United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Technology and Procurement Policy, Committee on Government Reform, House of Representatives

For Release on Delivery
Expected at
2:00 p.m. EDT
Monday
October 1, 2001

PUBLIC-PRIVATE PARTNERSHIPS

Factors to Consider When Deliberating Governmental Use as a Real Property Management Tool

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GAO-02-46T

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our report entitled *Public-Private Partnerships: Pilot Program Needed to Demonstrate the Actual Benefits to Using Partnerships* (GAO-01-906, July 25, 2001), which identifies the potential benefits to the federal government of entering into public-private partnerships on real property. We have reported that the General Services Administration (GSA) has a multibillion dollar backlog of deferred maintenance in federal buildings, and that public-private partnership authority could be an important management tool to address problems in deteriorating federal buildings. However, further study of how the partnerships would actually work and of their benefits compared with other options, such as appropriations, is needed. Numerous buildings in GSA's inventory either have or are at risk of having a negative cash flow because of their deteriorating condition. In our report, we recommended that the Administrator of GSA use all available strategies to address the problems of such buildings in GSA's inventory. We also recommended that the Administrator of GSA seek statutory authority to establish a pilot program that would demonstrate the actual benefits that may be achieved from public-private partnerships that achieve the best economic value for the government. GSA's Commissioner for the Public Buildings Service agreed with the findings and recommendations in our report.

In my testimony, I will discuss four issues from our report that you asked us to focus on for this hearing:

- The structure of public-private partnerships;
- factors that indicate a property may be a potential candidate for a public-private partnership;
- benefits of public-private partnerships to the federal government; and
- factors a private-sector entity considers when determining the viability of a public-private partnership and its benefits to the private-sector entity.

In addition, as you requested, I will briefly discuss the authorities available to the Department of Veterans Affairs (VA) and the Department of Defense (DOD) that allow them to enter into ventures with the private sector.

In summary, the basic structure of a public-private partnership would entail the private sector providing cash and financing ability to renovate or redevelop real property contributed by the federal government and each partner sharing in the net cash flow resulting from the property. Location in a strong office real estate market and the demand for federal and non-federal office space are two key factors when considering properties for

partnership opportunities. Potential benefits to the federal government of public-private partnerships include the attainment of efficient and repaired federal space and the conversion of properties that are currently a net cost into revenue producers. Public-private partnerships are essentially financial business deals for the private sector and it would consider the financial benefits of such an arrangement. Unlike GSA, VA, and DOD currently have the authority to enter into joint ventures with the private sector.

To identify the potential benefits to the federal government of entering into public-private partnerships on real property, we contracted with Ernst & Young LLP, who, together with a subcontractor, Signet Partners, developed and analyzed hypothetical partnership scenarios for seven selected GSA buildings. We also contracted with AEW Capital Management, L.P. (AEW) to update a study it had previously done for GSA on the public-private partnership financial viability for three properties in Washington, D.C. For a complete listing of the 10 properties included in our study, see attachment I. Additional information about our methodology, including how the hypothetical partnership scenarios were structured and how the properties were selected, is included in attachment II. We obtained information on the authorities available to VA and DOD by talking with officials from these agencies and by reviewing applicable legislation.

Background

We have suggested that the Congress consider providing the Administrator of GSA with the authority to experiment with funding alternatives, including public-private partnerships, when they reflect the best economic value available for the federal government. Congress has enacted legislation that provides certain other agencies with a statutory basis to enter into joint ventures with the private-sector. This additional property management tool has been provided to VA and DOD. Furthermore, in an effort to provide more agencies with a broader range of property management tools, the Federal Asset Management Improvement Act (H.R. 2710) was recently reintroduced.

Structure of Public-Private Partnerships

The term public-private partnership can be used to describe many different types of partnership arrangements. When we refer to public-private partnerships, we are referring to partnerships in which the federal government contributes real property and a private entity contributes financial capital and borrowing ability to redevelop or renovate the real property. Regarding the structure of the hypothetical partnerships

developed for our study, the federal government and the private sector entity negotiate to agree on how the specifics of the partnership will work, including how the cash flow will be shared to form the partnership. The private partners will generally require a preferred return to compensate it for the risks it is taking in the partnership. This preferred return is generally a percentage of the cash flow; for our study, the contractors used 11 percent for the Washington, D.C. properties and 9 percent for the other properties. The net cash flow is then divided between the private partner and the federal government at an agreed-upon percentage. Attachment III shows graphically how the hypothetical partnerships in our study were structured.

In structuring partnerships for individual properties, it must be remembered that each property is unique and will thus have unique issues that will need to be negotiated and addressed as the partnership is formed. Great care will need to be taken in structuring partnerships to protect the interests of both the federal government and the private sector. In conducting this study, the contractors assumed that certain conditions would govern a public-private partnership.[1] For example, the property must be available for use, in whole or in part, by federal executive agencies, and agreements must not guarantee occupancy by the United States. In addition, the government would not be liable for any actions, debts, or liabilities of any person under an agreement, and the leasehold interests of the United States would be senior to any lender of the nongovernmental partner.

Factors That Indicated Potential Properties for Public-Private Partnerships

There are various factors that indicate whether a property is a potential candidate for a public-private partnership. There must be not only a federal need for space, but also a private-sector demand for space, since the government is not guaranteeing that it will occupy the property. The stronger the market for rental space, both federal and nonfederal, the more likely that the space will be rented and thus producing income. The property must have the ability to provide a sufficient financial return to attract and utilize private-sector resources and expertise. A property in a strong rental market and at a good location is more likely to attract private-sector interest than a property without these characteristics. Another factor is the existence of an unutilized or underutilized asset on

[1] These conditions are based on legislation that was introduced during the 106th Congress, H.R. 3285.

the property, which could be used to increase the value of the property. Several of the properties we studied had vacant land. The existence of excess land on the property that could be used to increase the amount of office space by expanding or building a new building, could increase the opportunity for an income-generating partnership. The property in Seattle, WA, has a deepwater port that the government is not using to its potential but that could be very valuable to another user.

Any partnership would have to conform with budgetary score-keeping rules. Federal budget scoring is the process of estimating the budgetary effects of pending and enacted legislation and comparing them to limits set in the budget resolution or legislation. Scorekeeping tracks data such as budget authority, receipts, outlays, and the surplus or deficit. Office of Management and Budget (OMB) staff indicated that where there is a long-term need for the property by the federal government, it is doubtful that a public-private partnership would be more economical than directly appropriating funds for renovation. In addition, depending on how OMB scores these transactions, some of the scenarios could trigger capital lease-scoring requirements due to the implicit long-term federal need for the space.

Multiple Potential Benefits to the Federal Government Identified

Our study designed a conceptual framework for public-private partnerships in order to identify potential benefits of these partnerships. Our contractors developed and analyzed hypothetical public-private partnerships for 10 specific GSA properties. Multiple potential benefits to the federal government were identified. These potential benefits include the

- utilization of the untapped value of real property,
- conversion of buildings that are currently a net cost to GSA into net revenue producers,
- attainment of efficient and repaired federal space,
- reduction of costs incurred in functionally inefficient buildings,
- protection of public interests in historic properties, and
- creation of financial returns for the government.

Our study did not identify or address all the issues of partnerships that will need to be considered by the decisionmakers and policymakers as partnerships are developed. Before any partnerships are developed, in-depth feasibility studies would have to be done to evaluate partnership opportunities and other options, such as appropriations, to determine which could provide the best economic value for the government. When

deciding whether to enter into a partnership, the government will need to weigh the expected financial return and other potential benefits against the expected costs, including potential tax consequences, associated with the partnership. Any cost associated with vacating buildings during renovation work would also have to be considered in any alternative evaluated. In addition, any actual partnerships involving the properties in our study may be very different from the scenarios developed by our contractors.

Considerations of and Benefits to the Private-Sector Entity

For a public-private partnership to be a viable option, there must be interest from the private sector in partnering with the government on a selected property. A private-sector partner would generally enter a partnership as a financial business decision. While the private-sector entity would consider numerous factors to determine the viability of a public-private partnership, the financial return from the partnership is the critical factor in the decision on whether to partner with the federal government. According to our contractors, about a 15-percent internal rate of return (IRR)[2] would likely elicit strong interest from the private sector in a partnership. However, this is only one factor, and the circumstances and conditions of each partnership are unique and would have to be evaluated on a case-by-case basis by both the private sector and the federal government. For example, a somewhat lower IRR could be attractive if other conditions, such as the risk level, are favorable. In addition, when our contractors discussed possible partnership scenarios with local developers, the developers said that, to participate, they would want at least a 50-year master ground lease.

A public-private partnership would generally be a financial undertaking for the private-sector entity, and the main benefit to it would be financial. With regard to some properties, the private sector may believe it is a benefit to be associated with a particular project if a developer believes that a project is prestigious and might open future opportunities.

According to our contractors, the analysis of the hypothetical partnerships for many of the properties in our study showed a sufficient potential financial return to attract private-sector interest in a partnership arrangement. Our contractors determined that 8 of the 10 GSA properties

[2] The IRR measures the return, expressed as an interest rate, that an investor would earn on an investment.

in our study were strong to moderate candidates for public-private partnerships. This determination was based on the (1) estimated IRR for the private- sector partner in year 10 of the project, which ranged from 13.7 to 17.7 percent; (2) level of federal demand for the space; and (3) level of nonfederal demand for space. The level of demand for space, both federal and nonfederal, affects the level of risk that the space will be vacant and thus non-income-producing. The stronger the local market is for rental space, the more likely the space will be rented and thus produce income for the partnership. The properties that were strong candidates for partnerships were located in areas with a strong federal and nonfederal demand for space, and many had untapped value that the partnership could utilize, such as excess land on which a new or expanded building could be built.

Authorities Available to VA and DOD

Leasing authority is available to VA and DOD.[3] Under VA's enhanced use leasing (EUL) authority, an EUL must enhance the use of the property and provide some space for an activity that contributes to VA's mission or otherwise improves services to veterans. VA receives fair consideration, monetary or in-kind, as determined by the Secretary and the lease term is not to exceed 75 years. For DOD, terms must promote national defense or be in the public interest, and the lease term may not exceed 5 years without the Service Secretary's approval. The lease proceeds may be used to fund facility maintenance and repair or environmental restoration at the military installation where the property is located and elsewhere. According to VA and DOD, their ventures yield both financial and nonfinancial benefits. Financial benefits include receiving below market rental rates and the receipt of cash revenue in some cases. Nonfinancial benefits include maximizing the use of capital assets as well as in-kind benefits such as the use of a child care center at reduced rates. In 1999, we reported on two projects under the VA's EUL authority.[4] In Texas, a private developer constructed a VA regional office building on VA's medical campus. VA then leased land to the developer on the medical campus and the developer constructed buildings on the land and rented space in them to commercial businesses. In Indiana, the state leased underutilized land and facilities from VA to use as a psychiatric care

[3] (38 U.S.C. § 8161-8169) and (10 U.S.C. § 2667)

[4] *Public-Private Partnerships: Key Elements of Federal Building and Facility Partnerships* (GAO/GGD-99-23, Feb. 3, 1999).

facility. The leasing revenue that VA receives from both sites is to be used to fund veterans programs.

Aside from the work we did in connection with our 1999 report, it is important to note that we did not explore these authorities in depth, nor did we examine the budget scoring implications for projects undertaken based on these authorities. Currently, we are examining DOD's implementation of its authority to lease non-excess property and how the military services are using this and other special legislative authorities to reduce base operating support costs. We expect this work to be completed early next year.

This concludes my prepared statement. I would be happy to respond to any questions you may have.

Contacts and Acknowledgments

For information about this testimony, please contact Bernard Ungar, Director, Physical Infrastructure Issues, on (202) 512-8387. Individuals making key contributions to this testimony included Ron King, Maria Edelstein, and Lisa Wright-Solomon.

Attachment I: GSA Properties Analyzed

Property	Tenants	Building size (square feet)	Current occupancy rate (percentage)	Funds from operations, fiscal year 2000	Private partner IRR[a]	Notes
Seattle, WA	Army Corps of Engineers, FBI motor pool, out-lease warehouse space	607,543 rentable (mixed use) 200,000 office	Office: 8% Warehouse: 80% Motor pool: 100%	$3,293,485	17.7%	Army Corps of Engineers believes that it must relocate to a facility that meets seismic standards
Washington, D.C. Federal Office Building 9	Office of Personnel Management (OPM)	768,530 gross 673,924 rentable	98%	$9,922,041	17.3%	Delegated building
Portland, OR	Immigration and Naturalization Service (INS)	137,281 gross 122,505 rentable	50%	$(207,980)	15.7%	May be hard to retain INS at end of lease in fiscal year 2002 if building needs are not addressed
Washington, D.C. GSA HQ	GSA headquarters	710,431 gross 623,233 rentable	100%	$4,456,891	15.3%	
Columbia, SC	Veterans Affairs (VA)	83,640 gross 802,249 rentable	100%	$332,684	14.5%	
Andover, MA	Internal Revenue Service (IRS)	400,502 gross 393,520 rentable	100%	$2,016,191	14.4%	Delegated building—IRS pays its operating costs
Washington, D.C. Federal Office Building 8	Food and Drug Administration (FDA)	522,491 gross 479,840 rentable	100%	$12,362,825	13.7%	FDA to vacate building and return it to GSA in 2002 clear of any environmental hazards
Charleston, SC	Unoccupied	99,695 BOMA	0	$(1,003,372)	13.7%	Building vacant since 1999 due to damage from Hurricane Floyd
Jacksonville, FL	U.S. District Courts U.S. Postal Service	290,855 gross 278,870 rentable	94%	$1,517,038	12.4%	Courts will move to new courthouse in 2002
Minneapolis, MN	Military Enlistment Processing Service (MEPS)	154,049 gross 143,197 rentable	10%	$599,365	10.3%	MEPS plans to vacate building June 2001

[a]In year 10 of a 50-year partnership.

Source: GSA and Ernst & Young.

Attachment II: Methodology

To identify the potential benefits to the federal government and private sector of allowing federal agencies to enter into public-private partnerships, we hired contractors to develop and analyze hypothetical partnership scenarios for 10 selected GSA buildings. GSA's National Capital Region had previously contracted for a study to analyze the financial viability of public-private partnership ventures for three buildings in Washington, D.C. Because the majority of the work for these properties had already been done, we had the contractor update its work on these 3 buildings and selected them as 3 of the 10 GSA properties. To help us select the other 7 properties for our study, GSA provided a list of 36 properties that it considered good candidates for public-private partnerships. In preparing this list of properties, GSA officials said that they considered factors such as the strength of the real estate market in each area, the extent to which the property was currently utilized or had land that could be utilized, and the likelihood of receiving appropriations to rehabilitate the property in the near future. We judgmentally selected seven properties from this list to include properties (1) from different geographic areas of the country, (2) of different types and sizes, and (3) with historic and nonhistoric features.

To analyze the potential viability of public-private partnerships for each of the 10 selected GSA properties, the contractors

- analyzed the local real estate markets,
- created a hypothetical partnership scenario and redevelopment plan, and
- constructed a cash flow model.

In the contractor's judgment, the partnership scenarios were structured to meet current budget-scoring rules and provisions in H.R. 3285, introduced in the 106th Congress. These provisions included the requirements that the

- property must be available for lease, in whole or in part, by federal executive agencies;
- agreements do not guarantee occupancy by the federal government;
- the government will not be liable for any actions, debts, or liabilities of any person under an agreement; and
- leasehold interests of the federal government are senior to those of any lender of the nongovernmental partner.

However, a determination on how the partnerships would be treated for budget-scoring purposes would have to be made after more details are available on the partnerships.

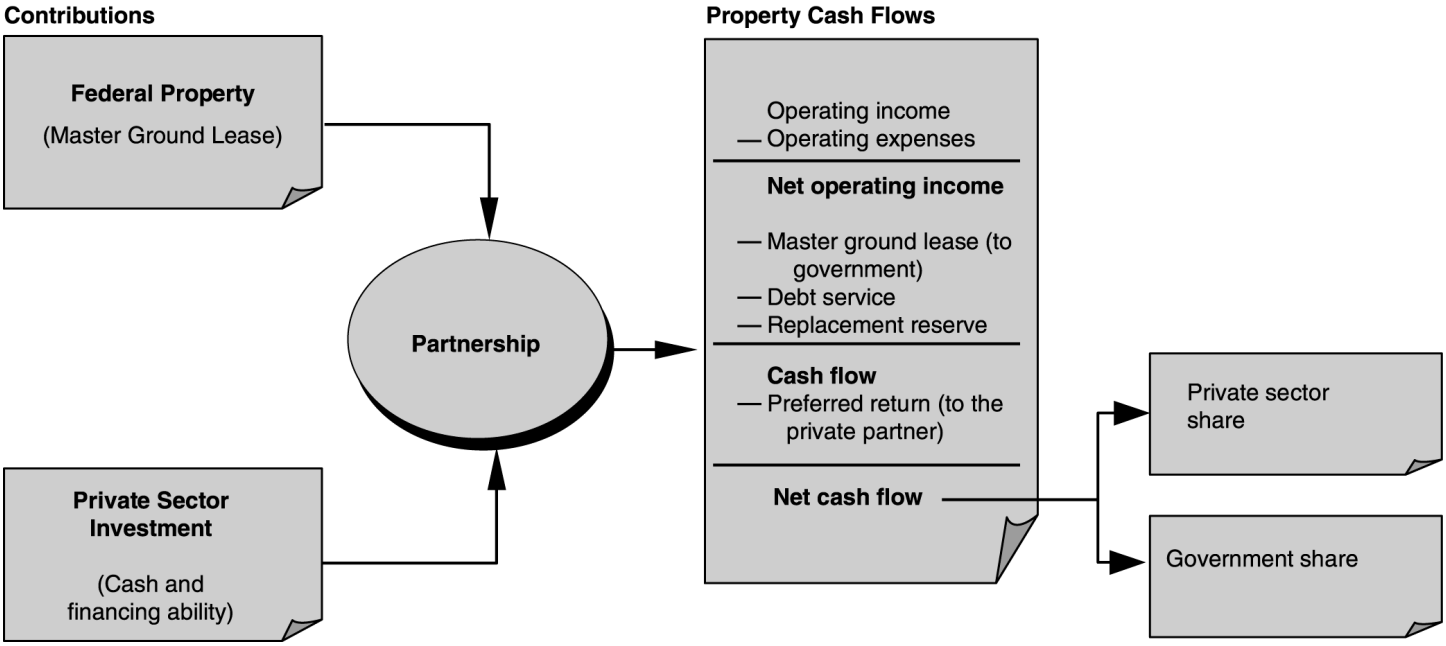
We accompanied the contractor on visits to the seven GSA properties that had not been previously studied. We interviewed, or participated in discussions with, developers and local officials in the areas where the properties were located as well as officials from GSA. We reviewed the contractors' work on the 10 properties for reasonableness but did not verify the data used by the contractors.

The partnership viability scenarios developed for this assignment are hypothetical, and were based on information that was made readily available by representatives of the local real estate markets, city governments, and GSA. Any actual partnerships involving these properties may be very different from these scenarios. In-depth feasibility studies must be done to evaluate partnership opportunities before they are pursued. There may be other benefits and costs that would need to be considered, such as the possible federal tax consequences and the costs of vacating property during renovation in some cases.

This study only looked at the potential benefits to the federal government and private sector of public-private partnerships as a management tool to address problems in deteriorating federal buildings. We did not evaluate the potential benefits of other management tools that may be available for this purpose. We did, however, discuss the implications of using public-private partnerships with OMB representatives.

We did our work between November 2000 and June 2001 in accordance with generally accepted government auditing standards.

Attachment III: Public-Private Partnership Structure



Source: Ernst & Young LLP and Signet Partners.

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