CONGRESSIONAL TESTIMONY 1998

MARCH 1998

REPORT TO CONGRESS
ON THE SECOND YEAR OF THE HOUSING REVITALIZATION INITIATIVE

INTRODUCTION

The Department of Defense has completed a successful second year in the implementation of the Military Housing Privatization Initiative (MHPI). During this year, we worked diligently to refine the most efficient uses of the authorities provided by the Congress to improve the quality of housing for our military families. This report describes the progress made in the second year of this important initiative. It also discusses how this initiative fits in the Department's overall housing goals and describes the keys to future success.

DOD'S HOUSING PROBLEM

Last year, the Department of Defense set a critical goal for the Military Services to eliminate all inadequate housing by 2010. The challenge is significant: Approximately 200,000 of DoD's domestic housing units are inadequate. Fixing this problem using traditional military construction alone would cost as much as $20 billion and take over 30 years. To meet our 2010 goal, the Military Services have begun to prepare detailed installation-by-installation plans. These plans will describe the condition of the housing at each installation and delineate how various tools and approaches - including privatization - will be used collectively to meet the 2010 objective.

FY 1996 AUTHORITIES

The Military Housing Privatization Initiative legislation provides a range of important authorities:

Guarantees, both for loans and rental occupancy

1. Conveyance or lease of existing property and facilities
2. Differential payments to supplement Service members housing allowances
3. Investments, both limited partnerships and stock/bond ownership
4. Direct Loans

These authorities are provided for a five-year test period. They can be used individually, or in combination. (A description of each of these authorities is provided in Appendix A.)

PROJECTS COMPLETED

Naval Air Station Corpus Christi, Texas

In May 1997, military families from Naval Station Ingleside, Naval Air Station Kingsville and Naval Station Corpus Christi started moving into two new townhouse complexes. This project - a limited partnership agreement with Landmark Organization Inc. of Austin, Texas - built 404 units of off-base family housing at a cost of approximately $30 million. The Navy's total equity contribution is $9.5 million with the developer financing the rest. (Spending the same amount of money using the traditional government construction approach would have yielded one-fourth the number of units.) These complexes offer quality affordable rental housing with amenities such as swimming pools, soccer and baseball fields, and basketball courts. All units have been completed with sailors being given first preference to rent at specified rates, which are below that of comparable housing in the local community. At the end of the ten-year partnership, the Navy will receive one-third of the net value and will be repaid its equity share. The authorities allow the money to be redeposited into the Family Housing Improvement Fund (FHIF) for use on future privatization projects.

Naval Station Everett, Washington

A second Navy Limited Partnership project was completed in the summer of 1997. The units are now occupied by enlisted personnel from Naval Station Everett. For this project, the Navy contributed $5.9 million to facilitate the development of approximately 185 units of off-base family housing. The developer provided the remainder of the total project cost of approximately $19 million. As is the case with the Corpus Christi project, sailors are given first preference to rent at rates that are set below that of comparable housing in the community and the Navy's share of the equity and proceeds is available for future projects at the end of the ten year partnership. An added feature of this project is that the military occupants have the option to purchase their units, at below market prices, starting in the last five years of the partnership.

PROJECTS IN PROCUREMENT

Fort Carson, Colorado

On February 10, 1998, the Department notified Congress of our intent to transfer $15.82 million of family housing construction funds into the FHIF and to award the contract for the Army's project at Fort Carson. This project is the first to use a number of our new authorities, including a loan guarantee and transfer of existing government units. The developer is responsible for the construction, maintenance and management of 840 new single and multifamily structures and the phased revitalization, maintenance and management of the 1824 existing housing units on base at Fort Carson - a total of over 2600 units. Rent for these units is set at the soldier's housing allowance and will be paid to the developer via an allotment. The developer will also maintain unoccupied and public areas associated with the housing community; construct and maintain associated new roads and infrastructure; and undertake any required reinvestments or improvements in community areas, such as green areas, parks, picnic areas, and day care centers. The Army will outlease land for both the new and existing units and convey title to the existing structures. The contract is set for a period of 50 years, with a renewable option of 25 years.

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The procurement for Lackland Air Force Base is in its final stages with best and final offers expected in late March of 1998. This project requires the developer to construct, manage, and maintain 420 family housing units located on base. Rent for these units is set at the airman's housing allowance and will be paid to the developer by an allotment. The installation is offering to outlease 96 acres of land for a period of up to 50 years. The request for proposals (RFP) also requires the developer to demolish 272 substandard housing units currently on a portion of the property to be outleased. Additionally the RFP notes that the government is willing to offer a limited loan guarantee, as well as a direct second mortgage. This project is expected to provide the first use of our direct loan authority.

REQUESTS FOR PROPOSALS READY FOR ISSUE

Marine Corps Logistics Base (MCLB), Albany, Georgia

Notification was provided to Congress on January 5, 1998 of intent to issue an RFP for a project at MCLB Albany. The successful offeror will be required to construct, manage, and maintain approximately 155 family housing units on base. This project does not have a family housing construction appropriation and will be funded through the divestiture of 419 family housing units which are located in an off base enclave called Boyett Village. Proceeds of this divestiture will be used to leverage development of the on base housing under a long term lease arrangement.

Marine Corps Base (MCB) Camp Pendleton, California

The Department of Defense expects to provide notification of intent to issue an RFP for a project at Camp Pendleton this spring. This project requires the private developer to construct, manage, and maintain 204 new single and multifamily housing structures. In addition, the developer will be responsible for the phased renovations, maintenance and management of 512 existing housing units. All units will be on base in this project.

REQUEST FOR PROPOSALS UNDER DEVELOPMENT

Five more projects have been approved for RFP development which is currently underway. Upon completion of the RFP, we will provide notification to Congress of our intent to issue RFP's for these projects. The locations of these projects are listed below along with the number of housing units expected to be privatized:

Robins AFB, Georgia	760 units
Fort Hood, Texas	5825 units
Elmendorf AFB, Alaska	828 units
Fort Stewart, Georgia	3282 units
Fort Lewis, Washington	3956 units

PROGRAMMATIC ISSUES AND IMPROVEMENTS

Our work on housing privatization this past year was affected by two key issues: budget scoring and loan/loan guarantee documentation. For the first six months of the year, we worked with the Office of Management and Budget (OMB) to determine appropriate rules to score obligations of the government incurred by using our new authorities. The Director of OMB approved scoring guidelines in June that enable us use our new authorities and maximize the leveraging of our scarce Milcon funds. (OMB scoring guidelines are provided in Appendix B) Developing the loan and loan guarantee instruments for both the Ft. Carson and Lackland projects proved very time consuming. In particular, the Housing Revitalization Support Office (HRSO) had to work with the financial community to translate the loan guarantee concepts into actual documents that would receive favorable - i.e., investment grade -- financing. Resolution of these two issues will now enable us to move more quickly on the projects that follow.

In addition, we completed a competition for consultant support to the Housing Revitalization Support Office (HRSO) so that it could increase its workload and bring creative new perspectives to the program. The HRSO also continued to refine the comprehensive pro forma used to help screen the financial viability of projects. Joint HRSO and Military Service teams have now completed visits to over 30 potential privatization sites and evaluated their financial feasibility. This process has markedly enhanced our understanding of how best to use our authorities over a large spectrum of projects and geographic locations.

As with any complex program, the devil is in the details and we will continue to resolve these issues as they arise and ensure that all lessons-learned make the next projects easier and faster.

STATUS OF FUNDS

The Family Housing Improvement Fund was established in FY1996 with an initial appropriation of $22 million. In FY1997, the Department received a $25 million appropriation for the FHIF and a $5 million appropriation for the Unaccompanied Housing Improvement Fund. In the first two years, the Department used about $9 million for administrative costs including contract support. In FY1998, we anticipate administrative costs of $7 million and have requested a $7 million appropriation to the FHIF for HRSO administrative costs in FY1999. Additionally $9.5 million was used to fund the Corpus Christi project, and another $760 thousand to fund development of RFP's for the projects at Ft. Carson and MCLB Albany. The primary method of funding projects continues to be transfer of existing family housing construction funds into the Family Housing Improvement Fund. The $5.9 million cash investment for the Naval Station Everett limited partnership was funded in this manner. The statutory notification and reporting requirements will provide the Congress oversight, at key steps, as the Department increases the number of projects in the procurement process.

MOVING THE PROGRAM FORWARD

While we continue to conduct aggressive outreach to the private sector, we are also working to institute lessons learned from our first projects. In February of this year, we convened a two day seminar with all key participants of the Fort Carson privatization project attending. This face-to-face interaction helped capture all the minute details needed to provide lessons learned for our next projects. We have continued active training programs to increase the knowledge of privatization and private sector financing among all DoD personnel involved in housing privatization. Combining lessons learned with increased training, we expect to significantly reduce the time and effort required to complete privatization projects.

In the two years since enactment of this legislation, the Department has made significant progress in establishing required policies and procedures. Equally important, we have moved forward with a number of important projects - totaling about 18,000 housing units. We are paying close attention to our current projects to ensure effective implementation and expect to propose permanent legislation next year.

APPENDIX A

FY 1996 PRIVATIZATION OF MILITARY HOUSING LEGISLATIVE AUTHORITIES

1. **Guarantees.**
   These can be loan or rental guarantees. DoD can guarantee mortgage payments, directly or through an intermediary; or, it can provide a more limited guarantee. Additionally, the Department can provide guarantees for mortgage insurance.
2. ***Leasing.***
   The Department may enter into contracts for the lease of family housing units to be constructed by the private sector pursuant to the MHPI authorities. A lease contract may include an operation and maintenance provision. The Department may also provide for an interim lease of housing acquired or constructed by the private sector as such units are complete. Finally, the Department may lease land or housing units to private parties for use in providing housing for Service members.
3. ***Differential Lease Payment.***

This authority allows the Department to pay an amount in addition to the rent paid by the Service members, in order to encourage the private lessor to make its housing available to Service members.

4. ***Investments.***
   The investment authority allows the Department to make investments in non-governmental entities involved in the acquisition and/or construction of family housing and supporting facilities. These investments can be in the form of a limited partnership, a purchase of stock or other equity interest, a purchase of bonds or other debt instrument, or any combination of such investments. Although there is no minimum cash contribution for any DoD investment in a project, there is a maximum cash contribution that the Department may offer. The Department may invest a maximum of 33 1/3% of the capital cost of a project if the entire investment is cash. Because all sites and projects are different, and because the Services will each prioritize their own projects, the full 33 1/3% cash contribution may not be needed in each project. The Department also has the authority to convey land or buildings as all or part of its investment, in which case its total contribution, including the value of land and facilities, may not exceed 45% of the total capital cost of the project.
5. ***Direct Loans.***
   The Department may offer a direct loan to a private developer to provide funds for the acquisition or construction of housing that will be available to military members.

APPENDIX B

SCORING DOD's MILITARY HOUSING PRIVATIZATION INITIATIVES

Military Housing Privatization Initiative Authorities

The Military Housing Privatization Initiative (MHPI) in P.L. 104-106 provides DoD with many authorities that may be used to attract private capital investment for revitalizing the stock of military housing. This document defines the guidelines that OMB will use to determine the budgetary impact of DoD's use of these authorities.

Scoring Determines Obligations to be Recorded

Each privatization agreement that DoD enters must be scored for budget purposes. Scoring seeks to determine the cost that should be recognized and recorded as an obligation of DoD at the time a contract is signed. Sufficient appropriations must be available to cover the amount obligated for each contract. The Department, with OMB concurrence, will determine the amount of funds to be obligated to cover future costs that are associated with the use of the tools provided in the MHPI.

Direct Loans and Loan Guarantees

Two important financing tools available to DoD for housing revitalization efforts are direct loans and loan guarantees. Each provides a government subsidy that must be considered and accounted for in making financing decisions. For direct loans, the government provides funds directly to a private borrower and agrees to absorb a portion of the cost of a default by the borrower. For loan guarantees, the government makes a binding commitment to absorb a portion of the cost of default on credit extended by a private financial institution to a private borrower. The budget impact of using each of these authorities must be estimated and sufficient finds obligated to cover the estimated cost to the government.

The amount of obligations to be recorded for a direct loan or loan guarantee depends on the subsidy rate. The rate represents, in net present value terms, the cost of estimated defaults (net of recoveries) and interest rate subsidy, if any, over the life of the loan or guarantee. For example, if the subsidy rate is 25 percent, obligations of $10 million would be recorded for a $40 million loan or guarantee. Before funds are obligated for a loan or guarantee, appropriations sufficient to cover the subsidy cost of each project must be available in the Family Housing Improvement Fund.

Participation Test for Direct Loans and Loan Guarantees

For both on-base and off-base revitalization projects, substantial private sector risk is necessary to conform with the provisions of the Federal Credit Reform Act. Each housing privatization project that uses a direct loan or loan guarantee must meet the following risk, or "participation" test: at least 20 percent of all resources for a project must be provided from private sources. If a project does not pass the participation test, the full amount of a loan or guarantee will be recorded as an obligation. This is especially critical for on-base projects, given the inherently governmental nature of any construction and federal use of projects built on federal land. Additional information for determining government and private sector participation is included at the end of these guidelines.

Additional Considerations for Direct Loans and Loan Guarantees

Loans that Subordinate the government's position, but have fixed repayment schedules, are scored like first mortgages. The credit subsidy, however, may be higher because the government is not the first creditor to be paid in case of default. Soft second mortgages, loans without a fixed repayment schedule, will be scored as grants, or equal to 100% of the loan.

A guarantee of bonds that are exempt from Federal taxes will be recorded as an obligation equal to 100 percent of the amount of the guarantee.

Discount Rate for Direct Loan and Loan Guarantee Calculations
DoD should use the interest rate on Treasury securities of similar maturity to the loan. This is the rate required by the Federal Credit Reform Act to estimate the cost of credit programs for the budget. The Government should make its decisions based on its own cost of borrowing, and it should use the same rate for all forms of government subsidies so as to provide consistent measures of cost.

Differential Payments, Income or Occupancy Guarantees, and Leases
Differential payments, income or occupancy guarantees, and leases provide, or seek to guarantee, an income stream to a housing provider. Use of these authorities will be scored "upfront", with the entire net present value of the lease or commitment recorded as an obligation at the time a contract is finalized.

Investments
If the Department acquires part ownership of a corporation or limited partnership through the purchase of stocks, bonds, or other types of equity, an obligation will be recorded equal to the cash investment at the time a contract is finalized.

Conveyance of Real Property
The Department may convey property in exchange for housing or an equity investment in a corporation or limited partnership. There will be no scoring impact if there is no cash income or expenditure.

Provision of Goods and Services
The Department shall not provide goods or services that would normally be paid for by a developer, home owner, or tenant (e.g. utilities, maintenance, waste removal, pest control, snow removal, or roads for exclusive use in housing areas) as a subsidy to housing providers. When appropriate, the Department may provide goods and services, at cost, to housing providers or tenants. If used, the subsidy value will be scored.

Assignment of Service Members to Housing
The assignment of Service members to private housing is inconsistent with privatization. Moreover, assignment of services members would reduce economic risk to the private sector and reduce incentives for private developers to build, operate and maintain quality housing. Any proposal to privatize DoD family housing should not include assignment of Service members to that housing. Assignment of Service members to housing, when combined with a loan guarantee for base closure, deployment and downsizing, would effectively eliminate default risk, and therefore, would require the full face value of the loan to be counted as government participation.

OMB Review Process
OMB will work with the Housing Revitalization Support Office (HRSO), prior to issuance of a Request for Proposal (RFP) and prior to final contract award, to review and approve/amend the HRSO's scoring determinations for each proposed project. If the parameters of a project remain consistent from the RFP development stage through final contract award, OMB does not anticipate making significant changes after scoring determinations are made during the RFP development stage. Items to be reviewed include, but are not limited to:

- percentage of government and private sector participation;
- qualification for credit reform scoring; credit reform subsidy estimates; and
- total obligations to be recorded at time of contract signing.

OMB will review HRSO scoring determinations as quickly as possible, especially during the period immediately preceding final contract award.

Interpretation of Government and Private Sector Participation
The factors that HRSO and OMB will consider Federal government participation include:

- Value of land and units conveyed to private developer.
- 100 percent of the loan amount guaranteed by the Federal government, unless the Department issues a loan guarantee that protects a lender only in case of default due to base closure, deployment, or downsizing. Then, 10 percent of the value of a first mortgage shall be considered as government participation. The participation percentage may vary, up or down, depending on the specific conditions that would trigger payment under such a guarantee.

- 100 percent of the amount of a direct loan by the federal government.
- Cash investments.
- Differential payments.
- Income or occupancy guarantees.

The factors that HRSO and OMB will consider private sector participation include:

- Cash investments.
- Value of assets other than cash (excluding assets conveyed to private sector by the Federal government).
- Portion of net income generated by new units used to fund construction and revitalization costs or capital improvements, or In the case of revitalized units, the portion of net income (after revitalization) used to fund construction and revitalization costs or capital improvements.
- 90 percent of the value of a first mortgage if the Department issues a loan guarantee that protects a lender only in case of default due to base closure, deployment, or downsizing. The participation percentage may vary, up or down, depending on the specific conditions that would trigger payment under such a guarantee.

CONGRESSIONAL TESTIMONY 1998

MARCH 10, 1998

STATEMENT BY:
JOHN B. GOODMAN
Deputy Under Secretary of Defense
(Industrial Affairs and Installations)

BEFORE THE SUBCOMMITTEE ON
MILITARY CONSTRUCTION
OF THE HOUSE APPROPRIATIONS COMMITTEE

MARCH 12, 1998
&
BEFORE THE SUBCOMMITTEE ON
MILITARY INSTALLATIONS AND FACILITIES
OF THE HOUSE NATIONAL SECURITY COMMITTEE

INTRODUCTION

Mr. Chairman and distinguished members of the Subcommittee, thank you for this opportunity to update you on the status of our Military Housing Privatization Initiative. Quality of life for our military personnel and their families continues to be of utmost importance in attracting and retaining the high quality personnel who make our armed services the envy of the world. Secretary Cohen's Defense Reform Initiative identifies housing as a critical element of that quality of life and our housing privatization initiative is a cornerstone of our efforts to improve living conditions for our personnel.

The Department of Defense has completed a successful second year in the implementation of the Military Housing Privatization Initiative (MHPI). During this year, we worked diligently to refine the most efficient uses of the authorities provided by the Congress to improve the quality of housing for our military families. This report describes the progress made in the second year of this important initiative. It also discusses how this initiative fits in the Department's overall housing goals and describes the keys to future success.

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CONCLUSION

In closing Mr. Chairman, thank you and your Subcommittee members for giving me the time to discuss this important privatization initiative. I look forward to working with you over the next year as we refine the program and seek permanent legislation. I would be pleased to answer any questions you may have.