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Information for the House Committee on Transportation and Infrastructure and the Subcommittee on Economic Development, Public Buildings, and Emergency Management

Federal Real Property: Leases with Purchase Options Are Infrequently Used but May Provide Benefits

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Introduction

- Our work over the years has shown that, in general, buying a building costs less than entering into a long-term lease.
- We have also found that the General Services Administration (GSA) typically lacks the budget authority from the Federal Buildings Fund (FBF) to purchase buildings outright[1] and, according to GSA officials, must resort to leasing to fulfill the federal government's space requirements.
- Including a purchase option as part of a lease may reduce costs and provides a future option to own the building.
- Acquiring a building by exercising a purchase option may be a lower cost alternative to making ongoing rent payments, particularly rent payments over a long time period.

[1]The FBF, administered by GSA, is the primary means used to finance the capital and operating costs associated with federal space. Congress exercises control over the FBF through the appropriations process that sets annual limits—called obligational authority—on how much of the fund can be obligated for various activities, such as rental of space and construction and acquisition of buildings. See GAO-12-646.

Introduction

- The decision to lease or purchase a building is influenced by the budget scorekeeping process, among other factors, which determines the amount that GSA must obligate when it enters into a lease.
- Scorekeeping rules are established by the Office of Management and Budget (OMB), the Congressional Budget Office (CBO), and the Senate and House Budget Committees.
- Budget Committees and CBO apply the rules to estimate the costs associated with proposed legislation. OMB uses the rules to determine amounts to be recognized in the annual federal budget when an agency signs a contract or enters into a lease.
- In the early 1990s, scorekeeping rules on how GSA budgets for capital acquisitions, such as leased building space, were adopted. In particular, these new rules affected the treatment of discounted purchase options, which give the government an option to purchase a leased building for a price that is, at the time the lease is signed, lower than the building's expected future fair market value.

Objectives

You asked us to provide information on budget scorekeeping rules and the potential costs and benefits of entering into leases with purchase options. The objectives of our review were to describe

(1) the adoption of budget scorekeeping rules in the early 1990s, and the effects of these rules on the use of leases with purchase options;

(2) the extent GSA has been able to capture any financial benefits from exercising purchase options; and

(3) selected stakeholder views on the use of lease purchase options, including potential advantages and disadvantages.

Scope and Methodology

- To address these areas, we reviewed OMB guidance that described scorekeeping rules.
- We reviewed congressional testimony presented by us, CBO, and OMB on public buildings and budget issues that arose after the rules were adopted (1993-1994).
- We identified 17 examples of GSA leases from 1992 to 2014 that included purchase options and described their characteristics, including any financial benefits of including a purchase option where the purchase price was less than the appraised, assessed, or estimated value of the building.
  - These financial benefits only reflect the difference between a purchase made by exercising a lease purchase option and a purchase made without such an option; they do not incorporate other costs and benefits such as rent paid under the lease leading up to when the purchase option was exercised.
- We also interviewed officials from OMB and CBO, as well as stakeholders, such as GSA officials—including officials from all 11 GSA regions, lessors, and industry association representatives. We selected lessors based on their involvement in one of the 17 leases that included a purchase option we identified, or their involvement in high-value leases with GSA.[2] Our interviews were conducted for the following purposes:
  - To understand the impacts of the scorekeeping rules.
  - To describe the extent to which purchase options have been included in GSA leases, any financial benefits GSA has captured through such mechanisms, and stakeholder views on the advantages and disadvantages of including purchase options in leases.

[2]Lessor involvement with a high-value lease was used as a selection factor because it was an indication that the lessor had experience with large, complicated GSA leases. To identify these lessors we used data from a prior GAO engagement. See GAO-13-744. The views we gathered from these lessors are not necessarily representative of all lessors who enter into leases with GSA.

Background: Purchase Options

- Purchase options give an agency the choice to buy the building, typically at the end of the lease term. The purchase price can be determined in one of two ways:
  - fixed-price which is determined when the lease is signed and stays in effect until a future date when the option can be exercised; or
  - through an appraisal process conducted at the time the option can be exercised.
- Leases with purchase options can be categorized under budget scoring rules as a discounted “lease-purchase” if, at the time the lease is signed, the option to purchase is at a discount compared to its expected future fair market value.

Background: Overview of GSA Scoring and Acquisition Alternatives

- According to current scoring rules, when GSA enters into a contract for a lease, the budget authority and outlays[3] may be "scored" as follows:
  - *Lease-purchases and Capital Leases*: budget authority is scored 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.
  - *Operating Leases*:[4] budget authority is scored in the year in which the budget authority is first made available. The amount scored will include the estimated total payments expected to arise for the first fiscal year.
  - *Purchases*: budget authority is scored in the year in which the authority to purchase is first made available for the total amount of the asset (whether the asset is existing or is to be manufactured or constructed).

[3]Budget authority is authority provided by federal law to enter into financial obligations that will result in immediate or future outlays involving federal government funds. Budget outlays are the issuance of checks, disbursement of cash, or electronic transfer of funds made to liquidate a federal obligation.

[4]A number of OMB-defined criteria are used to distinguish an operating lease from a lease-purchase and a capital lease. For example, under an operating lease the present value of the minimum lease payments over the life of the lease should not exceed 90 percent of the fair market value of the asset at the inception of the lease. For a list of the five other criteria used to define an operating lease, see OMB Circular A-11. App. B.

Background: Scorekeeping Rules

- In the early 1990s, the adoption of scoring rules affected the way lease-purchases, including leases with discounted purchase options, were treated.
  - Prior to these rules, agencies that had negotiated a lease with a discounted purchase option were only required to record the lease payments (plus any cancellation costs) on an annual basis for budgeting purposes.
  - Following the adoption of these rules, agencies that signed a lease with a discounted purchase option were required to assume the option would be exercised and obligate funds for the full estimated costs of the building, including aggregated rent costs and the purchase price.

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Objective 1: Budget Officials Adopted Scoring Rules to Better Reflect the Total Costs of Ownership

- According to testimony from CBO, GAO, and OMB in the early 1990s, scoring rules were adopted to ensure the full costs of lease-purchases were recorded in the budget at the time the decision to acquire the building was made.
- Officials further testified that the scoring rules made the comparison of acquisition alternatives more equitable and allowed Congress and GSA to more clearly identify and evaluate the most cost effective ownership option.

Objective 1: Budget Officials Adopted Scoring Rules to Better Reflect the Total Costs of Ownership, cont'd

- Adoption of the scoring rules affected the treatment of buildings acquired through lease-purchases—including leases with a discounted purchase option—rather than constructing or purchasing a building outright.
- We have reported that constructing a building upfront is almost always more cost effective than entering into a lease-purchase.[5]
- Lease-purchases are more expensive, in part, because they are financed through private sector borrowing which costs more compared to the Treasury's cost of funds to purchase or construct a building up front.

[5]GAO, *General Services Administration: Comparison of Space Acquisition Alternatives - Leasing to Lease-Purchase and Leasing to Construction*, GAO/GGD-99-49R (Washington, D.C.: March 1999).

Objective 1: Scoring Rules Resulted in GSA Eliminating Use of Discounted Purchase Options

- GAO and others agree that adopting scoring rules effectively eliminated the use of lease-purchases.
  - In a 1994 hearing before the House of Representatives, Committee on Government Operations, we testified that the budget scoring rules helped correct the bias toward using lease-purchases. CBO also testified at this hearing that federal agencies ceased to enter into lease-purchases following the adoption of the new rules.
  - GSA headquarters officials we interviewed stated that, as a result of scoring rules, the agency has not entered into any leases with a discounted purchase option since the early-to-mid 1990s.[6]

[6]Officials also noted that reductions in budget authority and initiatives such as 2013 Freeze the Footprint initiative have also played a key role in determining how GSA acquires office space.

Objective 1: Scoring Rules Resulted in GSA Using Purchase Options Less Often

- Scoring rules did not alter the way non-discounted purchase options were treated under budget scoring rules. However, GSA officials, lessors, and industry stakeholders we spoke with stated that there has been a reduction in leases that included a non-discounted purchase option.
- Officials from 6 out of 11 GSA regions who offered an opinion stated that GSA was less likely to include purchase options as part of leases as a result of the scoring rules.
  - Officials from several GSA regions noted that the scoring rules send a signal that all purchase options are under intensified scrutiny.
  - GSA regional officials also expressed confusion about how the scoring rules are applied and, in a few cases, mistakenly believed the rules prevented the use of purchase options.

Objective 1: Scoring Rules Resulted in GSA Using Purchase Options Less Often, cont'd

- As we noted, the intended effect of adopting scoring rules was to level the playing field between ownership options, i.e., lease-purchases and upfront purchase and construction.
- However, we and others have pointed out that correcting the bias toward lease-purchases in the scoring rules had the unintended effect of creating a greater incentive to use operating leases. Specifically, scoring rules only require GSA to recognize the annual costs of operating leases, not the total costs as is required for scoring lease-purchases, construction, and outright purchases.
- We previously offered a possible remedy, which would score operating leases that are used for long-term needs similarly to ownership options.[7]

[7]GAO, *Budget Issues: Budget Scorekeeping for Acquisition of Federal Buildings*, GAO/T-AIMD-94-189 (Washington, D.C.: September 1994).

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Objective 2: GSA Rarely Includes Purchase Options in Leases

- According to GSA officials, it is challenging to identify the number of historical leases that included purchase options because GSA databases only began to collect this information within the past few years. Officials also told us they seldom use purchase options, especially discounted purchase options.
- Through our interviews with GSA, lessors, and industry stakeholders, we were able to identify 17 leases from 1992 to 2014 that included a purchase option.[8] (See Enclosure II for a summary of these leases and Enclosure III for specific details on each lease).
- According to GSA data, GSA entered into approximately 18,600 leases during this same time period (1992 to 2014).

[8]As a result of staff turnover and challenges with historical documentation, officials were only able to identify leases with purchase options after 1992.

Objective 2: GSA Rarely Includes Purchase Options in Leases, cont'd

- Compared to other GSA assets, most of the 17 leases with purchase options we identified are for relatively large spaces with high rents.
  - Of the 17 leases, 15 were for leases over 100,000 square feet and 12 out of those 15 were for leases over 250,000 square feet.
  - Out of 17 leases, 15 had annual rents over $1,000,000.
  - All 17 leases were for longer than 10 years.
- Out of the 17 leases, 12 included a fixed-price purchase option, 3 included an appraisal process for determining the purchase option price, and 2 included some combination of those two approaches.

Objective 2: GSA Has Realized Financial Benefits from Use of Purchase Options in Some Instances

- We identified 3 leases which included a purchase option that was exercised at below fair market value.
  - According to OMB officials, the purchase option for one of the leases was considered to be "discounted" for budget scoring purposes because, at the time the lease was signed, the $1 purchase price was expected to be lower than the building's future fair market value.
  - The other 2 leases were not considered to include discounted purchase options because, at the time the leases were signed, the purchase prices were not expected to be lower than the future fair market values.
- GSA exercised the purchase option for these leases, resulting in almost $80 million in financial benefits relative to what the government would have paid to purchase the buildings at fair market value.
- A full accounting of acquisition costs would include the costs incurred and benefits received over the long term, including the life of the lease. For example, prior to exercising these purchase options GSA paid rent, operating costs, and other expenses.

Objective 2: GSA Has Realized Financial Benefits from Use of Purchase Options in Some Instances, cont'd

Figure 1: Examples of Buildings GSA Acquired through Exercising Purchase Options at Prices Below Market Value

Columbia Plaza
(2401 E Street NW, Washington, DC)

Purchase option:
GSA exercised a purchase option for $100 million when the property was valued at approximately $150 million, resulting in $50 million in financial benefits.

USDA Center
(4700 River Road, Riverdale, MD)

Purchase option:
GSA exercised a purchase option for $31 million when the property was valued at approximately $45 million, resulting in $14 million in financial benefits.

985 Michigan Avenue, Detroit, MI

Purchase option:
GSA exercised a discounted purchase option for $1 when the property was valued at $14.5 million, resulting in $14.5 million in financial benefits.

Source: GAO and General Service Administration. | GAO-16-536R

Note: A full accounting of the acquisition costs of purchase options would include the costs incurred, such as rent paid, and the benefits received over the long term.

Objective 3: Selected Stakeholders View Using Purchase Options in Leases as Generally Favorable for GSA

- According to stakeholders—including GSA regional officials, lessors, and industry association representatives—we spoke with, including purchase options in leases was generally favorable for GSA.
  - Out of 23 stakeholders, 13 stated that including a purchase option in a lease was a way to ensure GSA maintained a unique property that meets specific tenant needs. For example, officials from several GSA regions said that in cases when funding is not available to purchase a building, but the building has specialized equipment or is designed specifically to meet the needs of a particular tenant agency, it makes sense to include a purchase option so that GSA retains the right to potentially take ownership of a unique asset.
  - Out of 23 stakeholders, 12 viewed purchase options as a way for GSA to take advantage of market conditions. For example, several lessors noted the opportunities for GSA to capture value under some circumstances, including choosing to exercise the option when the market is at a high point.

Objective 3: Selected Stakeholders View Using Purchase Options in Leases as Generally Favorable for GSA, cont'd

- Stakeholders cited the possibility of increased rent as a concern for GSA when including purchase options in leases.
  - Out of 23 stakeholders, 12 noted that lessors could demand higher rent as a concession for including a purchase option.
  - However, no one we spoke with could identify how much of a rent premium lessors might demand in exchange for offering a purchase option.

Objective 3: Selected Stakeholders View Using Purchase Options in Leases as Generally Favorable for GSA, cont'd

- Stakeholders identified several ways in which purchase options were less preferable to lessors.
  - Out of 23 stakeholders, 12 stated that purchase options present the possibility for lessors to lose annual cash flow from ongoing rent payments.
  - For example, several stakeholders noted that one of the main reasons lessors wanted to own GSA-leased spaces was because of the consistent rent payments and how valuable this income stream became, especially once the lessor retired any debt it used to finance its purchase of the building.
  - In addition, lessors may face penalties if they repay lenders (from building sale proceeds) earlier than planned.

Objective 3: Selected Stakeholders View Using Purchase Options in Leases as Generally Favorable for GSA, cont'd

- Out of 23 stakeholders, 12 stated that purchase options increased the level of risk and uncertainty for lessors.
- Including a purchase option with a lease shifts risk and uncertainty to lessors because GSA has control over whether or not to exercise the option.
- Stakeholders noted that this risk and uncertainty can manifest itself in several ways that are disadvantageous to lessors, including additional costs associated with borrowing capital to finance the purchase of the building, and the possibility of incurring a loss on the sale of the building in adverse market conditions.

Objective 3: Selected Stakeholders View Using Purchase Options in Leases as Generally Favorable for GSA, cont'd

- Stakeholders identified several reasons lessors might be willing to offer a purchase option in a lease.
  - Out of 23 stakeholders, 7 noted that some lessors may want to use the lump sum payment from a property sale to re-invest in other real estate opportunities.
  - Out of 23 stakeholders, 6 stated that some lessors may want to sell the property to avoid maintaining and repairing an aging building that is towards the end of its useful life.