

Recommendations from the ABA White Paper and Position of CBO

Stephen Sorett
Partner
McKenna Long & Aldridge LLP



McKenna Long
& Aldridge^{LLP}
Attorneys at Law

RECAP: What Are the Rules?

- Budget Enforcement Act (BEA) of 1990: Budget Authority, Outlays, and Receipts
- BEA Amended in 1993 and 1997 and lapsed in 2002
- OMB Circular A-11 based not only on BEA but also Congressional Budget Act of 1974 and Graham Rudman Hollings Balanced Budget and Emergency Deficit Control Act of 1985, as amended (2 USC 900)

The Criteria: Based on FASB 13

- 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.

Risk

- “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.

The Problem

- 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.

Key Principles

- 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.
- The ABA White Paper's Recommendations are designed to satisfy these principles.

Administrative Changes

- **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. Also, there is too much room for uncertainty on how to establish fair market value.

Administrative Changes

- **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.

Administrative Changes

- **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.

Administrative Changes

- 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. 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.

Administrative Changes

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

Administrative Changes

- **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.

Administrative Changes

- **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.

Administrative Changes

- **Redefine Treatment of “Special Purposes” and Other Enhancements**
- 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).

Administrative Changes

- **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. 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. 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.

Administrative Changes

- 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.
- This recommendation may require a legislative change.

Legislative Changes

- **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.
- 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. 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.
- GAO, however, has reported that implementation issues could overwhelm the potential benefits of CAFs, which could be achieved through simpler means. Accordingly, GAO has concluded that CAFs do not seem to be worth the implementation challenges they would create. Moreover, GAO has indicated that, except for OMB, other agencies generally agreed with their conclusions.

Legislative Changes

- 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.

Legislative Changes

- **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.

Legislative Changes

- 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

CBO Position

Statement of Peter R. Orszag

- Director, CBO, July 10, 2008 Investing in Infrastructure Before Senate Finance Committee
- Proposed increase use of Transportation Infrastructure Finance and Innovation Act (TIFIA). Established as part of TEA-21 in 1998 and extended by SAFETEA-LU in 2005, TIFIA is a federal credit program that funds transportation projects of national and regional significance on a competitive basis. As of April 15, 2009, TIFIA has provided \$6.6 billion in assistance to 19 projects, which sum to \$24.4 billion in total investment, and all loan repayments have been made on time. Instead of creating a bank to provide similar credit assistance, it makes more sense to capitalize on the success of this existing program
- Proposed increase use of State Revolving Funds that are capitalized by Grants. EPA and FAA use these mechanisms now

CBO Position

- Establish Independent Special Purpose Entities along the lines of the TVA which does not record financial activities on the budget. Government Sponsored Enterprises (GSEs).
- One example is the National Cooperative Bank established in 1998 and then converted to private ownership in 1981. Draws upon federal financial support without recording financial activities on the budget.
- Infrastructure Bank could be similarly structured along the lines of the European Investment Bank offering technical assistance and loan guarantees to its clients. The EIB works in tandem with the European Investment Fund (EIF) to promote development of small and medium-sized companies in the new-technologies sector.

Infrastructure Bank

- Needs to be structured so as not to record financial activities on the budget
- Congresswoman DeLauro's plan would give the final say over which transportation, energy and telecom projects receive assistance from the development bank to an independent board of directors. Separate risk management and audit committees would keep an eye on the bank's balance sheet, which would get a \$5 billion annual infusion of taxpayer money to help attract more capital from private investors.
- The development bank has won backing from a collection of strange political bedfellows, including the U.S. Chamber of Commerce, the AFL-CIO and [Felix Rohatyn](#), the investment-banking magnate who helped New York City avert insolvency in the 1970s.

Infrastructure Bank

- Still, the risk-management aspect of the plan appears particularly crucial. Why? The development bank would be able to "purchase and sell infrastructure-related loans and securities on the global capital market," according to DeLauro's summary. That phrase sounds innocuous enough, but several communities that issued infrastructure-related bonds to pay for recent improvement projects have [found themselves facing bankruptcy](#) after making risky bets to help keep pace with fluctuating interest rates.
- With the municipal bond market [on shaky ground](#) right now, it's easy to envision the infrastructure bank taking -- to use a euphemism -- creative measures on the market to help convince private investors to participate. It's important, therefore, for the bank to ensure states and localities aren't getting talked into overly complex financing arrangements.
- Does the infrastructure bank proposal have a real future in Congress? Its current 27 co-sponsors in the House are all Democrats, but former GOP senator [Chuck Hagel signed onto](#) a similar plan in 2007, and its appeal is undeniably bipartisan. Transportation Secretary Ray LaHood also has spoken approvingly of the bank, meaning that it has a strong chance of appearing in [the federal transportation bill](#) slated for introduction this summer.

CBO on Federal Capital Budget

- Moving to a budget that is more reliant on accrual-based accounting could increase complexity, diminish transparency, and make the federal budget process more sensitive to assumed parameters such as depreciation rates.
- Providing special treatment to certain areas of the budget, such as capital spending, could make the process more prone to manipulation – i.e., how do you define “capital” for budgeting purposes?
- Another alternative might be to attribute a portion of the cost of assets each year to programs that use them. Requiring users to pay the costs might improve incentives for agencies to sell assets that were no longer appropriate to their needs.

The Wrap Up

