Congressional Budget Office

Testimony

The Budgetary Treatment of Medical Facility Leases by the Department of Veterans Affairs

Robert A. Sunshine
Deputy Director

Before the
Committee on Veterans' Affairs
U.S. House of Representatives

June 27, 2013

This document is embargoed until it is delivered at 10:00 a.m. (EDT) on Thursday, June 27, 2013. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

Mr. Chairman, Congressman Michaud, and Members of the Committee, thank you for inviting me here to discuss the Congressional Budget Office's (CBO's) budgetary treatment of leases of medical facilities by the Department of Veterans Affairs (VA).

The main points of my testimony are as follows:

- In estimating the budgetary impact of a proposed financial transaction, CBO assesses the nature and extent of the government's financial commitment, taking into account not just the form, but also the substance of the transaction.

- Although VA classifies its leases of medical facilities as operating leases, most of them, in CBO's judgment, are akin to government purchases of facilities built specifically for VA's use—but instead of being financed by the U.S. Treasury, they rely on third-party financing (that is, funds raised by a nonfederal entity), which is generally more expensive.[1] For VA leases, the cost premium is even greater because, when the department vacates the facility at the end of the lease term, it loses the residual value of a building that it has fully or mostly paid for.

- Because those transactions are essentially governmental purchases, the full costs of acquiring the facilities should be recorded in the budget when VA enters into the lease—as is done for other purchases that the government makes—rather than spread out over the duration of the lease.

I will discuss why CBO reached those conclusions and how CBO's treatment of proposed VA leases is comparable to the approach it has applied in other, similar cases.

VA's Leases of Major Medical Facilities

Under current law, VA must receive specific legislative authorization to lease medical facilities with average annual rental payments in excess of $1 million. VA classifies those arrangements as operating leases (an agreement to use a property for a limited amount of time in exchange for periodic payments) and records the obligations on an annual basis in an amount equal to the lease payments due in that year.[2]

Before 2012, CBO followed that treatment in estimating the cost of legislation that would authorize those leases on the assumption that all of the leases were short-term contracts for the use of existing facilities or renewals of leases on facilities currently used by VA.

However, while preparing a cost estimate for the introduced version of H.R. 6375, the VA Major Construction Authorization and Expiring Authorities Extension Act of 2012, CBO received additional information from VA regarding the department's practices in contracting and executing most of the existing leases. On the basis of that information, CBO concluded that most of VA's leases of major medical facilities are not operating leases, but instead are a form of third-party financing because they have many of the following key features:

- The facilities are designed and constructed to the unique specifications of the federal government;

- The facilities are constructed at the request of the federal government;

- The leases on the newly constructed facilities are long term—usually 20 years;

- Typically, payments from the federal government are the only or the primary source of income for the facilities;

- The term of the contractual agreements coincides with the term of the private partner's financing instrument for developing and constructing the facility (that is, a facility financed with a 20-year bond will have a 20-year lease term);

- The federal government commits to make fixed annual payments that are sufficient to service the debt incurred to develop and construct the facility,

1. Third-party financing is a type of arrangement wherein a nonfederal entity borrows money in private capital markets to finance a facility or other asset that is built at the behest of and for use by a federal agency. For more information on the budgetary treatment of third-party financing, see Congressional Budget Office, *Third-Party Financing of Federal Projects* (June 2005), www.cbo.gov/publication/16554.

2. For further information on the budgetary treatment of operating leases, see the Office of Management and Budget, *Preparation, Submission, and Execution of the Budget*, Circular A-11, (August 2012), Appendix B, www.whitehouse.gov/omb/circulars_a11_current_year_a11_toc.

regardless of whether the agency continues to occupy the facility during the guaranteed term of the lease; and

- The fixed payments over the life of the lease are sufficient to retire the debt for the facility.

Whereas entering into an operating lease is similar to renting an apartment—a renter can move out after a short period with no further commitment—VA's build-to-lease contracts are similar to obtaining a mortgage to buy a house; through the agreement, the agency acquires an asset along with a corresponding liability to pay for the asset over time.

Like arrangements involving third-party funding for other federal facilities, VA's leases for medical facilities are more expensive than traditional acquisition methods because the third party borrows funds at interest rates higher than Treasury rates. In the case of VA's leases, the cost premium is even greater because, when the agency vacates the facility at the end of the lease term, it loses the residual value of a building that it has fully or mostly paid for.

Third-Party Financing of Federal Projects

Proposals to enter into arrangements involving third-party financing are not unique to veterans' medical centers. Other agencies have structured third-party transactions to try to justify recording investment costs in the federal budget over the life of a project instead of in full when the investment is made—as would be the case with up-front appropriations for acquisition and construction projects. However, such budgetary treatment is at odds with established principles of federal budgeting, which require agencies to record the costs of government investments when they are made.

Examples of Third-Party Financing

Over the past 10 years, CBO has evaluated many projects involving third-party financing, and it has consistently estimated up-front budgetary effects of legislation that would authorize those projects. Some examples of other uses of third-party financing are energy savings performance contracts (ESPCs), enhanced-use leases, lease-leaseback ventures, and military housing privatization projects.

Energy Savings Performance Contracts (ESPCs). Federal agencies enter ESPCs to acquire energy-efficient equipment—such as new windows, lights, and heating, ventilation, and air conditioning systems—while paying for the equipment over time. Because the government does not pay for the equipment at the time it is acquired, the contractor borrows money from a nonfederal lender to finance the acquisition and installation of the equipment. When the government signs the ESPC, it commits to paying for the full cost of the equipment as well as the interest costs on the contractor's borrowing for the project.[3]

Enhanced-Use Leases. Various federal agencies are allowed to lease out underutilized property to a nonfederal entity in exchange for cash or in-kind compensation. In some instances, agencies have employed that authority to enter into enhanced-use leases to obtain third-party financing for the acquisition, construction, rehabilitation, operation, and maintenance of real property used by the agencies. Those agencies use a variety of agreements and contracts to assure the nonfederal partner that it will be able to recover its capital costs for the facilities over time through payments from the federal government.[4]

Lease-Leaseback Ventures. A few agencies such as the Tennessee Valley Authority can lease out new or existing facilities to a nonfederal entity in exchange for an up-front payment. The agency then leases those same facilities back from the lessee for the life of the asset—which can extend 30 years or more—at prices set to cover the lessee's debt. Such arrangements allow agencies to raise financing while avoiding statutory limits on their direct borrowing.[5]

3. See the discussion on energy savings performance contracts in Congressional Budget Office, cost estimate for S.1321, the Energy Savings Act of 2007 (June 11, 2007), www.cbo.gov/publication/18735.

4. See the discussion on enhanced-use leases and build-to-lease military housing in Congressional Budget Office, cost estimate for S. 1042, the National Defense Authorization Act for Fiscal Year 2006 (June 2, 2005), www.cbo.gov/publication/16561.

5. See the discussion on lease-lease backs in Congressional Budget Office, cost estimate for H.R. 2548, the Federal Property Asset Management Reform Act of 2003 (November 18, 2003), www.cbo.gov/publication/15048.

Military Housing Privatization. The Department of Defense can enter into partnerships, provide direct loans and loan guarantees, enter into long-term leases, and use other financial arrangements to renovate, build, and operate military housing in concert with residential housing developers. The capital costs for the housing are repaid over time on a monthly basis through housing allowances provided to service members.[6]

Features of Projects That Use Third-Party Financing

Although projects that use third-party financing employ a variety of contractual arrangements and result in the acquisition of a broad range of assets, they generally have several features in common. In most cases, the government:

- Initiates the project, selects the developer, and specifies the project's parameters;
- Has significant economic interests as owner, beneficiary, or lessor;
- Retains substantial control over the project's assets, business operations, and management; and
- Serves as the sole or primary source of capital backing the project's financing.

As a general rule, the conditions that make projects viable for investors are usually some of the same features suggesting that the projects should be classified as governmental activities. To secure private financing, agencies must demonstrate the government's long-term economic interest in the asset or service. Likewise, many of the contractual conditions that agencies seek in order to protect the government's interests in a project give the government ultimate control over the activity.

Third-party financing arrangements have a number of other consequences. Relying on third-party financing generally increases costs to the government. Each intermediary charges a fee for its services, which together can add at least 2 percent—and in some cases more than 50 percent—to the costs of a project.[7] Interest rates on projects' debt usually exceed interest rates on Treasury bonds by anywhere from 1 to 3 percentage points, depending on the terms negotiated by the parties.

In addition, if agencies do not initially record the full cost of governmental activities, the budget understates the size of the federal government and its obligations at the time when those obligations are made. Third-party arrangements may also skew decisions about how to allocate budgetary resources by giving preferential treatment to investment projects on the basis of their method of financing rather than their relative merits.

Such arrangements also reduce an agency's flexibility when managing its budget. The agreements entail a stream of mandatory payments that cannot be avoided. When faced with budgetary pressure, such as emergency expenses or the reductions in budget authority that arise from sequestration, for example, reductions must come from other programs or activities.

Finally, third-party financing allows agencies to raise capital in private markets without the full scrutiny of the Congressional appropriation process.

Budgetary Treatment of Third-Party Financing

The way in which an activity should appear in the federal budget depends on the nature of the activity, not its method of financing. Under the principles that govern federal budgeting, budgetary treatment should be based on whether the activity is governmental (that is, initiated, controlled, and funded largely by the government for governmental purposes) or is an initiative of the private sector (driven by market forces independent of the government). An investment that is essentially governmental should be shown in the budget whether it is financed directly by the U.S. Treasury or indirectly by a third party that is borrowing on behalf of the government.

To properly measure the scope of the federal sector, the 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 provides the most accurate and timely measure of the magnitude of the government's

6. See the discussion on military housing privatization in Congressional Budget Office, cost estimate for H.R. 4879, the Military Housing Improvement Act of 2004 (July 30, 2004), www.cbo.gov/publication/15869.

7. Government Accountability Office, *Capital Financing: Partnerships and Energy Savings Performance Contracts Raise Budgeting and Monitoring Concerns*, GAO-05-55 (December 2004), www.gao.gov/products/GAO-05-55.

financial commitment and the net costs of projects to taxpayers. It also discourages the use of costly third-party financing mechanisms and ensures that various types of acquisitions by federal agencies receive equivalent budgetary treatment.

Budgetary Treatment of VA's Leases

In estimating the budget impact of authorizing legislation for VA, CBO treats leases for existing medical facilities under short-term contracts as operating leases, showing costs on an annual basis. However, on the basis of VA's practices over a number of years, CBO concludes that the majority of the leases proposed in 2013 would not qualify as operating leases. Most of those arrangements are long-term contracts for the development and construction of new facilities that are built for VA to its unique specifications.

Therefore, CBO has determined that budget authority for leases of VA medical facilities should be recorded up front when the leases are initiated, in amounts equal to the development and construction costs of the medical facilities; that is, the cost should be recorded when the acquisition occurs, not when the debt is repaid. Because VA records a smaller amount (based on annual lease costs), CBO treats legislative authorization for such leases as contract authority—a type of budget authority that allows an agency to enter into a contract and incur an obligation in advance of appropriations.

Those conclusions reflect CBO's best objective judgment as to the appropriate budgetary treatment of VA's planned transactions, formed on the basis of the general principles that apply to federal budgeting and precedents established over a number of years. Ultimately, in such cases, the Office of Management and Budget and the affected executive branch agencies determine how transactions are recorded in the federal budget once legislation is enacted.

I would be happy to answer any questions you may have on this topic.

Ann Futrell, Sarah Jennings, and David Newman contributed to this testimony, with guidance from Theresa Gullo. John Skeen edited the document, and Jeanine Rees prepared it for publication. The testimony is available on CBO's website (www.cbo.gov).