Do you mean the amount of money that one should spend every year on your maintaining your capital inventory?

Ms. NORTON. Yes.

Mr. PECK. The benchmark which we have used in the past is the one from the National Research Council, which recommends that 2 to 4 percent of the replacement value of an inventory be reinvested every year as a capital upgrade. We have discovered that there is a similar benchmark used by the association of the University Business Administrators, so somewhere in between 2 and 4 percent, and I think the range suggests that if you have an older inventory, you go toward the top of that range.

Ms. NORTON. I was going to make sure I was not being misunderstood. I am really interested in your overhead costs, costs which, I think, you testify in your testimony need to be reduced.

Mr. PECK. Right. I do not have a good benchmark on those because, you know, again, speculative real estate owners typically don't have large workforces. They contract everything out. The only thing I can say is I think, you know, in the Public Buildings Service budget, about 95 percent of what we spend is already contracted out and is, I think, managed pretty efficiently. On the remaining 5 percent, which is what we spend on our own salaries, I honestly don't know what a good benchmark is. We are really good at benchmarking our utility costs and cleaning costs.

Ms. NORTON. Well, wouldn't what you contract out have to be figured into your overhead costs as well?

Mr. PECK. Well——

Ms. NORTON. There must be some way in which you would have to capture that.

Mr. PECK. No. Most of what we contract out is building operations, cleaning, maintenance, architecture services, construction services, those kinds of things.

Ms. NORTON. Leasing you contract out a lot.

Mr. PECK. Correct. Although that presumably does not cost us, because we at least pay those brokers who are doing that work out of the lease cost——

Ms. NORTON. True.

Mr. PECK. —but I will have to get you a number. The one thing——

Ms. NORTON. But you believe that those costs exceed what industry costs generally are, and that they should be better controlled? You don't have a handle on that?

Mr. PECK. Let me answer it two ways. One is I think they could always be better controlled, although I think we are pretty good. I don't want to go farther than that at the moment because we are doing a pretty serious review.

The other thing I will just note is because we are the government, and we have procedures for letting contracts and doing leasing that are much more time-consuming than the private sector has, most of the time for good reason, and requiring that we get competition and fairness in a way that private sector people don't always have to do, I think it would be hard to benchmark the overhead costs. I am not trying to evade it. I just think overhead costs can always be reduced if you get serious about it.

Ms. NORTON. Well, I think you have got to find some way to compare yourself to the private sector to see how much and whether, for that matter. We agree that there is room to reduce overhead costs in what you do.

I was in a quandary to understand why a couple of years ago PBS reduced the fee it charges to customers, its agencies—to the agencies for leasing services. Why was that done? What was the impact on the profitability of this?

Mr. PECK. We reduced the—I will have to get you the number. I believe it was a year and a half or 2 years ago that we reduced the leasing fee from 8 percent to 7 percent. The rationale for that was that as we used private sector broker services for some of the work, we felt that we needed to—it was before my time, but we felt that there should be a commensurate reduction in how much work the Public Buildings Service employees had to do. But we only reduced by 1 percent, in part because a large percentage of that leasing fee is what is required for us to administer the lease during its term, which is after the brokers go away.

Second, it is an insurance fund, in a way, against the fact that agencies can give us 120 days' notice and walk away from their space, leaving us with rent on vacant space, but I don't know how much that 1 percent reduction has cost us.

Ms. NORTON. They can do what?

Mr. PECK. You know, one of the fundamental precepts of GSA's being a government-wide real estate organization is that we bear the risk in the government that somebody on short notice might

not need the space that they occupy because we have the opportunity—theoretically, if agency X decides they don't need space, we can invite agency Y, which may be looking for space, to reoccupy it. So agencies can give us 120-days' notice that they have a marketable block of space, and we will take it back.

Ms. NORTON. But you are not left holding the bag very often, are you, Mr. Peck?

Mr. PECK. No, we are not.

The only time we have been we have solved this issue. Notice I said they have to give us a marketable block of space. There have been times when people have said, Okay. I no longer need this office. You can give it to somebody else, and we say, You know, we are not quite sure that the Department of Defense really wants to occupy one office in the middle of the Park Service space, so we don't let them do that.

Ms. NORTON. Mr. Peck, we don't know any way to look at GSA, which, after all, is in the marketplace along with everybody else in the real estate market, except by comparing you with others in the market. So I wonder how you would respond to these facts and figures.

You control Federal properties, according to your estimates, of something like $24 billion to $30 billion. Now, just think of it. This is debt free. You don't pay any real estate taxes. However, you collect equivalent rent, which is inclusive of real estate taxes. Using—your own parlance—funds from the operation, you are supposed to be netting in the vicinity of $1.5 billion a year, which equates to about 5 to 6 percent, but one would expect an investment on income, since GSA does charge commercially equivalent rents, to be at least 7 or 8 percent and possibly more when the real estate market is robust.

Why can't the Federal Buildings Fund over, the long term at least, produce returns in the range of the commercial rates?

Mr. PECK. You know, we produce a pretty good return. If you take a look at our—let me approach it this way.

Of our $8.5 billion or so of rental income this year, about $5 billion immediately goes out as lease payments, and that is on about half of the square footage. So, of the rent that we collect on the rest, we have about $3.5 billion left to maintain operations—overhead, utilities, cleaning, all those things, and minor and major alterations on our buildings.

The way it works out when all is said and done and over the last several years on an annual basis, we are at about $700 million, $800 million worth of major and minor repairs, and given the age of our inventory, that is less than we probably need to stay even with the needs. That is the way our budgeting looks.

Ms. NORTON. So you are blaming it on the fact that you don't produce the same percentage return on your investment as—you are blaming that on the fact that you increasingly lease so much, and that so much of what you get goes into the leasing market and not——

Mr. PECK. Well, let me put it a different way. I mean, leasing is pretty much a wash, but when you look at this huge rent roll we have got—and $8.5 billion is serious money—it looks like you

should have a lot of money left over to work on your buildings, but that $5 billion is kind of gone.

You know, the $3.5 billion that we collect on the rest of the inventory in part is relatively low because in old buildings—and this, again, goes back to what a revolving fund is all about—on an old building, we charge a relatively low rent, because, in real estate parlance, it is often a class C building. So when you compare it to other buildings in the market—you know, when you look at law firms renting class A space, they are renting a much better building for a much better price. Our class C buildings, in essence, don't make enough money, clearly, to fix them up, and we rely on new buildings that are charging higher rents and are having less real estate need to make the profit.

Basically what is happening is we don't have enough of those to clear a really good profit to make up for ones that get low rents, that don't make much profit, but that have the needs. So we are a little bit upside down on our income and our needs.

I have to say, lest anybody take this to mean that our buildings are just in terrible shape, you know, you can look around here. We have now, but in some measure with appropriated funds, been able to fix up almost all of the Federal Triangle buildings. The Commerce Department and the FTC still need significant work.

Ms. NORTON. But that goes back to how we are doing it.

Mr. PECK. Right.

Ms. NORTON. That goes back to the fact that this has nothing to do with the Federal Buildings Fund. This has nothing to do with the original concept or theory of how we would do this upkeep or how we would build buildings.

One of the things that I hope we get out of this hearing is what do we do next. This ain't working, people. This is not functioning well. This is not the way to do it, to continue to operate off of a faulty theory.

You know, Congress does this all the time. This doesn't have anything to do with GSA. Congress hides the ball all the time and just hopes for the best. Clearly, that is what was happening here. But it really does mean, Mr. Peck, that we need to face up and say, for example, that the Federal Buildings Fund will no longer have to do with one of these functions, possibly construction, because it doesn't do it anyway, and then consider what else we should do.

You talk about—you know, you look around and you say, But we have been able to do X, Y and Z, but then you put in the right caveat "with appropriated funds." It is appropriated funds that are helping you to fix up buildings all over the United States as I speak, precisely because the Federal Buildings Fund could do nothing about it, and we had a deteriorating set of assets.

Mr. PECK. Right. That is right.

Ms. NORTON. I want to know, have you and GSA thought about how to eliminate what amounts to a structural imbalance built into, inherent in, the Federal Buildings Fund? Have you given any thought to another formula or to another way to manage your capital assets?

Mr. PECK. We have certainly had ideas over the years. I was just reflecting that had someone offered the Federal building inventory to private investors in 1972, they probably would have taken a look

at the numbers and said, I can only do this if you capitalize a renovation fund, because I need to bring these buildings up to a certain standard so I can charge enough rent to have this revolving fund get the running start it needs to keep going over time. And that clearly didn't happen.

To bring it forward and to answer your question more directly, we have certainly over the years considered a number of other things. One is—and again, this requires an upfront infusion of appropriated dollars—going out and buying new assets so that we can trade in old assets or fix up old assets.

Ms. NORTON. See, that would mean, of course, we go to appropriated funds. I don't need to tell you, Mr. Peck—you worked in the Senate—that the hardest money to come by is bricks and mortar money.

Mr. PECK. Correct. I am clearly not here to suggest, and would be in some hot water if I did, that I will see those funds on the horizon any time soon.

Ms. NORTON. So why don't we just write that off, Mr. Peck, and come up with a real formula.

Mr. PECK. Well, every once in a while we get infusion funds.

Ms. NORTON. No. Your own administration has shown—for example, if the administration—let us try to work out a way to deal with this.

If the administration said, We—in 1 year in office and with our first budget, we bought a building—a building, I might add, that we had bought several times over—but that we bought a building because we weren't going to do that anymore, and in the second year in office, with our newest budget, we are buying another building, and if this President spent 8 years—and I am hoping for 8—buying a building, he would have done more in the purchasing of real estate than any administration in the history of the United States with only eight buildings.

If we don't have a goal like that, the whole notion of, well, we could always buy buildings—Mr. Mica talked about buying a building, and he asked you how much money was there in your portfolio to buy a building, and you ran down where the money goes. We know that the money isn't there, and we know that Congress isn't going to come up with the money except in a circumstance like the one we are in now where you are trying to stimulate the economy, so I am not sure we should even put that on the table unless we put a goal on the table as well.

Mr. PECK. Well, one other thing I will just note, and you certainly know, is that funding the Coast Guard headquarters building is also getting us out of a—will put us in a good position for a long time in the Federal Buildings Fund, as will the rest of the Department of Homeland Security's consolidation of St. Elizabeth's, which will get us out of——

Ms. NORTON. By the way, Mr. Peck, have you done any analysis of just how much in the Federal Buildings Fund will be generated by those moves alone? Could you get within 30 days to this? I mean, would it get us some distance toward making the case that building does matter?

Mr. PECK. We can get you that. We have actually done the analysis on the leases that will be vacating for DHS.

Ms. NORTON. We know that there are as many as 60 different locations. I don't know if all will be vacated, but we do know a fair number of them not only will be vacated with what is going up now but the RFP that is out on the streets now.

Mr. PECK. The number is—I have to be careful, because I am recused from talking about that lease. But I do know DHS will go from something like 43 leased locations down to 3 or 4 leased locations when it is all done.

Let me just note one other mechanism that is really important to put on the table and that is, since we have so much leased space—and, as you know, over the years we have talked about this a number of times—to the extent that we can turn some of our leased locations into government-owned locations, either by buying them up front now or purchasing them over time is probably——

Ms. NORTON. Funny you should bring up 412 authority.

Mr. PECK.—probably the most significant way to make a change in the profile of the inventory.

As you know, that has been proposed. We have looked at it any number of times. We have had some limited success, but only limited success. And partly for legitimate government accounting reasons, many of those if they are regarded as installment purposes, the government scores them as a capital lease.

Ms. NORTON. This leads to the 412 authority to increase government ownership, and it may be the only thing on the table that is realistic at this point. Although I would ask you in your discussions with OMB to consider keeping up the pace of at least buying some building that you keep paying for if you don't buy it. That may be the criterion to set. You have at least an option to buy most or many.

I should ask that question. Do you often have an option to purchase?

Mr. PECK. Not that often. We do have some.

Ms. NORTON. What determines if you are leasing a whole building, in the course of the negotiations would you normally want to have—and you don't anticipate moving out of the location—would you normally want to have an option to buy?

Mr. PECK. Yes and no. Yes, it is a nice thing to have. But I think since the scoring rules were written the way they have been, we can no longer write a purchase option that allows us to purchase at a below-market rate, which means, in essence, that you come——

Ms. NORTON. How did you do the State Department or the Columbia Pike——

Mr. PECK. That purchase option was written before the scoring rules were put into effect, so we have an incredibly favorable below-market purchase option.

Where we are left today if we write a purchase option, we get to the end of the lease and we can go to the owner and say, we would like to buy the building; and he or she says, sure, for market value; I will put it out to bid. And so, whether we have a purchase option or not, we don't have any different situation than we would have if we would just sort of go to them at the end of the lease.

Ms. NORTON. Oh, my, I didn't even know that.

Could you within 30 days tell—write to this Committee about how many below-market purchase options you have outstanding now, recognizing that you couldn't do that scoring. Every time I find a new way in which scoring costs the taxpayers money.

Mr. PECK. We can get you that.

Ms. NORTON. Appreciate that.

On 412 authority—we have had this dialogue over and over again—you were to go to OMB to say, can we use what Congress told us to use? We, of course, were insulted by that. We thought we were the ones who got to tell you what to do.

But, in any case, let me ask you, if you have had a conversation with OMB, did you have it around specific 412 projects? If you have it in the abstract, of course, I can imagine what they would say. Has that conversation been taken—been had about projects on which 412 authority could be used?

Mr. PECK. We have had—at least since I have been back at GSA, we have had that conversation with OMB about their openness to looking at some 412 projects; and they have said, as you suggest, on a project-by-project basis they are open to it.

We have brought one or two projects to them within the last year that are potential that we don't yet have—we have not yet done all the analysis we need to go to them and talk about how it might be done in a way that will conform to those—we haven't gotten the numbers to the point where we can say with assurance to them or to ourselves that they don't violate the scoring rules. But we do have a couple in the pipeline.

Ms. NORTON. Mr. Peck, I am going to have to ask you, because the Subcommittee believes it has to advance the conversation every time we meet, to submit to us fact sheets for five projects. Theoretical, we are not asking you to commit to them, where at least theoretically you believe GSA believes 412 authority would be appropriate to use, the numbers and all of what would be appropriate turned out; and if you would include in the fact sheets all the information that would be included in a prospectus. We need to judge this against something realistic so we don't keep asking questions in the abstract.

Could you get that? I will give you 60 days on that one.

One more question. This comes from your testimony. You indicated PBS has sold unneeded assets totaling $198 million and I think that you testified about that as an indication of your use of 412 authority.

Mr. PECK. What I meant was, before section 412, when we sold the property we certainly had the authority to sell a property, but the revenue from that went into either the general treasury or the landlord conservation fund. But now we have the opportunity to put it back into the Federal Buildings Fund——

Ms. NORTON. That's it. This is why 412 authority is just so valuable. If I were in your position I would spend all my waking hours trying to find ways to use 412 authority. There are so many avenues that it opens for a creative real estate developer to try to take advantage of it, even within scoring rules, we believe.

But you found $198 million. Does that mean $198 million went into the Federal Buildings Fund?

Mr. PECK. Yes, yes.

Ms. NORTON. Were these under-performing assets? Give us an idea of what kinds of properties and over what period of time are we talking.

Mr. PECK. This was going back to fiscal 2005 through I think the middle of 2009—or the end of fiscal year 2009. So over 4 years.

We had one—for example, the Thaddeus Dulski Federal Building in Buffalo, New York, which we were able to vacate in its entirety and sell, I think was one of the bigger sales. I would be happy to provide you a list of the others.

Ms. NORTON. I wish you would.

Mr. PECK. There were a couple of large sales that usually happens.

Ms. NORTON. They were under performing? I mean, why did you decide—on what basis did GSA decide to sell an asset?

Mr. PECK. Typically, where we are building a new building or new courthouse.

Ms. NORTON. Is that what happened here?

Mr. PECK. I think we just reached a point in Buffalo where we didn't need as much space anymore, and it wasn't worth putting money back into it. We were able to move enough people out to vacate it in its entirety.

Ms. NORTON. Do you have a goal for looking for under-performing assets and selling assets? And, if so, how is that done and what do you expect for this coming fiscal year.

Mr. PECK. Well, in fact, we organized this morning a task force to look at vacant surplus property because we want to put more emphasis on that as well. We are trying to scrub our inventory to see what realistically we might sell in a realistic time frame.

Ms. NORTON. Recognizing this is not the market where you have many people trying to buy except us, we should be trying to buy, but it is a very good thing to be doing, and we applaud it and encourage it.

I am going to ask you a last question about courthouses, the bane of our existence. Are you building any courthouses as I speak?

Mr. PECK. Oh, yes, ma'am.

Ms. NORTON. Where are the courthouses being built?

Mr. PECK. Under construction as we speak—Austin, Texas—I am trying to think. I know of courthouses in design. I believe we have just let a design-built contract in Bakersfield, California. I don't know exactly where it is in the process. San Diego is under construction again.

Ms. NORTON. I am asking you this question really to make sure about any new courthouses, and I must ask you straight up: Will each and every new courthouse you are building comply with the sharing standards established in this Subcommittee's San Diego resolution? And those are: two magistrates for one courtroom, two senior judges for one courtroom.

Mr. PECK. As far as I know. Needless to say, I have had conversations about this. The information that I have from the courts, at least on all the conversations I have had with them on projects—and so I am want to issue a caveat in a moment—they have said that they are meeting the sharing guidelines——

Ms. NORTON. It is not up to them.

Mr. PECK. No, I know that. But the courts have agreed to a set of sharing guidelines which we are, in fact, enforcing. In San Diego specifically, I know that the Committee put a standard in the resolution, and we are following that in the San Diego project.

Ms. NORTON. Those standards were not for San Diego alone. I mean, we would not do to San Diego what we would not do to every courthouse. We have found scandalous inventory unused in courthouses, and that is now a well-known fact that will be documented in a GAO report that is going to come out soon. We found courtrooms that nobody was using for long periods of time, because the judges said so. The judges are no more in charge of building their own premises than any Federal agency is. The fact that they took control of what is your province was a reflection on GSA and much to the detriment of the courthouse.

They were found, as you know, Mr. Peck—I am not sure you were here or not when really scandalous stuff was found in the courthouses. Like they were building as if they were CEOs of some Fortune 500 company. Building extra kitchens and bathrooms and thinking of things. What else can we do? It was particularly inappropriate behavior for a judge, because it bordered on the kind of stuff people go to jail for, using taxpayers' money beyond what anybody could possibly have expected. And we talked to GSA. GSA said, well, the judge did it. What does a judge know?

Mr. PECK. Madam Chair, when I was at GSA before, we established a design guide with the courts; and after a lot of——

Ms. NORTON. —are going to put that guide exclusively under the control of GSA. We have had a hard enough time with GSA keeping control of its own function when it comes to sister agencies, but with respect to the courts GSA gave it up, and they became essentially their own GSA.

Mr. PECK. What I think happened—well, one of the issues that I think you and we and the courts have been concerned with—because I wanted to describe my conversations recently with the courts—is a question aside from the issue you raise, which is legitimate, about how much we are using existing courtrooms—is the projection of how many judicial officers will there be in a district or a circuit in a given amount of time. Because some of what we are doing is building for expansion needs, some of which has clearly not come about.

Ms. NORTON. Let's stop right there. The judges and GSA bought it, had insisted on building courtrooms for judges that Congress had never even authorized on the theory that one day we will have bigger courts. The outrage of assuming for us that we are going to somehow authorize increasing numbers of district and Court of Appeals judges is a way of getting one courtroom per judge, nothing more and nothing less; and we are not falling for it anymore.

Mr. PECK. Well, let me say I don't think—except for meetings on security, I don't think I have had any more meetings since I have been back at GSA with anyone other than the courts.

I will say I think there has been a change in the judicial conference in the administrative office. I think their leadership on the space committee of the judges and the leadership at the top of the AOC, I think they have recognized that the courthouse building program—which I have to say we have been fortunate to be a part

of just because we are building great courthouses and I think they are an important function for our democracy—I think that there is a realization that if we don't get pretty tight about space utilization that the program is in jeopardy. And I think there is much more of a recognition that they really have to take a look at what the projections are for judgeships and build to a more realistic expectation. And I have to say they are working in a much more cooperative manner with us than they were when I was here before.

I feel like I need to say that. I am not sure we are at the perfect balance yet, but I think we are working pretty hard at it. And the courthouses that we are designing now, I think—and I would be happy to talk to you about this—meet the standard that I understand has been one agreed to about what senior judges get and what magistrates get and at least they are sharing there.

Ms. NORTON. That is very good news. The judges have only a right to inform us of courthouses in terms of vacancies, not they anticipate that Congress will authorize new judges and to leave us with courthouses, courtrooms standing. But, again, this will become more apparent when the GAO report comes out.

Mr. Peck, your testimony has been very helpful. We look forward to getting the list of potential—and we understand it to be only highly potential—but potential of 412 authorities. Frankly, we are at a loss. That is why this hearing is so important, to fill in what we appreciate you candidly told us in your testimony, that the present formula doesn't work, and we think it is important for the Subcommittee working with GSA to come forward with a new formula.

That is why you see me trying out things—can we get the administration, I wish you would have a conversation with OMB, recognizing that there is—we are certainly not going to cure this problem by building a whole bunch of new buildings.

Can we get at least the goal of purchasing a building on the order of Columbia Plaza where you keep buying the building? That could be one standard you could put. Can we carve out 412 authorities that stay within scoring where the return for the government is so great that it becomes, particularly in this market, almost irresistible? Are there parties who could cooperate with the Federal Government in this economy to do so? If we begin to do the planning, we will see, the more we flesh it out, whether we are talking about anything realistic.

Thank you very much, Mr. Peck.

Mr. PECK. Thank you for the opportunity.

Ms. NORTON. I ask for the second panel to come forward, please. I ask you to testify in the order in which you are seated.

Panel II, David Nash, the President of David Nash & Associates, testifying for the National Academy of Sciences.

**STATEMENTS OF DAVID NASH, PRESIDENT, DAVE NASH & ASSOCIATES, ONE PERIMETER SOUTH, NATIONAL ACADEMY OF SCIENCE; JOHN HENTSCHEL, PRESIDENT, HENTSCHEL REAL ESTATE SERVICES, MEMBER, COUNSELORS OF REAL ESTATE; RICHARD GRENINGER, MANAGING PARTNER, CARR SERVICES; AND KEVIN STOKLOSA, ASSISTANT TECHNICAL DIRECTOR, FINANCIAL ACCOUNTING STANDARDS BOARD**

Mr. NASH. Thank you, Madam Chair.

As you said, my name is David Nash; and I am the President of Dave Nash & Associates. It is a firm that provides project and program management consulting.

I am on about my third retirement now, so I have had a lot of action over the 45 years I have been in this business. I have been involved with buildings and infrastructure for, as I said, 45 years in various places, from the U.S. Navy shore establishment around the world to, most recently, the reconstruction of Iraq's infrastructure.

I am here today as a member of the National Academy of Engineering and the Chair of the National Research Council's Board on Infrastructure and the Constructed Environment. My primary message here today is that, although we may have a crisis in Federal capital assets, we also have a tremendous opportunity to change how we invest in Federal facilities so we can operate them more cost effectively and more sustainability. Change is both necessary and possible, in my opinion.

In 2004, I was Vice Chair of the National Research Council's Committee on Business Strategies for Public Capital Investment. The committee's task was to develop guidelines for making better decisions about investments in Federal facilities based on best practices from private-sector organizations.

From the start, our committee recognized that there are inherent differences between the mission's goals and operating environments of the private-sector organizations and those in the Federal Government. Nonetheless, we identified a number of best practices from the private sector that we thought could be adapted through the Federal Government and could result in a better and more cost-effective management of our Federal facilities. Such practices include life-cycle costing, approaches for acquiring facilities, determining when to own and when to lease, and, finally, disposal of excess facilities. Our committee found that the Federal budget practice provide few if any incentives for Federal agencies to use these procedures.

Although your hearing today is focused on the General Services Administration's building fund, in our research we found that there are 30 other Federal agencies that are also responsible for investing and operating and maintaining facilities. In total, those agencies own more than 400,000 facilities worldwide. Many of these agencies are reporting billions of dollars in deferred maintenance.

Obviously, one of the reasons is lack of funding. Another reason is that all of the buildings are at least 50 years old and much older in DOD and are deteriorating due to wear and tear.

In the last 50 years, the missions and programs of some of these Federal agencies have changed, although their buildings haven't, for the most part. The result is that many departments and agen-

cies have excess, underutilized and obsolete facilities that are still operating and they are still operating and maintaining.

So what can we do to change this situation? One important step, in our opinion, would be the change to require life-cycle costing for major facilities proposals. Life-cycle costing considers not only what it will cost to build a facility but also what it will cost to operate and maintain it for 20 or more years.

Private-sector organizations use life-cycle costing to calculate what a building will cost and what it will cost for equipment and furniture and staff. This process provides transparency about the total commitment of the resources that they—and the ″they″ are the boards and the leadership of these various companies—are making. They intend to determine what the total impacts will be on the organization and what trade-offs that will have to be made.

In the Federal Government, the budget process and the scoring rules are structured not only to look at design and construction costs but facility which—the first cost, which may be only 10 percent of the life-cycle cost. In other words, the rest of the cost of owning a building occurs over the years it is in use. So when the funding is approved to acquire a new Federal building, what it will actually cost to operate the building for 20 or more years is not transparent to decisionmakers or the public.

The NRC has recommended that agencies should use life-cycle costing for all significant facilities investment decisions to better inform decisionmakers about the full cost for a proposed investment.

Best practice private sector organizations also use life-cycle costing when they are deciding whether to own or lease facilities. Large private-sector corporations typically own those facilities that are most important to their business success and for which they want to exert maximum control for a long period of time. They lease those facilities that are less critical to their operations for which they may need only for a short time. This allows private-sector firms to divest facilities they no longer need.

For Federal agencies, the own versus lease decision is not as clear-cut. Again, the budget process focuses on design and construction costs and focuses only on the next fiscal year. These budget practices create an incentive to lease space, because the 1-year cost is much lower than the cost of designing and constructing a new building. However, over those 20 or 30 years the building is in use the cost of leasing may be greater than the cost of owning.

The budget process also encourages agencies to continue to use old and obsolete facilities, which may cost more to operate and maintain but where costs are not transparent to the decisionmakers.

Our committee did find that some Federal agencies were able to use some alternative approaches for acquiring, operating, and maintaining facilities in order to leverage available funding. These approaches included some public-private partnerships, out leasing arrangements. However, all these approaches were used on a case-by-case basis under an agency specific legislation.

Our committee recognized that using alternative approaches on a more widespread basis does carry some risk and raises concern about transparency. Nonetheless, the NRC has recommended that

more widespread use of such approaches be allowed in order to leverage funding.

We also recommended that pilot programs be used to test the effectiveness of various approaches and to evaluate the outcome of national, State, and local perspectives. Making this happen will require a collaborative effort on the part of Congress, the administration, Federal agencies, including the Office of Management Budget and Congressional Budget Office.

Finally, I would like to address the issue of excess, underutilized, and obsolete facilities. Significant amounts of available funding for maintenance and repair are invested in such facilities, just to keep them up and running. Potentially significant amounts of taxpayer dollars can be saved over the long term if greater emphasis was placed on divesting the government of unneeded but still viable properties. Under current procedures, agencies have few incentives and significant disincentives to dispose of excess facilities.

The National Research Council has recommended long-term requirements for maintenance and repair expenditures should be managed by reducing the size of the Federal facilities portfolio. The Council has also recommended that Congress and the administration lead an effort to streamline government-wide policies, regulations, and processes related to facilities disposal.

This concludes my remarks. Thank you for the opportunity to testify.

Ms. NORTON. Thank you very much, Mr. Nash.

John Hentschel, who is President of Hentschel Real Estate Services, Counselors of Real Estate.

Mr. HENTSCHEL. Good afternoon, Madam Chairwoman and Members of the Committee. Thank you for the opportunity to testify before you today.

My name is John Hentschel. I am a member of the Counselors of Real Estate and President of Hentschel Real Estate Services, a real estate consulting and advisory firm that, among other things, advises government leaders in the U.S. and abroad about real estate valuation and asset and portfolio management issues.

I can also empathize with Mr. Peck because in a former portion of my career I also had to manage a government portfolio of real estate for the city of Baltimore.

The testimony that I am presenting today is based on the findings of a 2001 CRE Consulting Corps assignment commissioned by the Public Building Service. It was designed to independently assess PBS's portfolio management policies and procedures and compare its newly devised asset management strategy at the time with best practices employed in the private sector.

PBS's new strategy sought to shift its capital decision-making process from a tactical to a strategic one. It envisioned that only self-sufficient properties that would be capable of producing revenues greater than operating expenses for the Federal buildings fund would be retained and allotted funding for repairs, alterations, and replacements. Those properties that failed to meet that criteria would be targeted for disposal.

The Counselors of Real Estate, an affiliate of the National Association of Realtors, is a professional society whose approximately 1,100 members are among the world's most respected and highly

qualified advisors on real estate matters. As a public service, the Counselors organized a Consulting Corps which provides strategic advice to government agencies and non-profit organizations who seek strategies to resolve real estate problems.

The Consulting Corps employs a collaborative process for which CREs volunteer their time and effort on a pro bono basis. For this assignment, I chaired a panel of CREs that also included Mahlon Apgar, Howie Gelbtuch, Barbara Hampton, and Frank Livingston.

After reviewing relevant documents and briefing materials and conducting 5 days of intensive interviews and thoughtful deliberations, the panel presented its findings and recommendations to the PBS Commissioner in a verbal report entitled An Agenda for Strategic Change on September 14th, 2001, followed by the panel Chair's address to a conference of PBS regional administrators in Kansas City on November 6th, 2001.

With respect to the PBS portfolio, the CRE panel observed that:

In terms of age, the building inventory was old, with an average building age of more than 50 years, and was below average in quality and physical condition.

In terms of productivity, the income produced by the building inventory for the Federal Buildings Fund was highly stratified and concentrated, with 55 percent of the square footage generating 95 percent of the funds from operations.

The capital needs of the building inventory for RAR—repairs, alterations, and replacements—were excessive, estimated by the GAO at that time to be in excess of $4 billion, with many repairs having been deferred repeatedly and indefinitely.

The availability of and access to investment capital to address the portfolio's RAR needs was extremely limited, well beyond the FBF funding capacity, with little prospect with direct congressional appropriation and few other identifiable sources.

Unlike the private sector, the legal and budgetary environment within PBS operated was highly structured, rigid, unsympathetic, and not amenable to change, modification, or exception.

In comparison to private-sector standards, PBS's allocate of administrative overhead to each building within the portfolio was exorbitant, counteracting any benefits associated with self insurance and local property tax exemption.

PBS at the time lacked a strategic mind-set. Its narrow caretaker focus and preference for long-term property ownership conflicted with PBS's stated mission and the Federal Government's inherent budgetary and accounting bias against capital investment reflected in its ″scoring″ rules, the absence of a capital budgeting process, and PBS's inability to retain disposition proceeds for other uses at the time.

Unlike prior studies commissioned by PBS, the CRE panel approached the issue from a much broader perspective that considered PBS's mission, funding, structure, systems, and skill sets.

In addition to endorsing the adoption of PBS's more strategic approach to allocating its limited resources, the panel also recommended that PBS assume and demonstrate its capacity to perform a strategic leadership role as an advisor to help Congress, the OMB, and client agencies make informed real estate decisions. The panel further suggested that PBS should define and develop cost,

efficiency, and performance standards to guide real estate decisions of the Federal Government.

Organizationally, the panel believed that PBS should reduce redundancy and streamline regional entities, intensify management controls and institute uniformity and universal application of all processes, procedures, and decisions which were lacking at the time.

Procedurally, the panel felt that PBS should instill more discipline in its decision-making process and introduce more rigor and uniformity in its analytical procedures. Among the panel's many suggestions were that PBS should compare and contrast the cost and benefits of leasing versus ownership—including the cost of repairs, alterations, and replacements—on a net present value basis as well as calculating the cost of inertia—that is, the cost of doing nothing for every property related decision.

The panel also thought that adopting a 5-year capital budget process which compared and contrasted portfolio results with and without the expenditure of the needed RAR investments, even if performed internally for information purposes, would impose a level of fiscal discipline then lacking at the PBS analytical process. In the panel's view, opportunities for outsourcing, especially the management of small, remote, or isolated facilities, should be examined and encouraged whenever possible to save money.

The panel encouraged PBS to seek the authority to not only negotiate cancellation rights and purchase options in its lease agreements but also the ability to segregate maintenance from new construction funds and retain property sale proceeds within the Federal Buildings Fund to fund RAR requirements, which was subsequently done.

In closing, the panel commended PBS's foresight and its commitment to adopt contemporary asset management procedures. The panel exhorted PBS to continually strive to achieve the efficient and balanced deployment of Federal real estate assets by periodically evaluating portfolio contents and electing to dispose of those properties that under perform established benchmarks to yield the most benefits at the least cost.

Thank you very much for your time and attention.

Ms. NORTON. Thank you very much.

Mr. Greninger, Managing Partner, Carr Services. Mr. Greninger.

Mr. GRENINGER. Good afternoon. I am Richard Greninger, Managing Partner, Carr Services; and I am here today on behalf of the Building Owners and Managers Association International. Thank you for the opportunity to share BOMA's perspective on best practices in managing building maintenance programs.

To begin, I could like to clarify that my comments are limited to general industry practices and are not intended to infer that GSA does or doesn't follow these practices.

According to BOMA's annual income and expense benchmarking report, the Experience Exchange Report, private-sector commercial office buildings in 2008 spent $1.80 per square foot on repair and maintenance and an additional $0.23 per square foot on the maintenance of roads and grounds. This represents approximately 25 percent of a building's operating expenses.

For government buildings, the amount spent on repairs and maintenance is quite a bit higher, $2.43 per square foot. The combined expense of repairs, maintenance, roads, and grounds for government buildings accounts for approximately 28 percent of the operating budget.

For the building as well as the building systems to remain fully operational as designed, the property manager and the engineering team need to develop a maintenance program. Most properties' programs include three basic types of maintenance: reactive, preventive, and predictive maintenance. The degree to which the property dedicates its resources to each form of maintenance depends greatly on the owner's objective for the property, the staffing level and skill set of the engineering employees assigned to the property, and many other factors.

Reactive maintenance occurs when the building system has already broken and needs repairing or requires calibration. This type of maintenance typically bothers tenants the most because they have no warning that the system will be out of service. Examples of reactive maintenance include replacing light tubes and bulbs when they burn out, fixing a motor when it fails, or repairing a pump when it seizes up.

All buildings employ some degree of reactive maintenance. No maintenance system can predict or prevent failures with 100 percent certainty. Even if such a system existed, it would be too expensive to manage in a commercial building. In the long term, however, reactive maintenance programs tend to be expensive. Equipment that is not maintained proactively often fails earlier and costs more to operate than equipment that is maintained aggressively ahead of time.

In some cases, reactive maintenance may actually be the preferred strategy. If, for example, the owner is preparing to perform extensive renovations of a vacant building, he may choose to contain costs before construction begins by fixing only the critical components that malfunction.

Preventive maintenance strives to prevent the system components from ever breaking. Preventive maintenance lowers operating costs and utility costs and, in many cases, extends the useful life of systems components. In addition, evidence of a good preventive maintenance program improves the value of the property at sale because the purchaser believes the systems are in good condition and won't need to be replaced in the near future. Plus tenant satisfaction and retention levels may improve because tenants are inconvenienced less when maintenance is done on a time-based schedule.

Preventive maintenance is based upon visual inspections of equipment and regular maintenance schedules. The centerpiece of the preventive maintenance program is a schedule listing of all the preventive maintenance tasks and a plan to achieve them during the year.

The third type of maintenance, which is growing in popularity among high-performance organizations, is predictive maintenance. Predictive maintenance is a program that uses approved nondestructive testing procedures to analyze the condition of building equipment and relies on statistics, measurement, and experience to

predict equipment service and maintenance requirements. Like preventive maintenance, predictive maintenance is proactive. Where preventive maintenance relies upon a time-based schedule, predictive maintenance uses statistics, measurements, and experience to determine the service interval for a particular piece of equipment.

Predictive maintenance is based upon the fact that, before a piece of equipment fails, certain measurements will start to change. In a typical predictive maintenance program, the time intervals between preventive maintenance operations are based not on the calendar but on when the equipment actually needs maintenance to continue to optimize performance.

Major equipment manufacturers have begun to embrace the concept of predictive maintenance. Preventive maintenance may call for a part to be replaced every year, regardless of the amount of use the equipment received. With predictive maintenance, the specific use pattern of each piece of equipment and the measurement taken to show how the equipment is working are used in the decision process.

In conclusion, building owners and managers must look at both short-term and long-term costs when developing a maintenance plan and budget for their buildings. The General Services Administration has done a good job with the tools they have been given. However, to most effectively manage a diverse range of facility design, construction, rehabilitation, restoration, renovation, and operations projects, they must be given sufficient funding.

Thank you. I welcome any questions you may have.

Ms. NORTON. Thank you, Mr. Greninger.

Finally, Kevin Stoklosa, Assistant Technical Director, Financial Accounting Standards Board.

Mr. STOKLOSA. Thank you, Madam Chairperson.

My name is Kevin Stoklosa. I am Assistant Director of Technical Activities at the Financial Accounting Standards Board.

The FASB is an independent private-sector organization that establishes standards for financial accounting and reporting for private-sector entities, including businesses and not-for-profit organizations. Those standards are officially regarded as generally accepted and authoritative.

The Subcommittee has identified the challenge of maintaining a dwindling Federal Buildings Fund. As the Subcommittee considers ways in which to address these challenges, I would like to focus my remarks on the FASB's Statement 13, Accounting for Leases, and how the expected revisions to the standard could impact the Federal Buildings Fund.

The primary reason for the FASB's current joint leasing project with the International Accounting Standards Board is the SEC's report from June, 2005, entitled Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002, and arrangements with off-balance-sheet implications, special purpose entities, and transparency of filings by issuers. A link to this report is provided in my written testimony.

The SEC report included several standard-setting recommendations, including reconsideration of the accounting guidance for

leases, noting that the current accounting for leases take an all-or-nothing approach to recognizing leases on the balance sheet.

Today, lease accounting standards require lessees to classify their lease contracts as either finance leases or operating leases. Finance leases are defined as those leases that transfer to the lessee substantially all the risks and rewards incidental to ownership to the leased asset. All other leases are deemed operating leases. Detailed rules and bright-line tests are used to differentiate between whether a lease is classified as a finance lease or as an operating lease.

Leases classified as finance leases are treated similarly to the purchase of an asset such as purchasing office furniture or a copy machine. Consequently, lessees recognize in the statement of financial position the leased item and an obligation to pay rentals. The lessee depreciates the leased items in a portion of lease payments between a finance charge and reduction of the outstanding liability. The lessor treats the leased item as a sale and removes its from its balance sheet.

For leases classified as operating leases, no similar assets or liabilities are recognized by the lessee; and the lessor does not remove the asset from its balance sheet. Other than rental expense being reported in the income statement each reporting period, operating lease accounting lacks transparency around the assets and liabilities inherent in the lease. Given this lack of transparency, the existing lease accounting model has been criticized by users of financial statements for failing to meet their needs.

Preparers and auditors also have criticized the existing leased accounting model for its complexity. In particular, the detailed rules and bright-line tests for differentiating between financed leases versus operating leases have proven difficult to implement.

After much analysis, the FASB and the IASB are developing a new approach to accounting for leases that would require all leases to be counted for similarly. Rather than treating some leases like the purchase of a leased item, which would be financed leases, and others as operating leases, the new, more transparent proposed approach would treat all these contracts as the acquisition of a right to use the leased item for the lease term. Under this approach, the lessee would recognize an asset representing its right to use the leased item for the lease term, also known as a right-to-use asset, and a liability for its obligation to pay rentals.

For lessors, the Board has decided to adopt a performance obligation approach. Under that approach, a lessor would recognize an asset representing its right to receive rental payments, which would be a lease receivable, and the liability representing its performance obligation under the lease, that being its obligation to permit the lessee to use one of its assets. The lessor would recognize revenue as the performance obligation to satisfy over the lease term.

This new approach to lease accounting also would be applied to sale leaseback type transactions whereby the owner of an asset such as a building sells the building to a third party and leases it back for an agreed-upon period of time. In those situations, the seller would derecognize—that is, remove—the building from its balance sheet, record any profits associated with the sale, and then

recognize an asset representing its right to use the leased building for the lease term and a liability for its obligation to pay rentals.

The FASB and the IASB have noted that this new approach to lease accounting would address many of the criticisms of the existing standards.

Madam Chairperson, that concludes my prepared remarks. I would like to thank you and the Subcommittee for the opportunity to testify this afternoon. I would be happy to answer any questions.

Ms. NORTON. Thank you, Mr. Stoklosa.

While we have you here, particularly in light of our discussion with Mr. Peck, would the proposed changes of the Board of FASB 13 make a material difference in the owned versus leased decision for real estate users?

Mr. STOKLOSA. The proposed changes would not make a major difference.

Currently, under current accounting guidance, there is a difference. Because if you have an operating lease, then you don't record an asset or liability. But under the new approach, regardless of whether you lease or you buy, you would record an asset and a liability, assuming you financed the purchase of it if you bought it.

Ms. NORTON. Has there been any response from OMB on the proposed new accounting standards?

Mr. STOKLOSA. There has been no response yet.

Ms. NORTON. When were these issued again, please?

Mr. STOKLOSA. We haven't issued yet. We are going to issue an exposure draft probably in June of this year, and we will issue an exposure draft for a comment period of about 4 months. During that time, we will solicit comments both in writing and we will reach to different constituents who have a lot of leasing activities and talk to them about the proposals.

Ms. NORTON. Do you think government and private for-profit entities should be governed by the same accounting standards?

Mr. STOKLOSA. In my opinion, I think if you buy or lease something, regardless if you are a government or private entity, I think you should account for the assets and the liabilities that you have.

Ms. NORTON. What do you think is the major contribution of these new standards? For example, are they going to make transactions more transparent?

Mr. STOKLOSA. That is correct. They will put on the balance sheet the assets and the liabilities that exist within a leased contract for investors to be able to analyze all the assets and all the liabilities that an entity may have, as well as the income statement impacts of those assets and liabilities.

Ms. NORTON. Have any private parties voluntarily adopted the standards that the Board is proposing?

Mr. STOKLOSA. They can't be voluntarily adopted until they become official, and then at that point they would have to become mandatorily adopted.

Ms. NORTON. What is the view of the private sector on what you have been doing? I am sure you have been having hearings of the kind we have been having.

Mr. STOKLOSA. The general view of the private sector is that they believe putting these assets and liabilities on the balance sheet is a good thing, and now they have some concerns about how the in-

come statement will be impacted by putting those assets and liabilities on the balance sheet. So we have to work through those issues.

Ms. NORTON. Mr. Hentschel, I was stunned by the statistic in your testimony that 55 percent of the buildings, I believe you said, in the GSA portfolio produced 95 percent of the funds.

Mr. HENTSCHEL. Yes, ma'am.

Ms. NORTON. I wonder what you think should be—with that kind of imbalance, does that relate to the age of some of the buildings versus others?

Mr. HENTSCHEL. Whenever you are dealing with an aging portfolio of properties, the other properties are probably going to require more maintenance, more repairs. But over time what it basically says and what our panel found was there is an inclination to, in this custodial function, what we found in terms of our paneled discussions, sometimes when you are managing assets you have to take a look from a strategic rather than a tactical standpoint.

The first thing you do when you say the roof is leaking is you say oh, gee, we should fix the roof; and that is not the first thing you should think. The first thing you should think is should we fix the roof? Because just because it is leaking doesn't necessarily mean you automatically spend precious resources to repair it.

Ms. NORTON. What would go into the decision not to fix a leaking roof?

Mr. HENTSCHEL. I had a similar circumstance when I was running real estate for Baltimore city with our police headquarters building. In that particular case, we had asbestos problems and we had systems failures.

The first inclination of the city was to say, let's move everybody out, and let's fix the building, and we will move everybody back in.

At that point in time, I said, from an asset management perspective, we should step back for a second in this one particular building and now let's start looking at are there other alternatives. Should we be thinking about leasing property instead of owning it. Should we be thinking about building a new building? Should we be thinking about other options, buying another existing building and moving our personnel in there, and making a cost comparison on a strategic decision-making process to then say, of the alternatives available to us, which of those alternatives on a net present value basis yields us the highest possible present value?

Ms. NORTON. If it has asbestos, I take it one of those alternatives would be simply abandoning the building. Who else is going to want to buy—if you don't take care of the asbestos, I can't imagine who else would want to do it. So was abandoning the building part of your——

Mr. HENTSCHEL. That was one of the circumstances. The other circumstance was build a new building, lease a new building, acquiring an existing building, move into it, but then either leave the building in its contaminated state and see what value we can obtain from the property in that state versus trying to mitigate the contamination, which would have been cheaper mitigating it without people in it than mitigating with people in it. And then saying using that as part of the decision-making process as a residual value to say, in a strategic decision, which of all of these alter-

natives, including remediating with people in place versus remediating with people someplace else in a vacant building, which of all these alternatives yields the best benefit and bang for the buck to the government—in that case, the city.

What we found as a panel and what we made recommendation to PBS at the time was and what we found their proposed strategic policy to be was let's start looking at these decisions strategically rather than tactically. Let's stop just responding and saying, the building is leaking, the roof is leaking, let's fix the roof. To start stepping back in advance.

And this is why one of our recommendations was, even if only on an informational basis, put together a capital budgeting process that goes out 5 years and then take a look. If you spend the RAR on these buildings, what happens to the value of the portfolio? If you don't spend it, what happens to the value of the portfolio? And always performing a cost-of-inertia analysis. What happens if we don't do anything both in the short run and in the long run?

Ms. NORTON. Did you find that PBS responded by going through that exercise?

Mr. HENTSCHEL. We didn't follow it over time. Obviously, Madam Chairwoman, it has been 8 and a half years. We didn't follow it over time. It was our understanding that they had intended to implement that procedure.

Ms. NORTON. They could go through the exercise and discover a great deal, even if strictures—Federal Government strictures kept them from acting on much of what they would want to do. At least they would be able to capture those strategies they ought to focus on, given the requirements we place on them.

Mr. HENTSCHEL. One of the things that we had advised PBS at the time was we recognized—in our report, which I provided a copy to your Subcommittee, in our report, we recognized that certain recommendations we were making we called it inside the box. And what we referred to was these are things you could implement immediately versus those decisions which would require long-term change, either in terms of policies, procedures, and sometimes loss.

But you have to start with data. You have to start with empirical information. And this is one of the things you recall in my testimony that we suggested, that PBS take a strategic advisory role, to advise Congress, to advise OMB; and to advise you have to have empirical data to back up what you are saying.

So what we were saying was go through the processes, go through the procedures that Mr. Nash also referred to inhis comments. Go through these procedures not just for the sake of conducting procedures but in building a database of information so that when you come to a Committee such as yours you have empirical data to show here is what we are doing, here is what we should be doing, here is how we can make things better, and here is the end result of that process.

Ms. NORTON. Well, this advice role to Congress and to OMB seems to be precisely the role that an expert real estate agency could and should play.

For example, we cannot account for the response of OMB to 412 authority or, for that matter, other ways of dealing with Federal real estate, except that they don't deal in real estate. In fact, if you

look at the business they are in, it is precisely the opposite. The whole notion of capital budgets and mortgages and the rest is simply not what their portfolio is all about.

So if GSA doesn't work up these issues—they do understand numbers. They do understand what costs and what does not. If you don't work it up as an exercise, then they never learn. We don't believe there are people at OMB who have a particular interest in real estate. That doesn't have much to do with what they are called upon to do every day. So we and GSA are always in a mode of, essentially—it is not educating. The word is in dispute with GSA, who throws back the government rules that seem perfectly in order for commodities, for example, but have nothing to do with real estate.

When you speak about work up the options, it does seem to me you make a valuable contribution. It may seem to a government agency that working of the options is a futile exercise. Because they begin from the outset saying, OMB would never do that or we could never sell this building or we could never lease to purchase so what is the use. And the result is that OMB and, for that matter, the Congress does not get educated as to what is in the best interest of the Federal taxpayers.

So it is important to hear you say that you work them up anyway. That is why I gave you the example: abandon the building. Put that right on the table along with everything else.

And, you know, if you say most of the time they do asbestos when people are in the building, okay, we do swing space. Maybe it makes sense. The real estate is so valuable. So move them out for a year and move them back in. Yeah, it costs moving costs in and out. But if somebody doesn't work that up, you don't know what in hell—excuse me—you do not know what you are talking about. And, increasingly, we are talking about matters of this kind as if they were theoretical matters that we couldn't put numbers to, and we are making our decisions on that basis.

Ms. NORTON. I feel we are stuck in the Federal Building Fund exercise in that way, and as a formula it doesn't work. One has to almost take it apart and say, If you were starting from scratch, now knowing what you know, what would you do? In fact, I think that is the question I would like to put to all of you.

For example, Mr. Nash, you say that current Federal budget processes and procedures provide few, if any, incentives for Federal agencies to use more innovative and more cost-effective management practices.

Well, they certainly do, and they build on one another endlessly into absolutely predictable results. So I would like to ask you, given what I regard to be wholesale and needed criticism: If you had your way, recognizing that there are some practical realities, what kinds of incentives would you put in place to drive this more innovative and cost-effective behavior?

I suppose it would be some analogy to what Mr. Hentschel is saying, working up all of the scenarios and putting those before the decisionmakers so that they know what they are talking about before they tell you that you can't do something or you can do something else.

Mr. NASH. Well, I am entering my 33 years in the Navy. I tried to be an innovator, and that is not without its penalty.

Our committee's advice was let's put together some of the best minds, both inside government and outside government, and look at things that we can try. Take some chances. Understand that there is risk associated with it.

I think what you did with the building program in terms of turning it into sort of a revolving fund, which I ran one of those for a while, is really intelligent. A lot of folks inside the government do not like those because they feel like they have lost control of those who allocate scarce resources.

So I think it is going to take a little bravery on the part of Congress and also on the part of the administration to say let's try some of these things, because I believe it is not a crisis of GSA's. I think it is a crisis of the Federal facilities in total, and we need to find something else to do because we are going to run out of airspeed and ideas pretty soon.

Ms. NORTON. We certainly ran out of that idea very quickly, but I love the revolving fund idea. It is perfect. You have an appropriations process, and you have an oversight committee and the agencies responsible. You have rules about how a revolving fund works. I think we are perfectly capable of keeping control of such a fund, and if we could keep that part in place—and I don't see that going anywhere—that would be fine, except that it is meant to do, from the beginning or almost the beginning, what they knew it could not do.

But since nobody—if I may venture this—wanted to find a way to get the money for construction, and since we can't get the money for construction the way the private sector does, borrow it even from a Federal bank, you pretend as though somehow this revolving fund will create enough funds for upkeep and for construction. The pretense wore out almost from the beginning.

Mr. NASH. I would suggest, Madam Chairman, that the way to do this is not just do it once and put something in place. It is to manage it over time and to keep checking on it, and whoever has that control—because there are always people, in my experience, who you will find who will want to hijack what is going on and will want to turn it back to the old way.

So I think it is exactly what you are doing;,and that is checking on how it is going and, you know, why it isn't working, and then tweaking it until it does work. Otherwise, it will just die on the vine.

So that is my recommendation, and I think there are a lot of people who want to help. The National Research Council has done a series of studies on how could the Federal Government do better in the facilities world. Some of them have been greeted with excitement. Others have been just turned into things you throw in front of the door to keep it from blowing shut. I think there is a body of knowledge, a body of people who want to help, and I think there are some real positive things you can do.

I have been in the private sector for 15 years, and I was in the government for 34 years, so I think there are some things on both sides that can be put together and used.

Ms. NORTON. Well, you described that it had a process of invention and reinvention. I can see how lots of that could take place in practice within GSA and real estate generally. I do believe that, when you start with a formula or an approach and when you, at the beginning, expect it to do more than any theoretical examination of it to show what it could do, then you are stuck with a false formula in the first place.

Now, Mr. Greninger, I was interested in your report of BOMA's experience with private sector commercial office buildings. I am looking at page 1 of your testimony. You spent $1.80 per square foot for repair, maintenance and some additional funds. Anyway, it adds up to 25 percent of the building's operating expenses. We go to, not $1.80 as in the private sector, but to a much higher rate of $2.43 per square foot for government buildings. When you combine the repairs and other features, it is 28 percent, not 25.5 percent, of the operating costs.

I did not know whether this had to do with use categories, if this was because the Federal Government engages in what you are terming ″reactive maintenance.″

Why is the cost per square foot so much greater for the public sector?

Mr. GRENINGER. I am not exactly sure why there is a disparity. It could be that all of the categories are identical and that the compensation figures in the private sector for engineers may be less than those in the public sector; or it could be that less predictive maintenance is being performed and that more reactive maintenance is being performed.

So it could be that the private sector's balance of those three types of maintenance methodologies is providing a more efficient approach than is the GSA; but why or if that is true, I am not sure.

Ms. NORTON. For example, it says that the Federal Government builds a Department of Transportation headquarters building. It leases it. Well, let's take something that it is building now. It is really building a state-of-the-art building for the Department of Homeland Security—I mean, platinum. They think, given how important this facility is and because the state of the art keeps changing and becoming less expensive, that they could actually reach a goal.

I was in a gold building in the District of Columbia yesterday. If you are building gold, wouldn't there be every incentive to do your so-called ″predictive maintenance″ on the theory that this building is here for a very long time? It has already been built to the highest state of the art, yet it will get higher. But this would be in terms of how you plan for the maintenance and upkeep of that building, as opposed, for that matter, of a building that was built 15 years ago.

Mr. GRENINGER. Well, absolutely.

In commissioning the building from development and construction into operations, those types of maintenance strategies are put in place. Then, of course, the LEED certification program, after a relatively short period of time, has to be upgraded to the existing building terms and certification requirements, and that likewise causes a need to incorporate new and more efficient maintenance practices. Absolutely.

Ms. NORTON. Mr. Hentschel, how do you expect the private sector is going to react to these new accounting standards that we have heard discussed here today?

Mr. HENTSCHEL. I have to agree. I mean it will be a more transparent process because there will be an asset with a corresponding liability. So, from that standpoint, you know, it will present more transparency in the decision-making process.

At the same time, if all of a sudden the lease now is at the same par as a purchase, you may start seeing more net present value analyses, comparing the difference between ownership and leasing. I am speaking personally now. You know, if I were looking at it myself, I mean, at that point, capital is capital whether I am sending my payment to a lender or whether I am sending my payment to a lessor. It then becomes more of a present-value decision because at the end, with ownership, I will have a residual value.

At the same time, if I have an asset that I have to maintain, I mean, I think part of this is going to be how the definition comes down because, you know, right now we have a financing lease and we have an operating lease. Well, if I have an operating lease and that operating lease mandates that I maintain it, versus an operating lease where the landlord maintains it, I am going to be looking at those kinds of circumstances in an entirely different fashion. But with everything being equal and the tenant is maintaining it in the same capacity as an owner, then the net present value of that residual value will be important.

The reason I say that is because, if you do not maintain the building properly, the residual value will be diminished at the end. So it is imperative that in the financial analysis being performed, whether you are in government or whether you are in private sector, that you reflect whether or not you intend to maintain the building; because if you do not maintain the building as it needs to be, the residual value will diminish, and the present value of your investment will go down.

Ms. NORTON. Mr. Stoklosa, I take it you agree with his analysis?

Mr. STOKLOSA. I do.

Ms. NORTON. Mr. Nash, I only have a few more questions, but I was delighted to see—I think it was on page 3 or 4 of your testimony—the recognition that the full costs are not reflected in government facilities investments and that often short-term, expensive decisions are made. This is the bane of our existence, indeed.

I wonder if you have any suggestions or would submit further information that might be included in a prospectus which would enable the Subcommittee to see the full costs of a GSA prospectus.

Mr. NASH. We did about three or four reports of this nature that talked about life-cycle costing and how to do it. We can provide more information.

Your point about we make sometimes in Federal Government bad decisions, normally they are different than you would make in the industry, because the industry—when they invest in a facility, it has something to do with something they are manufacturing or whatever their business is. It aligns with their mission, and it is easy to see what this investment is going to return for them.

In the United States Government, that is very hard to do since the government provides service. It doesn't make a profit. So I think that is one of the problems of trying to compare the two.

We will provide, and we will be happy to work with your staff to try to help wherever we can with the various and sundry things we have, plus our experts who are available to help you.

Ms. NORTON. That would be very useful.

I want to ask whether any of you are familiar—and perhaps you, Mr. Hentschel particularly—with this number that we keep throwing out, this so-called ″412 authority″ that this Committee or the Congress itself provided, which allows GSA to retain funds from the sale, lease, or exchange of real property instead of its going back to the Treasury.

Is this the type of authority, Mr. Hentschel, that the Counselors of Real Estate recommend being provided to GSA or has recommended in this report you cited earlier?

Mr. HENTSCHEL. Madam Chairwoman, that was one of our principal findings, and that is not just applying to the Federal Government. In my practice over the years, both as a public official as well as a private sector consultant and as a real estate practitioner, there was the fact that you cannot retain the money that is realized from proceeds of a sale to utilize that with regard to maintenance, repairs, and replacements of other properties.

You know, one of the big problems I had when I was running government portfolios is we constantly would look to fair market rent and fair market value and compare ourselves to private sector operations. The problem is, when you are operating in a public sector environment, you are not totally the same as when you are operating in the private sector, especially with respect to rates of return on investment, reinvestment funds, the way you can reinvest things.

I mean, if I am a private sector investor and I run into a situation where I have become cash poor and I need to maintain my portfolio and my buildings, I can make a decision to analyze which is my least likely performer or my least best performer, and liquidate it and take that money and then maintain the balance of my portfolio or use some of those proceeds to maintain the balance of my portfolio.

As a government operator, whether it is the Federal Government or local governments or State governments, most governments did not have or do not have the ability, or government real estate practitioners do not have the ability to do that because, with the 412 authority, it gives you that authority.

So my direct answer to you is that that is a very important tool in a government real estate decisionmaker's and practitioner's quiver of arrows to be able to perform his job.

Ms. NORTON. If one looks at what is available to us now and if you see that lying dormant on the books, you don't see almost any other way to proceed, and you see some breakthroughs here that, it seems to me, would begin to make the government understand real estate and understand how to operate in a real estate market. We don't see that the government operates as if it is in a real estate market.

I agree with you that we compare ourselves to the private sector. That is because we operate in the private sector. But when it comes to comparing the leases to commercial rents, that searches for something to compare it to that is a hard number; and if not that, the question becomes: What? That is how you get to that. That is really the only way I can see that we get to that number, because we don't have any other number, and it more closely approximates who the GSA is.

The GSA is a big player in the real estate market. We don't think it plays big, however, in that market because of these limits that we have placed on it and that sometimes it has placed on itself. We don't regard it as a very innovative real estate developer.

Mr. HENTSCHEL. Madam Chairwoman, you know, I will take this opportunity. I mean this panel that we convened is now 8-1/2 years old. I would take this opportunity publicly to offer the services, again, of this panel to the General Services Administration Public Building Service to revisit this issue. I would volunteer again to chair such a panel and to compare and contrast what has happened in that 8-1/2-year difference——

Ms. NORTON. Since that time.

Mr. HENTSCHEL. —and see if our recommendations, A, you know, had any effect. B, you know, we could see how, perhaps, we could make additional recommendations.

Ms. NORTON. You know, I am almost inclined to swear Mr. Peck in again. It was done, apparently, by one of his predecessors. I would ask you to consider, and very much appreciate that Mr. Peck has remained. I think it shows the respect he has for this panel and his own search for ways around some of the obstacles he has found.

I ask you to consider what Mr. Hentschel has said, and I think such a panel would also enhance our standing and yours with OMB's to review what has been done 7 or 8 years ago.

I would also like to ask Mr. Nash—I think it is Mr. Nash who spoke about something that is also close to our hearts, if you will allow, and that is enhanced lease authority, because you mentioned that several agencies have this authority.

Would you describe the kinds of authority you speak of and what your impression is of agencies with this authority and whether you think it would help the GSA to better fulfill its mission?

Mr. NASH. The only one that I am most familiar with is DOD and their enhanced use leasing. They have done things like in terms of public partners, public-private partnerships, plus in energy. They have provided land, and entrepreneurs come in and put in solar panels or they put in wind turbines, and then that allows the base to have a good source of power, and it is reasonable.

To me, it was really a significant move forward when enhanced use leasing was allowed, where the government is allowed to deal with the private sector and where both benefit. You use the government land, but you use the ability of the private sector to provide things that the government needs.

So I think an enhanced use lease is one of the best things that has happened in the Federal Government for a long time. It has to be watched, obviously. You know, there are always opportunities

for people to go off into the ditch, but I think those kinds of things are the kinds of innovative things that I am recommending.

I would say one other thing. When I was on Active Duty, Bob Peck was in GSA, and I considered him one of our finest innovators in the Federal Government. And I enjoyed working with him when we were both swimming upstream in heavy tides. So I think he is the right man to be able to do what you would like to have done.

Ms. NORTON. Well, I am glad he is here so he can hear the standard to which we are going to hold him, the standard of innovation.

Mr. NASH. And he didn't pay me, and I am not related to him.

Ms. NORTON. No. He couldn't have paid you enough for that, but I know he appreciates it and so do we.

It is interesting that you mentioned enhanced leasing and energy, because much of what the government is about is just that kind of quid pro quo, because we are very much about reducing our enormous energy costs. And to look at enhanced leasing that way very much fits where the administration is and where, frankly, the country and the globe is today with respect to where the savings are to be made and where the growth in industry is.

We think, for example, that the government is in the position to drive down markedly the cost of energy simply because of its holdings across the country and across the world, and we are trying to make those kinds of decisions now. GSA has done a fairly good job in real estate, in making those decisions.

The entire stimulus package, interestingly this time, had nothing the do with simply repairing the inventory. To be sure, it is going to do that, but there has got to be a strong component of energy conservation and every bit of that $5.5 billion that we are spending in the stimulus package.

I have a final question for Mr. Greninger that I did not get a chance to ask.

I wonder whether or not there is any industry standard you are aware of, at least using current best practices, for how long a new building should go without major capital repair investment, with the emphasis on ″major,″ or do you think that what you call predictive maintenance can mean that you don't get to that point?

Mr. GRENINGER. Well, no. We do a 20-year projection on all of our investments.

Ms. NORTON. That means you are going to need to do something with, for example, the energy system.

Mr. GRENINGER. Absolutely. Yes.

As buildings are developed or purchased during a commissioning effort, if the age is zero, then there is going to be a certain manufacturer recommendation on when certain elements of major maintenance and/or replacement are going to take place, and you put that into action. But the predictive index—I mean indexing and maintenance inspections are becoming vitally beneficial to our industry.

Ms. NORTON. So would you think that predictive maintenance is becoming an industry standard?

Mr. GRENINGER. Yes.

Ms. NORTON. Maybe you could predict what Mr. Hentschel used as his example in which you have a building where, some years from now, you find out that asbestos is a threat to the health of

anybody in the building. Maybe you can't predict that, but there are many, many factors, elements, that make up the maintenance of a building that are perfectly predictive today, and there are enough of them.

Mr. GRENINGER. Well, in that particular case, we inspect on a regular basis the air quality inside of our buildings, capturing particles of many different types that could, in fact, when the concentration gets too high, predict that something dramatic needs to change.

Ms. NORTON. Here, the prediction perhaps could not be—I don't know—50 years ago, that it would cause cancer. You don't want to get it too high, but you don't want to get it at all if it is asbestos. I mean I am allowing for that. I am allowing for things that nobody could predict because you seem to say that there are many, many things that are predictable that are built into how maintenance is done today as a matter of best practices.

Mr. GRENINGER. Correct.

Ms. NORTON. I want to thank this panel very much. This has been a very important panel for educating us about something that has been truly perplexing to the Subcommittee and even to GSA. I very much appreciate the testimony that all four of you have presented. It has been very helpful to the Subcommittee.

The hearing is adjourned.

[Whereupon, at 4:30 p.m., the Subcommittee was adjourned.]

**OPENING STATEMENT OF**
**THE HONORABLE RUSS CARNAHAN (MO-03)**
**HOUSE TRANSPORTATION AND INFRASTRCTURE COMMITTEE**
**SUBCOMMITTEE OF ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS, AND EMERGENCY MANAGEMENT**

**Hearing on**
Capital Assets Crisis: Maintaining Federal Real Estate with the Dwindling Federal Building Fund
Wednesday, March 24, 2010

Chairwoman Norton and Ranking Member Diaz-Balart, thank you for holding this hearing to examine the financial viability of the Federal Building Fund (PBF) to meet its core purpose of generating enough capital not only to maintain Federally owned offices and courthouses in good repair but also to allow new construction of Federal buildings to take place to meet the growing needs of Federal agencies whose facilities are served by the General Services Administration.

The Federal Building Fund was created to provide a revolving fund that required agencies to pay for the space they occupied and provide a revenue sources for new federal construction and upkeep of federal buildings. Additionally, the PBF was designed to replace annual appropriations to the GSA as the primary means of financing operations and capital costs associated with the Federal space owned and managed by the GSA.

However, as the Public Buildings Service Commissioner Robert Pack has recently said, there is concern about the ability of the PBF to generate sufficient revenue to cover the repair costs of the current federally owned inventory. Additionally, I am concerned that since the PBF has not generated a great deal of funding to finance construction of new Federal building, GSA has had to rely increasingly on leases to meet the growing needs for more space. Greater reliance on long-term leasing without even an ownership option is actually typically more expensive than Federal construction resulting in excessive costs to taxpayers.

In closing, I want to thank our witnesses for joining us today and I look forward to their testimony.

Eleanor Holmes Norton

**STATEMENT OF**
**THE HONORABLE ELEANOR HOLMES NORTON**
**CHAIR, SUBCOMMITTEE ON ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS AND EMERGENCY MANAGEMENT**
**HOUSE TRANSPORTATION AND INFRASTRUCTURE COMMITTEE**
"Capital Assets Crisis: Maintaining Federal Real Estate
With the Dwindling Federal Building Fund"

March 24, 2010

Good morning, and welcome to today's hearing on the Federal Building Fund (FBF). Today, we will examine whether the Federal Building Fund offers the General Services Administration (GSA) Public Building Service (PBS) a valuable tool for meeting its mandate of optimizing the use of federal office space and providing a source of revenue to maintain existing buildings and fund new federal construction. GSA owns more than 1,500 Federal buildings, totaling 176.5 million rentable square feet of space. It leases 177.5 million rentable square feet of space in almost 7,100 leased properties. However, in recent years the GSA construction program has essentially been reduced to land ports of entry and courthouses, with few exceptions, and GSA increasingly relies on private commercial office space to meet its needs, straining the Building Fund, and creating a growing crisis in meeting GSA's vital functions.

The FBF was created in 1975 by P.L. 92-313 to provide a revolving fund that required agencies to pay for the space they occupied and to provide a revenue source for new federal construction and upkeep of federal buildings. Today, we will hear from witnesses across the spectrum to help us evaluate GSA's capital asset management strategies and how GSA can manage federal assets more effectively. Our witnesses include two private sector witnesses with experience in maintaining and repairing buildings and an expert on capital asset management. We also will hear from an official from the Financial Accounting Standards Board, who will discuss how new accounting rules may affect how the federal government will evaluate the Public Building Service Capital Investment and Leasing Program. The current guidelines for the budgetary treatment of leases require the full cost of a capital lease or lease-purchase to be scored up-front, rather than only the first year's annual rent and the value of any cancellation provision, as in the case of operating leases. And of course, we will hear from Robert Peck, the PBS Commissioner, currently in

his second tour of duty with GSA as the PBS Commissioner. We will want to focus on what it takes to properly maintain a capital assets portfolio, and on the true costs of leasing versus owning federal office space.

Since its inception, the FBF has struggled to meet its original mission. As early as 1981, the Government Accountability Office (GAO) found that there was no evidence that the FBF had promoted a more efficient use of space or produced enough funds for new construction. Periodically since then, the GAO has noted the inability of the FBF to fund the repair and maintenance of existing federal assets. More importantly, the current head of the PBS has indicated that the FBF is on an unsustainable course, and will be unable to fund the proper maintenance of its federal capital assets in the near future. The FBF recently received a much needed infusion of cash, with $5.5 billion provided by the American Recovery and Reinvestment Act (P.L. 111-5). Even with this investment, there are public reports of a maintenance and repair backlog of almost $8.8 billion. Yet, the PBS building portfolio has a replacement value of nearly $42 billion, which makes mandatory the development of a more effective approach for generating the funds necessary to maintain our capital assets.

Two examples show that the government is beginning to recognize that it must right-size its Capital Investment and Leasing Program. The administration's Fiscal Year 2010 budget request included $100 million for the GSA to exercise the purchase option for the Columbia Plaza building located in Washington, D.C. In addition, the Fiscal Year 2011 Capital Investment and Leasing Program also includes a proposal to purchase an IRS Building in Martinsburg, West Virginia for $25 million. We continue to applaud the efforts of the agency to parse through the purchase opportunities available to them and to exercise them whenever it is prudent to do so. The GSA had long leased the Columbia Plaza building, but finally purchased this much-needed asset housing State Department employees at nearly 50% of its 2006 appraised value. The building, close to the State Department headquarters, would otherwise have required another round of leasing and lost dollars to the FBF and to federal taxpayers.

The Committee on Transportation and Infrastructure and this subcommittee have repeatedly expressed concern about the expensive trend toward providing Federal office space through leasing and not Federal ownership, to the point that for the first time, the Federal government was occupying more leased space than owned space in Fiscal Year 2008, according to a July 2009 GAO report. In almost every case, over the long term, leasing is more expensive than Federal ownership, and deprives the FBF of direct

payments from agencies occupying government-owned space, which instead go to developers. The intended purpose of the FBF, which was to provide the resources to enable GSA to construct, maintain, and repair buildings in the Federal inventory, is undermined by the steady shrinking of available funds to maintain Federal assets, much less to generate funds for new Federal construction. This skewed "leased-to-owned" ratio trend presents a distressing portrait of the condition of federal asset management, which is an essential government function.

We need to determine if the financial and managerial systems are in place for GSA to properly administer the FBF and maintain existing assets. We plan to address the assumptions used to justify the current capital asset management strategies. Finally, and perhaps most importantly, this subcommittee will examine whether GSA has the existing statutory authority to address its need to maintain its capital assets. We have consistently pressed GSA to use all the authority available to it, including Section 412 of P.L. 108, which grants GSA the authority to enter into agreements that include selling, leasing, exchanging of capital assets and retaining the proceeds within the FBF. When Congress granted this authority, it was contemplated that GSA would have a powerful tool at its disposal to enhance its ability to properly manage its capital assets portfolio and the FBF. Instead, this authority has not been exercised yet and we are facing, perhaps, a looming crisis in managing our nation's public buildings.

I look forward to hearing from today's witnesses.

Statement of

Richard W. Greninger
Managing Partner, Carr Services

On Behalf of the
Building Owners and Managers Association (BOMA) International

Before a Hearing of the Subcommittee on Economic Development,
Public Buildings and Emergency Management
Committee on Transportation and Infrastructure
United States House of Representatives

"Capital Crisis Management:
Maintaining Federal Real Estate with the Dwindling Federal Building Fund"

March 24, 2010

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Good morning Chairwoman Norton, Ranking Member Diaz-Balart, and members of the Subcommittee. Thank you for holding this important hearing on the Federal Building Fund. I am Richard Greninger, Managing Partner, Carr Services, and I am here today on behalf of the Building Owners and Managers Association (BOMA) International. Thank you for the opportunity to share BOMA's perspectives on best practices in managing a building maintenance program.

To begin, I would like to clarify that my comments are limited to general industry best practices and are not intended to infer that GSA does or doesn't follow these practices.

Buildings are designed and built to last for decades. But in order to keep the building in good repair, keep systems running at their optimal performance levels, and attract and retain quality tenants, buildings must have a management plan in place and adequately budget for repairs and maintenance.

Much of the work that needs to be done on a regular basis is the maintenance of the structure itself, including painting and façade repairs. Other basic upkeep items include general maintenance of the roads and grounds, including snow removal and landscaping.

According to BOMA's 2009 Experience Exchange Report (EER)[1], private sector commercial office buildings, on average, spent $1.80 per square foot on repair and maintenance, and an additional $0.23 per square foot on roads and grounds in 2008. This represents approximately 25.5% of a building's operating expenses (see Appendix 1). Other operating expenses include cleaning, utilities, security and administrative costs.

For government buildings[2], the amount spent on repairs and maintenance is higher ($2.43 per square foot). The combined expense of repairs, maintenance, roads and grounds for government buildings accounts for approximate 28% of the operating budget (see Appendix 2).

As you can see, the comparison is relatively dramatic. The repair/maintenance costs in public sector buildings are considerably higher than in private sector buildings. Less preventive maintenance and a higher average age of the buildings in the data set may explain this, although we just ask for the numbers and we do not survey about maintenance practices.

When setting the annual budget for a portfolio of buildings, property managers typically first look at their global standards (such as services, contracts, and insurance) that are passed through across the entire portfolio, and then look at the historical information for each specific building to determine if any major repairs need to be made, equipment needs to replaced, or if expenses can be expected to be higher or lower due to work that was done during previous years or deferred. Finally, we look to BOMA's EER to determine if we are in the same ball park as other buildings in our market in order to stay competitive.

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[1] The Experience Exchange Report (EER) is commercial real estate's benchmarking tool for income and expense data. Data set includes all buildings that submitted data for the 2008 calendar year.

[2] Government buildings reporting data were primarily GSA buildings, but some state and county government buildings were also included.

For the building as well as the building systems to remain fully operational as they were designed, the property manager and the building's engineering team need to develop a maintenance program. Most properties' programs include three basic types of maintenance: *reactive* maintenance, *preventive* maintenance and *predictive* maintenance.

**Reactive Maintenance**

The degree to which the property dedicates its resources to each form of maintenance depends greatly on the owner's objective for the property, the staffing level and skill set of the engineering employees assigned to the property, and a host of other factors.

As the name implies, reactive maintenance occurs when the building system has already broken and needs repairing or requires calibration. This type of maintenance typically bothers tenants the most because they have no warning that the system will be out of service.

In addition, reactive maintenance can be tremendously disruptive to your engineering team members. When reactive maintenance is prevalent at a property, the engineers no longer control the work schedule—the work schedule controls them. In reactive maintenance, your engineers often go from one system failure to another. As soon as they fix one component, something else breaks down.

Examples of reactive maintenance include replacing light tubes and bulbs when they burn out, fixing a motor when it fails or repairing a pump when it seizes up.

All buildings employ some degree of reactive maintenance. No maintenance system can predict or prevent failures with 100 percent certainty. Even if such a system existed, it would be too expensive to manage in a commercial building. In the long term, however, reactive maintenance programs tend to be expensive; equipment that is not maintained proactively often fails earlier and costs more to operate than equipment that is maintained aggressively ahead of time.

Sometimes, in buildings where reactive maintenance is a primary focus, the engineering team members do not have the skills, the staffing, or the time to design an engineering system that manages the maintenance function differently. When this is the case, additional education opportunities, supervision by a senior engineer, and additional staffing on a temporary basis may enable the team to "get ahead" and help change their mindset from reactive maintenance to a focus on preventive and predictive maintenance.

In some cases, reactive maintenance may actually be the preferred strategy. If, for example, the owner is preparing to perform extensive renovations of a vacant building, he may choose to contain costs before construction begins by fixing only the critical components that malfunction. But any savings are short-term; reactive maintenance is almost always more expensive in the medium and long term, both in terms of dollars spent and tenant dissatisfaction and ultimate turnover.

**Preventive Maintenance**

Preventive maintenance is the opposite of reactive maintenance. Instead of repairing system components only when they break, preventive maintenance strives to *prevent* the system components from ever breaking.

Preventive maintenance lowers operating and utility costs and, in many cases, extends the useful life of system components. In addition, evidence of a good preventive maintenance program improves the value of the property at a sale because the purchaser believes the systems are in good condition and won't need to be replaced in the near future. Plus, tenant satisfaction levels may improve because tenants are inconvenienced less when maintenance is done on a time-based schedule.

Preventive maintenance for a typical piece of equipment involves taking it apart, inspecting the parts, replacing any worn parts, replacing seals and gaskets, lubricating the moving parts to improve wear, and putting the equipment back together. In almost all cases, the manufacturer of the equipment provides preventive maintenance standards. The goal is that, by planning the preventive maintenance properly, the systems can remain in operation without failure.

Preventive maintenance is based upon visual inspections of equipment (looking for damaged components before they fail) and regular maintenance schedules. In fact, the centerpiece of the preventive maintenance program is a preventive maintenance schedule, a listing of all the preventive maintenance tasks (and a plan to achieve them) during the year, and diligent record keeping.

Typically, the manufacturer of each piece of equipment provides not only a list of the specific tasks required for each preventive maintenance session but also the suggested interval between maintenance sessions.

Using a common metric, one building engineer can handle preventive maintenance tasks for about 200,000 square feet of office space, depending upon the type of equipment in the building. This assumes that the engineer does only preventive maintenance, with someone else handling all service calls and repairs.

Take, for example, the recommended maintenance on a self-contained unit (SCU) as part of the HVAC system.

| **Description** | **Hours** | **Frequency** | **Total** |
|---|---|---|---|
| Annual Maintenance | 4.8 | 1 | 4.8 |
| Semi-annual Maintenance | 3.2 | 2 | 6.4 |
| Quarterly Maintenance | 1.9 | 4 | 7.6 |
| Monthly Maintenance | 1 | 12 | 12 |
| **Total Preventive Maintenance** | | | **30.8** |

Assuming the building has 11 SCUs and each SCU requires 30.8 hours per year of preventive maintenance, the 11 units will require a total of 339 hours of annual preventive maintenance.

That's 8 ½ weeks of time for one engineer just to maintain one portion of the HVAC system—assuming the engineer does nothing else but preventive maintenance. (Incidentally, this preventive maintenance function alone would represent almost one-sixth of the engineer's total work time for the year. Dozens of other pieces of equipment would need to be maintained during the year as well.)

Doing preventive maintenance well is time consuming. Often, the first task that gets delayed when the work tickets start piling up is preventive maintenance. In some cases, the logic is circular: Preventive maintenance prevents breakdowns of the equipment and reduces the number of reactive maintenance operations. When this is the case, the short-sighted owner or property manager may look at the work tickets, see very few reactive tickets, and cut staff to improve the financial performance of the property. This strategy tends to work for a short time, but without the proper preventive maintenance the systems will soon need expensive reactive repairs.

**Predictive Maintenance/Reliability Centered Maintenance (RCM)**

The third type of maintenance, which is growing in popularity among high-performance organizations, is predictive maintenance. Many people use the term reliability centered maintenance (RCM) interchangeably with the term "predictive maintenance." Predictive maintenance is a program that uses approved nondestructive testing procedures to analyze the condition of building equipment and relies on statistics, measurement, and experience to predict equipment service and maintenance requirements.

Like preventive maintenance, predictive maintenance is proactive. Systems are maintained before they break, as a means of preventing the breakdown completely. Where preventive maintenance relies upon a time-based schedule (every x weeks or months), predictive maintenance uses statistics, measurement, and experience to determine the service interval for a particular piece of equipment.

Typical measurements used in predictive maintenance include:

- Vibration analysis on motors
- Infrared testing on electrical components
- Fiber optic testing
- Ultrasonic testing
- Analysis of operating histories of similar machines over a long period of time

Predictive maintenance is based upon the fact that, before a piece of equipment fails, certain measurements will start to change. In a typical predictive maintenance program, the time intervals between preventive maintenance operations are based not on the calendar but on when the equipment actually needs maintenance to continue its optimum performance (run time vs. scheduled time).

Returning to the example of the self-contained unit in the HVAC system, predictive maintenance would call for a measurement of the equipment's performance. Instead of performing monthly, quarterly, semi-annual, and annual maintenance tasks based upon the calendar, the chief engineer

would tailor the maintenance program to the specific SCU based on the results of a detailed analysis. Because each piece of equipment is evaluated individually and has different needs for service, each one would have a different maintenance schedule.

Major equipment manufacturers have begun to embrace the concept of predictive maintenance. As an example, an elevator company may determine that a particular part begins to fail after 100,000 stops at a floor in the building. The elevator mechanic will be able to record the number of stops made by each elevator cab and replace the part when each cab records 100,000 stops. Instead of guessing when the part will break down, the elevator company can use its previous experience to know that the part becomes more likely to cause a failure after a certain amount of use. By replacing the part shortly before it would fail on its own, the company minimizes the maintenance cost and maximizes the amount of time the elevators are in service.

Preventive maintenance may call for a part to be replaced every year, regardless of the amount of use the equipment received. With predictive maintenance, the specific use pattern of each piece of equipment and the measurements taken to show how the equipment is working are used in the decision process.

In conclusion, building owners and managers must look at both short-term and long-term costs when developing a maintenance plan and budget for their buildings. The General Services Administration has done a good job with the tools they have been given. However, to most effectively manage a diverse range of facility design, construction, rehabilitation, restoration, renovation, and operations projects, they must be given sufficient funding.

We thank the Subcommittee for holding this important hearing and hope this testimony has provided some insight on building maintenance programs and industry best practices. I welcome any questions you may have.

**About BOMA International**

Founded in 1907, the Building Owners and Managers Association (BOMA) International is an international federation of more than 100 local associations and affiliated organizations. BOMA International's members are building owners, managers, developers, leasing professionals, medical office building managers, corporate facility managers, asset managers, and the providers of the products and services needed to operate commercial properties. Collectively, BOMA's 17,000 members own or manage more than nine billion square feet of office space, which represents a $100 billion marketplace and more than 80 percent of the prime office space in North America.

**Appendix 1:** Experience Exchange Report ®

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **Report Year:** | 2008 | **Sector:** | Private | **Building Size:** | All Sizes | **Unit of Measure:** | Square Feet |
| **Country:** | USA | **Building Type:** | All Building Types | **Public Transit:** | Any Proximity | **Location:** | All Locations |
| **Market:** | All Markets | **Ownership Type:** | All Types | **All Electric:** | Any | **Building Age:** | All Ages |
| **Zip Code:** | All Zip Codes | **Number of Floors:** | All Heights | **Agency Managed:** | Any | | |
| **% Gov't Tenants:** | All Occupancy Ranges | **% 24/7 Tenants:** | All Occupancy Ranges | **% Pvt. Tenants:** | All Occupancy Ranges | | |

| | **Total Building Rentable Area** | | | | | **Total Office Rentable Area** | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2,948 Bldg | 511,492,264 Sq. Ft. | | | | 498,619,570 Sq. Ft. | | | |
| | | **Dollars/S.F.** | | **Mid Range** | | **Dollars/S.F.** | | **Mid Range** | |
| | *# Bldg* | *Avg* | *Mdn* | *Low* | *High* | *Avg* | *Mdn* | *Low* | *High* |
| **Income** | | | | | | | | | |
| Total Rental Income | 2,348 | 23.31 | 20.13 | 15.80 | 25.58 | 23.90 | 20.47 | 15.94 | 26.19 |
| Total Income | 2,344 | 24.66 | 20.87 | 16.08 | 26.90 | 25.33 | 21.01 | 16.25 | 27.24 |
| **Expense** | | | | | | | | | |
| Total Oper Exp | 2,497 | 7.75 | 5.87 | 4.73 | 8.26 | 7.07 | 5.56 | 3.76 | 8.43 |
| Total Oper + Fixed | 2,481 | 11.55 | 9.62 | 7.93 | 11.80 | 11.87 | 9.71 | 8.00 | 12.00 |
| **Income** | | | | | | | | | |
| Office Rent | 2,363 | | | | | 23.58 | 20.17 | 15.96 | 25.99 |
| Retail Rent | 329 | 19.65 | 17.71 | 9.77 | 30.00 | | | | |
| Other Rent | 238 | 1.77 | 0.67 | 1.80 | 10.91 | | | | |
| Telecom Income | 475 | 0.23 | 0.07 | 0.02 | 0.21 | | | | |
| Miscellaneous Income | 1,587 | 1.24 | 0.10 | 0.09 | 1.21 | | | | |
| **Expense** | | | | | | | | | |
| Cleaning | 2,525 | 1.41 | 1.19 | 0.93 | 1.57 | 1.43 | 1.19 | 0.94 | 1.58 |
| Repair / Maintenance | 2,693 | 1.56 | 1.32 | 0.80 | 1.98 | 1.60 | 1.39 | 0.95 | 1.91 |
| Utility | 2,554 | 2.24 | 2.11 | 1.55 | 2.75 | 2.42 | 2.20 | 1.66 | 2.85 |
| Maintenance Materials | 2,632 | 0.23 | 0.24 | 0.13 | 0.46 | 0.23 | 0.24 | 0.13 | 0.47 |
| Security | 2,190 | 0.70 | 0.33 | 0.09 | 0.66 | 0.71 | 0.34 | 0.09 | 0.68 |
| Administrative | 2,793 | 1.58 | 1.32 | 0.85 | 1.62 | 1.38 | 1.23 | 0.86 | 1.65 |
| Fixed | 2,739 | 3.79 | 2.64 | 1.88 | 3.68 | 3.89 | 2.67 | 1.90 | 3.72 |
| Direct Expensed | 1,490 | 1.28 | 0.83 | 0.06 | 1.31 | 1.52 | 0.11 | 0.06 | 1.23 |
| Amortized Leasing | 562 | 2.61 | 1.47 | 0.59 | 3.10 | 2.70 | 1.51 | 0.61 | 3.18 |
| Capital | 799 | 1.08 | 0.81 | 0.14 | 0.90 | 1.12 | 0.27 | 0.15 | 0.91 |
| Telecom | 203 | 0.05 | 0.04 | 0.02 | 0.07 | 0.05 | 0.04 | 0.02 | 0.07 |

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**Appendix 2:** Experience Exchange Report ®

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Report Year:** | 2008 | **Sector:** | Government | **Building Size:** | All Sizes | **Unit of Measure:** | Square Feet |
| **Country:** | USA | **Building Type:** | All Building Types | **Public Transit:** | Any Proximity | **Location:** | All Locations |
| **Market:** | All Markets | **Ownership Type:** | All Types | **All Electric:** | Any | **Building Age:** | All Ages |
| **Zip Code:** | All Zip Codes | **Number of Floors:** | All Heights | **Agency** | Any | | |
| **% Gov't Tenants:** | All Occupancy Ranges | **% 24/7 Tenants:** | All Occupancy Ranges | **% Pvt. Tenants:** | All Occupancy Ranges | | |

| | Total Building Rentable Area | | | | | Total Office Rentable Area | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 515 Bldg | 106,806,629 Sq. Ft. | | | | 91,081,616 Sq. Ft. | | | |
| | | Dollars/S.F. | | Mid Range | | Dollars/S.F. | | Mid Range | |
| | # Blds | Avg | Mdn | Low | High | Avg | Mdn | Low | High |
| **Income** | | | | | | | | | |
| Total Rental Income | 65 | 17.76 | 17.81 | 12.84 | 24.97 | 18.08 | 17.81 | 13.26 | 25.11 |
| Total Income | 66 | 19.31 | 18.00 | 13.13 | 25.29 | 19.77 | 18.00 | 13.79 | 25.50 |
| **Expense** | | | | | | | | | |
| Total Oper. Exp. | 48 | 7.55 | 6.26 | 5.48 | 8.65 | 8.04 | 8.20 | 5.68 | 11.59 |
| Total Oper + Fixed | 46 | 10.19 | 8.89 | 7.11 | 10.72 | 10.48 | 9.35 | 7.33 | 11.01 |
| **Income** | | | | | | | | | |
| Office Rent | 64 | | | | | 19.67 | 19.78 | 15.07 | 24.97 |
| Retail Rent | 11 | 34.98 | 31.85 | 16.42 | 50.01 | | | | |
| Other Rent | 10 | 17.32 | 20.43 | | | | | | |
| Telecom Income | 6 | 0.22 | 0.01 | 0.01 | 0.53 | | | | |
| Miscellaneous Income | 30 | 1.86 | 1.80 | 0.69 | 2.88 | | | | |
| **Expense** | | | | | | | | | |
| Cleaning | 423 | 1.84 | 1.65 | 1.31 | 2.12 | 2.16 | 2.05 | 1.55 | 2.57 |
| Repair / Maintenance | 461 | 1.94 | 1.78 | 1.26 | 2.35 | 2.43 | 2.25 | 1.62 | 2.93 |
| Utility | 426 | 2.19 | 1.69 | 1.24 | 2.49 | 2.62 | 2.09 | 1.55 | 2.95 |
| Insurance | 376 | 0.14 | 0.13 | 0.05 | 0.36 | 0.15 | 0.15 | 0.07 | 0.42 |
| Security | 335 | 0.48 | 0.18 | 0.06 | 0.47 | 0.58 | 0.22 | 0.08 | 0.57 |
| Administrative | 430 | 1.14 | 0.82 | 0.56 | 1.35 | 1.32 | 0.96 | 0.66 | 1.61 |
| Fixed | 55 | 1.90 | 1.58 | 0.32 | 3.03 | 1.95 | 1.58 | 0.32 | 3.05 |
| Directly Expensed | 15 | 0.02 | 0.07 | 0.02 | 0.20 | 0.02 | 0.07 | 0.02 | 0.20 |
| Amortized Leasing | | | | | | | | | |
| Tenant | 11 | 0.04 | 0.25 | 0.06 | 0.04 | 0.04 | 0.25 | 0.06 | 0.04 |
| Telecom | 6 | 0.04 | 0.03 | 0.02 | 0.08 | 0.04 | 0.03 | 0.02 | 0.08 |

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**TESTIMONY BEFORE**
**THE U.S. HOUSE OF REPRESENTATIVES**
**COMMITTEE ON TRANSPORTATION & INFRASTRUCTURE**
**SUBCOMMITTEE ON ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS & EMERGENCY MANAGEMENT**

**BY:**

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Madame Chairwoman and Members of the Subcommittee:

My name is John Hentschel. I am a member of the Counselors of Real Estate and President of Hentschel Real Estate Services, a real estate consulting and advisory firm that, among other things, advises government leaders in the U.S. and abroad about real estate valuation, and asset and portfolio management issues.

This testimony is based on the findings of a 2001 CRE Consulting Corps assignment commissioned by the Public Building Service (PBS) that was designed to independently assess PBS's portfolio management policies and procedures and compare its newly devised asset management strategy with the best practices employed in the private sector.

PBS's new strategy sought to shift its capital decision making process from a tactical to a strategic one. It envisioned that only self-sufficient properties that would be capable of producing revenues greater than operating expenses for the Federal Buildings Fund (FBF) would be retained and allotted funding for repairs, alterations and replacements (RAR). Those properties that failed to meet such criteria would be targeted for disposal.

The Counselors of Real Estate, an affiliate of the National Association of Realtors, is a professional society whose approximately 1,100 members are among the

world's most respected and highly qualified advisors on real estate matters. As a public service, the Counselors organized a *Consulting Corps* which provides strategic advice to Government Agencies and Non-Profit Organizations who seek strategies to resolve complex real estate problems.

The Consulting Corps employs a collaborative process for which CRE's volunteer their time and effort on a pro bono basis. For this assignment, I chaired a panel of CRE's that also included Mahlon Apgar, Howie Gelbtuch, Barbara Hampton, and Frank Livingston.

After reviewing relevant documents and briefing materials and conducting 5 days of intensive interviews and thoughtful deliberations the panel presented its findings and recommendations to the PBS Commissioner in a verbal report entitled *"An Agenda for Strategic Change"* on September 14, 2001, followed by the panel chairman's address to a conference of PBS Regional Administrators in Kansas City on November 6, 2001.

With respect to the PBS portfolio the CRE panel observed that:

1. In terms of **Age**, the Building Inventory was **old** with an average building age of more than 50 years and was below average in quality and physical condition.

2. In terms of **Productivity**, the income produced by the Building Inventory for the Federal Building Fund (FBF) was highly **stratified and concentrated** with 55% of the square footage generating 95% of the Funds from Operations.

3. The **Capital Needs** of the building inventory for RAR were **excessive** estimated by the GAO at the time to be in excess of $4.0 Billion with many repairs having been deferred repeatedly and indefinitely.

4. **Availability of and Access to Investment Capital** to address the portfolio's RAR needs was extremely **limited**, well beyond the FBF's funding capacity, with

little prospect for direct Congressional appropriation, and few other identifiable sources.

5. Unlike the private sector, the **Legal and Budgetary Environment** within which PBS operated was highly structured, rigid, unsympathetic, and not amenable to change, modification, or exception.

6. In comparison to private sector standards, PBS's allocation of administrative **Overhead** to each building within the portfolio was **exorbitant** counteracting any benefits associated with self insurance and local property tax exemption.

7. PBS **lacked a strategic mindset**. Its narrow **caretaker focus** and preference for long term property ownership **conflicted with** PBS's stated **mission** and the federal government's **inherent budgetary and accounting bias** against capital investment reflected in its "scoring" rules, the absence of a capital budgeting process, and PBS's inability to retain disposition proceeds for other uses.

Unlike prior studies commissioned by PBS, the CRE Panel approached the issue from a much broader perspective that considered PBS's mission, funding, structure, systems and skill sets.

In addition to endorsing the adoption of PBS's more strategic approach to allocating its limited resources, the panel also recommended that PBS assume and demonstrate its capacity to perform a strategic leadership role as an advisor to help Congress, OMB and client agencies make informed real estate decisions. The panel further suggested that PBS should define and develop cost, efficiency and performance standards to guide real estate decisions.

Organizationally the panel believed that PBS should reduce redundancy and streamline regional entities, intensify management controls and institute uniformity and universal application of all processes, procedures and decisions.

Procedurally, the Panel felt that PBS should instill more discipline in its decision making process and introduce more rigor and uniformity in its analytical procedures. Among the panel's many suggestions were that PBS should compare and contrast the costs and benefits of leasing versus ownership (including the cost of RAR) on a net present value basis as well as calculating the Cost of Inertia (that is, Cost of Doing Nothing) for every property related decision. The panel also thought that adopting a 5 year capital budgeting process which compared and contrasted portfolio results with and without the expenditure of needed RAR investments, even if performed internally for informational purposes, would impose a level of fiscal discipline now lacking in the PBS analytical process. In the panel's view opportunities for outsourcing, especially the management of small, remote or isolated facilities, should be examined and encouraged whenever possible.

The Panel encouraged PBS to seek the authority to not only negotiate cancellation rights and purchase options in its lease agreements, but also the ability to segregate maintenance from new construction funds and retain property sale proceeds within the Federal Building Fund to fund RAR requirements.

In closing, the Panel commended PBS's foresight and its commitment to adopt contemporary asset management procedures. The Panel exhorted PBS to continually strive to achieve the efficient and balanced deployment of federal real estate assets by periodically evaluating portfolio contents and disposing of those that underperform established benchmarks to yield the most benefits at the least cost.

Thank you for your time and attention.

Respectfully,

John J. Hentschel CRE, MAI, FRICS

**EFFECTIVE STRATEGIES FOR FEDERAL FACILITIES ASSET MANAGEMENT**

Statement of

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and
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before the

Subcommittee on Economic Development, Public Buildings, and Emergency Management
Committee on Transportation and Infrastructure
U.S. House of Representatives

Hearing titled Capital Assets Crisis: Maintaining Federal Real Estate with a Dwindling Federal Building Fund

March 24, 2010
2:00 p.m.

Good morning, Madam Chairman and members of the Committee:

My name is David J. Nash and I am the president of Dave Nash and Associates, LLC, a firm that provides project and program management services throughout the world's emerging markets for bioenergy, energy and large infrastructure projects. I've been involved with buildings and infrastructure for more than 40 years and have managed multi-billion dollar physical asset programs, including the U.S. Navy's shore installations worldwide, and the reconstruction of Iraq's infrastructure.

I am here today as a member of the National Academy of Engineering and the chair of the National Research Council's Board on Infrastructure and the Constructed Environment. The Research Council is the operating arm of the National Academy of Sciences, National Academy of Engineering, and the Institute of Medicine of the National Academies, chartered by Congress in 1863 to advise the government on matters of science and technology.

In 2004, I was the vice chair of the National Research Council's Committee on Business Strategies for Public Capital Investment. The committee's task was to develop guidelines for making better decisions about investments in the construction, maintenance, renewal, replacement, and decommissioning of federal facilities based on best practices from private-sector organizations[1].

The committee recognized at the start that there are inherent differences in the missions, goals, and operating environments of private-sector organizations and those of the federal government.[2] Nonetheless, the committee identified 10 policies and principles used by best-practice private-sector organizations that could be adapted to the federal government and could result in more effective and efficient management of federal facilities. Among these are life-cycle costing, allowing greater use of alternative approaches for acquiring facilities, determining when to own and when to lease facilities, and disposal of excess facilities. However, the committee also found that current federal budget processes and procedures provide few, if any, incentives for federal agencies to use more innovative and more cost-effective management practices.

My main message here today is that although we do have a crisis in federal capital assets, we also have a tremendous opportunity to change how we invest in federal facilities so that we can operate them more cost effectively and more sustainably: Change is both necessary and possible.

**Issues Related to Federal Facilities Investment and Management**

As the Subcommittee on Economic Development, Public Buildings, and Emergency Management has recognized, effective management of and investment in federal facilities is a critical issue. In addition to the General Services Administration, more than 30 other federal agencies are responsible for investing in, operating, and maintaining facilities.

However, they have insufficient funds to do so effectively. Combined, these agencies own more than 400,000 facilities worldwide, including embassies, defense and space facilities, office buildings, hospitals, museums, laboratories, and housing.[3]

Facilities such as the Capitol building and the White House are symbols of our nation at home and abroad. Most federal facilities have been acquired to enable government agencies to meet their missions, to deliver programs, products, and services to the American public. Investments in federal buildings and infrastructure also help to meet other public policy goals for job creation, energy efficiency, greenhouse gas reduction, public transportation, urban revitalization, and historic preservation. [4]

Today, half of all federal buildings are at least 50 years old and many are in deteriorating condition. Many were originally built to serve functions or missions that have changed over time. Thus, many departments and agencies have excess, underutilized, and obsolete facilities that are no longer aligned with their current missions and programs. Nonetheless, obsolete and excess buildings still require some level of investment to keep them in an operable condition.

Lack of sufficient funding for the maintenance and repair of federal buildings is a long-standing issue and today, many federal agencies are reporting billions of dollars in deferred maintenance and repair. [5]However, lack of funding is not the only issue preventing effective management of federal capital assets.

**Life-cycle Costing**

Best practice private sector firms consider facilities as strategic assets and as mission enablers. They analyze the life-cycle costs of facilities up-front. That is, they consider not only how much it will cost to design and build a new facility but how much it will cost to operate, maintain, repair, and renovate that facility over the 20 or more years it will be used. Private sector organizations also evaluate how much it will cost to staff and equip a building, including the life-cycle costs of the computers and furniture that will be needed. Finally, they evaluate how they are going to sell, or otherwise walk away from a building when it is no longer needed.[6] Using life-cycle costing and developing an exit strategy makes the total costs of a proposal transparent. It allows senior executives to understand the total commitment of resources that will be involved in acquiring a new facility, identifies the tradeoffs, and identifies the short and long-term consequences for the entire organization.

In the federal government, policies and directives to use life-cycle costing have been issued and federal agencies do conduct such analyses for significant new facilities. However, the *budget* process is structured to consider the design and construction costs of a facility separate from its operating, maintenance, repair, and renewal costs. While a great deal of scrutiny may be given to a request to build a new facility, design and construction costs are typically only 5 to 10 percent of the life-cycle costs.[7] The costs of operating, maintaining, and renovating that facility for 20 or more years are not separated

out and are not scrutinized. The result is that when federal agencies acquire new buildings the total resource commitment is not transparent to decision-makers or the public. Considering the total life-cycle cost of a facility in the budget process would make the total cost of ownership more transparent, and could change how the federal government determines what to build, to own, or to lease.

The National Research Council (NRC) has recommended that each federal department and agency should develop and use a business case analysis for all significant facilities investment proposals. The intent is to make clear the underlying assumptions, the alternatives considered, the full range of costs and benefits, and potential consequences for the organization and its missions.[8] Further, the NRC has recommended that agencies should use life-cycle costing for all significant facilities investment decisions to better inform decision makers about the full costs of a proposed investment. [9] And that for every major facility proposal, agencies should include the exit strategy and costs for disposing of a building. [10] In doing so, decision makers and the public would have greater insight into the total commitment of resources that will be required over several decades, not just the up-front costs. These types of analyses would also help federal executives identify the potential long term consequences for their agency, help to identify ways to mitigate the consequences, and help to reduce life-cycle costs.

**The Decision to Own or Lease Facilities**

Best-practice, private-sector organizations also employ life-cycle costing for decisions about whether to own or lease facilities. Other factors include the level of control required and the planning horizon for the business functional requirement, which may or may not be the same as the life of the facility. Large private-sector corporations typically own those facilities that are most important to their business success and lease those that are less critical or for which demand may change more rapidly. [11]

Ownership entails a significant up-front investment and on-going operations and maintenance costs. It also allows the owner to exert maximum control over a facility's condition, functionality, and operations. [12]By choosing ownership, a private-sector organization also accepts the risk that if its business requirements change, it can dispose of the facility without a substantial loss.

When a private-sector organization decides to lease space, it cedes some control to the lessor. However, it also avoids the high up-front investment for design and construction, takes on less risk, and can more readily adapt to a changing market.

For federal agencies, the own versus lease decision is not as clear cut. Significant facilities investments are primarily funded from the annual budget. Departments or agencies must receive authorization from Congress for funding to cover the full, up-front (design and construction or purchase) costs in one fiscal year budget request. [13] This practice is reinforced by the budget "scorekeeping" rules enacted under the Budget Enforcement Act of 1990. These practices are intended to provide transparency to decision makers and the public, a laudable goal.

In actuality, full transparency is not achieved because only the first costs, not the life-cycle costs are disclosed. In addition, these practices can lead to decision making by agencies that may lower costs in the short term, but may result in higher costs to the public over the long term. For example, full up-front funding for a major facility creates a significant "spike" in an agency's budget request that must be offset by cuts in other program areas. To lessen the impact of the "spike", agencies may seek to drive down the first costs of a project even if it will eventually increase the total life-cycle costs.[14]

The requirement for full up-front funding also provides an incentive to lease space because the initial cost is much lower. The actual cost over 30 years or more is not transparent and could, in actuality, be greater than the cost of owning a facility. One other consequence of full up-front funding is that agencies may instead choose to continue using old and obsolete facilities in order to hold down short-term costs. [15]

The National Research Council has recommended that each federal department and agency should base its decisions to own or lease facilities on a clearly stated rationale linked to support of the organizational mission, the level of control desired, and on the planning horizon for the function. [16]

**Allowing Greater Use of Alternative Approaches for Acquiring Facilities**

Private-sector organizations can finance, lease, or otherwise acquire facilities in various ways. They may borrow money from a bank or other lending institution, use their own money, use third-party or equity arrangements, alliances with other firms, joint ventures, sale-and-leaseback, and public-private partnerships. All involve varying levels of risk and of debt.

Federal agencies are more restricted in how they fund facilities. Most investments in construction, operations, and maintenance are funded from the annual budget. Individual departments and agencies may not borrow funds or otherwise incur debt.

However, a number of alternative approaches for acquiring, maintaining, or renovating facilities are being used by federal departments and agencies, on a case-by-case basis under agency-specific legislation. [17] For instance, the Department of Veterans Affairs, the Department of Defense, and NASA have legislative authority to use enhanced use leasing or public-private partnerships. Under these arrangements, a private sector or other public entity leases underutilized federal property in exchange for renovating existing federal facilities or building new facilities that eventually become the property of the federal government. [18] Out-leasing arrangements have been used by the GSA and the Coast Guard for some underutilized or historic properties. In these instances, the federal agency leases all or a portion of a facility to a private-sector or not-for-profit organization, which then assumes the maintenance and operating costs of the facility for the term of the lease.[19] In contrast, sale-and-leaseback arrangements, which are routinely used by the private sector, offer few if any incentives for a federal agency unless it can retain the

proceeds of the sale and use them for some purpose or benefit not funded through the annual budget. [20]

Any alternative approach has advantages and disadvantages for particular types of organizations and types of facilities. All require effective management, agreed-upon performance measures, feedback procedures, and well-trained staff. Allowing the use of alternative approaches on a government-wide basis does raise concerns about the transparency of funding relationships and concerns about whether the approaches sufficiently account for the perspectives of state and local governments and constituencies.[21]

Recognizing such concerns the NRC has nonetheless recommended that, in order to leverage funding, Congress and the administration should encourage and allow more widespread use of alternative approaches for acquiring, operating, and maintaining facilities. It also recommended using pilot programs to test the effectiveness of various approaches and to evaluate their outcomes from national, state, and local perspectives.[22]

**Excess Facilities**

One of the objectives of effective facilities asset management is to align an organization's facilities with its missions and operating objectives. Private-sector organizations have a direct incentive to dispose of unneeded facilities as soon as possible because they are a drain on resources and are readily identifiable on their balance sheets. They dispose of excess facilities through sales, nonrenewal or breaking of leases, or demolition to free up resources that can be used for other requirements. [23]

The same is not true of the federal government, where the number of both owned and leased facilities has increased over time in response to new requirements, changing demographics, and other factors. Some of these facilities are now obsolete, underutilized, or no longer needed by federal agencies because their missions have changed. Potentially, significant amounts of money could be saved over the long term if greater emphasis was placed on demolishing obsolete facilities or divesting the government of unneeded but still viable properties. [24]

Under current procedures, however, agencies have few incentives, and significant disincentives to dispose of excess facilities. Demolition, like maintenance and repair is typically funded from the operations budget in most agencies, forcing program managers to choose between demolishing an unused facility or repairing one that is occupied. Transferring the title of a facility to a non-federal entity brings with it the responsibility to meet environmental and other regulations, which may cost more than retaining the property. Title transfer also is governed by myriad regulations, policies, and mandates, which require a significant investment of staff time to navigate, time that can be used for other programs. [25]

When agencies have been able to dispose of excess properties, significant incentives have been in place to do so. For instance, legislation was enacted several years ago that allowed the U.S. State Department to sell some of its excess properties at fair market value and to retain some of the proceeds for investment in mission-critical facilities.[26] The base realignment and closure process, of course, is a more extraordinary effort to divest the government of excess facilities. [27]

On the issue of excess federal facilities, the National Research Council has recommended that long-term requirements for maintenance and repair expenditures should be managed by reducing the size of the federal facilities portfolio[28]. It has also recommended that Congress and the administration lead an effort to streamline government-wide policies, regulations and processes related to facilities disposal, and to consider implementing more extraordinary efforts where agencies have many more facilities than are needed for their mission. [29]

This concludes my remarks. Thank you for the opportunity to testify today. I would be pleased to address any questions the subcommittee may have.

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Endnotes

[1] Investments in Federal Facilities, Asset Management Strategies for the 21st Century. 2004. National Research Council. P. x.
[2] Ibid.p. x.
[3] Ibid. p.1
[4] Ibid. p. 1.
[5] Stewardship of Federal Facilities: A Proactive Strategy for the Nation's Public Assets. 1998. National Research Council. P. 14.
[6] Investments in Federal Facilities: Asset Management Strategies for the 21st Century. 2004. National Research Council. P. 3.
[7] Ibid. p. 27.
[8] Ibid. pp. 6-7.
[9] Ibid. p. 7
[10] Ibid. p. 8.
[11] Ibid. p. 49.
[12] Ibid. p. 48.
[13] Ibid. p. 92.
[14] Ibid. p. 77.
[15] Ibid. pp. 77-78.
[16] Ibid. p. 9.
[17] Ibid. p. 76.
[18] Ibid. pp. 79-80,
[19] Ibid. p. 86.
[20] Ibid. p. 85.
[21] Ibid. p. 79.
[22] Ibid. pp. 10-11.
[23] Ibid. p. 97.
[24] Ibid. p. 97.
[25] Ibid. p. 98.
[26] Ibid. p. 98.
[27] Ibid. p. 99.
[28] Stewardship of Federal Facilities: A Proactive Strategy for the Nation's Public Assets. 1998. National Research Council. P. 7.
[29] Investments in Federal Facilities: Asset Management Strategies for the 21st Century. 2004. p. 100.

**STATEMENT OF**

**ROBERT A. PECK**

**COMMISSIONER**
**PUBLIC BUILDINGS SERVICE**
**U.S. GENERAL SERVICES ADMINISTRATION**

**BEFORE THE**

**COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE**
**SUBCOMMITTEE ON ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS, AND EMERGENCY MANAGEMENT**
**U.S. HOUSE OF REPRESENTATIVES**

**"CAPITAL ASSETS CRISIS: MAINTAINING FEDERAL REAL ESTATE WITH THE DWINDLING FEDERAL BUILDINGS FUND"**

**MARCH 24, 2010**

Good afternoon, Chairwoman Norton, Ranking Member Diaz-Balart, and members of this Subcommittee. My name is Robert A. Peck, and I am the Commissioner of the U.S. General Services Administration's (GSA's) Public Buildings Service (PBS). Thank you for inviting me to appear before you today to discuss maintaining our federal inventory through the Federal Buildings Fund (FBF).

PBS is developing new strategies and goals to strengthen the FBF. It is also an exciting time at PBS as we look to implement plans to increase revenue to the FBF and decrease our operating expenses. PBS will continue looking for ways to increase revenue through outleasing authorities, consolidating agency requirements in government owned space, disposing of unneeded buildings and backfilling existing underutilized buildings. We will work to improve matching revenues and expenses to ensure timely collection of rent. To reduce our operating expenses, PBS will improve the efficiencies of our buildings by promoting greening initiatives, as well as optimize the utilization of our inventory. PBS will also streamline business practices and processes to reduce overhead costs. With these changes, PBS will improve the viability of the FBF and increase the funds available for the reinvestment needed to meet our customer needs.

The American Recovery and Reinvestment Act of 2009 (ARRA) has provided significant investment in our Federal buildings inventory and we are working to transition our portfolio toward sustainable high performance green buildings.

Background of the Federal Buildings Fund:

The FBF, which was established through the Public Buildings Amendments of 1972[1], was designed to provide a stable source of funding for PBS operations and capital needs. Beginning in FY 1975, PBS began collecting rent from other agencies for the space they occupy. These rent revenues are deposited into the fund and then made available to cover the cost of PBS activities. The FBF has two main benefits. First, it provides a predictable source of revenue through agency rent payments that are appropriated annually as new obligational authority in the FBF. Second, the user charge system provides agencies with a financial incentive to reduce their overall cost of occupancy.

While initial intent of the FBF was to cover all of the operations and capital needs of the GSA, the FBF has received appropriations in order to cover necessary repair and alteration and new construction expenditures. In 1981, GAO reported that six years after the Fund's inception, the FBF was generating revenues for new construction less than Congress had appropriated annually to GSA before the Fund was created. GAO identified a number of contributing factors that lead to the need to appropriate funds including the high repair and alteration needs of GSA's older buildings, and a reduction in rental income due to administrative and

[1] Public Law 92-313

legislative actions. The same is still true today. GSA has received additional appropriations into the FBF in 8 of the last 10 years, beginning as early as 1979. The FY 11 President's Budget proposes an additional appropriation of $291M in funding for the FBF to assist GSA in meeting its R&A and New Construction needs.

From time to time, the Administration and Congress have provided funding for a significant number of building programs. For example:

- The Public Buildings Act of 1926 funded the construction of over 100 Federal buildings across the country, including Federal Triangle here in Washington DC.

- The Public Buildings Act of 1959 laid out a major construction program totaling over $350 million per year for a 5-year period.

- The Public Buildings Amendments of 1972 authorized a purchase contract program allowing GSA to construct over 60 buildings across the country.

- In fiscal year (FY) 1983, GSA received the authority for an opportunity purchase program and bought 13 buildings totaling 3.5 million square feet for $305 million.

American Recovery and Reinvestment Act:

The most recent example of appropriated funding for the FBF was the American Recovery and Reinvestment Act of 2009 (ARRA) which provided GSA with $5.5 billion for capital projects. Unlike previous building programs, the major focus of ARRA was promoting 'greening' initiatives and the sustainability of PBS' existing inventory, rather than providing new inventory to meet the changing requirements of Federal agencies. This infusion of capital has allowed GSA to make significant investment in our inventory of mission critical assets, many of which will see significant return on investment from the energy efficiency and other green investments made in the buildings.

Reinvestment Needs:

PBS' portfolio has an average age of 46 years. In fact more than 31 percent of the square footage in PBS' inventory was built before 1949 when GSA was created. As with any aging inventory, the repair needs need to be effectively managed. The anticipated needs over the next ten years, topped $7.3 billion in FY 2008, however that number has been significantly reduced through the completion of several major renovations, the infusion of Recovery Act projects currently underway and the implementation of a more accurate assessment tool with construction cost estimates reflecting lower costs in the current market. We

are currently working to determine the full impact of the Recovery Act on the aggregate ten year horizon of repair needs of the FBF and look forward to sharing that information with the Committee at a future date.

In recent years, GSA has primarily met new space needs through leasing. The leased inventory has grown steadily for the last 50 years and in FY 2008, PBS had more leased than government owned space for the first time in its history. While PBS receives rent for leased space, most of that revenue goes to pay the private sector landlord. Structurally, the FBF cannot support both the repair and alterations needs of an aging inventory and the new construction needs of customer agencies. As is mentioned above, direct appropriations have been necessary to enable the FBF to meet demands for new facilities while simultaneously investing the repair needs of the existing inventory.

Rent Revenues and Income:

PBS will continue looking for ways to increase revenue through outleasing authorities, consolidating agency requirements in government owned space, and backfilling existing underutilized buildings.

PBS continues to utilize its authorities to provide additional sources of income through outleasing space under the Historic Building Preservation Act and the Cooperative Use Act. Although beneficial, the revenue generated from these acts is minimal. In FY 2009, PBS used its authority under the National Historic Preservation Act to generate $4.5 million of revenue and $6.5 million of revenue under the Public Buildings Cooperative Use Act.

PBS also continues to maximize the utilization of its buildings, backfilling vacant space to generate additional revenue. Facilities that are no longer needed are disposed of. The disposal of unneeded buildings is an important tool for PBS allowing us to avoid the operating costs associated with the buildings and in when sold, realize proceeds to the Government. Further disposing of older buildings reduces the average age of the inventory and reduces repair and alterations costs. In fiscal year 2009, PBS:

- Reduced owned and leased vacant space to less than 4 percent, which is significantly below the 2009 private sector rate of 16 percent; and
- Disposed of 17 assets, generating close to $2 million in proceeds and avoiding $47.6 million in liabilities.

PBS is utilizing the retention of proceeds authority Congress granted GSA through Section 412 of the Omnibus Appropriations Act of 2005. Since receiving this authority, PBS has sold unneeded assets totaling $198 million[2], which has been allocated for capital reinvestment in the government owned portfolio.

[2] As of September 30, 2009

We will also work to be taking a look internal to our organization to determine what efficiencies we can gain. We will improve matching revenues and expenses to ensure timely collection of rent and look for operational efficiencies across the organization.

Minimizing Expenses:

PBS is examining all of its operating accounts to find ways of controlling costs and reducing expenses. We are aggressively implementing innovative green building technologies to increase building efficiencies, which will reduce operating costs. We will develop effective and streamlined practices, as well as cultivate emerging technologies to minimize energy and water consumption. PBS will reduce wasted energy, which will further reduce operating costs over the long-term. We will use renewable energy and co-generation to power offices with free, low- or no-carbon energy.

By developing these cutting-edge greening technologies, PBS will reduce the Federal government's carbon footprint, as well as lead the industry by creating new and innovative sustainability methods. These efforts will not only benefit our environment, but also improve PBS' operations, which will drive down costs and increase net income.

PBS is also committed to reducing overhead costs. We are evaluating current business processes for improvement and to streamline efficiencies. It is our fiscal responsibility to the American taxpayers to operate as efficiently and effectively as possible. PBS will excel at cost control by tightly managing our administrative and overhead costs.

Finally, PBS is working with its customer agencies to improve their operational efficiencies and space utilization. We are going to work with our customer agencies to create long-term, strategic customer portfolio plans and help shape customer requirements. Beginning this year, PBS will work with three major customer agencies to produce such plans by the end of FY 2011. PBS will develop innovative solutions with our customers to minimize expenses and maximize the performance of our buildings.

Conclusion:

Today, I have described the new strategies PBS is developing to strengthen the viability of the FBF. PBS is taking active strides to ensure we have the funds necessary to support our portfolio needs and meet our customer requirements. By implementing these strategies, PBS will increase revenue and income, as well as minimize expenses. Realizing these goals will strengthen the FBF and allow PBS to continue meeting the needs of our Federal customers and the American taxpayers.

Thank you for inviting me to appear before you today to discuss maintaining our federal inventory through the FBF. We look forward to working with you and members of this Subcommittee as we work to strengthen the resources available through the FBF.

A HEARING
BEFORE
THE U.S. HOUSE OF REPRESENTATIVES
Committee on Transportation and Infrastructure
Subcommittee on Economic Development, Public Buildings, and Emergency Management

"Capital Assets Crisis: Maintaining Federal Real Estate with the Dwindling Federal Buildings Fund"
March 24, 2010

Robert A. Peck, U.S. General Services Administration (GSA), Commissioner of the Public Buildings Service (PBS)

**1) Question:**

Has GSA been able to benchmark its overhead costs, with REITS or other real estate management entities?

**Answer:**

PBS has conducted a benchmark analysis to compare our indirect cost levels with those found in the real estate private sector. We learned that PBS and the private sector use two fundamentally different methods to measure indirect cost levels. Despite this difference, our analysis indicated that PBS's indirect costs are higher than those found in the private sector. Upon further analysis, we concluded that a majority of this difference occurs because PBS applies different cost coding practices than the private sector. We are currently reviewing these practices to determine if changes are warranted.

**2) Question:**

What percentage of GSA properties have higher operating costs than revenue generated? Does PBS have a plan to address these properties?

**Answer:**

At the end of FY 2009, 135 or 8.5 percent of our government-owned inventory generated negative net operating income (operating expenses exceeded revenue generated).

GSA strives to maintain a portfolio of assets that are located in strong markets, satisfy customers' long-term needs, and perform well financially. To meet this goal, we are continuously assessing our portfolio by disposing of underutilized assets, directing capital investment into our core assets, and monitoring the financial performance of

each asset. As part of our analysis in selecting a building for modernization, GSA also studies tenant backfill plans to ensure the property will maintain a strong return on investment after the project is completed. GSA will actively market vacant space and pursue disposal strategies for underutilized assets. As the steward of Federal buildings, GSA will continue to analyze our portfolio on a case-by-case basis to ensure we meet tenant needs and improve the viability of the Federal Buildings Fund.

**3) Question:**

Within 60 days, please submit to the Subcommittee facts sheets for 5 projects for which GSA believes use of 412 authority would be appropriate. Include in the fact sheets all information that would be included in a prospectus.

**Answer:**

Please see attached document.

**4) Question:**

Within 30 days, please report to the Subcommittee a plan that GSA will implement in order to assure that the Department of Agriculture (USDA) will meet its rent agreement under the previous delegation agreement.

**Answer:**

GSA and USDA have agreements in place that make USDA responsible for building operation, maintenance, and capital improvements at the Whitten and South buildings. As part of the consideration for these arrangements, USDA does not pay rent to GSA for either building. The agreements relieved GSA of responsibility for rehabilitating the building, which initially was estimated to be approximately $400 million.

We recognize that although the USDA is not paying us rent on these buildings, neither are we any longer responsible for the rehabilitation. We continue to support USDA by using our real estate expertise to assess the building's current condition and needed improvements for the planning of this modernization.

**5) Question:**

Within 30 days, please provide the Subcommittee with a list of all the below-market purchase options that GSA currently holds.

**Answer:**

GSA has determined that there are major leases containing purchase options that would be beneficial for GSA to exercise, while there are other leases with purchase options that are not favorable for the government in today's leasing market. The determination of favorable purchase options and the decision to request funds to exercise these purchase options requires a careful evaluation of the physical and financial condition of the assets, the long-term needs of the customer agencies, and market factors. GSA must assess the priorities of our entire portfolio and consider our new construction and repair and alterations project needs. The decision to pursue purchase options must be made in the context of these other priorities as well.

Increasing GSA's government-owned portfolio is a priority for GSA, either through new construction or acquisition. In FY 2010 and 2011, GSA has requested over $125 million for the acquisition of two leased facilities, Columbia Plaza in Washington, D.C. and the IRS Computer Annex in Martinsburg, WV. GSA also holds purchase options at fair market value for properties (such as FBI Field Offices) that are not enumerated in the list below. GSA currently holds the following leases containing purchase options with favorable purchase opportunities in today's market conditions.

| **Leases Containing Purchase Option with Favorable Purchase Opportunity** | | | | | |
|---|---|---|---|---|---|
| GSA Region | Lease Number | Building Name | Street Address | City | State |
| 3 | LWV40073 | IRS Computer Annex | 145 Murall Drive | Martinsburg | WV |
| 4 | LGA34033 | Sam Nunn Atlanta Federal Center | 100 Alabama Street | Atlanta | GA |
| 4 | FL1021ZZ | James L. King Federal Justice Building | 99 N.E. Fourth St. | Miami | FL |
| 10 | LWA05544 | Union Station | 1717 Pacific Avenue | Tacoma | WA |
| NCR | LDC10187 | Columbia Plaza, 2401 E Street, NW | 2401 E Street, NW | Washington | DC |
| NCR | LDC30168 | Union Center Plaza IV | 888 First Street, NE | Washington | DC |

**6) Question:**

Within 30 days, please provide the Subcommittee with a list of 412 asset sales since FY 2006.

**Answer:**

PBS is utilizing the retention of proceeds authority Congress granted GSA through Section 412 of the Omnibus Appropriations Act of 2005. Since receiving this authority, PBS has sold unneeded assets totaling $198 million, as of September 30, 2009.

Please see the enclosed spreadsheet with the full list of projects totaling $198 million, including the date that assets were sold.

It should be noted that not all receipts were booked as proceeds from Section 412 authority. Prior to the enactment of Section 412, special legislation directed receipts from Middle River and the Southeast Federal Center to be deposited directly into the FBF.

**7) Question:**

Within 30 days, please provide the Subcommittee with an analysis of the Federal Buildings Fund savings related the Department of Homeland Security's move to the St. Elizabeths Campus.

**Answer:**

GSA increases the Federal Buildings Fund through rents collected on our owned inventory. Rents collected from tenants occupying space leased from the private sector are paid to the lessor. Therefore, the Federal Buildings Fund will benefit by the construction of the St. Elizabeths Campus by increasing our capitalized assets and enabling GSA to consolidate DHS from leased locations into a federally owned facility. GSA will gain additional rent revenue, as estimated in the following chart.

Estimated Rents for St. Elizabeths (in $ millions)

| | FY2013 Phase 1 | FY2014 Phase 2 | FY2015 | FY2016 Phase 3 | FY2017 |
|---|---|---|---|---|---|
| Gross Rents | $32 | $77 | $120 | $140 | $180 |

The St. Elizabeths project is phased over a number of years. GSA projects stabilized gross rents in 2017 at approximately $180 million for the total project of approximately 4.1 million rentable square feet (RSF). These rents are based on a pro forma estimate. An appraisal will be ordered.

**QUESTIONS FOR THE RECORD**
**FEDERAL BUILDING FUND HEARING ON MARCH 24, 2010**
**HOUSE TRANSPORTATION AND INFRASTRUCTURE SUBCOMMITTEE**

**QUESTION #3**: Submit fact sheets for 5 projects in which it would be appropriate for GSA to utilize Section 412 authority. Include in the fact sheets all information typically provided in a prospectus.

## SECTION 412 AUTHORITY

Section 412 of Division H of the FY 2005 Consolidated Appropriations Act (Section 412) allows GSA to retain net proceeds from GSA's dispositions of its real and related personal property (or interests therein) and authorizes GSA to convey real property and related personal property through sale, lease, exchange, "or otherwise, including leaseback arrangements."

**RETENTION OF PROCEEDS:** Since receiving Section 412 authority in 2005, GSA has retained more than $120 million in net proceeds in the Federal Buildings Fund as of September 30, 2009.[1]

**Project:** An example of a disposition where the principal purpose is to retain proceeds is the sale of FOB Bethesda, an unutilized and vacant property reported excess by GSA. The property, located in Bethesda, Maryland, is a 13,860 square foot parcel improved with a 127,110 gross square foot office building and below-grade parking garage with 55 spaces. Public online auction for the property opened April 30, 2010 and ended on July 21, 2010, with a high bid of $12.5 million.

**OUTLEASING:** Section 412 is an alternative to other outleasing authorities, such as Section 111 of the National Historic Preservation Act of 1966, as amended, 16 U.S.C. § 470h-3, and the Public Buildings Cooperative Use Act, now codified at 40 U.S.C. § 581(h). These authorities are limited in scope, but support the adaptive use of and public access to GSA's public buildings.

**Project:** GSA is currently evaluating its inventory for outlease applications using Section 412. GSA has established guidelines and procedures for the appropriate use of Section 412 and for the proper accounting of the proceeds from these transactions. GSA is promoting the judicious use of the Section 412 outleasing authority where there is a long-term need for the asset and GSA's other outleasing authorities are not available.

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[1] The $120 million includes only proceeds retained under Section 412, and does not report proceeds retained under other authorities.

**LEASEBACK ARRANGEMENTS:** Leaseback arrangements may occur in various forms, but generally involve GSA selling or leasing Government-owned real property to a private-sector developer, who, in turn, makes improvements to the property and leases it back to GSA for occupancy and use by federal tenants. At the conclusion of the ground lease term, the improvements would revert to federal ownership. To date, GSA has not used the leaseback authority provided in Section 412. Any new space leases entered into pursuant to such a leaseback arrangement would be subject to budget scorekeeping rules, and space leases above the prospectus threshold would require separate authorization from Congress. All groundlease-leaseback transactions would adhere to the OMB Circular A-11 scoring criteria.

**Project: Denver Federal Center, Lakewood, Colorado**

The Denver Federal Center (DFC) is a 610-acre campus located in a developed suburb of Denver that houses approximately 6,000 Federal employees representing 62 agencies in 4.1 million square feet of improvements. Section 412 options under consideration include:

1. Sale of unutilized parcels and retention of proceeds. The campus is located in an area where there is limited land for new private development. Recent disposals of parcels from the campus for hospital and mass transit and transit-oriented development use created demand for additional private sector development. GSA could sell unutilized parcels for private development and retain the net proceeds for additional capital needs of the Federal Buildings Fund.

2. Outlease and leaseback of underutilized parcels. Federal tenants have a continued housing need in the area. In addition to the federally occupied space at the DFC, GSA leases approximately 2.7 million square feet of space at other sites in the Denver metropolitan area. GSA could outlease unutilized or underutilized parcels adjacent to public buildings on the DFC campus for private development. The resulting development could provide additional office space that would be available to compete for the right to accommodate the requirements of federal tenants not currently located at the DFC.

**Project: Federal Center South, Seattle, Washington**

Federal Center South (FCS) is an 800,000 square foot combined office/warehouse facility on a 45-acre parcel located in an industrial area south of the city of Seattle. The FCS property is divided by a major arterial road, with approximately 5 acres developed for overflow parking and available for redevelopment. Agencies housed at FCS have high security needs.

GSA is using funds appropriated under the American Recovery and Reinvestment Act of 2009 (ARRA) to modernize some aspects of the FCS complex. The Section 412 authority could be used in a separate outlease/leaseback arrangement to facilitate development of the underutilized 5-acre parcel to accommodate the requirements of federal tenants in energy-efficient, secured space.

**EXCHANGES AND OTHER CONVEYANCES:** The Section 412 authority would permit GSA to exchange federally owned property for privately owned property of equal or lesser value and, in the case of an exchange for property of lesser value, retain any additional cash consideration to compensate the Government for the full value of the property conveyed. GSA continues to explore opportunities where such exchange may be in the best interests of the Federal Government.

**Project: Chet Holifield Federal Building, Laguna Niguel, California**

The Holifield Building is a one million square foot facility on a 78-acre site in Laguna Niguel, a growing suburban market between Los Angeles and San Diego. Approximately 75% of the building is occupied, and the building has not been fully renovated since it was originally constructed in 1971. The tenants in the building have continuing housing needs in the Laguna Niguel area. Section 412 options under consideration to meet these continuing housing needs include both groundlease-leaseback arrangements and exchanges:

1. Outlease and leaseback to a private developer. An outlease and leaseback arrangement could provide for renovation of the existing facility or construction of a new facility on the federally owned vacant land to house federal tenants on the existing site. Depending on the agencies' space and mission requirements, the developer also would be able to enter into separate lease agreements with private sector tenants to use the remainder of the site.

2. Exchange for new construction at a new location. The Section 412 authority also would allow GSA to exchange its existing property for a newly constructed building at a different location within the commuting area. The Holifield Building would then be available for redevelopment for private sector use.

GSA received ARRA funds for limited scope projects to improve the Laguna Niguel facility. We are backfilling 75,000 rentable square feet in the main building with a new federal tenant. Current economic and market conditions limit the desirability of this building for private investment at this time.

Given the unfavorable current market conditions and in light of our recent reinvestment in the property, we are deferring further consideration of our Section 412 options at this time until the commercial real estate market improves in the area, which we expect to be three to five years from now. We will continue to monitor and evaluate market conditions so that we will be in a position to respond accordingly.

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**Testimony of**

**Kevin M. Stoklosa**

**Assistant Technical Director**

**Financial Accounting Standards Board**

**Before the**

**Subcommittee on Economic Development, Public Buildings & Emergency Management**

**Committee on Transportation and Infrastructure**

**March 24, 2010**

**Transparency in Accounting:**
**Proposed Changes to Accounting for Leases**

**Introduction**

Madame Chairman, Mr. Dias-Balart and members of the Subcommittee, my name is Kevin Stoklosa, Assistant Technical Director, of the Financial Accounting Standards Board ("FASB" or "Board"). I have prepared remarks that I would like to present to you today and I would respectfully request that the full text of my testimony be entered into the public record of today's hearing.

The Subcommittee has identified the challenge of maintaining a dwindling Federal Building Fund. As the Subcommittee considers ways in which to address these challenges, I would like to focus my remarks on the FASB's Statement No 13, Accounting for Leases, and how the expected revisions to this standard could impact the Federal Building Fund.

The FASB

The FASB is an independent private-sector organization. Our independence from enterprises, auditors, and other constituents is fundamental to achieving our mission—to establish and improve general-purpose standards of financial accounting and reporting for both public and private enterprises. Those standards are essential to the efficient functioning of the U.S. economy because investors, creditors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information to make rational resource allocation decisions.

The FASB's independence, the importance of which was reaffirmed by the Sarbanes-Oxley Act of 2002 ("Act"),[1] is a critical aspect of the standard-setting process and fundamental to our mission, because our work is technical in nature and designed to provide preparers with the guidance necessary to report information about their economic activities. The guidance creates the yardstick to measure and report on the underlying economic transactions of business enterprises. Like investors and creditors, Congress and other policy makers need an independent FASB to maintain the integrity of a properly designed yardstick in order to obtain the financial information necessary to appropriately assess and implement the public policies they favor.

[1]Sarbanes-Oxley Act of 2002, Public Law Number 107-204, Sections 108-109 (July 30, 2002).

While bending the yardstick to favor a particular outcome may seem attractive to some in the short run, in the long run an inaccurate yardstick (or a biased accounting standard) is harmful to investors, creditors, and the U.S. economy.

The FASB's authority with respect to public enterprises comes from the U.S. Securities and Exchange Commission ("SEC" or "Commission"). The SEC has the statutory authority to establish financial accounting and reporting standards for publicly held enterprises. For 35 years, the SEC has looked to the FASB for leadership in establishing and improving those standards. The SEC issued a Policy Statement in 2003 reaffirming this longstanding relationship.[2]

The Policy Statement, consistent with the language and intent of the Act,[3] also reemphasizes the importance of the FASB's independence described earlier. It states:

> By virtue of today's Commission determination, the FASB will continue its role as the preeminent accounting standard setter in the private sector. In performing this role, the FASB must use independent judgment in setting standards and should not be constrained in its exploration and discussion of issues. This is necessary to ensure that the standards developed are free from bias and have the maximum credibility in the business and investing communities.[4]

The SEC, together with the private-sector Financial Accounting Foundation ("FAF"), is responsible for maintaining active oversight of the FASB's activities.

The FASB has no power to enforce its standards. Responsibility for ensuring that financial reports comply with accounting standards rests with the officers and directors of the reporting enterprise, with the auditors of the financial statements, and for public enterprises, the Public Company Accounting Oversight Board ("PCAOB"), and ultimately the SEC.

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[2]Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, Exchange Act Release Nos. 33-8221; 34-47743; IC-26028; FR-70 (April 25, 2003).
[3]Sections 108-109; the legislative history of the Act is clear that the provisions of the Act relating to the FASB were intended to "strengthen the independence of the FASB . . . from . . . companies whose financial statements must conform to FASB's rules." Senate Report 107-205, 107th Congress, 2d Session (July 3, 2002), page 13.
[4]Page 5 of 8.

Accounting Standard Setting Process

Because the actions of the FASB affect so many organizations, its decision-making process must be fair, open and as objective as possible. The FASB carefully considers the views of all interested parties, including users, auditors, and preparers of financial information. Our Rules of Procedure require an extensive due process. That process involves public meetings, public roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and exposure of our proposed standards to external scrutiny and public comment. The FASB members and staff also regularly meet informally with interested constituents to obtain their input and better our understanding of their views.

The Board makes final decisions only after carefully considering and analyzing the input of all parties. While our process is similar to the Administrative Procedure Act process used for federal agency rule making, it provides far greater opportunities for interaction with the Board by all interested parties. It is also focused on making technical, rather than policy or legal, judgments. In making those judgments, the FASB's mission and Rules of Procedure require that the Board balance the often-conflicting perspectives of our various constituents and make independent, objective decisions guided by the fundamental concepts and key qualitative characteristics of financial reporting set forth in our conceptual framework.

In setting our standards, the FASB gives priority to the needs of investors because, in our view, the primary reason for developing high-quality accounting and external financial reporting standards is to enhance the efficiency of the capital markets by giving potential investors the information to confidently make lending and investing decisions. We also give careful consideration to the costs and benefits to companies that prepare the accounting information as well as the costs imposed on auditors, regulators, and the rest of society. In our view, these costs are important but secondary criteria for setting external financial reporting policy.

As significant reporting issues arise, the Board endeavors to understand those issues and to identify the reasons why they arose. Once the Board understands the underlying issues, it is able to assess whether there are potential accounting standard-setting matters that may need to be

addressed.

Lease Accounting

The primary impetus for the FASB's current joint leasing project with the International Accounting standards Board (IASB) is the SEC's report from June, 2005 entitled "Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, www.sec.gov/news/studies/soxoffbalancerpt.pdf.

This SEC report highlights several ways to improve transparency in financial reporting was submitted to the President of the United States, the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.

In addition, the SEC report included several standard-setting recommendations that would help further these initiatives including reconsideration of the accounting guidance for leases, noting that current accounting for leases takes an "all or nothing" approach to recognizing leases on the balance sheet.

As a result of the 2005 SEC report, the FASB and IASB are tackling this leasing accounting challenge and issued a "preliminary view" document in March 2009 presenting our early ideas about ways to improve FASB statement number 13 and also soliciting comment from all affected constituents. An executive summary of this document is included in my testimony and the entire document is available at http://www.fasb.org/draft/DP_Leases.pdf

Today, lease accounting standards require lessees to classify their lease contracts as either finance (capital) leases or operating leases. Finance leases are defined as those leases that transfer to the lessee substantially all the risks and rewards incidental to ownership of the leased asset. All other leases are deemed operating leases. Detailed rules and "bright-line" tests are used to differentiate between when a finance lease would be used versus an operating lease.

Leases classified as finance leases are treated as similar to a purchase of the underlying asset such as purchasing office furniture or a copy machine. Consequently, the lessee

recognizes in its statement of financial position the leased item and an obligation to pay rentals. The lessee depreciates the leased item and apportions lease payments between a finance charge and a reduction of the outstanding liability. The lessor treats the leased item as a sale and removes it from its balance sheet.

For leases classified as operating leases, no similar assets or liabilities are recognized by the lessee and the lessor does not remove the asset from its balance sheet. Other than rental express being reported in the income statement each reporting period, operating lease accounting lacks transparency around the assets and liabilities inherent in the lease.

Given this lack of transparency, the existing lease accounting model has been criticized by users of financial statements for failing to meet their needs. Preparers and auditors also have criticized the existing lease accounting model for its complexity. In particular, the detailed rules and "bright-line" tests for differentiating finance leases versus operating leases have proved difficult to implement.

After much analysis, the FASB and the IASB are developing a new approach to accounting for leases that would require all leases to be accounted for similarly.
Rather than treating some lease contracts like a purchase of the leased item (finance leases) and others as executory contracts (operating leases), the new proposed approach would treat all lease contracts as the acquisition of a right-to-use the leased item for the lease term.

The lessee would recognize the following:

- an asset representing its right to use the leased item for the lease term (the right-of-use asset); and
- a liability for its obligation to pay rentals.

For lessors, the Boards decided to adopt a performance obligation approach. Under that approach, a lessor would recognize:

- an asset representing its right to receive rental payments (a lease receivable)
- A liability representing its performance obligation under the lease (its obligation to permit the lessee to use one of its assets—i.e., the leased item)\

The lessor would recognize revenue as the performance obligation is satisfied over the lease term.

This new approach to lease accounting would also be applied to sale-leaseback type transactions whereby the owner of an asset such as a building sells the building to a third party and leases it back for an agreed upon period of time. In those situations, the seller would derecognize or remove the building from its balance sheet, record any profit associated with the sale, and then recognize an asset representing its right to use the leased building for the lease term and a liability for its obligation to pay rentals.

The FASB and IASB have noted that this new approach to lease accounting would address many of the criticisms of the existing standards.

## Conclusion

The FASB recognizes the challenges facing this Subcommittee as it works to maintain the Federal Building Fund. The fundamental issue that relates to the transparency of information available to investors to better enable them to understand and true financial health of an organization is the reason why the Board has undertaken this project to improve lease account.

Madame Chairman that concludes my prepared remarks. I would like to thank you and the Subcommittee for the opportunity to testify this afternoon. I would be happy to answer any questions.

# EXECUTIVE SUMMARY OF

# FASB PRELIMINARY VIEWS DOCUMENT

# LEASING

# Invitation to comment and summary

## Introduction

IN1 This discussion paper presents the preliminary views of the US Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) on significant components of an accounting model for lessees. It also includes a discussion of some of the issues that will need to be addressed in any new standard on lessor accounting.

IN2 It is designed to gather information to assist the boards in developing a new standard on lease accounting.

## Summary of the discussion paper

IN3 The following paragraphs summarise the content of this discussion paper and the preliminary views reached by the boards.

IN4 Chapter 1 explains why the boards decided to add a project on lease accounting to their agendas and describes the history of the lease accounting project.

IN5 The boards' proposed approach to scope is discussed in chapter 2. The boards tentatively decided that the scope of the proposed new standard should be based on the scope of their existing standards on lease accounting.

IN6 Chapter 3 describes the overall approach to lessee accounting proposed by the boards. The boards tentatively decided that in a simple lease the lessee obtains a right to use the leased item that meets the definition of an asset and that the related obligation to pay rentals meets the definition of a liability. Consequently, the boards tentatively decided to adopt a new accounting model for leases that results in the lessee recognising:

(a) an asset representing its right to use the leased item for the lease term (the 'right-of-use' asset)
(b) a liability for its obligation to pay rentals.

IN7 The boards also tentatively decided not to recognise the components of a lease contract separately (such as options to renew, purchase options, contingent rental arrangements or residual value guarantees). Instead, the boards tentatively decided that the lessee should recognise:

(a) a single right-of-use asset that includes rights acquired under options; and
(b) a single obligation to pay rentals that includes obligations arising under contingent rental arrangements and residual value guarantees.

IN8 Chapters 4 and 5 describe the boards' preliminary views on measurement of the lessee's right-of-use asset and its obligation to pay rentals arising in a simple lease.

IN9 The boards tentatively decided that the lessee's obligation to pay rentals should be measured initially at the present value of the lease payments discounted using the lessee's incremental borrowing rate. Subsequent measurement would be on an amortised cost basis.

IN10 The boards also tentatively decided that the lessee's right-of-use asset should be measured initially at cost. Cost would be equal to the present value of the lease payments discounted using the lessee's incremental borrowing rate. The boards tentatively decided that a lessee should amortise the right-of-use asset over the shorter of the lease term and the economic life of the leased item.

IN11 Chapter 6 discusses how to account for leases that include options that grant the lessee the right to extend the lease, terminate the lease or purchase the leased item.

IN12 The boards tentatively decided that the assets and liabilities recognised by the lessee should be based on the most likely lease term. For example, in a 10-year lease that includes an option to extend for an additional five years, the lessee must decide whether the lease term is 10 years or 15 years. Measurement of the obligation to pay rentals and the right-of-use asset would be consistent with the most likely lease term.

IN13 The boards tentatively decided to require the lease term to be reassessed at each reporting date. Changes in the obligation to pay rentals arising from a reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.

IN14 The boards tentatively decided that the accounting requirements for purchase options should be the same as for options to extend or terminate the lease. Thus:

(a) in recognising the obligation to pay rentals, the lessee must decide whether it is likely that an option to purchase will be exercised. If the lessee decides that the option to purchase is likely to be exercised, the obligation to pay rentals will include the exercise price of the option. This assessment will be based on the lessee's determination of the most likely outcome.
(b) whether a purchase option will be exercised will be reassessed at each reporting date. Changes in the obligation to pay rentals arising from a reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.

IN15 Chapter 7 describes the boards' preliminary views on the recognition and measurement of leases that include contingent rental arrangements and residual value guarantees. The boards tentatively decided that the lessee's obligation to pay rentals should reflect the lessee's obligation to make payments under contingent rental arrangements.

IN16 The IASB tentatively decided that the measurement of the lessee's obligation to pay rentals should include a probability-weighted estimate of contingent rentals payable. The obligation to pay rentals should be remeasured at each reporting date

to reflect changes in estimated contingent rental payments. Changes in the obligation to pay rentals arising from reassessment should be recognised as an adjustment to the carrying amount of the right-of-use asset.

IN17 The FASB tentatively decided that a lessee should measure contingent rentals on the basis of the most likely rental payments. A lessee would determine the most likely amount by considering the range of possible outcomes. However, this measure would not necessarily equal the probability-weighted sum of the possible outcomes. The FASB also tentatively decided that if lease rentals are contingent on changes in an index or rate, such as the consumer price index or the prime interest rate, the lessee would initially measure the obligation to pay rentals using the index or rate existing at the inception of the lease. Changes in amounts payable arising from changes in the indices would be recognised in profit or loss. For other forms of contingent rentals the obligation to pay rentals should also be remeasured at each reporting date to reflect changes in estimated contingent rental payments. Changes in the obligation to pay rentals arising from these reassessments should also be recognised in profit or loss.

IN18 The boards tentatively decided not to recognise residual value guarantees separately from the obligation to pay rentals. The boards also tentatively decided that leases that include residual value guarantees should be measured on the same basis as leases that include contingent rental arrangements.

IN19 Chapter 8 describes the boards' preliminary views on how the assets, liabilities, expenses and cash flows arising from lease contracts should be presented in the financial statements. Those preliminary views are based on existing presentation requirements. The effect that proposed changes to financial statement presentation could have on the boards' preliminary views is discussed at the end of chapter 8.

IN20 Chapter 9 provides a brief overview of a number of lessee accounting issues the boards have not yet discussed in sufficient detail to reach a preliminary view. The boards will need to resolve those issues before publishing an exposure draft.

IN21 Chapter 10 describes some of the issues that will need to be addressed in any new lessor accounting standard.

## The leases working group

IN22 In 2006 the boards set up a joint lease accounting working group that includes users, preparers and auditors of both lessees' and lessors' financial statements. The group met in February 2007 and provided valuable comments on the early proposals for lease accounting. Since then, members of the working group have continued to contribute to the project informally and at a meeting in October 2008 commented on an early draft of this discussion paper.

## Next steps

IN23 In April 2008 the boards announced their intention to produce a revised standard for lessees by mid-2011. Consequently, after publishing this discussion paper, the boards intend to work on an exposure draft of a proposed new standard for lessees. The boards will decide on the timing of any new standard for lessors after publishing this discussion paper. In developing an exposure draft, the boards will review the responses to this paper and decide whether to modify or confirm their preliminary views. The boards will pay particular attention to the need for users of financial statements to receive relevant and reliable information at a reasonable cost to preparers.

IN24 As discussed in subsequent chapters, the boards reached different preliminary views in some areas. The boards will resolve those differences in the light of comments received on this discussion paper.

IN25 The boards expect the work on lease accounting to proceed in parallel with other projects that may provide useful inputs to this project (including those on the conceptual framework, derecognition, revenue recognition, financial statement presentation and financial instruments) but they will not necessarily wait for the outcome of those projects. In addition, the work on lease accounting may provide useful input to other projects.

## Invitation to comment

IN26 The boards invite comments on all matters in this paper. Chapters 2 - 10 include questions for respondents. Appendix A lists all the questions. Comments are most helpful if they:

(a) respond to the questions as stated
(b) indicate the specific paragraph or paragraphs to which the comments relate
(c) contain a clear rationale
(d) describe any alternative the boards should consider.

IN27 Respondents need not comment on all the questions and are encouraged to comment on any additional issues.

IN28 The boards will consider all comments that are received in writing by July 17, 2009.