COMMONWEALTH of VIRGINIA

Department of General Services

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October 6, 2009

The Honorable Charles J. Colgan, Chairman
Senate Finance Committee
10th Floor General Assembly Building
Richmond, VA 23219

Dear Senator Colgan:

The attached report is submitted in accordance with Item C-5.30 of the 2009 Appropriation Act pertaining to the Replacement/Renovation of the 8th/9th Street Office Building Complex under the Public-Private Education Facilities and Infrastructure Act (PPEA) of 2002.

The attached report outlines the Department of General Services' potential for proceeding with any of the PPEA proposals under an operating lease concept and the cost of such PPEA proposal relative to the Commonwealth's standard capital program.

Sincerely,

Richard F. Sliwoski

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Attachments

C: The Honorable Lacey E. Putney, Chairman House Appropriations Committee
The Honorable Viola O. Baskerville, Secretary of Administration

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House Appropriations Committee
General Assembly Building Room 947
Richmond, VA 23219

Dear Delegate Putney:

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Report on the

Replacement/Renovation of the $8^{th}/9^{th}$ Street Office Building Complex

Virginia Acts of Assembly – Chapter 781

Item C-5.30

1. Introduction:

This report is prepared pursuant to the 2009 Virginia Acts of Assembly - Chapter 781, Item 5.30. Item 5.30 specifically states:

> *"The Director, Department of General Services, in consultation with the State Comptroller, the Auditor of Public Accounts, and the Department of Planning and Budget shall review all submissions under the Public-Private Education Facilities and Infrastructure Act of 2002 (§56-575.1 et seq., Code of Virginia) pertaining to the Replacement / Renovation of the 8th / 9th Street Office Building Complex including alternative financing options. The Director, Department of General Services shall report to the Chairmen of the House Appropriations and Senate Finance Committees by October 1, 2009 on: 1) the potential for proceeding with any of the PPEA proposals under an operating lease concept or how the PPEA proposals could be modified in order to proceed under an operating lease concept, and 2) the cost of such PPEA proposal relative to the Commonwealth's standard capital program."*

2. Background:

Pursuant to the authorization in the Virginia Acts of Assembly – 2008 Special Session I, the Department of General Services (DGS) initiated a Public-Private Education Facilities and Infrastructure Act (2002) (PPEA) procurement process for the development of Commonwealth of Virginia property located between 8th and 9th Streets between Broad and Grace Streets in the City of Richmond. Four private sector Developers submitted conceptual PPEA proposals to develop the 8th and 9th Street property. The 2008 Special Session I authorization required that DGS prepare and submit a project progress report during the 2009 session of the General Assembly (GA). DGS complied with the General Assembly (GA) direction to compete this work under the PPEA and report its findings to the 2009 GA. DGS reported its findings to the 2009 GA and was then directed, in the 2009 Virginia Acts of Assembly – Chapter 781; Item 5.30, to continue to study the 8th and 9th Street development in consultation with the State Comptroller, the Auditor of Public Accounts and Department of Planning and Budget.

Complying with the direction stated, the DGS Director, the State Comptroller, the Auditor of Public Accounts, and the Department of Planning and Budget Director met in May 2009, to discuss the requirements as set forth in Chapter 781, Item 5.30, and develop a plan of action to satisfy the report requirements of Chapter 781, Item 5.30; as they relate to the development of the 8th and 9th Street property; specifically:

- The potential for proceeding with any of the PPEA proposals under an operating lease concept or how the PPEA proposals could be modified in order to proceed under an operating lease concept; and,

- The cost of such PPEA proposals relative to the Commonwealth's standard capital program

3. PPEA Proposals Exploring Operating Lease Concept:

The potential for proceeding with any of the four PPEA proposals under an operating lease concept or how the PPEA proposals could be modified in order to proceed under an operating lease concept required additional analysis of the conceptual proposals. Therefore, in June 2009, DGS requested each Developer respond to a series of questions regarding their proposal. Specifically Developers were asked to describe how their proposal met the operating lease requirements as established by the Governmental Accounting Standards Board (GASB) Statement No. 13 "Accounting for Operating Leases with Scheduled Rent Increases" and the Financial Accounting Standards Board (FASB) Statement No. 13, "Accounting for Leases". Developers responded in July 2009 with the following:

Developer*	Operating Lease Responses from Developers to DGS Request for Information
#1	"Based on our review of the requirements for an operating lease, the current market yield rent requirements for a transaction of this nature and size – both length of term and annual amounts, the estimated fair value of the leased assets at incept, and the lessee's incremental borrowing rate (as provided by you), we believe that the combined 8th and 9th Street office building project using a minimum lease term acceptable to us as developer (at least 20 years) will not qualify for operating lease accounting."
#2	"We propose to purchase the existing 9th street building and all land associated with the 8th and 9th street building from the Commonwealth at fair market value.......Developer is willing to give the Commonwealth an ongoing right of first refusal to purchase the building at fair market value" [after 10 year initial lease term].
#3	Developer provided an approach it believes meets the operational lease requirement. Developer response: "Based on the forgoing analysis of the FASB/GASB 13 criteria it is our belief that the leases must be accounted for as operating leases."
#4	Did not respond.
* There is no significance to the order of the Developers listed in the above table.	

. Table 1

Developers #2 and #3 offered an approach they believed qualified as an operating lease. Developer #1 responded that their approach would not qualify, and Developer #4 did not respond.

Developer #2's approach would require the Commonwealth to sell the 8th and 9th Street property (including the 9th Street Office Building) to the Developer. The Developer offered a right of first refusal to the Commonwealth to purchase the property from the Developer after an initial 10 year lease agreement. The cost to the Commonwealth to purchase the site and property at the end of the initial 10 year lease term is estimated to be $295.2M (the Commonwealth would be responsible for separately paying all operating and maintenance costs during the lease term) based on the Developer's provided financial structure (Developer #2's July 2009 proposal can be found in the attachments section of this report):

Developer #2	
Commonwealth's lease payments proposed by Developer over 10 years:	$144M
Commonwealth's cost to purchase property at Developer's proposed fair market value sale price at 10 years:	$160M
Developer's proposed payment to Commonwealth for purchase of the 8th and 9th street property (fair market value analysis was not performed on Developer's proposed purchase price:	($8.8M)
Commonwealth estimated costs over a 10 year period with buy back at 10 years:	$295.2M

Table 2

Developer #3's approach would require the Commonwealth enter into a long-term (99-year) land lease. The lessee (Developer) would pay the Commonwealth $3.14M annually to lease the property; this payment could be made on an annual basis or, at the sole option of the lessee, on an accrued basis over a 22-year period with compounded interest at 9.9%. In addition to the lease payments to the Commonwealth, the Developer would pay the Commonwealth approximately $11.7M, at lease commencement, as prepayment of 42 years worth of the portion of the rent allocable to the lease of the 9th Street Office Building. To then occupy the developed property, the Commonwealth would pay rent to the Developer over a 20-year initial term of approximately $13.6M annually with the Commonwealth separately paying for all operating and maintenance costs estimated to be approximately $3 million per year (under the Developer option to accrue ground lease payments to the Commonwealth). The Developer proposed that the lease agreement would allow for the Commonwealth, at the sole option of the Developer, to purchase, at fair market value, the lease at the 10th and 20th anniversary of the lease. The Developer, in its proposal, estimates the fair market value of the property to be approximately $275M at the 20th anniversary of the lease. In addition, as stated in the Developer's proposal, the Developer would be entitled to the value (determined by arm's length appraisal) of the discounted balance of the 99-year land lease. The estimated total cost to the Commonwealth, if the Commonwealth was allowed to exercise its option to purchase the 8th and 9th Street property at the end of a 20-year lease term including buying out the Developer's lease, is estimated to be $326.4M + X (i.e., X = the unknown value of the land lease). Developer # 3's July 2009 financial structure proposal can be found in the attachments section of this report:

Developer #3	
Commonwealth's lease payments proposed by Developer over 20 years under accrue lease payment agreement:	$283.7M
Commonwealth's cost to purchase property at Developer's proposed fair market value sale price at 20 years:	$275M
Developer payment to Commonwealth if land lease payment is deferred for 20-year term:	($220.6M)
Developer payment to Commonwealth for 99 year-land lease;	(11.7M)
Payment to Developer for discounted value of the remainder of the 99 year land lease of the site as determined by arm's length appraisal.	Unknown X
Commonwealth estimated costs over 20 years with buy back at 20 years:	$326.4M + X

Table 3

4. PPEA vs. Commonwealth's Standard Capital Program Costs:

To date the Commonwealth, through the Department of General Services as authorized in the 2006 Virginia Acts of Assembly – Chapter 3, has spent approximately $10.7M in design and other 8th and 9th Street development related expenses under the Commonwealth's standard capital program. The Department of General Services estimates it would cost the Commonwealth an additional $174M + $104M debt service to complete the 8th and 9th Street development should the standard capital program process be authorized to move forward. This number includes an allowance for furniture, fixtures and equipment. The table below summarizes the Commonwealth's costs to develop the 8th and 9th Street properties under a PPEA approach (as presented to DGS by Developers under the PPEA initiative describe in this report), and the Commonwealth's standard capital program.

Commonwealth's Standard Capital Program Cost to Complete Development of 8th and 9th Street	
Funding required under state construction and financing standard capital program approach:	$278M
PPEA Developer #2	$295.2M
PPEA Developer #3	$326.4M + X

Table 4

5. Conclusion:

It is the opinion of the Department of General Services (DGS) based upon opinions from the Department of Planning and Budget, Department of Accounts and the Auditor of Public Accounts that none of the PPEA proposals submitted to DGS under this PPEA initiative met the operating lease definition as provided for in the Governmental Accounting Standards Board (GASB) Statement No. 13 "Accounting for Operating Leases with Scheduled Rent Increases" and the Financial Accounting Standards Board (FASB) Statement No. 13, "Accounting for Leases". For a lease to be considered an operating lease, none of the following criterion can be satisfied:

Criterion 1: The lease transfers ownership of the property to the lessee by the end of the lease term.

Criterion 2: The lease contains a bargain purchase option.

Criterion 3: The lease term is equal to 75 percent or more of the estimated economic life of the leased property.

Criterion 4: The present value at the beginning of the lease term of the minimum lease payments equals or exceeds 90 percent of the fair value of the leased property to the lessor at the inception of the lease.

PPEA Developer #3 proposed a structure it believes does not satisfy any of the four criterions. However, after review by the Department of Accounts and Auditor of Public Accounts, both agencies concluded that Developer #3's proposal may satisfy the ownership criterion and conclusively satisfies the present value criterion due to the required treatment of ground lease payments to the Commonwealth. Satisfying either criterion results in capital lease accounting treatment.

An operating lease option is possible however only if the Commonwealth were agreeable to and sold the 8th and 9th Street property to a private entity for development. The private entity would take ownership and develop the property then lease the constructed office space to Commonwealth under an operating lease arrangement. This option would result in the Commonwealth losing control of the 8th and 9th Street property to a private entity; subjecting future development and use of the property to the interest of a private concern.

Simplistically evaluating the costs presented to the Commonwealth for the development of the 8th/9th Street property, it appears the PPEA financial models proposed as described in this report and found in the attachments would be more costly for the Commonwealth than if the Commonwealth were to develop the site under the standard capital program (see Table 4).

Conceptual proposals from all Developers, including subsequent proposal information submitted to DGS during this PPEA process, can be obtained from DGS for review. The July 2009, operating lease position papers submitted by Developers are included in this report as attachments.