The Crisis in the Federal Government's Infrastructure

Federal Budgetary Scorekeeping:

Impediments, Alternatives and Opportunities

A

White Paper

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EXECUTIVE SUMMARY

The Federal Government faces a well known and growing crisis in maintaining and upgrading its infrastructure. The agencies with the largest portfolios of capital structures (DOD, GSA, and the VA) report that they are unable to keep pace with the need to operate and maintain their assets, and a major part of the problem can be attributed to the current methods of funding which have proven to be inadequate to address their needs. This has resulted in a slow but steady erosion in the overall federal asset portfolio accompanied by an increase in health, welfare and morale issues for employees, difficulty in attracting and retaining employees and an inability to accommodate rapidly changing technology. The very ability of government to provide quality services is being threatened.

For example, the Government Accountability Office ("GAO") has designated the Department of Defense's ("DoD's") management of its support infrastructure — which includes facilities sustainment, facilities recapitalization, installation services, and facilities operation services- as a "High-Risk" area. The primary reason for this designation is that under current budgetary rules the dollars needed to address the "High Risk" problem cannot be diverted from other critical programs and needs, including the direct needs of the warfighter in the field. According to DoD, this lack of available funding for necessary infrastructure sustainment work that is continuously deferred or not performed at all will eventually result in damaged facilities, shortened facility service lives, increased future costs for facility restoration, difficulty in attracting and retaining employees, and an inability to accommodate rapidly changing technologies. At times, the crisis becomes overtly apparent as in the situations at Walter Reed Hospital where the lack of repairs and infrastructure upgrades made headline news and at Fort Bragg and Fort Sill where videos showed that soldiers returning from Iraq were housed in barracks that were falling apart and filled with mold and rust;[1] but mostly the crisis goes unnoticed except by those whose duty it is to deal with deteriorating assets and insufficient funding.

Yet, even while the Federal assets of all agencies are being categorized as "High-Risk" by GAO, the private sector has become aware of the infrastructure financing crisis; and dozens of investment banks, private equity funds, and other sources of capital have raised billions of dollars designed to be invested in infrastructure projects at all levels of government. The managers of many of these funds would welcome the opportunity to invest in federal infrastructure.

Private sector participation has been hampered, however, by a Federal Government set of budgetary scoring rules that, while well intentioned, have the direct effect of frustrating the ability of the private sector to devote its considerable assets to address the federal infrastructure crisis. In contrast, at the state and local government level of the United States as well as abroad, no such rules exist. Naturally these are where the private sector has turned to make its investments through third-party financing.

The federal budgetary scorekeeping rules, which are implemented primarily through Office of Management and Budget ("OMB") Circular No. A-11, came about in the early 1990s in reaction to perceived abuses during the 1980s, especially in the area of lease purchases where off balance sheet financing techniques left many believing that more visibility into the extent of financial commitments was needed. At the time these rules went into effect, OMB elected to use the principles embodied in Financial Accounting Standards Board ("FASB") Statement No. 13 which is a set of accounting rules designed to govern how private sector companies either expense or capitalize leases. Now that more than 15 years have passed, many federal and private sector executives and analysts see a compelling need to revisit the logic of continuing to apply all of the principles in FASB Statement No. 13 inasmuch as those rules were never intended to address how government entities account for their actions and programs. The desired result would be to continue with the spirit of full disclosure and transparency in the budget process but to do so in a way that would not so readily discourage Federal agencies from looking to the private sector and its considerable resources to aid those agencies in addressing their infrastructure crisis.

The Federal government has been unwilling or unable on its own to make direct Federal cash and credit available to fully fund their massive infrastructure needs up front, as current budgeting rules require. Current application of the budget rules in fact dooms the government to a continually worsening infrastructure; or, as an alternative, to agencies turning to the only option that sometimes may be available, the extremely costly use of short-term operating leases to avoid adverse budget scores. Those who advocate strict application of the current scoring rules, the CBO, OMB, and others, take the position that the current budgetary methods of full disclosure of funding commitments are essential (even though operating leases are allowed under the rules and are certainly NOT full disclosure, requiring only the budgeting of the annual payment for each lease plus any termination liability, not the full payments over the life of the lease); and that the Congress and the executive agencies should not work outside the traditional budget process. Unfortunately, up to now, meeting this admirable goal has led many innovative means of addressing the country's infrastructure needs to fail. As a result, there currently is no clear path forward to resolve the crisis in infrastructure financing; and no solution is in sight without a major change.

This white paper explains the federal budgetary scorekeeping rules, provides the public and private sectors' view of these rules, and discusses potential legislative and regulatory alternatives that may enhance the Federal Government's ability to efficiently and cost-effectively fund important infrastructure and other capital-intensive projects. We acknowledge that the dynamic nature of federal capital planning and the impact of political sentiments relating to third-party financing and private investment in public infrastructure, animate any discussion about changes to budgetary planning in general and budget scoring in particular. Accordingly, this white paper should not be viewed as providing the solution to all problems relating to budget scoring. Rather, it should be seen as laying the foundation for understanding the nature of the problem, identifying potential alternatives and galvanizing support from within the public and private sectors to work together to resolve the actual and perceived issues relating to federal budgetary scoring and its impact on revitalizing our nation's infrastructure.

I. INTRODUCTION

Infrastructure in the United States has long been neglected. The U.S. transportation infrastructure is threatened by increasing demand for services while revenue from traditional funding mechanisms such as taxes, tolls and user fees for the nation's highway and aviation systems may be unable to keep pace with such demand.[2] Earlier this year, the National Surface Transportation Policy and Revenue Study Commission, a bipartisan body created by Congress, concluded that for 2008 through 2035, a combined average annual capital investment needed for all modes of transportation equals $220 billion, which is $134 billion higher than the $86 billion combined amount of currently sustainable annual funding identified for transportation infrastructure.[3] Further, revenues to support the Highway Trust Fund — the major source of federal highway and transit funding — are eroding, with recent estimates forecasting a negative balance of more than $14 billion by the end of fiscal year 2012.[4]

With respect to the nation's airways, there is concern that under the Federal Aviation Administration's ("FAA's") current funding system, the costs of providing and modernizing air traffic control services might increase without a corresponding increase in revenues collected from users.[5] Under one limited, preliminary estimate, the FAA's requirements would, on average, exceed its fiscal year 2006 appropriation level by about $1 billion a year (in today's dollars) through 2025. The FAA and others have questioned whether the current funding system — the Aviation Trust Fund — can generate revenues to meet these budgetary needs.[6] In the future, freight traffic is projected to grow substantially, putting strain on our nation's transportation systems, but current planning and financing mechanisms impede public strategies to address needs, and industry's ability to fund those needs is largely uncertain.[7] As a result of these concerns, the GAO designated financing the nation's transportation infrastructure as a "High Risk" issue this year.

The federal funding shortfall is not limited to transportation infrastructure. The nation's military also is at risk. For example, DoD's management of its support infrastructure — which includes facilities sustainment, facilities recapitalization, installation services, and facilities operation services — has also been designated by GAO as a "High-Risk" area because such necessary projects have affected the department's ability to devote funds to other critical programs and needs.[8] Indeed, a recent GAO report indicated that the Army, Navy and Air Force had recapitalization backlogs of approximately $20.4 billion, $27.6 billion, and $9.3 billion, respectively, at the end of fiscal year 2007.[9] According to DoD, necessary sustainment work that is not performed will eventually result in damaged facilities, shortened facility service lives, and increased future costs for facility restoration.[10]

The General Services Administration ("GSA") has indicated that the capital reinvestment requirements to maintain existing federal buildings exceed $7 billion which far exceeds the resources of the Federal Buildings Fund, which is relied upon to operate, maintain and invest in GSA-owned assets and to meet current and projected commitments. Likewise, the U.S. Department of Veterans Affairs ("VA") acknowledges that its capital investment needs over the next five years are approximately $11.8 billion. The VA reports, however, that its average annual appropriation for such investments over the last four years was less than $500 million. It is clear that the Federal Government is not reinvesting the depreciation rate in an orderly fashion to maintain its asset base.

In general, the nation's inability to fully fund repair and replacement of vital infrastructure is exacerbated by deep-rooted obstacles that include competing stakeholder interests, legal and budgetary limitations, and the need for improved capital planning.[11] These obstacles are related and have resulted from underlying issues such as competing stakeholder interests in real property decisions, various legal and budget-related disincentives to businesslike outcomes, and the need for better capital planning by federal agencies.[12] Furthermore, resource limitations, in general, often prevent agencies from addressing real property needs from a strategic perspective.[13] Based on these problems and limitations, GAO has opined that "[w]hen available funds for capital investment are limited, Congress must weigh the need for new, modern facilities with the need for renovation, maintenance, and disposal of existing facilities, the latter of which often gets deferred."[14] Thus, unless current practices are altered in a material fashion, deterioration will accelerate and the financial challenges of revitalization will continue to grow.

A. Potential Private Sector Support

The private sector — private equity funds and investment banks — is aware of the funding inefficiencies and funding shortfalls that hamper the Federal Government's ability to fully fund the repair and replacement the nation's infrastructure. These private financiers and investors have the financial resources to actively participate in the repair and rebuilding of key public infrastructure. It was recently reported that investment bank Goldman Sachs estimates that transportation assets in the U.S. — 98% of which are owned by the government — have an estimated enterprise value of between $300 billion to $400 billion.[15] Perhaps in response to the potential for private investment in infrastructure projects, Stanford University's Collaboratory for Research on Global Projects estimates that more than 72 new infrastructure funds have been introduced since the beginning of 2006 and that more than $160 billion has been raised during that period for infrastructure investment.[16] In particular, several U.S.-based private equity "infrastructure funds" have been established to invest in major infrastructure projects here in the U.S. and abroad. Not surprisingly, money flowing into these funds has increased from $7 billion in 2005 to $31 billion in 2007, according to research boutique Private Equity Intelligence.[17] In early 2007, the Carlyle Group announced that it had completed raising its first infrastructure fund, Carlyle Infrastructure Partners ("CIP"), with equity commitments totaling $1.15 billion.[18] CIP will invest primarily in transportation and water infrastructure projects in the U.S. and Canada generally ranging from $100 million to more than $1 billion in enterprise value.[19]

The private sector's buildup of financial resources to invest in infrastructure has continued into 2008. Investors in 2008 have thus far invested almost $10 billion in funds run by Morgan Stanley Infrastructure Partners and Global Infrastructure Partners ("GIP").[20] Morgan Stanley recently closed on a $4 billion new infrastructure fund, surpassing its original target of $2.5 billion and better positioning the Wall Street powerhouse in the crowded field of investing in airports, roads, and other public-works projects world-wide.[21] Approximately 40% of the Morgan Stanley fund's resources may be put toward projects based in the U.S.[22] GIP, an independent fund that invests in infrastructure assets worldwide, reported that it raised $5.64

billion in equity commitments to be invested in the energy, transport, water, and waste management sectors. IP [IS THIS "GIP?'] was established by General Electric Company and Credit Suisse.[23] The combined demand for the fund was about $4 billion more than expected.[24] Similarly, Citigroup Inc. has reported that it is also raising money for an infrastructure fund that is expected to be in the $4.5 billion range.[25]

By seeking to expand the private sector's role in rebuilding the U.S. infrastructure, these infrastructure funds have the potential to make available the technological, managerial, and financial resources to leverage limited public funds while expediting the delivery of major projects and services in a more cost-effective manner and with reduced risk to the Federal Government. In fact, the use of private sector resources to leverage scarce public sector resources for infrastructure and other projects is not new; however, what is new is the growing interest in and variety of funding, financing, and project delivery approaches that are emerging under the guise of public private partnerships ("P3s").[26] A U.S. Department of Transportation ("DOT") report indicates that this transformation has been spurred by "fundamental changes in how nations overseas perceive the relative roles, responsibilities, risks, and rewards of the public and private sectors for infrastructure ownership, funding, development, and operation."[27]

B. Private Investments in Public Infrastructure Around the World

The use of private financing for infrastructure projects is widespread around the world. According to some estimates, over 2000 governmental projects of all kinds have been planned and/or financed with public-private funding since 1985.[28] This includes approximately $887 billion in projects planned since 1985, of which about half or $451 billion were completed by October 2004.[29] To facilitate financing of infrastructure, the European Union established the European Investment Bank ("EIB") in 1957 to finance energy, infrastructure and industrial projects. Owned by the European Union's 27 member states, the EIB provides low interest loans to finance the capital projects of public and private sector enterprises. The EIB can also offer loan guarantees and technical assistance.

The private sector's involvement in the provision of non-U.S. transportation infrastructure and services has evolved over the last twenty-five years.[30] Apparently, other countries realized early on that the lack of a dedicated transportation funding source required different approaches to financing and delivering transportation infrastructure.[31] A recent DOT report indicated that the strongest impetus for transportation public-private partnership activity overseas occurred in England, where economic reforms encouraged an ongoing effort to privatize major elements of the nation's transportation systems.[32] These early initiatives were focused primarily on mature transportation systems, including railroads, public transportation, and aviation.[33] Those efforts were later expanded to include initiatives to garner additional private sector resources to help finance and deliver projects in various sectors of the economy, such as health care, accommodations, defense, and transportation.[34] In the past two years, the level of investment has grown to almost $2 trillion when counting all forms of infrastructure.[35]

The DOT report indicates that international spending on road-related P3 projects has been over six times the amount spent on these types of projects in the U.S.[36] This reflects the greater level of responsibility and risk taken by the private partners involved in P3 initiatives overseas, where the need for private capital financing is greater than in the U.S. which has traditionally relied on funding provided by motor fuel taxes paid into a trust fund intended solely for surface transportation capital and renewal projects. Even in the U.S. where a substantial dedicated funding mechanism long supported a robust highway development program, there is growing recognition that traditional infrastructure funding and delivery approaches are inadequate to meet the increasing economic development and mobility needs of citizens and businesses alike, while keeping the existing highway system in a state of good repair.[37]

C. State and Local Government Use of Alternative Funding Sources

Various local and state governments in the U.S. have begun to embrace private investment in infrastructure projects through P3s and by implementing legislative and regulatory changes conducive to attracting and maintaining such investment. The use of P3s to fund and execute various projects has increased dramatically over the last three years. Between 1985 and 2004, there were over 60 P3 roads planned and funded in the U.S. representing approximately $42 billion.[38] During 2005 and 2006, 58 P3 projects valued at over $54 billion were planned or funded.[39] Other evidence of the increased use of P3 projects can be found in the increased number of toll projects which, collectively, are valued at over $80 billion.[40] Moreover, it is projected that up to $50 billion in surface transportation concession projects could be awarded in the U.S. during the next few years.[41] The domestic P3 market is estimated to grow significantly over the next 10 years as traditional transportation funding sources are projected to become more scarce.[42]

D. Is the Federal Government Out of Step with Best Practices?

As discussed in further detail below, OMB and CBO rely upon two fundamental principles of budgeting when evaluating the impact of proposed projects on federal spending. First, both entities believe that federal financial commitments should be recognized up front in the budget, at the time those commitments are made. Second, both believe that the budget should be comprehensive, capturing all financial activities of the Federal Government. Both entities apply these principles when evaluating proposed programs to ensure that Congress and the Administration have the information they need to oversee federal spending.

Despite the proven ability of state and local governments, other countries and the private sector to implement costly infrastructure projects and major programs using third-party financing and other innovative approaches, it appears that a major impediment to the Federal Government's ability to implement such projects and programs can be traced back to strict adherence to these two fundamental principles, which often are applied without regard to the realities of the marketplace and the availability of other capital planning tools. Some commentators argue that CBO and OMB apply budget scoring rules in an unnecessarily rigid way that focuses solely on strict compliance with such rules without regard to any other factors instead of seeking to find ways to implement necessary projects and programs within the general framework of the rules. Unfortunately, no clear path forward has been defined by any of the stakeholders affected by the current rigid and, as many believe, inconsistent application of rules that affect funding of major infrastructure projects.

II. PROBLEM STATEMENT

The ever-widening gap between federal infrastructure funding and projected funding requirements will not disappear unless a major effort by the public and private sectors is undertaken to address all aspects of the nation's appropriation processes relating to such funding. Other countries have successfully used P3s and other forms of alternative financing to reap the benefits of private investment in public infrastructure to minimize similar funding gaps. Moreover, state and local governments in the U.S. have benefited from the use of similar forms of alternative financing and private investment to minimize funding gaps and leverage private sector involvement. Furthermore, top-tier investment banks and private equity funds have amassed significant amounts of private funds for these projects and are seeking opportunities to invest in public infrastructure.

Despite these methodologies and the availability of private sources of funding, a variety of factors continue to contribute to the U.S. government's inability to take full advantage of these ways and means to fully fund its infrastructure needs. One major factor, in particular, is the budgetary scorekeeping rules applied by OMB and the CBO.

These budget scoring rules have, in many instances, caused the Federal Government to pay significantly higher than fair market value rates for capital assets. For example, a recent GAO report indicated that for four of seven GSA leases which GAO analyzed, leasing was more costly over time than construction — by an estimated $83.3 million over 30 years.[43] Although ownership through construction is often the least expensive option, federal budget scorekeeping rules require the full cost of this option to be recorded up-front in the budget whereas only the annual lease payment plus any cancellation costs need to be recorded for operating leases, making them "look cheaper" in any year even though they generally are more costly over time.[44] Resolving this apparent funding fiction, however, is not the primary issue relating to budget scoring. The more important issue is that because of the effect of the budget scoring rules, the Government often will not fund important infrastructure repair or revitalization projects through tax revenues, which would increase taxes, or by borrowing money, which would increase the national debt. Thus, the issue often becomes a forced choice between doing an expensive operating lease to avoid the adverse budget scoring impact or doing nothing and accepting continuing operation and maintenance ("O&M") costs and larger downstream capital expenses. However, if the budget scoring rules would be revised so that capital leases are less often treated as purchases, the Government can fund its infrastructure revitalization needs with private sector funding and use a more economic approach than by using operating leases.

The problems associated with budget scoring are not new. In 1995, for example, GAO found that 55 of 73 operating leases that the GSA had entered into cost a total of $700 million more than the construction of new buildings in lieu of the lease arrangements.[45] Five of the nine largest real property-holding agencies — Energy, Interior, GSA, State, and VA — reported an increased reliance on operating leases to meet new space needs over the past 5 years.[46] Resolving this problem has been difficult; however, change is needed because the current practice of relying on costly leasing to meet long-term space needs results in excessive costs to taxpayers and does not reflect a sensible or economically rational approach to capital asset management, when ownership would be more cost effective.[47] Simplistically, if the same rule (up front funding) were to be applied to home ownership, very few Americans could afford to purchase a home.

Budget scoring issues are not limited solely to leasing. GSA's, DoD's and VA's inability to fully fund their respective construction projects are exacerbated by federal budget scorekeeping rules.[48] Many public- and private-sector stakeholders believe that the budget scoring provisions in OMB Circular No. A-11 ("OMB A-11") are unnecessarily restrictive and thus give agencies less flexibility in scoring capital investments.

The rest of this paper will focus on the budgetary scorekeeping rules, their impact on the funding deficit relating to infrastructure repair and replacement, alternatives to such rules, and goals that can be used to define the approach to a reasonable solution that would enable federal agencies to maximize their ability to fully fund their needs and leverage private sector resources in fulfillment of such needs. It should be noted that a revision of the budgetary scorekeeping rules is not a panacea for all of the issues relating to budgeting for full funding of necessary infrastructure improvements. Accordingly, the intent of this paper is to provide a full analysis of this major aspect of the U.S. government's ability to fund needed infrastructure improvements. The analysis and the proposed solution presented herein can be used by key decision-makers to understand and, hopefully, implement well-reasoned, meaningful solutions.

III. WHAT IS BUDGETARY SCORING?

Budgetary scorekeeping or "scoring" means measuring the budget effects of legislation, proposed contracts and other projected expenditures generally in terms of budget authority, receipts, and outlays, for purposes of the Budget Enforcement Act of 1990, as amended (the "BEA").[49]

Prior to 1991, budgetary guidelines allowed many long-term leases that were the equivalent of purchases to be scored in the budget on an annual basis, as the lease payments were made. In the 1980s, that practice, together with budgetary pressures and tax laws favoring leasing, encouraged many agencies to increase their use of such leases. In 1991, with the passage of the BEA and the introduction of new budgetary guidelines for leases, the costs of these activities were made more visible and effectively stopped the use of lease-purchases. The Congressional Budget Office notes:

> In some cases, agencies decided not to undertake investments that — when scored up front with their full budgetary costs — did not appear worth the expense. In other cases, less costly direct purchases replaced lease-purchases. In the early 1990s, for example, DoD abandoned its plan to replace 40 percent of its housing stock using a type of lease-purchase known as Section 801 housing. Instead, it limited its spending on military housing to what could be financed using appropriations.
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> The guidelines did, however, have an unintended and undesirable effect: some managers turned to other, even less cost-effective approaches. For example, federal managers sometimes chose to rely on a series of operating leases to obtain access to assets for which they had a long-term

> need — a strategy that is generally less cost effective than a lease-purchase. In some cases, managers designed operating leases for specialized federal assets that, while achieving the effect of a lease-purchase over the long term, were written to avoid triggering the guidelines requirement for up-front scoring. In other cases, to acquire assets, agencies turned to more complex financing arrangements, including special-purpose public/private partnerships.[50]

The BEA, which was extended in 1993 and 1997, significantly amended the laws pertaining to the budget process. Although the BEA expired at the end of 2002, OMB continues to apply many of the concepts and scorekeeping principles embodied in it in its review of proposed legislation and other actual obligations which agencies incur when entering into contractual arrangements.[51] OMB's scorekeeping guidelines can be found in Appendix A to OMB A-ll. The stated purpose of the scorekeeping guidelines is "to ensure that the scorekeepers measure the effects of legislation on the deficit consistent with established scorekeeping conventions and with the specific requirements of those Acts regarding discretionary spending, direct spending, and receipts."[52] The scorekeeping rules are supposed to be reviewed annually by the scorekeepers and revised, as necessary, to adhere to the rules' stated purpose.

The scoring guidelines are used by the U.S. House and Senate Budget Committees, CBO, and OMB (collectively, the "scorekeepers") in measuring compliance with the Congressional Budget Act of 1974 ("CBA"), as amended, and the Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act of 1985, as amended (2 U.S.C. § 900).

When an agency has the statutory authority to enter into a contract for the purchase, lease-purchase, capital lease, or operating lease of an asset, budget authority and outlays are generally scored as follows:

- **Purchases**: No special rules apply to scoring purchases of assets. Budget authority is scored in the year in which the authority to purchase is first made available in the amount of the agency's estimated legal obligations.

- **Lease-Purchases and Capital Leases**: Budget authority is scored against the legislation in the year in which the budget authority is first made available in the amount of the estimated net present value of the government's total estimated legal obligations over the life of the contract, except for imputed interest costs calculated at Treasury rates or marketable debt instruments of similar maturity to the lease period and identifiable annual operating expenses that would be paid by the government as owner (*e.g.*, utilities, maintenance, and insurance). With respect to lease-purchases and capital leases in which the government or the private sector assumes substantial risk (*e.g.*, through a government guarantee of third-party financing), outlays for these arrangements in which the Government assumes substantial risk are spread across the period during which the contractor constructs, manufactures, or purchases the asset. Outlays for such arrangements in which the private sector retains substantial risk are spread across the lease period. In all cases, the total amount of outlays scored over time against legislation will equal the amount of budget authority scored against that legislation.

- **Operating Leases**: Budget authority is scored against the legislation in the year in which the budget authority is first made available in the amount necessary to cover the Government's legal obligations. The amount scored includes the estimated total payments expected to arise under the full term of a lease contract[53] or, if the contract will include a cancellation clause, an amount sufficient to cover the lease payments for the first fiscal year during which the contract is in effect, plus an amount sufficient to cover the costs associated with cancellation of the contract.[54]

  With respect to funds that are self-insuring under existing authority, only budget authority to cover the annual lease payment is required to be scored.[55] For many of the government's operating leases — including GSA leases, which, according to GSA, account for over 70 percent of the government's leasing expenditures and are self-insured in the event of cancellation — only the budget authority to cover the government's commitment for an annual lease payment is required to be scored in the budget.[56] Given this, while operating leases are generally more costly over time, compared with other options, they add much less to a single year's appropriation total than these other arrangements, making operating leases a more attractive option from the agency's budget perspective. This is particularly evident when funds for ownership are not available in an era of constrained budgetary resources. Since, in reality, leasing may be the only alternative available. Therefore, the requirement for "upfront funding" provides for congressional control over the full costs to which the government is committing itself, the budget scorekeeping rules for self-insuring funds like GSA's Federal Buildings Fund allow costly operating leases to appear to be the lowest cost option in the short term and have encouraged an over reliance on them for satisfying long-term space needs.[57]

To distinguish lease purchases and capital leases from operating leases, the following criteria is used to define an operating lease:

- Ownership of the asset remains with the lessor during the term of the lease and is not transferred to the Government at or shortly after the end of the lease period;

- The lease does not contain a bargain-price purchase option;

- The lease term does not exceed 75 percent of the estimated economic lifetime of the asset;

- The present value of the minimum lease payments over the life of the lease does not exceed 90 percent of the fair market value of the asset at the inception of the lease (the "90% Test");

- The asset is a general purpose asset rather being for a special purpose of the Government and is not built to the unique specification for the Government as lessee;

- There is a private-sector market for the asset; and

- Risk of ownership of the asset should remain with the lessor.[58]

"Risk" is defined in terms of how governmental in nature the project is. If a project is less governmental in nature, the private-sector risk is considered to be higher. The amount of private-sector risk associated with a lease-purchase, legislation and lease-purchase contracts are considered against the following types of illustrative criteria, which indicate ways in which the project is less governmental:

- There should be no provision of government financing and no explicit government guarantee of third-party financing;

- Risks of ownership of the asset should remain with the lessor unless the Government was at fault for such losses;

- The asset should be a general purpose asset rather than for a special purpose of the Government and should not be built to unique specification for the Government as lessee;

- There should be a private-sector market for the asset; and

- The project should not be constructed on Government land.[59]

Unless language that authorizes a project clearly states that no obligations are allowed unless budget authority is provided specifically for that project in an appropriations bill in advance of the obligation, the legislation is interpreted as providing obligation authority, in an amount to be estimated by the scorekeepers.[60]

These criteria are essentially derived from FASB Statement No. 13 which is an accounting standard used in private sector commercial dealings to determine when a lease obligation must be capitalized or expensed. They are commonly used for the purposes of deciding whether an asset needs to be identified on a commercial entity's balance sheet for disclosure and depreciation purposes. FASB Statement No. 13 was not drafted with the intent of applying literally to public sector accounting or budget scoring purposes.

To demonstrate how these rules are applied and then evolve over time, it is important to review the history of the military housing program. In 1997, OMB Director Franklin D. Raines, issued guidelines (the "Raines Memo") that essentially provided a carve out from the budget scoring rules for the Military Family Housing Privatization Initiative ("MHPI"). Initially, the scoring used for the MHPI was drafted to comply with the Credit Reform Act of 1990 and the Budget Enforcement Act of 1990 (both laws were included within the Omnibus Budget Reconciliation Act of 1990 [P.L. 101-508]), as interpreted by OMB A-11.[61] The Raines Memo, among other things, provided DoD with the authority to convey property in exchange for housing or an equity investment in a corporation or limited liability company ("LLC"). Under such a circumstance, there would be no scoring impact if there was no cash income or expenditure. The project costs of the purely private entity, or of the co-owned LLC, were scored similarly to the costs of a private party.

As the military housing program grew in popularity and use, the overall program attracted the attention of the CBO which wrote in a report issued in February 2003:

> Taken as a whole, the OMB guidelines allow DoD housing ventures to obtain on-base family housing without recording large budgetary obligations up front. To a large extent, the opportunity exists because the guidelines do not consider the possibility that interactions among the different agreements between DoD and a housing venture might create a commitment that is more than the sum of its parts. In most cases, they allow DoD to record each provision in its contract with a venture as if it were a separate transaction between the government and a purely private entity.
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> The OMB guidelines for applying credit reform to the loans and loan guarantees that DoD makes to the ventures provide only a partial exemption to that treatment. Under the Federal Credit Reform Act of 1990, the budgetary cost of federal loans and guarantees to private entities is not based on their immediate cost but on their net present value over the life of the loans or loan guarantees, taking into account future expected receipts and outlays resulting from the transaction…. In the case of Fort Hood, the Army applied the OMB guidelines by counting its direct investment in the limited partnership as an immediate obligation. Its transfer of land and existing housing units to the limited partnership, which was not a cash transaction, had no budgetary implications…The Army viewed the limited partnership's rentals of units to service members as transactions among private parties. Although the project would increase DoD's future spending on housing allowances as members shifted to the privatized units and began to collect allowances, that spending was not recorded up front as a budgetary cost of the project.
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> As a result of that budgetary treatment, Fort Hood will obtain on-base housing units worth an estimated $273 million while recording up-front obligations of only $52 million — a leverage of more than five to one. The Army views the limited partnership's debt of approximately $186 million as the debt of a private entity. The Army, although the major contributor of equity to the limited partnership, is not legally obligated to

> cover the partnership's debt if the project fails. However, the housing units are located on federal land and the terms of the partnership are such that the units are, effectively, under the control of the Army.
>
> The aging of DoD's existing inventories of on-base housing is a serious concern within the department. The ability of public/private ventures to quickly provide adequate, affordable housing has been a powerful factor behind DoD and Congressional support for these ventures. Yet analysts concerned with maintaining Congressional control over federal resources and visibility into federal financial commitments would argue that non-budgetary financing through public/private ventures is not the best solution. According to those analysts, the Army is using Fort Hood LLP and the Air Force is using Aurora Housing to acquire assets without recognizing the costs of the purchases in their budgets.[62]

In response to this criticism and other factors, in 2005, OMB Director Joshua Bolten issued a memorandum (the "Bolten Memo") which approved DoD's continued use of the LLC structure under the scoring treatment outlined in the Raines Memo through September 30, 2010. Via the Bolten Memo, OMB approved the use of the co-owned LLC structure for permanent housing for single soldiers (*i.e.*, military barracks). The Bolten Memo indicated that existing co-owned LLCs as of September 30, 2010 would continue to receive the scoring treatment approved in the Raines Memo for any subsequent operations and recapitalization of assets. Although the memo indicated that OMB would continue to work with DoD to further refine the criteria for post-2010 scoring, it put DoD on notice that, if LLCs under the MHPI borrow any additional funding after 2010, the borrowing will be scored under the traditional scoring rules, regardless of the borrowing purpose.

Reasonable people can disagree about application of the scoring criteria to specific transactions, and this is one of the major points of frustration for those who are attempting to solve the crisis in infrastructure financing. The CBO observed, for example, that OMB and CBO did not see eye to eye about how to score the military housing program:

> In CBO's view, housing privatization ventures that result in the construction of family housing on military bases should be reflected in the budget as if they were investments by the government because, in effect, it controls the ventures and ultimately will own the housing. OMB takes a different position, emphasizing that DoD may have little if any equity ownership, DoD may not be legally liable for the ventures' debt, and the rental payments are made by individual service members — even though such payments are funded by annual appropriations.[63]

IV. THE IMPACT OF BUDGETARY SCORING ON CAPITAL INVESTMENTS

A. Initiatives Substantially Modified Because of Adverse Budget Scoring Impact

As noted above, budget scoring has a significant impact on agency efforts to obtain approval of and funding for capital investments. Agencies often must reshape the proposed initiative so that it is positioned to achieve a lower score rather than being structured in a manner that provides a solution to the agency's needs. The following summaries are examples of initiatives that were substantially modified because of the budget scoring rules:

1. Build-to-Lease Military Housing in Korea

In order to improve family living conditions for military service members stationed in South Korea, the Army initiated a program to generate family housing by contracting with a developer to build 2,400 housing units. The Army would enter fifteen-year leases for the housing, allowing the developer to amortize its construction costs over time. To support the program, in 2003 Congress enacted an amendment to increase the maximum annual rent for the 2,400 houses from $25,000 to $35,000, which was an amount necessary to support the required private debt. The build-to-lease solution was part of the Army's theater master plan for the Republic of Korea and a key component of its force transformation. At the time of enactment in 2003, the CBO made no budget cost estimates concerning the amendment.

The legislation had been a Congressional insert and included ambiguous wording. When incorporated into the existing statute under the DOD financial regulations, the $35,000 limitation turned out to have less purchase power than the previous $25,000 limitation. In 2006 and 2007, the Army proposed technical legislation to clarify the statute and to increase the purchase power to the 2003 levels. However by that time, CBO was taking a much harder budget scoring line and estimated the cost of the project to be $630 million in budget authority. The CBO cost estimate stated that "a build-to-lease contract is a governmental activity that uses a private-sector intermediary to serve as an instrument of the Federal Government by borrowing funds to finance the construction of housing on the government's behalf. Those build-to-lease agreements should be considered acquisitions rather than leases."

The Army was unable to find the "headroom" in its 2008 budget to cover the $630 million cost estimate, and the technical amendment was not passed by Congress. To meet its Korean housing requirement, the Army is now taking an incremental budgetary approach and exploring other alternatives to leverage its housing appropriations. In the meantime, commitments made to the Republic of Korea may be affected, and an improvement in the quality of life of service member families has been delayed.

2. VA's Milwaukee Regional Office of the Veterans Benefit Administration Lease

In 2004, VA embarked on a plan to construct and occupy a 100,000 sq. ft. general purpose office building to house the Milwaukee, WI Regional Office of the Administration ("VBA"). It was to be located on 5 acres of underutilized land on the campus of the VA Medical Center Milwaukee for which the Veterans Health Administration was to receive fair market value pursuant to a 45 year land lease. A special purpose entity ("SPE") in the form of an Owner Trust was formed as part of in-kind consideration received from an earlier Enhanced Use Lease ("EUL") project for a similar building constructed and occupied in Chicago, IL. VA was identified in the Owner Trust as the beneficiary. The SPE was the EUL lessee for the ground and the lessor for the newly constructed office building, which was leased back to the Veterans

Benefit Administration as the tenant. The Owner Trust determined that there was private sector demand for the office space in the event VBA decided to terminate or adjust its occupancy.

Utilizing the services of an independent real estate advisor, the Owner Trust selected a fee-based master developer through an open competitive process. The Owner Trust also used an open competitive process to obtain financing, which was ultimately provided by a local redevelopment authority. The VA then negotiated with the SPE for lease terms mindful of previously applied OMB scoring criteria using the recent Chicago project as the paradigm. The lease term was determined to be a two-year firm term with no unilateral right of renewal by either party. Any additional terms would require a notification and written agreement by both VA and the Owner Trust. As there was no automatic renewal provision, the objective was to reduce the government's financial obligation to a very short term commitment. This arrangement was satisfactory to both the local development authority which issued bonds to finance the project and even more importantly the Bond Insurer (needed to obtain an AAA rating). The rental rate to VA was set at fair market value for comparable space.

Following the successful completion of the project, OMB opined that since VA was the beneficiary in the Owner Trust, it had an interest in the lease and, therefore, the transaction was a lease-back from a public private partnership in terms of the OMB Circular. Hence, OMB scored it as a capital lease. This ruling effectively precluded future financings of this type and resulted in significant additive costs to future development. The Securities and Exchange Commission used a similar approach by reducing the terms of a proposed 20-year lease for its facility to 14 years.[64] Other real property-holding agencies with leasing authority—such as the Department of State—also face the same obstacles to ownership.[65]

3. U.S. DOT Headquarters Lease

GSA and DOT have worked together to create an updated headquarters for DOT since the late 1980's. There were several attempts that failed due to OMB's insistence that the DOT Headquarters be in Government-owned space. However, money was never appropriated for the project. In 1998, Congress directed GSA to start a procurement for a new leased DOT Headquarters. This was an unusual start to the project, due to the lack of OMB approval of a Prospectus for this lease.

Having received Congressional direction to proceed, GSA attempted to get OMB guidance on the appropriate rent cap. However, OMB's guidance was based on an unrealistically low Fair Market Value ("FMV") yielding a below market rent, which would have resulted in another failed attempt. GSA rejected the OMB guidance. Under pressure from Congress, GSA negotiated an agreement with OMB to solicit the requirement and work with OMB on the pricing after the marketplace had submitted its proposals.

The solicitation was issued in November 1999. Proposals were received and evaluated and discussions on the appropriate FMV and resulting rent cap were started in October 2000. However, since the building was not yet built, OMB's regulations required the FMV to be created by calculating the cost for the Government to construct an equivalent building. The FMV was in question for a period of about ten months, as OMB sought to bring the FMV to as low a number as possible. The discussions covered every aspect of the calculations. For example, OMB challenged the need to include the cost of certain elements, such as construction of required parking facilities and certain design elements related to environmental considerations that OMB believed were not required. OMB also insisted upon using a national escalation rate rather than the higher local construction rate.

Finally, OMB agreed to a FMV of approximately $430 million after Congress applied pressure and indicated it would conduct Congressional hearings. This required the reduction of the tenant improvement ("TI") allowance by $44 million to make the rent come in below the rent cap. An appraisal was conducted that showed the value of this proposed building to be around $470 million. Using this market appraisal, the rent as proposed with the appropriate TI allowance would have met the scoring test for an operating lease.

4. National Oceanographic and Atmospheric Administration ("NOAA") Building, Gloucester, Massachusetts

In May 2006, NOAA entered into a new lease with a developer for an approximately 82,000 square foot building, which was large enough to consolidate all of the various offices of the NOAA Fisheries Northeast Regional Office in Gloucester, Massachusetts. This building will replace four smaller facilities currently dispersed throughout the Gloucester area. Compliance with OMB A-11 rules to obtain an operating lease limited the lease term to fifteen years. Although the developer offered two additional five-year renewal terms at a favorable set rate, these renewal options had to be removed from the lease to the detriment of NOAA to allow the agency to be able to sign the lease with the proper budget authority in place. If this lease were to extend to 15 years and 3 months, it would be capital under OMB restrictions (present value of net rent greater than 90% of the fair market value of $16M). NOAA would be required to forward fund $14.4M to cover the present value of the minimum lease payments excluding payments for identifiable annual operating expenses.[66]

Under FASB Statement No. 13, if this lease were capital, the agency would need to report the net present value ("NPV") of the stream of lease payments as an obligation in its financial statements. NOAA does not have any special legislation for the budget authority for this lease nor is it able to fund the budget authority requirement from its normal appropriation. The lease is below prospectus[67] and was done under a GSA delegation of authority for special purpose space. It should also be noted that in furtherance of its mission, NOAA has maintained a presence in Gloucester for over a century and there are no plans to locate the Northeast Fisheries office elsewhere. Therefore, the deletion of the option periods will result in the payment of revised market rate lease payments at renewal rather than the locked in lower rates offered by the developer, which were offered at the conception of the transaction.

B. Budget Scores that Resulted in Above FMV Expenses

As noted above, ownership through construction is often the least expensive option; however, the budget scoring rules require the full cost of this option to be recorded up-front in the budget whereas only the annual lease payment plus any cancellation costs need to be recorded for operating leases. This scoring approach often encourages an agency to accept an operating lease as a "quick fix" solution. However, such an approach usually results in the Federal Government paying above FMV for the leased facility. As noted above, the more important issue is that because of the effect of the budget scoring rules, the Government often will not fund important infrastructure repair or revitalization projects through tax revenues by increasing taxes, or by borrowing money, which would increase the national debt. Thus, when seeking to craft solutions to resolve this complex issue, the primary choice should not be between doing an operating lease to avoid the adverse budget scoring impact or doing nothing and accepting continuing operation and maintenance ("O&M") costs and larger downstream capital expenses. Rather, an appropriate solution would provide changes to the scoring rules in a manner that would allow the Government to fund its infrastructure revitalization needs with private sector funding and by relying on approaches that are more economic and efficient than operating leases.

C. Other Adverse OMB and CBO Scoring Actions

Program Execution Within Existing Law:

Program	OMB Scoring Action
VA Enhanced Use Leasing with Trust Agreements and/or Leasebacks	OMB revised scoring guidance in OMB Circ. A-11 to require stringent guidelines for leasebacks to require "upfront scoring" of budget authority
DoD and VA Enhanced-Use Leasing[68]	OMB changed scoring guidance in OMB Cir. A-11 for leasebacks to require upfront scoring of budget authority. This change had a significant negative impact on both agencies' ability to rely on enhanced use leases.
Privatization of Army Lodging (PAL) program	OMB required upfront scoring of proposed transaction with LLC established to implement PAL program

Legislative Proposals

Legislation	CBO Scoring Action
Military Housing Privatization — Permanent authorization of program (Ronald W. Reagan National Defense Authorization Act for 2005)	CBO scoring report declared upfront scoring of budget authority at $6 billion — Congress passed legislation[69]
GSA Property Reform Legislation (H.R. 3947, Federal Property Asset Management Reform Act of 2002)	CBO scoring report declared upfront scoring of budget authority at $173+ million — Congress **did not pass** legislation[70]
National Health Museum Act (H.R. 5164, Sep. 2004) — Sale/leaseback of office space at Food and Drug Administration's Cotton Annex	CBO scoring report declared upfront scoring of budget authority at $170 million — Congress **did not pass** legislation.[71]

V. PUBLIC AND PRIVATE SECTOR VIEWS OF BUDGETARY SCORING

A. Public Sector View

1. Congressional Budget Office ("CBO")

During a symposium on Federal Budgetary Scorekeeping, which was co-sponsored by the National Coalition for Public-Private Partnerships and the American Bar Association Section of Public Contract Law, a presenter commented that, despite the dire warnings of the crumbling infrastructure of the Federal Government, there does not appear to be an organized, systematic effort to get information about such an important issue before Congress. Specifically, the presenter questioned concerns about "diminishing budgets" and "budget shortfalls" by noting that Congress' fiscal year ("FY") 2007 budget authority of $873 billion will increase to over $1 trillion for FY 2009. Similarly, he questioned whether there is a need for funding alternatives because within the current Administration or any of the agencies affected by the so-called "need," there does not appear to be an organization that is working to identify such alternatives. Lastly, he questioned the idea that the Federal Government is denied needed capital to finance certain infrastructure projects by noting that there is no problem with respect to the Federal Government obtaining financing for its projects. To work through budgetary scoring issues, the presenter suggested that agencies should partner with private entities, and then go to OMB to get appropriations for the project in the agency's budget request. Then, while Congress is deliberating the proposed budget, the agency should go back to Congress to influence key decision makers. To do so, he added, the agencies must present a solid cost/benefit analysis in order to be successful.

With respect to third-party financing of federal projects, CBO has taken the position in pre-symposium published comments that such arrangements have a number of negative consequences. First, CBO has indicated that projects are more costly to the government when third-party financing is used.[72] Second, third-party arrangements tend to skew decisions about how to allocate budgetary resources by giving preferential treatment to investment projects on the basis of the method of financing rather than their relative merits.[73] Finally, third-party financing allows agencies to raise capital in private markets without the full scrutiny of the Congressional appropriation process and without reference to the statutory limits on borrowing that exist for some agencies (such as the Tennessee Valley Authority and the Bonneville Power Administration).[74] To properly score third-party financed projects, CBO has opined:

> [T]he budget should record obligations and expenditures for projects financed by third parties the same way that it records costs for other federal programs. Thus, amounts obligated and expended by intermediaries on behalf of the government should be recorded in the budget when they occur. Such treatment would provide the most accurate and timely measure of the net costs to the taxpayers and would discourage the use of costly third-party financing mechanisms.[75]

With respect to long-term leases and public/private ventures in general, CBO has indicated that "in many instances, long-term leases and public/private ventures used by federal agencies to finance the acquisition of capital assets are treated in the budget in a manner that is inconsistent with two fundamental principles of federal budgeting:

- First, that federal financial commitments should be recognized up front in the budget, at the time those commitments are made; and

- Second, that the budget should be comprehensive, capturing all financial activities of the Federal Government."[76]

Further, CBO has opined that "budgetary treatment inconsistent with those principles could deny the Congress and the Administration the information needed to oversee federal spending."[77] Moreover, CBO has concluded that, "unless the costs of asset purchases financed through leases and public/private ventures appear up front in the federal budget, in the same way as the costs of assets purchased directly by the government, federal managers will be more likely to rely on such financing techniques even though they are inherently more costly."[78]

2. Department of Veterans Affairs

Consistent with the private sector trends, the VA has transitioned from a hospital-based healthcare delivery system constructed in the World War II era to one giving emphasis to outpatient treatment. Today, the average VA facility is over 55 years old; there is a reduced demand for inpatient beds and conversely an increasing demand for outpatient care and specialty medical services. Healthcare delivery has benefited greatly from the application of technology including the use of an electronic medical records system widely recognized as the gold standard. Veteran demographics are shifting geographically as well, reflecting an aging and diminishing population. While demographics can be predicted with relative certainty, the impact of technology is much harder to gauge. Therefore, given this ambiguity and the accelerating cost of hospital construction (upwards of $3,000,000 per bed and growing) it is clear that other alternatives beyond appropriated purchased facilities must be considered.

The VA's predicament is further exacerbated by its current backlog of projects, the limited funding available for construction and the inherent delays in constructing and renovating space needed to provide access. VA believes, however, that there is an alternative approach to acquiring needed facilities. Specifically, leased facilities (including large outpatient clinics using a standardized design/module as well as continued expansion of traditional community-based outpatient clinic) would provide an additional tool to meet facilities needs with an inherent degree of flexibility, allowing the system to shrink or flex depending on future needs and requirements (patient load and technology). Further, it would not only accelerate delivery by avoiding the extensive project backlog but steer clear of long-term ownership of obsolescence-prone fixed assets as well as encourage a decentralized delivery model placing resources closer to veterans and their families. Additionally, in proximity to the large outpatient clinics, inpatient services could be supported by local contracts with affiliate or community hospitals.

The budget scoring rules have a substantial impact on the VA's ability and flexibility to address the foregoing needs and requirements. Accordingly, any revisions to the budget scoring rules that would provide appropriate capital planning flexibility would enhance the VA's ability to carry out its mission to provide patient care and federal benefits to veterans and their dependents.

VI. ALTERNATIVE METHODS OF SCORING CAPITAL INVESTMENTS — SOME POSSIBLE SOLUTIONS

As discussed above, a prime effect of the current scoring rules and how OMB and CBO have evolved their interpretations is that long-term, privately-financed obligations are discouraged. Agencies are led by the scoring rules to favor purchase, which although often the least expensive option is also politically untenable, structuring uneconomic, short-term arrangements such as operating leases, or doing nothing at the expense of continuing high sustainment costs and future even higher capital expenditures. This is unlike the practices of state and local governments in the US, private sector entities, and most foreign governments. Some commentators, however, have responded that the resolution is not to score certain transactions as other than what they are. Masking the true nature of certain transactions would not be an optimum or acceptable way to address the country's infrastructure needs. Under this view, the real question is what should an agency be permitted to undertake once a project score is assigned. Should a high score doom a capital infrastructure project because an agency's budget for that fiscal year is insufficient or force the agency into an uneconomic restructuring of the project, *e.g.*, by using an operating lease? A more appropriate alternative under such circumstances may be to acknowledge that doing nothing or entering into an uneconomic lease is actually more expensive in the long run, so the agency should be allowed to execute the transaction under some exception authority from OMB or Congress, or to have a federal capital budget that will be expected to fund large outlays from time to time for major infrastructure projects. Along with the foregoing alternative, officials from the private and public sectors have suggested a number of other alternatives to the current way that large capital intensive infrastructure projects are analyzed for budgetary scoring purposes. Some of these would require statutory changes, but others can be accomplished without statutory change by making adjustments at the executive level through changes to OMB Circular A-11. All of these alternatives would continue the practice of providing transparency in the budget process.

A. Administrative Changes

1. Alter Some of the Criteria

The current criteria used to determine whether a project qualifies as an operating lease, as stated above, are derived from FASB Statement No. 13 which is in essence a private sector accounting principle which need not automatically apply to all types of public purpose projects such as infrastructure. Significantly, these criteria are not mandated by statute but, rather, were used back in 1991 as a convenient means to restrict the use of lease-purchases which were perceived to be attempts to circumvent the budgetary planning process. Looking back over the years since 1991, it appears that rigorous application of these rules has negatively affected the government's ability to finance infrastructure

The 90 percent rule — where the present value of the minimum lease payments over the life of the lease may not exceed 90 percent of the fair market value of the asset at the beginning of the lease — has proven to be difficult to satisfy for large scale infrastructure projects. From a public policy perspective, it is not clear that the Federal Government benefits from strict adherence to this criterion as a matter of doctrine. Rather, the rule should be viewed more as a guideline that may assist analysis of a project — but failure to meet the criteria should not automatically lead to characterizing the project as a capital lease.

The general purpose criteria — where an asset is considered to be for a general purpose rather than being a special purpose of the government and not built to the unique specification of the government as lessee — is a subjective criteria. As can be seen from the above discussion about the military housing program, DoD, OMB and CBO disagreed on how to characterize such program. Where reasonable people can disagree, there is no apparent benefit from viewing this criterion as a critical "gate" for infrastructure projects to navigate in order to avoid an adverse score.

The bargain-price purchase option — where the lease does not contain a bargain-price purchase option — is another criterion that could be revisited for infrastructure projects. Under current rules, after a capital asset has been fully depreciated, private entities are typically willing to sell the fully depreciated asset at a bargain price — even for as little as $1. So, the Federal Government should consider why it would want to discourage such arrangements by assigning a high budget score to a project offering the option.

OMB should examine these criteria carefully to determine whether, as a matter of public policy, it makes sense to adhere to them as absolutes in the context of the infrastructure financing crisis. In so doing, it should not encourage lack of candor or accounting practices that lead to less than full financial disclosure.

2. Score Operating Leases Up Front

This alternative which has been advanced by the CBO and others interested in making a level playing field as it pertains to transparency in the budget process recognizes that many operating leases are used for long-term needs and should be treated on the same basis as ownership and is one that could result in long-term savings for the Federal Government.[79] This alternative would make such operating leases comparable in the budget to direct federal ownership and would foster more cost-effective decision-making by OMB and Congress.[80] Applying the principle of full, upfront recognition of the long-term costs to all options for satisfying long-term space needs is more likely to result in the selection of the most cost-effective alternative rather than a less desirable alternative achieved using the current scoring rules.[81]

In response to this proposed alternative, CBO has opined that capitalizing all leases could mean scoring all leases up front on the basis of the present value of lease payments over the lease term, without attempting to distinguish between leases that are equivalent to purchases, *i.e.*, capital leases, and those that are not, *i.e.*, operating leases.[82] Indeed, this alternative would, in effect, eliminate use of the above-referenced scoring criteria that distinguishes between operating and capital leases. The question then is what would OMB use as its new criteria?

One idea is that the Federal Government could consider special treatment for projects that meet a tightly defined definition of "infrastructure" so that private sector financing can be brought to the table in a meaningful fashion while concurrently adhering to budget transparency principles.

3. Score Sale/Leaseback Arrangements or Lease Financing Specific to Real Estate or Infrastructure Projects as Operating Leases

If purchase contract or lease purchase authorities scored as operating leases but agencies were granted budget authority for the entire amount, Federal agencies could contract for new facilities that would be constructed and financed through the private sector. The government would pay for the construction through the lease payments and obtain ownership at the end of the purchase contract agreement. If financing, for example, through the Federal Financing Bank were unavailable, this solution would be slightly more expensive because of the increased cost of capital underlying the lease with the private sector, but it would essentially provide a lease-to-own solution to fund capital projects.

This alternative would allow agencies to outlease a property for a set period of time and lease it back improved or to execute a ground lease on underutilized land allowing the private sector to construct a new facility on government owned land. For example, this alternative would allow the government to finance the renovation of an existing facility or the construction of a new facility through the rental payments to the private sector. Ownership of the asset would revert to the government at the end of the outlease or ground lease.

Proponents of this alternative acknowledge that this is the very definition of a capital lease and, therefore, such transactions could not be construed to be an operating lease under GAAP. However, they suggest that these transactions be classified as a capital lease for accounting purposes but budgeted for in a manner (*i.e.,* similar to operating leases) that is more acceptable to OMB.

4. Score Renewal and Purchase Options as Operating Leases

Under the current rules, if the lease agreement contains an option to renew that can be exercised without additional legislation, it is presumed that the option will be exercised. If the agreement contains an option to purchase at less than fair market value (at the time the option is to be exercised), and the option can be exercised without additional legislation, it will be presumed that the option will be exercised.

The rules could be revised to allow for operating lease treatment without the assumption that options will be executed and scored upfront. It costs nothing to remove the presumption that any FMV options that can be exercised will be exercised for scoring purposes. For below-market options, if they must be presumed to be exercised, then the rules could allow the value (cost) of the option to be reflected (scored) over the term of the lease.

5. Redefine "Risk" to Allow for Increased Flexibility

As noted above, "risk" means the level of private-sector risk. Lease-purchase agreements are scored as with or without substantial private risk. "Substantial private risk" means the absence of substantial government risk. Generally, if the project is less governmental in nature, the private sector risk is considered to be higher. The scoring rules could be revised to redefine allocation of risk to allow for more flexibility, including 100% government occupancy in leaseback transactions.

It is important to note that there is no finite calculation for risk as it is based on individual and collective assessments of informed and less-informed analysts and therefore inherently subjective. Risk can never be eliminated, only mitigated, and is roughly inversely proportional to the perceived benefit or reward. While risk assessment manifests itself in pricing in the market place and represents the collective judgment of the free market based on the best available information, not all participants will come up with the same valuation. The government should strive to be the beneficiary of the risk assessment process by open market competition through receipt of the most favorable terms and conditions to be derived from a specific situation.

6. Provide Special Treatment for Self-Insuring Funds

Under the current rules, where funds are self-insuring under existing authority, only the amount of budget authority needed to cover the annual payment is required to be scored. The rules could be changed to broaden this provision to allow the annual payment or annual debt service to be scored for purchase contracts, lease acquisitions, or Federal Financing Bank borrowing.

7. Redefine Treatment of "Special Purposes" and Other Enhancements

Assets that have special features or enhancements that were built or added for the Government's unique needs or special purposes need to be evaluated on a case-by-case basis to ascertain whether they can be considered to be general purpose assets. Under the current rules, special purpose features or enhancements are scored up-front and separate from the lease. These definitions limit what can and cannot be amortized into the lease rental rate, as special features are scored upfront. For example, the current additional security measures and technological requirements for federal buildings must be funded lump-sum and upfront. The rules could be revised so that "special features" are redefined so they apply to today's market and elevated federal security requirements applicable to all federal buildings. For example, the rules could be revised to state (or define in a different way than is currently applied by OMB) which specific types of modern space building-outs would be funded upfront and which buildouts would be funded as part of rent. This approach may provide more latitude to GSA when it is deciding what is considered "general purpose" and amortized into lease rental payments and how those amounts are included in rent and, most importantly, included in the "fair market value" definition for purposes of the OMB A-11 90% test. Also, the rules could be revised to clarify that, simply because a specification or feature is described in a governmental request, it is not "uniquely governmental." Finally, special purpose features could be included in the rent and amortized over the life of the lease (or over the useful life if the special purpose feature is shorter than the lease term).

8. Score Agency Borrowing from the FFB for Real Estate and Infrastructure Projects as Operating Leases

The FFB is a government corporation, created by Congress in 1973 under the general supervision of the Secretary of the Treasury.[83] The FFB was established to centralize and reduce the cost of federal borrowing, as well as federally-assisted borrowing from the public, and has statutory authority to purchase any obligation issued, sold, or guaranteed by a federal agency to ensure that fully guaranteed obligations are financed efficiently.[84] Currently, not all agencies have authority to borrow from the FFB. An agency must have specific statutory authority to borrow from the FFB. If an agency that has authority borrows from the FFB, that agency must obligate budget authority for the full amount of the loan, *i.e.,* principal plus financing costs. Under current scoring rules, this would require Congressional appropriation for the borrowing authority, which scores equal to budget authority.

The use of the FFB as a source of funding for all federal real estate or infrastructure projects could address unintended consequences of budget processes provided that the budget authority could be scored so as to be budget neutral to the FFB and only scored against the borrowing agency as the funds are spent, *i.e.,* on an annual basis, rather than upfront as required by the current rules. Projects often are forced to align with the budget cycle which may provide needed funds but on a schedule incongruent with project execution timelines. In some cases, spending caps force projects to compete for construction funding, even after receiving prior year funds for site acquisition and design.

FFB borrowing would provide a dependable and low-cost source of funding that could be structured to reflect the various phases in planning and design and construction of a Federal construction project. It would allow for expeditious project delivery with fewer interruptions grounded in the budget process. Ultimately, it would limit exposure to the impact of inflation and altered customer requirements, two of the primary drivers of delayed project delivery, and increased project costs. FFB borrowing, if made available in connection with traditional lease construction projects or lease-purchase contracts, would provide a lower cost of capital to developers that would ultimately translate into lower rental costs for the government.

B. Legislative Changes

In addition to the administrative changes presented above, there are a number of statutory changes that can be considered to address infrastructure financing.

1. Establish Capital Acquisition Funds to Pursue More Ownership

Under this alternative, agencies with capital-intensive operations would establish a separate capital acquisition fund ("CAF"), which would be "fenced off" from other discretionary appropriations, within their budget that would receive appropriations for the construction and acquisition of large capital projects.[85] CAFs would use authority to borrow from Treasury's general fund and then charge operating units within the agency rents equal to the debt service (interest and amortization costs) on these projects.[86] Each CAF would be similar to the Defense Business Operating Fund ("DBOF"), a revolving account that provided various types of services and materials to the military, which paid for these items with O&M funds.[87] GAO, however, has reported that implementation issues could overwhelm the potential benefits of CAFs, which could be achieved through simpler means.[88] Accordingly, GAO has concluded that CAFs do not seem to be worth the implementation challenges they would create.[89] Moreover, GAO has indicated that, except for OMB, other agencies generally agreed with their conclusions.[90]

However, the CBO has come out in favor of CAFs noting that such mechanisms would smooth out capital costs in the user's budget even though the agency's total budget would reflect the capital costs up front. CBO also supports a broader but simpler approach that would require agencies currently holding an asset to pay the Treasury rent to cover both depreciation of the asset and interest costs based on its market value. Although Treasury receipts would offset the rents in the federal budget as a whole, agencies would become eager to give up assets unless the services they provide justify their costs.

2. Create a Separate Capital Budget

One approach that has been advanced is to create a separate and distinct Capital Budget for the Federal Government for assets that are susceptible to long term financing. The rationale for this approach is that central governments throughout the world as well as state and local governments in the United States routinely approach capital asset funding through the use of capital budgets that are separate and distinct from their operating budgets. These governments typically issue long term debt instruments such as general obligation or revenue bonds whose debt retirement obligations are recorded and accounted for in the capital budgets without having an impact on the operating budgets. Through this approach, there is visibility into the funding process; but the principal focus is on the regular payments needed to retire the debt on a monthly or annual basis. However, in order to establish a capital budget for the Federal Government at this point, it would be necessary to make a statutory change to the budget rules; and the one time charge against the budget to implement the capital budget would be quite large. GAO does not favor this approach as it prefers to maintain the current Unified Budget approach. Despite this objection from GAO, it is noteworthy that the Congress already recognizes the distinction between operating budgets and capital budgets in the way that it appropriates DoD dollars by using two appropriations — one for military construction and one for operations.

VII. CONCLUSION

As shown above, a variety of factors affect the Federal Government's ability to fund its infrastructure revitalization needs. It is apparent that there are several substantive alternatives or revisions to the current budget scoring rules that could have a positive impact on the Federal Government's ability to fully fund important infrastructure and other capital-intensive projects while still maintaining transparency in the budget process. Fundamentally, any changes to the scoring rules should seek to correct the unintended consequences of causing bad business decisions and incentivizing inaction. Moreover, a common recommendation is that the scoring rules — in their current form or as revised — should be applied in a clear, consistent and expeditious manner with a view towards solving rather than perpetuating the infrastructure funding crisis. More importantly, most stakeholders believe that these changes can be implemented in a way that does not sacrifice the budget scorers' obligation to ensure that Congress, the President and the American public have sufficient information from which it can make appropriate budgetary decisions.

This paper has presented several of the myriad of issues associated with budget scoring and its effect on the Federal Government's ability to tap into the significant amount of private investment funds that stand ready for investment in critical U.S. infrastructure. Because of the multi-faceted nature of the perceived budget scoring impediments and the impact of political sentiments relating to the source of funding used to finance key infrastructure projects, it is difficult, if not impossible, to adequately explain the nature of the budget scoring issue and then provide a single approach to resolving all of the issues relating to the subject. Accordingly, this White Paper should be viewed as laying the foundation for understanding the nature of the problem, identifying potential alternatives and for galvanizing support from within the public and private sectors to work together to resolve the issues relating to this complex issue.

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[51] OMB, Circ. No. A-11, at § 20.9(a), at p. 33.

[52] *Id.*, Appendix A, at p. 1.

[53] The "full term of a lease contract" includes any renewal options that can be exercised without additional legislation. OMB Circ. No. A-11, Appendix B, at p. 3.

[54] *Id.*, Appendix A, at p. 3.

[55] *Id.*

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

[57] GAO, *Federal Real Property: Reliance on Costly Leasing to Meet New Space Needs is an Ongoing Problem*, GAO-06-136T, Oct. 6, 2005.

[58] OMB, Circ. No. A-11, Appendix A, at pp. 3 and 4.

[59] *Id.*, Appendix B, at p. 8.

[60] *Id.*, Appendix A, at p. 4.

[61] MHPI FAQs, available at http://www.acq.osd.mil/housing/faqs.htm#14.

[62] CBO, *The Budgetary Treatment of Leases and Public/Private Ventures*, Feb. 2003, *see* n.49*, supra.*

[63] *Id.* at 13.

[64] GAO-03-122, *High-Risk Series: Federal Real Property*, Jan. 2003.

[65] GAO-06-136T, p. 6.

[66] "Forward funding" is budget authority that is made available for obligation beginning in the last quarter of the fiscal year for the financing of ongoing grant programs during the next succeeding fiscal year. The budget authority for such programs is included in the budget totals for the year in which it is appropriated. *See* www.whitehouse.gov/omb/budget/fy2007/pdf/ appendix/aaa.pdf.

[67] The Public Buildings Act of 1959, as amended, provides for GSA to submit a prospectus for review by the appropriate Senate and House authorizing committees when the cost of a proposed construction, lease, or alteration project exceeds the legislatively established dollar threshold for leases or alterations to leased buildings, which is indexed and revised each year. *See* GAO-06-918, NIH Has Improved its Leasing Process, But Needs to Provide Congress With Information on Some Leases, Sept. 2006. For an agency with delegated leasing authority, GSA, working in consultation with the agency, prepares a prospectus for any lease involving a net annual rental — excluding services and utilities — in excess of the prospectus threshold. For alterations to leased buildings, the prospectus threshold is one-half of the lease prospectus threshold. After the prospectus is prepared, GSA submits it for approval to the appropriate congressional committees. Id. Accordingly, "below-prospectus" indicates a proposed lease or alteration to a leased building that is below the legislatively established dollar threshold.

[68] Enhanced-use leasing is a cooperative arrangement under which government-owned property is made available to public or private entities, compatible with governmental missions and private-market needs. The entity can manage the property, receiving revenue either from the government's use of the property, lease of excess space, or both. The government gets facilities, space, services, monetary payments or other "in-kind" considerations free or at reduced cost. This results in significant cost savings when compared to new construction or traditional leasing. In addition, it brings substantial private investment in the government's capital facilities and infrastructure, new long-term sources of revenues, and the creation of local jobs and tax revenues. The VA has used enhanced-use leasing to obtain energy centers, regional offices, housing for homeless veterans, senior housing, childcare centers, parking structures and medical/clinical facilities. *See* http://www.whitehouse.gov/results/agenda/department updates09.html.

[69] CBO, H.R. 4200, Ronald W. Reagan National Defense Authorization Act for Fiscal Year 2005, *Estimate of direct spending effects for the bill as cleared by the Congress on October 9, 2004*, available at http://www.cbo.gov/doc.cfm?index=5957.

[70] CBO, H.R. 3947, Federal Property Asset Management Reform Act of 2002, *Cost estimate for the bill as ordered reported by the House Committee on Government Reform on March 20, 2002*, available at http://www.cbo.gov/doc.cfm?index=3451.

[71] CBO, H.R. 5164, *National Health Museum Act of 2004, Cost estimate for the bill as ordered reported by the House Committee on Transportation and Infrastructure,* September 29, 2004, available at http://www.cbo.gov/doc.cfm?index=6008.

[72] CBO, *Third-Party Financing of Federal Projects*, June 1, 2005, at p. 1, available at http://www.cbo.gov/ doc.cfm?index=6399.

[73] *Id.*

[74] *Id.*

[75] *Id.* at 5.

[76] CBO, *The Budgetary Treatment of Leases and Public/Private* Ventures, Feb. 2003, available at http://www.cbo.gov/doc.cfm?index=4035.

[77] *Id.*

[78] *Id.*

[79] GAO-08-197 at 25.

[80] *Id.*

[81] *Id.*

[82] *Id.*

[83] *See* http://www.treas.gov/ffb/.

[84] *Id.*

[85] GAO-08-197 at 25.

[86] *Id.*

[87] NSIAD-96-220, 1997 DOD Budget, Potential Reductions to Operation and Maintenance Program, Sept. 1996. On December 11, 1996, the Under Secretary of Defense (Comptroller) reorganized DBOF and created four working capital funds: Army, Navy, Air Force, and Defense-wide. This was done in order to clearly establish the military services" and DOD components" responsibilities. *See* GAO/T-NSIAD/AIMD-97-152, Defense Depot Maintenance: Challenges Facing DOD in Managing Working Capital Funds (Testimony), May 7, 1997, for managing the functional and financial aspects of their respective business areas.

[88] GAO-05-249, *CAPITAL FINANCING, Potential Benefits of Capital Acquisition Funds Can Be Achieved Through Simpler Means,* Apr. 2005.

[89] GAO-05-249, *CAPITAL FINANCING, Potential Benefits of Capital Acquisition Funds Can Be Achieved Through Simpler Means,* Apr. 2005.

[90] *Id.*