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Testimony

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

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# FEDERAL REAL PROPERTY

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

Statement of Mark L. Goldstein, Director



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# Highlights

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

## Why GAO Did This Study

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

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

## What GAO Recommends

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

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

[www.gao.gov/cgi-bin/getrpt?GAO-06-136T](http://www.gao.gov/cgi-bin/getrpt?GAO-06-136T).

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

## FEDERAL REAL PROPERTY

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

#### What GAO Found

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

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

#### Examples of Leased Federal Facilities



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

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

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Mr. Chairman and Members of the Subcommittee:

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

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

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

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

<sup>2</sup>Presidential Executive Order 13327, Feb. 4, 2004.

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

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

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## Federal Real Property: A High-Risk Area

Over 30 federal agencies control hundreds of thousands of real property assets—including both facilities and land—in the United States and abroad. These assets are worth hundreds of billions of dollars.

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

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

More specifically:

- *Competing Stakeholder Interests* - In addition to Congress, the Office of Management and Budget (OMB), and the real property-holding agencies themselves, several other stakeholders have an interest in how the federal government carries out its real property acquisition, management, and disposal practices. These include foreign and local governments; business interests in the communities where the assets are located; private sector construction and leasing firms; historic preservation organizations; various advocacy groups; and the public in general, which often views the facilities as the physical face of the federal government in local communities. As a result of competing stakeholder interests, decisions about real property often do not reflect the most cost-effective or efficient alternative that is in the interests of the agency or the government as a whole, but instead reflect other priorities.
- *Legal and Budgetary Disincentives* -The complex legal and budgetary environment in which real property managers operate has a significant impact on real property decisionmaking and often does not lead to economically rational and businesslike outcomes. For example, we have reported that public-private partnerships might be a viable option for redeveloping obsolete federal property when they provide the best economic value for the government, compared with other options, such as federal financing through appropriations or sale of the property. Resource limitations, in general, often prevent agencies from addressing real property needs from a strategic portfolio perspective. When available funds for capital investment are limited, Congress must weigh the need for new, modern facilities with the need for renovation, maintenance, and disposal of existing facilities, the latter of which often gets deferred. In disposing of excess property, agencies also need to consider a range of laws intended to address other objectives—such as historic preservation

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and environmental remediation.

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

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

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

<sup>4</sup>OMB, *Circular No. A-11, Appendix B*.

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

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

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## Reliance on Costly Leasing

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

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<sup>5</sup>U.S. Postal Service, *Transformation Plan* (Washington, D.C.: Apr. 2002); U.S. Postal Service, *Progress Report* (Washington, D.C.: Nov. 2004).

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

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\$107 million compared with operating leases but would have cost \$19 million more than construction.<sup>7</sup>

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

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

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



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



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

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

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<sup>9</sup>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.

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

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

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## Scope and Methodology

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

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

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

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## Contacts and Acknowledgments

For further information on this testimony, please contact Mark L. Goldstein on (202) 512-2834 or at [GoldsteinM@gao.gov](mailto:GoldsteinM@gao.gov). Key contributions to this testimony were made by Christine Bonham, Susan Michal-Smith, David Sausville, and Kelly Slade.

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