CREDIT CRUNCH: EFFECTS ON FEDERAL LEASING AND CONSTRUCTION

(110–158)

HEARING

BEFORE THE

SUBCOMMITTEE ON
ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS, AND EMERGENCY MANAGEMENT

OF THE

COMMITTEE ON
TRANSPORTATION AND
INFRASTRUCTURE
HOUSE OF REPRESENTATIVES

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July 29, 2008

SUMMARY OF SUBJECT MATTER

TO: Members of the Subcommittee on Economic Development, Public Buildings, and Emergency Management

FROM: Subcommittee on Economic Development, Public Buildings, and Emergency Management Staff

SUBJECT: Hearing on "Credit Crunch: Effects on Federal Leasing and Construction"

PURPOSE OF THE HEARING

On Wednesday, July 30, 2008, at 10:00 a.m., in room 2167 Rayburn House Office Building, the Subcommittee on Economic Development, Public Buildings, and Emergency Management will examine the effects the current credit crunch has on the commercial office space market and its effect on the General Services Administration's capital program, specifically leasing.

BACKGROUND

The Subcommittee hearing will examine the nexus between the current credit crunch and the federal leasing program. There are several definitions of "credit crunch". In general, it involves a condition in which there is a short supply of cash to lend to businesses and consumers and usually occurs during a recession or poor economic times. In reaction to a decade of banking industry's lax lending practices and poor due diligence which lead to unprecedented residential foreclosures, access to capital for real estate has become burdensome and restricted. There are scant signs that the market has reached its lowest point. According to the International Monetary Fund ("IMF") in its latest global financial stability report, "falling house prices and slowing economic growth are hitting credit". Banks are under renewed stress and any further reductions in leading will only deepen the slowdown. Since bank reserves only covered about two thirds of the residential losses, banks will more than likely need to restrict lending even further. Thus even healthy companies are or will be deprived of money for expand. Access to capital is essential to growth and when access is denied a healthy economy is weakened. Another notion to consider when examining a credit crunch is the notion of how tightening lending criteria have contributed to the crunch.

The General Services Administration ("GSA") relies on the private sector to supply by lease over 50% of the government's need for general purpose office space. The inability of the private sector to supply space will negatively affect not only GSA's space distribution within its portfolio but also the budgets of federal agencies that rely on GSA to supply office space.

PRIOR LEGISLATIVE AND OVERSIGHT ACTIVITY

The Subcommittee has not held any prior hearings specifically on the credit crunch and its effect on the GSA inventory. However, on May 8, 2008, and June 10, 2008, the Committee on Transportation and Infrastructure held joint hearings with the Budget Committee on financing infrastructure investments. During those hearings attention was given to the costs and benefits to the government of long term leasing.

WITNESSES

David Winstead
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Public Buildings Service
U.S. General Service Administration

Raymond DiPrinzio
Managing Director, Head of Project Finance
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Richard D. Purtell
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Building Owners and Managers Association (BOMA) International

Kenneth Rudy,
International Director
Corporate Capital Markets
Jones Lang LaSalle

Steven A Grigg
President and Chief Executive Officer
Republic Properties Corporation
Representative DCBIA

HEARING ON CREDIT CRUNCH: EFFECTS ON FEDERAL LEASING AND CONSTRUCTION

Wednesday, July 30, 2008

HOUSE OF REPRESENTATIVES
COMMITTEE ON TRANSPORTATION AND INFRASTRUCTURE,
SUBCOMMITTEE ON ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS, AND EMERGENCY MANAGEMENT,
Washington, DC.

The Subcommittee met, pursuant to call, at 1:10 p.m., in Room 2167, Rayburn House Office Building, the Honorable Eleanor Holmes Norton [Chair of the Subcommittee] presiding.

Ms. NORTON. Good morning. I welcome the witnesses to today's Subcommittee hearing concerning the tightening credit market, which originated in the subprime mortgage crisis, and on other factors affecting Federal leasing and construction in the commercial marketplace.

GSA is perhaps the largest customer for office space in the real estate market in the United States. GSA leases slightly more space than it owns, approximately 176 million square feet of leased space, housing over 700,000 employees compared with 175.5 million square feet of owned space, providing office space for 640,000 Federal workers. The Federal inventory ranges from 2500 square foot border crossing stations to a million square foot courthouse complexes in major metropolitan areas. GSA's stake in maintaining its strong position in the marketplace is high, particularly in the leasing market, in light of the continuing shift to Federal agency leased space.

At this hearing, we seek to learn how developers, building owners, lenders, and construction companies, who are accustomed to unimpeded access to credit, position themselves in today's puzzling market. We have concerns, even though the strictly competitive system for Federal contract awards guarantees that only the most creditworthy need apply or need compete. When I began talking with experienced developers and building owners as the subprime mortgage crisis worsened, their strong credit standing with lenders and the lengthy time frames and lead time for construction and leasing left them pretty much unworried.

However, since then, seven banks have closed, particularly IndyMac, which had significant home ownership loans. It seems doubtful that a departure as unprecedented as a mountain of bad, securitized subprime mortgages sold in an unregulated global market, can be contained. Today, a year after the housing crisis became full blown, even the largest banks, whose customers also signifi-

cantly include commercial real estate, are showing record profit losses.

Although many of the players in today's commercial marketplace remain untouched for now, experts say that today's crisis is unmatched since the Great Depression. The Nation's largest bank, the Bank of America, has experienced a large increase in bad small business-related loans and recently took a 41 percent reduction in profit. Some analysts have raised the possibility that commercial loans could be a "ticking bomb." Some also predict that this quarter may mark a turning point, with lending flat, down from record highs.

However, the best evidence that something that cannot be ignored is afoot are recent actions by the Federal Reserve and Congress, who have moved to quell the perfect storm of a housing downturn on which economic growth, although housing has been the basic source of our economic growth, double-digit increases in many basic food products, and indeterminate gas increases. Driven by the economy itself, rather than by any piece of it, President Bush has thought better of his threat to veto the most far-reaching housing bill in decades.

This Subcommittee has an obligation to look now at whether there is or could be a metastasis of the housing crisis and other economic problems that could surface in the commercial sector and what, if anything, could be done about it when it comes to Federal leasing and construction.

A credit crunch typically refers to factors that lead lenders to reduce the available credit by declining to make loans or doing so only at increased costs or with special terms, even for those who are creditworthy. The uncertainty about the losses from the subprime mortgage crisis still playing out with mortgage lenders has caused the credit markets to shrink considerably.

Although Federal leases and construction contracts might be said to be worth their weight in gold, private sector competitors don't have that assurance when they compete for a lease or construction contract. If credit becomes too difficult or costly, commercial office space available to the Federal Government could diminish or allow too few to take the risk of competing, raising costs to taxpayers.

GSA's reliance on the commercial office space market to house Federal agencies ties the agency directly to commercial market conditions. The agency must begin to use its prime position in the commercial marketplace by leveraging its buying power and capturing its great potential for reduced costs to taxpayers. For example, in the last three years, fiscal year 2005 to 2008, the FBI presented this Subcommittee with 23 leases, the largest group of long-term leases.

As a result, the Subcommittee has indicated that it wants GSA to look very closely at a comprehensive lease package for agencies like the FBI, which have long-term viability in metropolitan areas. Almost all the FBI leases will be built-to-suit the agency, but already GSA has seen a reduction in competitors for these FBI leases. We must discover why this is so and whether it constitutes the beginning of a trend.

In today's atmosphere of soaring budget deficits and rising costs for all concerned, GSA also must work collaboratively with the pri-

vate sector to reduce the cost of acquiring commercial office space. By working with our private sector partners to achieve the vision and the know-how necessary to cut costs across the board, together we have the potential to help stimulate the local and national economy while addressing the needs of the Federal Government. Today, we are very pleased to hear from the GSA, from financial and economic experts on the commercial markets and office development who are before us and have prepared testimony.

The Ranking Member had very much wanted to be here and had asked that we change the day of the hearing so he could, but something has come up as we near the end of the session, so I am inserting his remarks in the record by unanimous consent.

We want to begin by figuring out where we are. We are not going to get to the remedy unless we have a fix on what is happening in a very puzzling economy. It has fascinated me from the beginning, just as a general matter, and even more so as it has progressed with all of the unknowns that we are having to deal with for the first time.

Therefore, I am pleased to welcome panel one, James Chessen, the Chief Economist of the American Bankers Association; Raymond DiPrinzio, Managing Director and Head of Project Finance at CIFG Assurance North America, Inc.; and Kenneth Rudy, International Director of Corporate and Capital Markets, Jones Lang LaSalle.

Actually, you may testify in whatever order you feel like. I have no preference, since you are not Government officials and there is no protocol.

Mr. Chessen, of the American Bankers Association.

TESTIMONY OF JAMES CHESSEN, CHIEF ECONOMIST, AMERICAN BANKERS ASSOCIATION; RAYMOND DIPRINZIO, MANAGING DIRECTOR, HEAD OF PROJECT FINANCE, CIFG ASSURANCE NORTH AMERICA, INC.; AND KENNETH RUDY, INTERNATIONAL DIRECTOR OF CORPORATE CAPITAL MARKETS, JONES LANG LASALLE

Mr. CHESSEN. I would be happy to begin, Madam Chairwoman.

Madam Chairwoman and Members of this Subcommittee, my name is James Chessen. I am the Chief Economist of the American Bankers Association, and I very much appreciate the opportunity to testify on the current state of funding for commercial real estate, including properties leased by the Federal Government. Our Nation is certainly facing difficult economic conditions, one that affects all businesses, including banks. We have gone through these periods before and have emerged much stronger as a result.

I want to emphasize one basic point: the core business of banking is lending. That is what banks do. Banks will continue to be a source of financial strength in their communities in both good times and bad. Even in a weak economy, there are strong borrowers, including developers and owners of government leased property, that merit bank funding.

I am also very positive about the banking industry. Before turning to my main points, many of you may be wondering about the health of the banking industry in light of the several recent failures that you mentioned, Madam Chairwoman. Let me assure you

that the industry remains fundamentally sound. Banks entered this period with a very strong capital base and banks have continued to build capital over the last several quarters.

In fact, 99 percent of the banks are classified as "well capitalized," which is the highest designation that can be given by bank regulators. Simply put, the industry has the capital and reserves to continue to make loans that are so vital to our communities.

Let me now turn to commercial real estate lending. Like all specialized forms of lending, loans for construction, development, long-term funding of government leased properties have unique risks. These risks exist regardless of the economic cycle. The weak economy, however, does add an extra element of risk that affects the availability and price of credit. Against this backdrop, it is only reasonable and prudent that banks exercise caution in making new loans. Bankers are asking more questions of their borrowers and our regulators are asking more questions of the banks that they examine. This does mean that some higher risk projects that might have been funded when the economy was stronger may not be funded today.

A very important factor affecting the volume of lending is the ability to sell loans on the secondary market, something that you mentioned, Madam Chairwoman. Even though problems in commercial real estate loans are low by historical standards, investors reacted to the problems in housing and have shunned new commercial mortgage-backed securities. As you mentioned, this has the consequence of reducing funding and raising the cost of new commercial real estate loans.

Certainly, just as too much risk is undesirable, a regulatory policy that discourages banks from making good loans to creditworthy borrowers also has serious consequences. We are very concerned that a regulatory over-reaction could quickly convert a credit caution to a credit crunch. We witnessed just such a regulatory-induced credit crunch following the 1991 recession, and we are hopeful that regulatory reason will win the day this time.

However, we hear reports from our bankers that examiners are demanding costly new appraisals on properties and forcing banks to write down collateral values even though the bank is not relying on collateral for the repayment of the loan. These unnecessary appraisals and write-downs will discourage banks from lending on similar projects.

Fortunately, the bank agency heads seem to be sensitive to this potential problem and have pledged to avoid a repeat of the 1990s. The great challenge, however, may be to ensure that that message from those agency heads reaches the regulatory personnel examining banks in the field.

To achieve our mutual goal of a safe and strong financial system, it is extremely important to remember the vital role played by good lending in restoring economic health, and not to allow a credit crunch to stifle the economic recovery.

Thank you again, Madam Chairwoman, for the opportunity to present the views of the American Bankers Association at this hearing today. I would be happy to answer any questions that you have.

Ms. NORTON. Thank you very much, Mr. Chessen.

Who would like to go next? Mr. DiPrinzio?

Mr. DIPRINZIO. Sure. Thank you.

Good morning, Madam Chairperson, Members of the Committee. My name is Raymond DiPrinzio. Thank you for the opportunity to address the Committee on the impact of the current credit crisis on the development and financing of Federal real estate. I am currently head of Project Finance for CIFG, a financial guaranty firm headquartered in New York.

Financial guaranty providers are essential proxies for retail and institutional investors in the capital markets, or lenders in the case of the bank loan market, since under the terms of their guaranty or credit protection contracts they are obligated to make principal and interest payments to investors and lenders in the event the borrower fails to do so. In this capacity, I am responsible for underwriting all forms of project financings for infrastructure, including transportation, energy, environmental and public use real estate facilities, such as office buildings, military and student housing, stadiums, and arenas.

Federal project financing is a subset of the larger infrastructure market, a sector that has enjoyed unprecedented levels of interest from institutional investors across the globe due to the deep levels of demand for financing infrastructure in the United States which is in need of replacement or for new facilities which must be built to accommodate growth. In my 24 years working as a finance professional, I have had the opportunity to work on Federal projects as a financial advisor and investment banker to Federal agencies, as well as a provider of credit protection to investors in the capital markets.

I have worked on financings for Energy, Justice, Veterans Administration agencies in both GSA form, as well as what I would refer to as direct agency leases. Given my background, I am speaking today with the perspective of a practitioner in the capital and bank markets, and more specifically one who has the perspective of both the borrower as well as the lender.

The current difficulties in the financial market are unprecedented in both the breadth and depth of its reach, and it should come as no surprise that the market for Federal lease transactions has not escaped unharmed. I should mention I am looking really from the perspective here of the lease construction market, the types of financings that GSA and agencies enter into that require a build-to-suit and, more specifically, the raising of capital in either the bank market or the capital markets.

While real estate projects involving Federal tenants under long-term leasing arrangements are viewed more favorably relative to their commercial counterparts, the overall reduction in liquidity, repricing of risk, and either the unavailability of credit protection from monoline bond insurers or the market's diminished view of the value they bring, has led to delays in completed financings, tighter credit terms and, most importantly, dramatically increased credit spreads, i.e., higher borrowing costs. Indeed, higher borrowing costs are making many transactions impossible to complete as it translates to rental rates outside of approved levels.

More specifically, financings that were able to get credit protection and complete a transaction saw spreads widen to 70 to 100

basis points over previous levels compared to the pre-credit crisis. Without credit protection, spreads have widened 200 to 300 basis points, levels never seen in markets for credit for Federal leasing.

What can be done? In my prepared testimony, I have laid out a number of recommendations, but I think I would like to just touch on them briefly.

What is striking to me, as an investment banker and a lender, is how unknown this market truly is to the wider capital markets. I have been struck by its obscurity, the lack of understanding of these transactions given the depth and the role the Federal Government plays in the real estate market, and the needs of the GSA. In many ways, Federal financing has significant untapped potential which, if properly harnessed, can result in broader market acceptance, higher levels of investor interest, lower borrowing costs, and ultimately lower rental costs.

In this regard, I offer the following areas for consideration, and they are basically, I would say, four areas: market education, a more programmatic approach, addressing OMB rules that impact the structure of these transactions, and the consideration to enhance use leasing potentially for GSA agencies.

On the market education front, my point basically is I think GSA and the other agencies could take a more comprehensive approach to educating both the bankers and advisors, as well as the rating agencies on the operation of the Federal Government in Federal financing.

With respect to a programmatic approach, what is striking to me is how decentralized the approach to financing the Federal Government is in these markets, and an effort to bring together a more comprehensive programmatic approach to the market would go a long way, I think, to addressing these issues.

OMB, quite rightly, guards the Federal budget process and balance sheet, but consideration should be given to revising the rules with an eye to an appropriate level of risk allocation between Federal agencies and private sector developers and financial participants, as well as the ultimate impact on financing structure and costs.

In summary, while the current crisis in the credit markets is taking its toll on all players, including Federal agencies, the dislocation in market coupled with unprecedented levels of demand for properly structured infrastructure investments also provides an opportunity for the Federal Government going forward in its approach to financing real estate and other essential infrastructure. Steps should be taken to broaden the level of understanding of the Federal role as a user of facilities critical to the operation of government, streamline its approach to the market, and address the rules and regulations which govern its role while maintaining a careful eye on the impact on risk and return.

Thank you, and I am happy to answer any questions.

Ms. NORTON. Thank you, Mr. DiPrinzio.

Mr. Rudy?

Mr. RUDY. Good morning, Madam Chairwoman. Thanks for having me. I am Kenneth Rudy, and I am President of Jones Lang LaSalle's Capital Markets organization in the Americas. I have been a practitioner for about 25 years. Our group tends to serve

private sector investors, owners, and occupants on capital strategies dealing with the capital markets in the United States.

I hope you had a chance to read my prepared testimony, so at this time I will just take the opportunity to summarize and reflect on some of the things that have already been said.

With your opening remarks, Madam Chairwoman, you talked about the subprime mess and how it has spread to larger markets, so I think it is good to level-set and understand where we are so we can predict where we might be going. With that, there is the recognition that real estate has always operated in cycles; it is a very cyclical asset class subject to lots of volatility, lots of swings because it is a complicated asset class subject to debt, supply, demand, confidence, and other economic fundamentals. As a result, it will swing. In my career, I am in my fifth real estate cycle of significance, and this one is a very significant one.

So when you try to predict where we are going to go, why we are where we are today, and principally it is overflow from the massive amounts of capital that was chasing real estate investments both on the commercial and residential side. We all know what has happened with the abundance of mortgage debt and the origination of debt for less worthy creditors and borrowers.

In the residential markets, that has led to an oversupply of product, as well as defaults for people who can no longer afford to pay their mortgages. What has happened now is those very same lenders, who are having trouble with their balance sheets because of the mortgage mess from the residential side, are also restricted from providing loans on the commercial side.

You mentioned also earlier you don't think that the commercial mortgage mess has spread, or there is such a mess yet, and that is true; the default rates on commercial mortgages are very low today. That is because on the commercial the fundamentals, meaning the supply and demand that creates value in commercial real estate, has largely been in balance since the last cycle.

However, as a lot of these commercial loans are coming due, especially the acquisition loans that were made during this last cycle peak, it may be difficult for a lot of owners to refinance these loans. That, coupled with the overall scarcity of acquisition debt in the commercial markets, makes the investment cycle or the market pricing of assets very difficult, and therein lies the conundrum.

A market is determined by buying and selling activity, or by two parties coming together. When transaction activity has hit the levels that it has hit today, which is nearly down 70 to 80 percent from years prior, it is difficult to come up with a market clearing price for asset values, commercial asset values. There is a big gap between the bid and ask, as they say. And when that occurs, the lending markets who help finance these acquisitions, they themselves have difficulty determining the value of the underlying asset as they are considering granting loans to commercial developers or investors buying real estate.

So the whole pricing process is in disarray. And whenever there is disarray, uncertainty goes up and risk goes up, and risk is reflected in higher pricing of capital, both on the debt and on the equity side. For occupiers of leased or investment real estate, that

translates into higher occupancy costs or greater challenges in doing deals.

So this is where we are today. People often ask where are we going in the future, and the only thing I can assure you is that—again, this is a cliche being in the real estate business—the only constant in real estate is change. You can be certain that it will improve, we will find a new bottom, but most economists will tell you you don't know when you are there until you are looking in our rearview mirror, until you have already passed that bottom.

Right now there is a great deal of uncertainty. Just this week you read that Merrill Lynch finally sold what was a portfolio of $30 billion of CDOs to a private investor that they had previously marked down to $11 billion, and they sold it for $5.8 billion. That gives you an indication of the great deal of uncertainty that there is in pricing securities and assets associated with real estate.

Also in my written testimony I showed you the drop-off in the CMBS market, which is the amount of securitization of commercial loans that are available in the market. It is running at nearly 10 percent of where it was at the last market peak. So the scarcity of capital is creating difficulty for borrowers and investors and speculators in real estate. Again, we won't know where the bottom is until we are passed it and there has been a market clearing price for real estate assets.

What does that mean to the Federal Government? Well, for the Federal Government it represents the best credit out there, and there is still money available, as you heard in the prior testimony. Real estate is still a valued investment asset across the world. It is in a balanced portfolio for most investors and it will continue to remain so, and there are lenders that are available.

The difference between today and yesterday is now the lenders are primarily balance sheet lenders who do sound underwriting, sound credit analysis, as opposed to what you have heard in the residential market, the covenant-light, no dock loans. That occurred in the commercial market too, where there was a covenant-light commercial mortgages. That doesn't exist any more.

What it means when you have covenants in underwriting is the lenders and equity sponsors need to be able to pay back the loans more quickly, have lower amount of loan relative to the overall value of the asset—and that value is still undetermined in this marketplace today—and other sort of more restrictive terms. The Government can play well in that market because it can promise the equity sponsor and the lenders better ability to have that loan repaid, provided that the documents that are securing that income flow to that property are what we would call market conforming, or at least have market conforming sort of provisions to allow the equity sponsor and the lender to underwrite that risk, to know what they are getting when they make a loan on a commercial property.

So I have provided in my written testimony a list of potential clauses and other features of GSA leases which, when made market conforming, have the effect of reducing borrowing costs and, therefore, equity yields and, therefore, occupancy costs for the Federal Government when they do leases. But the money is there for good projects, good sponsors, and good tenants.

Thank you.

Ms. NORTON. Thank you very much, Mr. Rudy.

Now, let me see if we can get some of the basics. This is very, very compelling testimony.

Let me ask you, Mr. Chessen. You warned about the so- called 1991 overreaction and the reaction today. Do you consider what the Fed is doing, what the Congress is doing, do you reconsider that within the realm of reaction or overreaction?

Mr. CHESSEN. I think, Madam Chairwoman, that was a very good reaction to try to stop what could eventually become a bigger credit problem. So I congratulate you and the Members of Congress for moving forward on that plan.

My concern is what happened in the 1990s was that the regulators were looking over banks' shoulders for every type of loan they made, and the message back then from Congress, as well as the regulators, was make no mistake in lending; and that has a chilling effect on the willingness of banks to get out and make any type of loans.

Just to give you a recent example of that, Madam Chairwoman, we had a big meeting with 300 bankers and a banker from New York came up to me and he said they had examiners in his bank, and he has a lot of capital, never got into the problems with the housing, and he is anxious to lend, and he was describing to the examiner a loan that he wanted to make on a commercial property, and the examiner said why on earth would you want to make this type of loan in this environment, and he was stunned by that.

He is a bank that is out there, willing to lend, he has the capital, doesn't have the problems that are out there, and his regulators are saying, whoa, wait, I am not sure that is going to be a good loan a year from now. That is what we worry about.

Ms. NORTON. His Federal regulators were saying that?

Mr. CHESSEN. Yes, ma'am.

Ms. NORTON. And you do not believe this was a risky loan?

Mr. CHESSEN. I don't know the details of the loan. He believed that this was a loan that met his underwriting standards and he was comfortable in making.

Ms. NORTON. And if he was comfortable, one would wonder why the regulator was not. I don't know the particulars there, but I must say to second-guess somebody, unless there is some issue for the Federal Government, is an interesting notion for a regulator.

Mr. DiPrinzio, you mention on page two of your testimony properly harnessing—these are your words—properly harnessing Federal financing. I wish you would elaborate that and describe some of the benefits that you think this harnessing would bring to the Federal Government.

Mr. DIPRINZIO. What I am getting at, really, is that the role of the Federal Government in the capital markets as a user of financing, if you will, a borrower, is not very well understood. There is a very small subset of practitioners out there who really understands how Federal leasing contracts work either at the GSA level and certainly at the agency level.

It is striking to me how decentralized the financing of real estate for Federal properties is, and I have been doing it now for a number of years, so I have kind of seen it from time to time. If you look

at other examples of the Federal Government approaching the market comprehensively, military housing, the privatization of family military housing is a great example of where a comprehensive approach was taken, legislation was put into place in 1996 and private capital has come in in droves. I think the numbers are roughly $20 billion has been raised over time.

Ms. NORTON. What are they doing with military housing compared with what they were doing before?

Mr. DIPRINZIO. Essentially, the Federal Government got out of the role of providing housing for military families.

Ms. NORTON. So what, did it contract to get it before and now what does it do?

Mr. DIPRINZIO. And now basically money is raised in the capital markets; bonds are sold, either with bond insurance or without bond insurance, or privately placed to investors and the Federal Government is essentially allowing the BAH, the basic allowance for housing, to be used as a source of repayment for those bonds.

The point being, not to get into the specifics of that program, but that it was a comprehensive approach. While there are differences among the services, Army versus Navy versus Air Force—they do things slightly differently, they have maintained the flavor of the different services in their approach to the market—there are broad rules and understanding as to what the intent of the Defense Department is in bringing in private capital, and it has worked really well. The rating agencies understand it and the market has accepted these transactions.

Ms. NORTON. I am trying to analogize to the GSA, where I take it the lease payment would be the analogy.

Mr. DIPRINZIO. That is correct.

Ms. NORTON. How is the VA in the picture, then?

Mr. DIPRINZIO. How is VA in the picture?

Ms. NORTON. How is VA in the picture?

Mr. DIPRINZIO. Right. Among the agencies, VA probably has the most sophisticated program and approach, and is probably one of the more well known agencies to the market. Again, it does things differently; it has its own approach to how it wants financings done. But as a practitioner, as a lender or finance professional, I recognize how the VA has been——

Ms. NORTON. I am sorry, I said VA. I meant DOD. DOD. I am trying to see if essentially the housing is given over to the private sector to build.

Mr. DIPRINZIO. That is right.

Ms. NORTON. What role does DOD play in the process?

Mr. DIPRINZIO. Well, essentially, the Government is deeding the property over, it is conveying the property to a private entity under a 50 year development contract. At the end of 50 years, the property comes back to the agency. So unlike a project where you have nothing from scratch, you are basically going into the market with an existing group of housing that service members are living in, and the Defense Department or the services themselves convey that property and then basically enter into a development agreement with a private developer who is raising financing in the capital markets to either renovate or construct new housing for mili-

tary family members and operate that housing over the course of a 50-year period.

Ms. NORTON. I am searching for whether or not we have done anything like this. We have often spoken of the DOD and the VA and what looks like a one-time transaction, because I haven't been able to spread it. We were able to do that at the Southeast Federal Center when I was tired of not being able to get a Federal agency to move down there and put in a bill, which essentially has allowed that to happen, and look what is happening; they are building on the property.

This was one of the most valuable properties in the Country. When I tried to say there must be similar property across the Country, why don't we do it elsewhere, we were met with the notion, well, it scores. How can it score if it didn't score here? I still haven't been able to find that out.

But this notion of scoring may be familiar to all of you. I don't know if it was you, Mr. DiPrinzio, but one of you mentioned in your testimony scoring. I wish I could say that something would happen to change it. The worst times get, the more I think we won't. The waste of it sends us up the wall, I can tell you. The willingness to spend money, billions of dollars because something scores, and especially because real estate is treated as if it were like any other commodity.

I wonder if you have any notions about how to encourage the Federal Government to understand how distinctly different real estate is from other goods and services that are scored, because if we go with scoring generally, we obviously get pushed back, and we find that scorers have almost no understanding of real estate, and this is very threatening to us. We just got a bill, I had to do a bill—shouldn't have had to do a bill, but because I had to do a bill because OMB wouldn't move on the Old Post Office, this priceless heirloom at 12th and Pennsylvania Avenue.

Obviously, no cost to the Government and we have a perfect example to prove it, and that is the old Tariff Building, which is now the Hotel Monaco, and the scorers scored it. Susan Britta here was tasked with somehow beating them back and she beat them back, frankly, because she knew a whole lot more about real estate than they did, number one, and, two, the Tariff Building was an example of how it works.

But anything the three of you have to say on scoring, we would particularly pleased to hear. For example, does the DOD approach meet any scoring problems? How are they able to do that? I can't imagine doing that on this side.

Mr. RUDY. I am moderately——

Ms. NORTON. Maybe it is the 50-year, because it comes back to the Government and, of course, we could do that as well. The Government still owns the property. You put it in the hands of the developer long enough so that he can in fact benefit, even though he doesn't own it. I can see that.

Could we do something like that approach, Government property in that way? For example, at Saint Elizabeths we are about to build the Department of Homeland Security. This Department, GSA has never built anything like this. It is not like building a building; it is building a half dozen buildings and putting them in

one place. It is a compound. If you were tasked with that, what approach would you use? How would you do it? And keeping in mind some of the issues we have in the Federal Government.

I am taking some of my cues from this 50-year military housing approach. How would you do it other than the way we do it now, which is building by building, essentially direct appropriation? The ownership of the property is the—the ground is ours, but the building belongs to the person who puts it up there. How would you do it if somebody said, okay, for the first time—because this really is—if we have any chance, we have it now, because we have never done anything like this. Even the Pentagon wasn't like this. That is the biggest one, maybe.

This, by the way, will probably be the second biggest, but it won't be one building. So you could argue that precisely because you know exactly what you are going to do. There had to be a plan for what agencies, how many, exactly where they are located on federally owned property. Brand new situation for the Government. What would you do?

Mr. RUDY. Madam Chairwoman, I want not remind you that my perspective and my history is servicing the private sector, which is I think why you asked me to testify, to bring private sector ideas to questions like you just asked. So I run the risk, when giving you some analogies, that I may not have a perfect analogy, whether it is to the DOD program or how you may want to build out Saint Elizabeths, but a real quick comment on the DOD program.

My company is heavily involved in helping the Department of Defense with Army and Air Force housing. There were some different objectives there. Clearly, it was to keep the Department of Defense from using its war fighting dollars on housing and to bring in private sector capital——

Ms. NORTON. There is no different objective. This is awful. This uses what is unheard of in real estate. We are now waiting to get out $300 million for the Coast Guard building, over $300 million for one building. Direct appropriation means here is the money.

Mr. RUDY. You are right. Money is——

Ms. NORTON. So I understand that you can understand that is for war fighting, but most of it doesn't go into war fighting. So they are using taxpayer dollars, and instead of handing the money over in one lump sum to build this housing, ——

Mr. RUDY. Well, they actually did it a positive way. They didn't hand any money over, they attracted capital, and they attracted it because they needed the capital and the management and development expertise to upgrade the housing and to modernize it and maintain it in a very nice fashion for the soldiers. So it has been a successful program.

You asked about Saint Elizabeths, what would you do with Saint Elizabeths. I am setting aside whatever scoring rules or other rules of engagement there are and just saying, if it was a clean sheet of paper, what would you do. One of the things the private sector certainly would be interested in is some sort of a public-private arrangement where the Government owns the land—it is very valuable land, it is a terrific location—the Government has the occupancy demand with the agencies that want to be there, and these are permanent agencies, if there is such a thing as permanent.

They could provide a very long-term commitment to be housed in buildings to be built.

So what does the private sector wants? The private sector wants what they wanted with the DOD, they want a reasonable rate of return to provide their own capital, both debt and equity, to build buildings to house the Federal Government, with the recognition that maybe at some point in the future there could be some risk out there of the Government no longer needing those buildings and them still having some financial responsibility for what is remaining on those buildings. So building a market conforming asset, one that physically could have adaptive reuse; designing the campus in a way where it is flexible, yet still meets the needs of the Government.

So instituting some of the private sector disciplines in terms of asset value creation and financing, and on the financing side they would need to be able to secure whatever debt financing and equity yields by the lease structure that is in place; and that goes back to some of the market conforming comments I made in my written testimony. And the Federal Government is already experienced with those sort of lease forms.

There is a form I am not that familiar with, called 3517X, which is essentially a financially optimized lease structure that the Government has used that enables the private sector to understand and underwrite the cash flow streams and separate cash flows between retiring debt or paying operating expenses and utilities and other sort of features that reduces the risk of those investors and allows them then to commit capital to get these sort of assets built. So there are tools out there that are available.

I could elaborate more if you have questions.

Ms. NORTON. That distinction you were just making, does GSA do that, does the Government do that?

Mr. RUDY. This lease form is a Federal Government lease form, yes.

Ms. NORTON. Do you have any ideas as well, Mr. DiPrinzio, on the Saint Elizabeths opportunity for the Federal Government?

Mr. DIPRINZIO. Yes, thank you, Madam Chairperson. I think what I would add to Mr. Rudy's testimony is that with a situation like Saint Elizabeths, the problem you are going to run into is if you have multiple buildings in a campus-like environment, in some ways that is an ideal situation for attracting private capital. The problem that you are going to have is to the extent that you allow the Government to walk away from one building, but not another, addressing that risk is always going to be a problem.

Where the private sector gets most comfortable is when we see the Federal Government coming in and taking a large amount of space. If you go back and you look at the lease renewal statistics for GSA, the biggest campus-like transactions are the ones that have the least amount of risk for the private sector. Again, the problem here would be to the extent you have multiple buildings and one can be cherry-picked, if you will, over the course of a 10, 20, 30-year period, that is going to cause a concern.

So an all or nothing approach I think is something that you consider. If there is some way that the renewal of the leases are not building-specific, but across the entire campus, that may not be

possible, but that is going to be probably the biggest issue that you grapple with.

Ms. NORTON. I am sorry, the biggest issue will be what again?

Mr. DIPRINZIO. To the extent that a Federal agency within that complex can decide to not renew the lease on a particular building, versus the entire whole, if you can cherry-pick one building off of another, that is going to diminish the ability of the capital markets or the bank markets to finance the entire project.

Ms. NORTON. I must say, when you consider—I am interested that you say that. I could understand if this were a finite—this is Federal property.

Mr. DIPRINZIO. Right. I understand.

Ms. NORTON. So the last group that can afford to just take the risk of the building that nobody will be in the building would be, of course, the Federal Government. Now, we are also putting out there maybe six agencies out of how many? There may be twice as many agencies there. We can't find any one place to house them all and to get them all. They are headquarters agencies, so they have to be there. So I am interested in your notion that an agency might walk away.

Mr. DIPRINZIO. Individually. I think——

Ms. NORTON. Of course, they can't just walk away, they would have to come through—it would have to be an awfully good reason, maybe growing. Let me give you your hypothetical. Maybe it just grows—normally, as you may know in this region—so it gets an asset somewhere else for where it grows. The FBI has grown, so it is also going up to NoMa. So one wonders.

Maybe I should go to Mr. Chessen. Is that a risk from the point of view of a bank who is lending the money? What is the risk you see at Saint Elizabeths at the Homeland Security?

Mr. CHESSEN. Well, I don't claim to know a lot about Saint Elizabeths. I can tell you, though, that protection of collateral for a bank is extremely important. So, as was described here, any danger that might undermine that— separating out that collateral, having that become vacant, not being able to lease that again—does pose a risk to that lender. So I think anything that reduces the risk to that lender is going to lower the price of that loan.

Ms. NORTON. Do you think that the Government, if that is a risk with a cost, should seek to reduce that risk by—I hate to use the word guarantee—by some assurance that would be given to the owner?

Mr. DIPRINZIO. I think to the extent that your objective is the lowest cost of financing and the lowest rental rates, some mechanism that groups together the multiple properties at Saint Elizabeths and the multiple rental streams from the different agencies that will be occupying those properties would go a long way to allowing you to approach the market with a comprehensive larger revenue stream to raise the most amount of dollars at the lowest rate.

That is really the issue. It is very hard to—it is not easy to do. We saw one situation, I believe, with the Energy Department——

Ms. NORTON. The rental streams do not come individually from the agency, they come to one agency. That is one thing the Government has done right; it has a real estate arm.

Mr. DIPRINZIO. So you wouldn't have a GSA lease for all of it on a comprehensive basis.

Ms. NORTON. Well, no, whether it will be for all of them is the—the point is that it is all GSA construction, it all comes out of GSA. There may be individual agencies. What intrigues me about you was the notion of rental stream. It is one agency. How come all the rental streams—the existing rental streams, albeit paid over to GSA——

Mr. DIPRINZIO. Will there be a single GSA lease for the entire campus or will it be multiple GSA leases?

Ms. NORTON. The way it is now—and this is what, of course, I rebel against—it is done as if GSA was building, let's say, six different buildings in six different places, without leveraging the benefit of having a compound where you could say look at all of these.

Now, you might want to compete them differently, especially since it is not being built at the same time, but the notion of not regarding this, when, in order for the authorization to occur, you have to have indicated what it is you intend to do over the time; and then to kind of forget that and to go back to what you always do, building by building, is what I am trying to find a way out of.

Of course, we are dealing with not only the way it has always been, but within an entire Federal Government who has no knowledge and not much interest in real estate unlike the DOD, which is spread all over the world and has far more of its dollars going to real estate.

I don't even know how the VA got—I am not sure whether the VA has more of its dollars going, but you mentioned the VA — I think it was Mr. DiPrinzio—which has its own authority and apparently deals with building various kinds differently from GSA. Would you speak about their enhanced authority?

Mr. DIPRINZIO. Well, the VA, quite rightly, Madam Chairperson, does have its own leasing authority, and it also has enhanced use leasing authority, which it has been utilizing in recent years to reduce its cost, ultimately of——

Ms. NORTON. So speak about what do you mean by enhanced leasing authority?

Mr. DIPRINZIO. Enhanced use leasing authority allows the VA to basically take excess space—that may not be the proper term, but basically space that is not currently at the highest level of priority—and allow a private developer to develop that excess space in return for providing the VA with a lower cost of overall occupancy at say, for instance, a separate facility. There is a lot of interest in that.

Obviously, it depends upon the particular property at hand. In Cleveland, the VA is vacating one facility and basically allowing the developer to take control of the land at that particular facility that it is vacating in return for a lower rental rate on a new facility that it is building at Louis Stokes. So, in that instance, the EUL, the enhanced use lease, basically allows the VA to lower the cost of financing to a new build-to-suit building that is being put in place at Louis Stokes. Very powerful.

The Defense Department is attempting to do similar things using its own EUL authority.

It is striking to me, if I am not mistaken, GSA does not have its own EUL authority, and I would think, just based on my understanding, that there would be a lot of opportunities to better utilize and bring in private capital for space that is either deemed excess or not at the highest priority.

Ms. NORTON. We attempted to give GSA what we call Section 412 authority, which bit off a piece of that, and they not only sat on it, but OMB has kept them from using it, and I am going to try to—with the change in administration— loosen this up, make somebody understand how much money we are losing in the OMB; and OMB tends to have a say. If you have to go to OMB for everything, then, of course, you are really dealing with people who are outside of the whole real estate conundrum, dealing in another world, and yet they make rules that have to do with real estate.

I am trying to find out how does the GSA lease? Because we build a lot of stuff. We are not going to build a lot more stuff, and that is why the Homeland Security is so important to me. But the Federal Government continues to grow, even in this climate. We always think, because there is so much competition in this region for a GSA lease, that that is the gold standard. How is the GSA lease viewed in terms of risk?

Mr. RUDY. Let me try that one. If you don't mind, can I just circle back and put an exclamation point on the Saint Elizabeths scenario?

You have been asking how to compare it to the DOD. I think there are actually a lot of great analogies. What I think the Federal Government is trying to accomplish with Saint Elizabeths is to get a commitment from private sector capital and development capabilities that extends beyond one asset but goes over a period of time. Because in a cavernous environment, you are going to be building for quite a long time. And the DOD has been successful in arranging those sort of structures in exchange for all the right documents, the right risk assessment, risk assignment between the parties, deeding land or buildings or improvements to the private sector, then allowing the private sector to compliment with their own capital and get a good rate of return.

For Saint Elizabeths, again, a similar structure could be thought about, where you already own the land, so the cost basis of that land does not have to be embedded in the overall project cost once a building goes up. So now a developer has the ability, using whatever the private sector cost of capital is, with a good lease structure—you have asked about leases. You said the gold standard.

Maybe there is a gold standard of a lease structure out there that an investor could get their arms around and underwrite along with their lending partners, and provide not only capital for one building, but a forward commitment for multiple buildings over a period of time. And if that lease has the right assignment and allocation of risk between the Federal Government and the developer in terms of design, delivery, long-term maintenance and occupancy costs that the private sector is accustomed to, you will get very low cost capital commitments and a lot of interest in delivering that sort of real estate to the Federal Government to be occupied. And these 20-year leases are sufficient to get ample amortization of debt, so when the debt is nearly fully paid off or reduced to a sig-

nificant amount, it really almost doesn't matter whether the Government decides to renew or not.

I would suggest that that campus environment, there is a story to be told about it that private investors understand when they do real estate deals, and that is there is a reasonable probability that the Government is not going to leave; and they are not afraid of that residual risk tail. And that residual risk tail is an important component of your overall occupancy cost.

You said in your earlier testimony educate the consumer, educate the development investment community around what it means to do business with the Government. So educate them on risk of departure or renewal, educate them on the use of the facilities, perhaps deed the land over under a ground lease so it is not embedded in the building cost, write a commercially conforming lease, and you will attract abundant capital with good development expertise to get commercially viable buildings built for your agencies. I mean, that is a clean sheet of paper solution utilizing tools that I think are available to the Federal Government now.

Mr. DIPRINZIO. If I may, I would like to pick up on Mr. Rudy's point about residual or renewal risk at the end of a GSA lease term.

We use the term "essentiality" quite a bit in the larger public finance markets and specifically with respect to Federal facilities that are being financed. To the extent that one educates the investor—and obviously the investment bankers and the advisors that are working on these transactions—of the essential nature of a particular facility, the essentiality of that facility to the Federal Government, that will go a long way to reducing that residual risk and that renewal risk.

It is significant. It is probably the biggest issue that anyone faces in looking at a GSA financing from a credit risk perspective, setting aside the terms and conditions of the lease and how those may impact one way or the other. The renewal risk at the end of 20 years or 15 years, depending upon how it is structured, is critical.

One of the things that the market does understand is the notion of essentiality as it applies to State and local government, we see it all the time. Appropriation risk, the risk of annual renewal is something that the public finance markets have been used to taking for State and local government financings.

We are essentially applying that to Federal financings, and being able to communicate the essentiality of a given facility to an agency, to a larger campus environment is critical to reducing that residual risk; and taking it outside of the way the commercial market looks at residual risk and putting it more in the context of an infrastructure financing for a Federal agency that, quite frankly, in many instances has no intention of not renewing.

So you want to get that down. You want to do a good job of educating the investor ultimately, and the rating agencies or the bond insurers, whoever it might be that is involved in the financing, on the essentiality of that facility.

When we look at military housing—just, again, to touch on another analogy—if a military base were to close, the investors are taking the risk of base closure. What the DOD does is essentially—

pardon the term—it educates the investors on the essentiality of that base, on the importance of that base overall.

Ms. NORTON. Well, that is interesting. Let's take that one, because I have gone through a couple of BRAC proceedings here and bases have closed. I think the chances of a base closing are perhaps greater than the chances of having an agency move out of Saint Elizabeths.

Mr. DIPRINZIO. I completely agree. And the market has done $20 billion worth of military housing financing that has base closure risk all over it. So the notion of Federal——

Ms. NORTON. So what happens when a base closes? So a base closes, nobody knows what BRAC is going to do the next time, so what happens to the housing then?

Mr. DIPRINZIO. Essentially, the housing converts to commercial housing.

Would you like to pick up on that?

Mr. RUDY. I would suggest that the bases that the Air Force, Army, and Navy have pursued in terms of the housing privatization, they probably started at the top of the list of core bases, ones that had the least amount of risk for a closure. They haven't rolled the program out——

Ms. NORTON. Least amount of risk because?

Mr. DIPRINZIO. They have the least amount of closure risk.

Mr. RUDY. Closure risk for whatever reasons. I can't speak to the military strategy there. It may have been a very essential base.

Mr. DIPRINZIO. But the important point is there is an education effort that is put in place to let the capital markets and the investors understand that. Federal renewal risk on a lease is a similar issue, and to the extent that one focuses on that and you reduce that concern, especially in a campus-wide environment, that is in some ways at the top of the list of the kinds of financings that the Federal Government can very easily tap private capital for.

Ms. NORTON. What we struggle for and forget, frankly, is the ownership option, and staff always presses this, but the push-back is awful, and last time we did do it—before I came to Congress—it wasn't an ownership option. In fact, I am not sure when the Government has allowed that and, therefore, I always look for analogies.

What strikes me, particularly since it took a statute that I was able to get through when I was in the minority without any trouble here, for the Southeast Federal Center, what strikes me is to take a closer look at the enhanced use authority, at least of the VA. Now, are they outside of the scoring system?

Mr. DIPRINZIO. It is always risky to venture——

Ms. NORTON. Mr. Winstead is shaking his head, so scoring—do you think that the kind of enhanced authority you have described—I guess it was Mr. DiPrinzio—if that was used again, let's take Saint Elizabeths, Homeland Security, how would that work and would that reduce the risk? How would that improve or not things for building out there?

Mr. RUDY. I am not an enhanced use leasing expert, but it seems to me—again, I go back to this financially optimized lease form that the Federal Government already uses. They use it for the PTO. So you have a campus environment, private sector capital,

and leases that are in place that allow those sort of improvements to be built and leased to the Federal Government.

Ms. NORTON. What are you calling it? I am sorry.

Mr. RUDY. What is called a financially optimized lease.

Ms. NORTON. What?

Mr. RUDY. Financially optimized lease.

Ms. NORTON. Financially optimized. All right.

Mr. RUDY. And the components of that, as I understand it, are components that make it more financiable, almost like a private sector bondable lease. It has a lot of definitions around where the lease cash flows go in terms of reducing debt service, in terms of paying for operating expenses. It has better assignment of risk relative to default provisions and capital improvements, and other sort of features that allow the private sector holder of that lease to get it financed.

Ms. NORTON. Goodness. If the PTO used it——

Yes, Mr. DiPrinzio.

Mr. DIPRINZIO. Just along those lines, I think one of the biggest concerns that the capital markets would have is the ability to set off lease payments because of some degradation in service provided within the building. So to the extent that you segregate a debt service component, if you will, of the rental rate versus the O&M component, and the two can never really go against each other—I have seen that done, if I am not mistaken, PTO I think did have that.

Mr. RUDY. That is a feature of this lease, it is a bifurcated lease stream.

Mr. DIPRINZIO. That is critical.

The EUL authority, you had asked about that as it applies to Saint Elizabeths. Not knowing, frankly, enough about the current approach that the Government is taking at Saint Elizabeths, I don't want to——

Ms. NORTON. They are taking no approach. Please, the approach is the same approach that we used for building, I don't know, the ATF, all right. There is nothing different. So whatever you know about how the Government in fact goes about bidding for a new building and then moving a Federal agency in it, that is exactly what the Federal Government is trying to do here and what I am trying to get out and regard the building of a compound as an opportunity, at least for the compound, to get out of.

Mr. DIPRINZIO. Let me just put one possibility out there that might be helpful in the context of a campus like Saint Elizabeths. At Fort Detrick, where the national interagency bio defense campus is being developed, enhanced use leasing authority allowed the Defense Department to take a parcel of land, give that parcel of land under an enhanced use lease to a private developer—in this case Keenan, in conjunction with Chevron—and have Keenan and Chevron build a central utility plant to provide steam, chilled water, conditioned power, backup power to the agencies that are taking those services from that plant.

It would seem as though you could do something very similar with EUL authority at Saint Elizabeths, where, if you are building multiple buildings, the need for steam, chilled water, backup power would apply in a campus-like environment like that, and you would

get a lower cost for that by using an EUL in order to provide the site for that central utility plant at a facility such as Saint Elizabeths.

Again, I am just positing one example.

Ms. NORTON. No, keep positing, because, first of all, what you are dealing with are versions of things we are already using, and that is the only way I am going to be able to convince people; otherwise, they have to educate themselves in a whole area that they are not much interested in, which is real estate.

Mr. DIPRINZIO. My years of advising the Government has trained me to reach for analogies. If it is done over here, it is always helpful to be able to pick up on that and see to what extent we can replicate something maybe that was done in one area or one agency for another.

Ms. NORTON. In today's market, if somebody has a GSA— I was interested that you said the market doesn't have— that GSA is not as if—and that is interesting. Here, you would think GSA is a big player in the market nationally, but they are not much knowledge in the knowledge about how the Federal Government operates.

Why is that? I mean, maybe they are not as big a player as I have posited. Here, we live, of course, in a region where there is a lot of Government work. How is the GSA lease regarded? Do GSA leases make up a significant part of the market or a part of the market that the market is interested in because it is the Federal Government? How does the GSA lease stand in the market when somebody goes with such a lease?

Mr. RUDY. Let me give you a few of my personal observations over my career. I was talking about this at breakfast this morning.

Outside of the National Capital region, while the Federal Government is clearly an important occupier of space, it pales in comparison to many other occupants all over the Country, so the private sector——

Ms. NORTON. But you see that the work is done here.

Mr. RUDY. Understood. But you are asking a question about the understanding, I think, of the private sector's perception or knowledge of the GSA lease instrument. And when developers in other parts of the Country or landlords are interested in doing a lease with the Federal Government, this is not something they do on a regular basis. Most of the development community here in Washington, just to exist here, has done lots of business with the Federal Government and are probably more expert at it.

But out in everywhere else it is back to the education discussion earlier, educating the private sector on really what does it mean to do business with the Federal Government, how do you go through a procurement, what are the risks of renewal, what are the rules governing how do you comply with the RFP or the SFO, and all those things. That level of uncertainty or just unknowingness on behalf of private developers leads them to price and risk.

Ms. NORTON. This is important to hear from you because the Subcommittee had to beat the agency about the head and shoulders in order to get some centralized leasing component here. I mean, it bothered us to no end that leasing was going on in the field with out the centralized component here, essentially in charge, if I may

say so, in charge; and now, apparently, that has been rectified. We will be following that.

But you can see just how far behind GSA is in measuring up to what, let's say, if this were headquarters of a major corporation that had to build things around the Country, imagine letting those folks go out there and do their leases, and they are knowledgeable, without bringing to bear the market position of the Federal Government. That is what we are contending with and what we are trying to move from.

But we are contending with it because the GSA has had a lot of incentive to do things differently. That is why you hear me keep talking about GSA. Perhaps people will see the huge waste, if they see that you have many leases to deal with.

Now, in terms of credit rating and Wall Street recognition of the Federal lease, how does the Federal lease stand? Here you have something close to the full faith and credit of the Federal Government; you know that that is going to be paid. Is that how it is regarded by the market? What kind of credit rating does the Federal Government have?

Mr. RUDY. It is about as good as it gets. Again, my comment just a moment ago and now was not so much as to the process of leasing and how it is done centrally versus distributed, it was more a matter of the private sector's understanding of the process of doing a lease, their side of it, their perception; how complicated is it to do a lease and how complicated and nonconforming is the lease itself, which I think is the question you are now asking.

The credit is great, but then you start detracting away from the benefits of that credit when the investor starts looking at clauses in the lease that gives them concern.

Ms. NORTON. Such as?

Mr. RUDY. Such as caps on operating expense pass- throughs, the inability——

Ms. NORTON. Say that again?

Mr. RUDY. Limits on the ability to pass through actual operating expenses—maintenance and utilities—associated with that lease to the Government because of the structure of the limitations of those pass-throughs in the lease is one example.

Ms. NORTON. How would you control that if you just had an ordinary pass-through? It is the Government, now.

Mr. RUDY. Well, the private sector has the same concerns, by the way, so I don't want to make you——

Ms. NORTON. What did you say?

Mr. RUDY. The private sector has the same concerns. A strong credit corporate tenant is also concerned, oftentimes, about whether a landlord runs building amuck, does it run it efficiently, and they try to negotiate limitations on those pass-throughs. So the private sector is used to those sort of negotiations and limits——

Ms. NORTON. So those should be negotiated, you are saying.

Mr. RUDY. They can be negotiated.

Ms. NORTON. And this, I take it, would give an incentive to the owner to come up with perhaps ways to control it that would be attractive to the GSA.

Mr. RUDY. Correct, energy saving, other sort of cost savings. So that is one feature of the lease. There are default features. Some-

body on the panel mentioned earlier about the risk associated with potential interruption of services or some other sort of failure of a generator or an elevator or piece of plumbing.

Ms. NORTON. Yes, that is troublesome. Spell out what would happen, what that lease means, that default clause means.

Mr. RUDY. Well, if a tenant claims default, ultimately constructive default, it can terminate the lease as a result. That is pretty Draconian.

Ms. NORTON. Now, of course, we know that never happens.

Mr. RUDY. Well, if it never happens——

Ms. NORTON. But how should the Government—it doesn't. These things happen. They are not going to move somebody out of the building, probably. I can think of no circumstance. I won't say it won't happen, but I would be interested—just a moment. Apparently, in the old DOT building there was mold and—they moved them out of two or three floors.

I was trying to come up with whether it had ever happened. The only reason I raise it has never happened is that if, in the experience of the Federal Government it almost never happens, then to continue to put it in like it does, without making any modification, at higher cost to the taxpayer sweats me. So the question becomes what should the Government use instead of something like a blanket default, which, of course, they have never had to use.

Mr. RUDY. Well, the Government definitely needs its protection, so I am not suggesting they don't need any of the protection——

Ms. NORTON. Yes. So what kind of protection?

Mr. RUDY. I am only suggesting that in the private sector, the triggers and clauses and remedies available to the private sector may be up here in terms of the negotiated thresholds; whereas, for the Federal Government it is much lower, much quicker, much more ability for the Federal Government to claim a default, to provide self-help and their own remedies. Which means they can offset rent, stop the rental payments, they can fix the buildings themselves, repair things, going around what might be the third-party management that is responsible for doing that, as opposed to going through what I would say is, again, a commercially viable private sector negotiated path for doing those things. So it is those additional trip wires that create additional risk to the investor that they have to somehow underwrite, they have to embed in their expected rate of return.

Mr. DIPRINZIO. Again, I would add to that. You picked up on rating and credit rating for a GSA lease financing, setting aside what agencies can do themselves. That is where renewal risk and essentiality comes into play from my perspective, what I underwriting, a setting aside the term of the lease. When GSA is in the firm term period, no one questions the creditworthiness of the tenant at that point. What we have at the front end is construction risk and what we have at the back end typically is renewal risk, and those two components will degrade from AAA, which is essentially the Federal Government's rating, down to some lower——

Ms. NORTON. Well, now, renewal risk would be there for everybody. Nobody can expect that they have the benefit of a lease. I don't know why it would be any greater for the Federal Govern-

ment than anybody else. Nor do I know why the front end would be any greater.

Mr. DIPRINZIO. Right. I think that is correct. The construction risk on the front end is no different. But, frankly, I think, with respect to the renewal risk, given what we were talking about earlier, about essentiality and the importance of a facility to a Federal agency, reducing that risk of non-renewal through an education process, an ability to allow the investor—and this is what I do when I underwrite these transactions, I go in there and I understand what is the likelihood of non-renewal. How important is that facility to the Federal agency.

I think, frankly, the Federal Government has a much better story to tell in the vast majority of cases with respect to renewal, which would ultimately raise the rating and bring down the financing cost and ultimately the rental cost.

Ms. NORTON. Indeed, I bet the Federal Government has a better record at renewal than private agencies, particularly in this region, where there is no place to run, no place to go.

Is this what you mean, Mr. Chessen, when you speak in your testimony about Government leases that add risk to doing business? You call them covenants.

Mr. CHESSEN. Right. That is exactly right, it is all the terms that surround the loan or the lease that a bank has to look at to evaluate how to price that loan and what risk they assume, and I think it was described very well here. You do have the construction at the beginning, which is like any other construction project; you have to weigh that and who is doing it and how you are financing that, what is the risk of that builder defaulting.

And on the back side I would absolutely agree with you, I think the Government is probably better at that renewal rate than most companies. But there may be cases where the Government wants to abandon a property or they are leasing property that is only a small percentage of that overall building, and could put that owner in a situation where they may want to do something different, such as get another tenant and lease in the property, as opposed to the Government.

So there are factors you have to weigh in terms of what is the risk—we think of the property, of course, as being owned and fully occupied by the Government, but I am sure there are areas where the government only leases a certain portion of that building, and that would be considered by the lender in terms of the risk of that whole property of non-renewal.

Mr. RUDY. Mr. Chessen brings up a very interesting point on the renewal thing. I also agree with you that the renewal risk is inherent in any lease for any occupant, whether it is Government or private sector. But it is actually the end of the term issues that are also non-market conforming in a Federal lease that present some risk, such as the private sector developer has much less teeth or ability to move the Federal Government tenant out of the space at the end of the expiration if the Federal Government tenant wants to hold over, even beyond expiration. And that is a problem because they may have re-leasing plans or plan to bring in a new tenant to replace the income they may in fact be losing. So it is the end of the term issues that is one example.

Another one is the Federal Government has the ability to make physical alterations to their improvements, their space, through the lease term without necessarily having the obligation to restore those improvements to an originally approved condition.

That is not correct?

Mr. DIPRINZIO. No, no, that wreaks havoc on the financing.

Mr. RUDY. Yes. So, again, those residual risks we are talking about go up, not because of renewal risk, necessarily, but because of some of the end of the term issues, such as the two I mentioned.

Ms. NORTON. Talking about irrational issues in the Government, the condemnation and the holdovers, we tried to get behind that to find out what it is doing. Here, you raise the cost of credit because you don't have enough experienced staff, apparently, to renegotiate, as we heard testimony, the renewal of the lease, so you put the homeowner—sorry, the building owner in an impossible position. You use this authority that nobody else would have, only the Federal Government, and it is a total outrage.

As you can see, part of the problem is that nobody has looked with fresh eyes at any of this process for a very long time, and as we try to do so and are harnessed somewhat by OMB, we nevertheless see, particularly from your testimony, ways to begin to find our way out of this thicket.

I want to thank each of you for, really, very, very helpful testimony to us as we try to look next term toward what can only be called a redesign of the entire system. We want to do leasing and construction very differently. We think we will have a good case to make about taxpayer savings, and we want to use some of the testimony you have given us to try and get an entirely different approach based on the model, perhaps, of showing what can be done with the group of buildings that will go up for the Homeland Security Department.

So I thank you once again for excellent testimony; it has been very useful to us.

The next witnesses Steven Grigg, Executive Committee past President, as well as District of Columbia Building and Industry Association; Richard Purtell, Chair and CEO, Building Owners and Management Association, or BOMA; and, of course, our Commissioner of the Public Building Service, David Winstead.

We will, of course, begin with Mr. Winstead.

TESTIMONY OF DAVID WINSTEAD, COMMISSIONER, PUBLIC BUILDINGS SERVICE, U.S. GENERAL SERVICE ADMINISTRATION; RICHARD D. PURTELL, CHAIR AND CHIEF ELECTED OFFICER, BUILDING OWNERS AND MANAGERS ASSOCIATION INTERNATIONAL; AND STEVEN A. GRIGG, PRESIDENT AND CHIEF EXECUTIVE OFFICER, REPUBLIC PROPERTIES CORPORATION, REPRESENTATIVE DCBIA

Mr. WINSTEAD. Madam Chair, again, I am David Winstead, Commissioner of the Public Buildings Service, and I thank you for inviting us here again today to discuss the impact of the tightening credit market on GSA's capital program. I want to recognize that we have had a number of hearings over the last three months. We appreciate the attention the Committee is giving our leasing program and our construction program, as well as trying to determine

what the impact of the current financial situation is on our business.

I did want to mention several areas I wanted to touch on. Clearly, the former panel—we very much appreciate their input—focused obviously on leasing and scoring issues, and the authorities that we have, or lack thereof, to do lease financing approaches. I did want to focus, first off, on new construction and modernization, because through the funding of direct appropriations from the Federal Buildings Fund, our new construction modernization R&A program is really not directly affected by the decreases in the availability of credit generally.

As noted by the former panel, we have seen 70 percent of the financing in real estate disappear over the last year. We see $235 billion that has been lost in financing for real estate and the economy generally. I think that Mr. Rudy's comments certainly demonstrated that. So we are continuing to see issues on the construction side in terms of escalation of cost and subcontractors in terms of what they typically require. But, as you know, we do not obtain third-party financing, and most of our construction is financed through the Federal Buildings Fund, direct appropriations.

Secondly, on the leasing side, which the prior panel and your questions largely dealt with, I do want to say that we are noticing some impact of the credit crunch on our leasing program. As you know, our leasing program consists of 176 million square feet of space, of which a third is in the National Capital Region, your district, or the Metropolitan Washington area. We have asked, as a result of this hearing, each of our regional offices whether GSA offerors were experiencing difficulty obtaining financing for GSA leases.

We had a prospectus hearing earlier last month on this, and we have determined that most costly leasing terms, of course, generally result in higher rates for the Government. But what we are finding is that we are not experiencing a lot of lack of competition on our major prospectus leases. Therefore, in a general way, when credit becomes more expensive, it obviously could be reflected in increasing rent downturn and, also, on the financing side, 75 percent of capital financing and real estate has disappeared over the last year. The terms are getting more constricted and, obviously, certain developers aren't going to find the financing to proceed and deliver new office space on time.

In a few instances, we have seen successful GSA offerors who, because of the issues in the credit markets that the former panel addressed, have not been able to proceed with lease construct projects. At our last hearing we dealt a lot with the FBI lease program, the SSA lease program. Offerors have attributed some of these issues to tighter credit markets. For example, in 2005, GSA initiated a lease construction project for the FBI for up to 266,000 square feet and 271 parking spaces in Detroit, Michigan.

In May of 2006, we finalized negotiations for a no-cost assignment of 10 acres on a two-phased, best value procurement for that space. We awarded the lease, actually, of that development in February of 2007. The developer indicated that, as a result of the tight credit market and post-award addition of modifications to the projects, they couldn't secure the financing as they had anticipated,

and we actually rescinded that contract in February of this year and are out now for rebidding it.

So while I testify here today, it is not as if we are not immune from impact; there are two or three cases which I would be happy to supply this Committee full information on where it has created problems.

Secondly, the former panel talked a lot about—a different term was used, but persuading and our utilization of credit tenant leases, or what we call CTL leases, and we have proceeded on that. The PTO project, the DOT project in the District that you know well, were under credit tenant leases, and it does allow the developer to gain better leasing terms for more effective financing availability. The CTL has been used with varying degrees of success in several GSA regions. We did have a GAO report that alluded to the fact that we can get, and are getting, better leasing terms under some of these CTL leases.

I will tell you that GSA has, in response to those two leases here in the region that you are probably most familiar with, modified general clauses in the CTL to enable better lease financing for major transactions. Under the CTL, successful offerors may be able to obtain better and higher loan amounts at lower interest rates under the CTL.

Once the lease space is delivered according to the lease requirement, the Government, GSA, has been able to compromise on some termination and setoff rights against the debt service portion of the rental payment in order to allow an uninterrupted rent flow to the lessor's debt. So the Government retains its rights to enforce the lease service obligation in any regard.

In order to ensure that we are obtaining the value of the lease modification, we have encouraged our regions to request pricing on both standard lease requirements and CTL so that we can be seeing savings, and, obviously, the current credit market requires this. At the same time, Madam Chair, I will tell you 80 percent of our lease actions nationwide are under 20,000 square feet, and what we are talking about is the real value or the large prospectus leases that we are looking at CTL approaches for. Chip Morris, who heads up our leasing programs, is behind me and could certainly provide additional information to the Committee on those specific cases.

A third area that we are seeing some impact, which I know has been the subject of hearings here before, and that is on our green building program. We are relying on energy savings performance contracts to accomplish renovations of building systems in our some 1500 owned inventory, of which 600 are 30 and 40 years old. Through these ESPCs, we conduct a comprehensive energy audit, identify improvements that will save energy to the facility, and arrange financing to pay for them.

The energy service company guarantees that the improvements will generate savings sufficient to pay for the project and we estimate that our potential use of these ESPC and utility energy service contracts in the current fiscal year, fiscal year 2009, will be approximately $24 million. We are seeing that ESPC financing is not traditional financing, it is based by guaranteed energy savings resulting from improvement, and, therefore, the financing markets

are impacting the ESPC contracts where we see rates now 6 to about 10 percent.

A fourth area that we do see some potential impact, but, fortunately, we haven't seen any here in the National Capital Region, is on retail leasing. Obviously, the economy is having real recession issues, purchasing and information is a bit more than it was a year ago, and we do, as you know, have mixed use and retail tenancy. The Ronald Reagan Building, the International Trade Center, the ATF Headquarters building has 8,000 square feet of retail and restaurant space and the ATF. Banks are tightening standards for loans to small business, and a lot of the retail food service vendors that we have.

But so far, fortunately, these more restrictive credit conditions that the former panel presented to the Committee are really not having an adverse impact on our retail tenants in the Reagan or the ATF situation. In fact, the Ronald Reagan Building is fully leased at 100 percent of retail space; the ATF Building, as you know well in the NoMa District, has four retail tenants that are in the process of moving in. We have had some unfortunate delays as a result of getting gas service to the facility, but we do anticipate that by the end of August [subsequently edited to "January" - ed.] those retail tenants will be in place and providing food service and other amenities to the ATF employees.

So in conclusion, Madam Chair, the tightening of the credit market does potentially affect GSA in three areas: obviously leasing, energy service performance contracts, and retail leasing, as well. So far, none of these areas we have seen any significant impact negatively on GSA and its leasing actions. Credit is available to our lessors at favorable rates with the Government tenancy, the AAA rating that the panel member earlier alluded to.

The Federal Government generally may experience an increased reliance on larger ESPC contracts that might have higher rates, but although some small businesses may in fact, in our retail functions in some of our mixed space in our buildings, may find tighter credit, we do not see that in the current situation with those buildings I mentioned in Washington.

Madam Chair, the last thing I would mention before turning it on to the other panelists is that, as Mr. Rudy mentioned, in the Jones Lang LaSalle testimony earlier, being a major player in the market, we do see the credit tenant leases getting very competitive offers to date. We are seeing, fortunately, in the slow down that there is less demand, for example, in Lower Manhattan because of the Bear Stearns collapse. There is a lot of space on the market in Lower Manhattan now and a lot better rates, and we are seeing 600,000 square feet available in Lower Manhattan for Federal tenants. We are actually getting better deals as a result of some of the market turning down.

But I would conclude, lastly, that we appreciate the Committee's inquiry into these leasing issues, the former discussion on scoring I dealt with on June the 10th in great detail and St. Elizabeths as an example. Thank you again for this opportunity.

Ms. NORTON. Thank you very much.

Mr. Purtell?

Mr. PURTELL. Thank you. Good morning, Chairman Norton and Members of the Subcommittee. Thank you for holding this important hearing on the impact the current credit crunch is having on the leasing and construction of Federal office buildings. I am Dick Purtell, Portfolio Manager for Grubb and Ellis Management Services, and I am here today in my role as Chair and Chief Elected Officer of the Building Owners and Managers Association International.

With the rise in delinquencies and defaults on subprime mortgages over the past couple of years, it is only inevitable that this financial crisis would ultimately have some impact on commercial real estate. My testimony today will touch on how the current economic circumstance is affecting the renovation of buildings, build-to-suit leases, attracting and retaining tenants, as well as rents and occupancy rates.

In general, much of the economic dynamics of the commercial real estate sector can vary due to local market forces. However, one thing our member all across the Country acknowledge: it is becoming increasingly difficult to acquire capital for new projects and renovations for public buildings, as well as those intended for private sector use. Lenders are making it more and more expensive for even the most economically sound companies to borrow money.

And for those whose balance sheets aren't as healthy, it is nearly impossible. Consequently, this has negatively affected building owners wishing to refinance, sell existing buildings, or plan for future renovations in which the financing for the project has not yet been secured. It could also become a favor in a building owner's ability to attract and retain tenants by limiting tenant improvement packages offered in the future.

An example of where access to capital has made it difficult to liquidate properties is in San Diego, where one BOMA member, who has the responsibility for a municipal government's portfolio, has had a number of buildings on the market for over a year at what are considered bargain basement prices. But due to the increased borrowing restraints and cost of funds, he has had trouble finding buyers without having to reduce the price even further. In Philadelphia, we have received reports that building owners are currently moving forward with renovations and improvements that were more than likely already in the pipeline; however, plans for renovations in 2009 do not appear to be in the budgets of most.

The increased difficulty to obtain capital for the purposes of developing commercial buildings has also negatively impacted build-to-suit leases. We are hearing that very few build-to-suit leases are being executed at this time. Stricter underwriting requirements, skyrocketing construction costs, combined with the increasing vacancy rate, decreasing effective rent and economic slowdown, has eliminated any new construction. Currently, those build-to-suit leases that are in the works were either begun some time ago or are being financed largely through private equity.

From the Federal Government's perspective, in areas where there are owners or developers with larger existing buildings or buildings under construction that are looking at the Government as prospective tenants, current conditions may actually help the Government, as their demand never goes down.

However, it is adversely affecting large build-to-suits, even those for the Federal Government, due to the uncertainty of financing, capitalization rates, and buyers. Since, in these times, the Government is an even more important player in the building and construction industry than it is normally due to its demand for space continuing at a more constant rate than private industry, it becomes even more critical for the Government to eliminate barriers and constraints to the Government leasing space, especially in build-to-suits that were discussed in previous BOMA testimony before this Committee.

The ability of building owners to attract and retain tenants, as well as stabilize rents and occupancy rates, are issues that appear to be more sensitive to the local area's supply and demand. Some reports from members have indicated that rents continue to be on the rise, but not quite as rapidly as in recent years, as is the case in the District.

In other markets, the economic slowdown has hurt overall occupancy levels as tenants are struggling to survive. Owners are still trying to maintain the same rental rates, but are now offering significant tenant and broker incentives. In these parts of the Country, it is definitely a tenant's market. In buildings with weak occupancy, owners are having even more trouble making mortgage payments.

In some markets, owners are taking a wait and see approach to see if the slowing economy leads to tenants shedding unwanted space. Due to the nature of the industry, the possible negative effects in certain parts of the Country may not be felt for several years.

If there is an upside to this, it is the amount of supply coming online over the next several years will be significantly less, which will have a positive impact on the market overall from a landlord's perspective.

We thank the Subcommittee for holding this important hearing and hope this testimony has provided some insight on the effect of the credit crunch has had on the commercial real estate industry. I would welcome any questions you may have.

Ms. NORTON. Thank you, Mr. Purtell.

Mr. Grigg?

Mr. GRIGG. Good morning, Chairman Norton. It is good to see you again, Ms. Britta and the rest of the staff. I am Steve Grigg, President of Republic Properties Corporation. I am here testifying on behalf of the D.C. Building Industry Association, where, as you know, I am past President, one of them, and member of the Executive Committee.

As it has been clear to the Committee and to everyone else, the credit crunch is having a direct and broad impact on development, leasing, and management of commercial office space nationwide. The District of Columbia and the Nation's Capital Region are neither distinct nor immune from those problems. The collapse of conventional debt financing for development projects and the permanent financing market are working in tandem to make new development and major renovations of existing buildings much more difficult and expensive.

With the collapse of securitized debt markets and with the values of existing loan portfolios in doubt, lenders have become reluctant to assume any risk, underwriting standards have been tightened, and loan-to-value ratios have shrunk. The result is higher borrowing costs and higher levels of required equity participation, if capital funding is available at all. Meanwhile, equity investors are repricing their conceivable participation to reflect higher perceived risk.

The Federal Government is a major user of office space and is not immune from the impact of this credit crunch. It is probable that the Government has not seen the impact of the credit situation thus far. As existing space is being absorbed up, however, that will become an inevitable change. Larger procurements with prospectus level rents that were established some time ago are going to be seeing less competition now and going forward.

The Government is a special class of user of commercial office space; hence, the Government leases are essentially flat for various terms. Space leased by the Government used to be advantaged by steady, prompt payment of rent. The margins associated with rental income have declined as a result of problems in timing and the amount of reimbursement in increases and real estate passthroughs and operating expenses, which are indexed to CPI increases. Both the business reality and underwriting standards have increasingly noted those changes in dealing with the Federal Government in leases and occupancies. Either the system has to change or face rents will dramatically increase to reflect these conditions.

The Government's prospectus level rents and expectations of various tenant agencies will have to be adjusted upward in the future. While we believe that the availability of financing will eventually be eased, the effective increased costs will become more predominant over the coming years.

Thank you for your attention. I am available to answer any questions.

Ms. NORTON. Thank you, Mr. Grigg.

We put the three of you together. Normally, the Government witness is separate. We mean no breach of protocol, but the fact is that Mr. Winstead's job is to work with people around his table, for the benefit of the taxpayer, to be sure. Thus, the exchange among you would be very valuable to us. For example, Mr. Winstead spoke of getting better deals. He spoke of the Government's AAA rating. And Mr. Winstead knows that my concern is whether or not we are taking full advantage of that rating.

But you have testified we are getting better deals. You pointed to the vacancy rate in New York. I would like to hear you elaborate on that and give me an example of what a better deal is and let me ask you about the vacancy rate in the National Capital Region. That is a two-part question. You hear Mr. Purtell say it is a tenant's market. You hear it from the—excuse me, Mr. Purtell—horse's mouth.

Mr. WINSTEAD. Madam Chair, I think, obviously, the market, as alluded to, in terms of the crunch and Mr. Grigg talked about the impact of the financing tightening lending on the delivery of new

space, and that will impact. I think it is going to be a couple years before we really see that.

Ms. NORTON. So it is very important to note for the record, because I think Mr. Winstead's testimony was like the early reports we had from developers who were already in the market, from business owners. They didn't see much different. The Committee sits here trying to think ahead, trying to think as I am, for example, about Saint Elizabeths. Hey, there are some people in some buildings now, there are some leases that neither party, frankly, can do much about, but the Federal Government is, for example—leave aside leasing new space all the time—about to build the largest compound, at least for GSA, in its history. So even when it comes to leasing, while I accept Mr. Winstead's testimony, I am sobered by the testimony of his brethren beside him.

Who am I quoting from here? Become increasingly difficult to acquire capital for new projects and renovations for public buildings, as well as those intended. This may be you, Mr. Winstead.

Mr. WINSTEAD. Madam Chair, your comment——

Ms. NORTON. Wait a minute. Both Mr. Grigg and Mr. Purtell have spoken really to the major concern we have. Mr. Winstead, our own work verifies what you say about present conditions. You have been dealing with the top of the mark; you always will. But the testimony here from those who have those leases, have those contracts is that those same very creditworthy owners are finding it difficult today—if they were today, not the process that we deal with—what does it take, 10 years, 8 years, 5 years, whatever it is, to get going — but today—that there would be increased costs to borrowing.

There would be, in other words, a totally different situation from what it is right now. And what I am trying to learn is, for example, from your own testimony, that you are already beginning to take advantage of the tenant's market, what is the difference between what you have been doing before and what you are doing—let's take your own example—in New York now.

Mr. WINSTEAD. Madam Chair, you have raised several questions and I will try to answer them. First one was about our vacancy. You know, this Committee well knows, improving our leases prospectuses, that we are managing our leased portfolio of 176 million square feet, a third of which is in the National Capital Region, very tightly because we control those terms and it is about a 1.5 percent vacancy on our leased inventory currently nationwide. So that is a very tight margin.

Secondly, your question about St. Elizabeths and the market and how it might change. There is no question that if in fact there is attrition in——

Ms. NORTON. I am sorry, I was trying to understand. What vacancy are you talking about?

Mr. WINSTEAD. I am talking about on our leased inventory. If you look at——

Ms. NORTON. Your own leases?

Mr. WINSTEAD. All leases, 176 million square feet nationwide, in terms of any vacancies. We keep that very tight because we are obviously leasing the space about 1 percent. Nationwide, in terms of Federal ownership, it is higher, unfortunately, because we have

had some attrition, consolidation of IRS, FBI moving out of some, as you well know, center city buildings in Federal field offices, new offices.

Your second question dealt with St. Elizabeths and its impact on the market, and there is no question that as financing of new projects and the——

Ms. NORTON. Wait a minute. I also asked you what were you doing—I am sorry, you said you were able to get better deals. I am not sure I heard the answer to that question. Because I wanted to know what is a better deal.

Mr. WINSTEAD. Well, I don't think there is any—okay, in terms of better deal, you know, whether—you want specific rental rates in D.C. or——

Ms. NORTON. You acknowledged——

Mr. WINSTEAD. There is no question the next couple of years, and currently, with the impact of the credit crunch, we are going to see vacancies creeping upwards; we are going to see effective rents going downwards; we are going to see specific markets in urban areas like New York and Lower Manhattan, where we have had huge vacancies created because of Bear Stearns' failing and consolidation, we are going to see better deals.

Ms. NORTON. So what would the GSA do? Not what is it doing, but what is it that the GSA would do differently, operating in that market today, with vacancy rates up? How would you operate any differently from how you have been operating before? What kinds of different deals might you be able to forge?

Mr. WINSTEAD. Well, I think, again, it is largely, unfortunately, the lack of authority for enhanced use leasing and some of these other authorities DOD has and VA——

Ms. NORTON. So you think enhanced use leasing would help?

Mr. WINSTEAD. Enhanced use leasing has been shown, Madam Chair—I supplied this Committee six months ago our 10 most costly leases in which we showed the relative cost of lease construct versus direct Federal construction versus enhanced use leasing, and enhanced use leasing is almost as cost-effective as Federal construction in building out those housing demands. So you have good evidence of our analysis of the cost of options.

Ms. NORTON. So you would need——

Mr. WINSTEAD. Authority.

Ms. NORTON. You would need authority, statutory authority.

Mr. WINSTEAD. We also would need OMB's approval in terms of prospectus, and from both the June 6th hearing, the July 11th hearing and this hearing, it is clear to me that this Committee would love to see more use of that kind of authority that DOD and VA——

Ms. NORTON. As of now—and you heard me say I am going to try to get more authority and you heard me say I am trying to find out as much about the authority that other agencies have that will help me convince the Congress that we should have the same authority, but being in the position you are now, seeing with some leases and some agencies are up, and an agency—I am trying to give you a direct hypothetical— an agency looking for space—and you have heard Mr. Purtell call it a tenant's market—how, given

the limitations on you now, would you go about seeking space in a tenant's market?

Mr. WINSTEAD. Madam Chair, I think we are leveraged very well with our partners in the private sector to take advantage of the best deals, and if they are going down in the near term because of this unfortunate credit crunch, then I think that through the national brokerage contract that you have asked a lot of questions about, we have supplied a lot of information, we are leveraging the strength of the Federal purchasing power and getting below market lease rates around the Country.

Ms. NORTON. Would you give us examples of getting below market lease rates?

Mr. WINSTEAD. Well, I would certainly suggest that recent acquisitions in NoMa—and I know some are being contested—have had very competitive rates because availability and new space coming online in NoMa.

Ms. NORTON. So you believe those were below market rates?

Mr. WINSTEAD. I think they were very effective rates. I mean, they responded——

Ms. NORTON. You may be right on NoMa. NoMa, of course, looked at the market and said what do our rates have to be to get people to move here, and you may be right there. If it were a part of the city, for example, midtown, would you be able to negotiate similar rates?

Mr. WINSTEAD. Well, Madam Chair, I am not a financial expert, I am a lawyer by background, but I will tell you that if some of the financing arrangements on these major landmark buildings, private sector buildings in downtown have to be refinanced with the impact of the credit crunch, and new financing terms that might be imposed on these building owners, we might see rental rates, because of that, them being forced, you know, for them to go up.

So we might see that under current credit and financing rates for these buildings they structure the deal with us based on a rent that we committed in contract to pay. If they are having to refinance these buildings at a time in which cap rates are going up and at a time in which leasing terms are more restrictive, they might find themselves less competitive for our leases.

Ms. NORTON. Let me take an analogy from the real crisis in the housing market. The marketplace knows how to respond when it is down, and if you take the worst place in the marketplace, they are all but giving away the house. But they don't want to do that, so you have heard fantastic things— obviously, real estate isn't in the same position, but it makes my point—if you buy this house, we will give you gas for a year, for example, because they see that one of the major problems with where homes are located today is something we really can't do anything about, and that is gas prices are going up with nothing except pricing, frankly, to bring it down.

Okay, we speak of concession packages. I think you spoke about them in your last testimony. Give me an example of a concession package that might be asked for by the Federal Government if it wanted to acquire space in Downtown Washington.

Mr. WINSTEAD. Well, obviously, we would be looking for the factors under our credit lease structure deal with right of assignment,

looking at tenant fit-out, looking at casualty and termination rights, looking at rental offsets for maintenance and services.

I mentioned earlier in my testimony——

Ms. NORTON. So some changes in these clauses.

Mr. WINSTEAD. That is correct. I mentioned earlier that under the credit tenant lease that we are applying to large prospectus leases, which you know a lot about and we have seen a lot come before this Committee—the bigger deals, not the 80 percent under 20,000 square feet, the large prospectus leases—we are, under this CTL, acknowledging that we do need to attend and are relaxing and modifying the casualty and termination rights under that kind of CTL lease approach, also the rental offset rights for maintenance and service. So we are acknowledging and are negotiating and applying——

Ms. NORTON. And those you are using with CTL.

Mr. WINSTEAD. That is correct.

Ms. NORTON. Is it the GSA now committed to using CTL wherever it can?

Mr. WINSTEAD. Madam Chair, on the large prospectus leases we are. The last two were obviously DOT and PTO and others, but we are looking at this and talking with the industry. Actually, yesterday—this came up in a lease construct workshop that I mentioned that we had in early June. Yesterday, our team was sitting down with financial experts as a result of the current market conditions and looking at the credit tenant lease and looking at how we can modify those clauses without damage to the Federal Government and our obligation, but to get better deals, to allow some flexibility in those two areas where a potential offeror or lessor could in fact get better financing terms and thus get better rates for us, as well as reflect the issues that Mr. Grigg mentioned that are in the market.

Ms. NORTON. This Subcommittee does not intend to press the GSA to put the Government at any substantial risk. We are very open to hearing why the GSA doesn't leverage some of these—it has got them now. We know industry hates it. Why it doesn't leverage that to at least get a better price by making modifications where there may be no history of needing, for example, clauses as strict as some of those. So risk might be said to be rather insubstantial. We don't want to ever put the Government in the position where anybody takes its thinking of risk, but the way in which—well, let me ask Mr. Grigg and Mr. Purtell.

Surely there are private sector businesses whose business is of a kind that they need certain kinds of protections when they move into a building, and they have the same financial pressures that we are speaking about in this hearing. What I am really interested in is how somebody who has—and I recognize the Government would be at the highest level—has to, let's say, lease a building that may be outside of the norms of what you might expect in particular clauses to accommodate this particular business and its lease. I mean, you might truly have such in this region, but I am talking about private businesses now.

I am trying to get some idea of how the business, let's say, would negotiate in order to offset its cost without substantial increase in risk where it knows it is almost using boilerplate language—be-

cause that is what the Government is doing—for many of these clauses, how some kind of accommodation would be reached between the business, which knows it needs something somewhat different from the average tenant, and the owner.

What kinds of things would they feel they could negotiate and how would that be structured? What kinds of exchanges of win-wins, whatever you like to call it, do you think might be structured in that kind of situation, where you really do need something extra but you really don't need the kind of standard clauses that they could get out of a book and, for that matter, GSA gets out of its play book?

Mr. Grigg?

Mr. GRIGG. Well, I think that the simple answer to that question is if you can make Government leases more consistent with the private sector, then you would gain some advantages. There are examples that deal with the reimbursement for tax increases, which are essentially, by lease, are phased many, many months beyond what a private tenant would have.

Ms. NORTON. Federal tax increases?

Mr. GRIGG. No, real estate tax increases. I didn't mean income tax. Essentially what that does is it requires the landlord to carry those payments as a balance over an extended period of time. The increases for Consumer Price Index have recently not been competitive. The increases in power and in wages haven't matched the published price indexes for years. There is some question as to what the Consumer Price Index means in general and who manipulates it, and that is beyond maybe the discussions today, but, from a cost standpoint, that represents essentially a phantom loss that one has to absorb in a way that you wouldn't in most private leases.

Ms. NORTON. And you think that negotiating with these items you have mentioned would reduce cost to the Government ultimately? See, the question is the Government is going to look and say, well, this is going to increase. It is going to do a straight line look at it.

Mr. GRIGG. Well, you have to look at it not in an individual moment of the next 12 months or two years, but you have to look over a long-term basis.

Ms. NORTON. Well, over, for example, the lease. You think over the lease itself, over the time of the lease itself. What are they, 10 year leases, usually? Ten or 15 year leases themselves. You think a case can be made for that?

Mr. GRIGG. I would think the average Government lease is actually somewhere about five to seven years, but they could——

Ms. NORTON. Mr. Winstead, are they really only five to seven?

Mr. WINSTEAD. Madam Chair, most of these smaller leases that I mentioned, 80 percent of the portfolio are shorter term leases, they are smaller, more flexible uses, under 20,000 square feet. So I think Mr. Grigg is correct.

Mr. PURTELL. I can speak, maybe, to that. I am from Cincinnati, Ohio and I have recent experience in this area with the Department of Energy on a lease of about initially 40,000 feet, and it was a five-year lease—actually, a ten- year lease with a five-year cancellation, which causes some issues.

Mr. NORTON. Is that good or bad for the private sector?

Mr. PURTELL. Probably a negative, if we have to be prepared for that lease to be cancelled after five years. But I would echo some of the things that have been said regarding flexibility and previous testimony——

Ms. NORTON. Excuse me.

Mr. Winstead, why are the leases five to seven years, so I can understand?

Mr. WINSTEAD. Well, again, they are based on our leased tiering approach and agencies' needs, and basically the term of the housing giving their tenancy and also getting the best deal on the market for the Government. I mean, this may not be the best deal for the offeror, but for the Government. That is what we negotiate for.

Ms. NORTON. So a long-term lease would not be the best?

Mr. WINSTEAD. Well, the DOT lease, which is, as I said, a CTL lease, a credit tenant lease, we did get a longer 20- year term, and you are well aware of the size, 1.2 million square feet.

Ms. NORTON. But you think that is appropriate only for larger leases?

Mr. WINSTEAD. Well, what in fact we do see is that the larger leases, the longer leases than the shorter leases, more flexibility under lease tiering approach that we are doing. We are looking to agency changes. We are having consolidation of the IRS. The Social Security Administration has wanted smaller, more rural offices because the demographics of retirees are changing, so they are going to where the retirees are. It is a constant flow.

And what I did mention in the June hearing is like we have on the portfolio side, with portfolio restructuring and using section 412 authority to access under—we are now applying the same sort of lease tiering approach so that we can predict when these leases are expiring, when we need to have notice, clear the housing plan with the agency and get back in the market to test the best deal, and that is really why those lease terms are structured to be short or long.

Ms. NORTON. I am sorry, I didn't want to interrupt you, Mr. Purtell, I was trying to understand.

Mr. PURTELL. That is all right. One thing we did in this lease, which is a fairly recent lease, we did take out the property tax issue, and that is a separate issue with this lease now, in that we have direct pass-through on property taxes. We still do not have——

Ms. NORTON. Was this a lease with the Government?

Mr. PURTELL. Yes, it was, it is a GSA lease, and worked with the Chicago office on this document.

Ms. NORTON. So you sat and simply negotiated that.

Mr. PURTELL. Yes. Yes. That was part of the negotiation, to have the direct pass-through on property taxes, because it is an uncontrollable expense which typically, with all the other leases, is the way it works.

But we still have issues, and I think to be more competitive, from your perspective, if there is more flexibility there—because when bidders are bidding on leases, they are protecting themselves by covering these items that they have to allow for certain increases. For example, one of the biggest ones right now is utilities. To have

to cover utilities and have that built in to the lease for a 10- year period is a real challenge for a landlord.

Ms. NORTON. Yes, Mr. Grigg.

Mr. GRIGG. I think in answer to an earlier question that you asked Mr. Winstead, how would you change the pattern, I think that from a portfolio standpoint, in an environment where there is a great vacancy that is available in a marketplace, the answer is that GSA should be leasing more rather than less, instead of self-building. And when there isn't much vacancy in the marketplace and it is essentially having to compete increasingly with that, it should use its buying power by building more buildings which——

Ms. NORTON. What do you mean, self-building? They don't build much, Mr. Grigg. They build to suit.

Mr. GRIGG. Right.

Ms. NORTON. So they are leasing most of the time. Now, they build to suit on these cross border stations. That is the FBI, of course. Their FBI stations are going to be built from the ground up, of course.

Mr. GRIGG. Well, you were describing the Homeland Security headquarters or cluster at Saint Elizabeths.

Ms. NORTON. But how could that—I mean, they own the land there, and that is the only reason it is being built on the West Campus of Saint Elizabeths, is that finally we own the land, we can build on our own land. And guess what? We act as if we didn't, because we are building in the same way we would in Downtown Washington. So I am not sure that Homeland Security provides us with an opportunity, since we don't have to purchase the land, at least, in order to build there.

Mr. GRIGG. Well——

Ms. NORTON. So if that is what you think should happen, I think it is happening and, thus, I am far more interested in the leasing market than I am in the construction market, because I don't see the Government coming up—particularly with the way in which we pay for construction—for a courthouse. If we are going to build a million square foot courthouse complex, which is usually a courthouse and an office building with it, we have to get the appropriation up front, and there is no capital budget here. If that sounds stupid, it is.

But that means that forces the Government into the leasing market and, therefore, I am looking for savings, for partnerships with the leasing market to save each money that is being spent because GSA makes it and, therefore, the taxpayers get left holding the bag. This is the big leasing territory for the Federal Government.

Mr. GRIGG. Well, certainly, the National Capital Region is that and Washington, D.C. But I think then I go back to my previous response, and that is to the extent the Government can make its performance more like the private sector, it will probably be able to negotiate the best economic terms on a long-term basis.

That is not to say in specific instances that it can't drive a harder bargain in the short-run, but the long-term benefits to the Government would be better served by modifying its standard practices to be more consistent, and those involve payment approvals, timing of reimbursements, term provisions, might include escalation of

costs over a period of time instead of demanding flat leases, and the like.

Ms. NORTON. Oh, well, this is an important point. We can't depend on, assuming we could get a better deal in this market, who would want this market.

So we have to assume that this is, I think, something more than cyclical, but we have to assume that it has real cyclical aspects to it and, if it does, that it is going to get better and it always does get better. If so, then we are left with the same procedures that we had before, and then we are robbed of whatever leverage we thought we had during a time of downturn.

Mr. PURTELL. I would comment that the full, as I said in my testimony, the full impact may not be felt for a couple years, and I think the timing of this hearing and what you are doing has well positioned GSA to prepare for the opportunities I think that are out there for any expiring leases or any new lease opportunities.

Ms. NORTON. Mr. Winstead, let me ask you, how are you preparing for that? We have many leases expiring. Indeed, you have leases that you are sitting on or using the condemnation notion or holdover notion.

Mr. WINSTEAD. Madam Chair, I think continue both with our existing landlords and successive offerors to look ahead to both space requirements and when those lease expirations are occurring.

I did state on the June 6th hearing that I was very concerned. I do not see a national trend in some of the holdover issues we discussed.

I know Mr. Grigg commented about rent payment, and we are committed to paying rent on time, and we are committed to paying our construction bills on time. I did mention at great length, I think in June, what we are doing to trying to ensure that.

Ms. NORTON. Are you saying, Mr. Purtell, holdovers, Federal holdovers are condemnation use by GSA?

Mr. PURTELL. I, personally, haven't witnessed that.

Ms. NORTON. Mr. Grigg, do you know of any?

Mr. GRIGG. Yes.

Ms. NORTON. In this region, for example?

Mr. GRIGG. Yes.

Ms. NORTON. What does a building owner do when these procedures are used?

Mr. GRIGG. Vote every couple years.

Ms. NORTON. Does what?

Mr. GRIGG. Votes every couple years. There isn't a lot that the building owner and the government——

Ms. NORTON. You can't vote the GSA in or out if you notice that, and my great frustration is that I see no difference between Republican and Democratic administrations. You need a sea change in this agency.

Mr. GRIGG. Although I have been guilty on commenting on GSA at various times, I don't think this is really a product of GSA's actions or inactions of and by themselves. They are providing services to tenant agencies. They have budget issues associated with the annual budgets. It is a big complex system that we all operate in.

But holdovers are major features, and the consequences of those holdovers or passive condemnations, whatever you want to call

them, and the imposing of terms on landlords, it is a tension that impacts landlords and others in the business market that could be avoided.

Ms. NORTON. Let me ask you this, what effect does that have on costs and on competition? If you know that holdovers occur, does that get built into the cost of doing business with the government?

Mr. GRIGG. It has an impact on the whole business plan depending on the individual buildings.

Ms. NORTON. Yes, that is what I mean.

Mr. GRIGG. It has impacts on the marketplace. You know you have the benefit of government occupancy as any other benefit of having occupants.

It is the only situation where a tenant gets an opportunity to stay where they are and pay an indeterminate amount of rent for an indeterminate amount of time with really no mechanism that is particularly palatable except going to the court of claims or whatever to kind of seek relief, and one doesn't get reimbursed for that or relief as opposed to private lease.

If a tenant holds over, the tenant is going to pay the cost, all the cost of that action including the cost of being made whole through the courts.

I am not suggesting here we try and restructure the whole relationship between the government as a tenant and the landlords in general, but as one would move that bar closer to a businesslike setting, the government will get long-term benefits.

It is necessary that the government be able to operate, and it has superior powers because of the nature of it being a government. But to the extent you can remove those and balance things out, the system will work better, more equitably, and eventually the government will get the benefit of the bargain.

Ms. NORTON. Let me ask all three of you this question. I am still enamored from my days as a full-time professional lawyer to hypotheticals to make me understand things. That is how people understand law school. You give them a real life example. So you have seen what my ever present real life example is. It is Saint Elizabeths.

Mr. Winstead's testimony says, and I think he is right, that in general the GSA has not felt the impacts now, as of when we speak, and he submits some evidence to that effect.

Then he says, however, one thing—is this him? No, sorry. This was Mr. Purtell's testimony.

I am reading from page two, although I must say Mr. Winstead agrees with you about the general effect now. But you said that it was becoming increasingly difficult to acquire capital for new projects and renovations for public buildings. That is your testimony.

Now let's assume, obviously, the Federal Government is committed to a new headquarters for the Homeland Security Department. Obviously, none of that is happening now. They have to clean up, and you know how long these things take.

I am not now assuming CTL or advanced. I am just assuming that it will be built in the ordinary way. How else can I proceed because we have an appropriation coming down, we hope? It has

been in the President's budget for the last three years to build the thing.

So if you were to look up the time scale, time frame, you wouldn't see anything happening there in terms of groundbreaking competition for how long, Mr. Winstead?

Mr. WINSTEAD. Madam Chair, as you know, the House and Senate just approved 300 and 180 million. So we now have funding in 2009 and looking at 2010 as well. We are looking at 2016 for a build-out of that.

Ms. NORTON. You are looking at what? Talk directly into the mic.

Mr. WINSTEAD. I am sorry. We are looking at 2016 for build-out of that four million square feet of space.

I know the St. Elizabeths situation, based on both panels, does provide the earlier finance panel looking at options and better approaches, Mr. Grigg's approach and a more private sector lease approach that is more conforming to the private sector. We looked at all those alternatives, as you know, the GAO study as well as our response to this Committee.

If you looked at the 30-year cost for the reason you mention, Madam Chair, the acreage we have up there at no cost to the taxpayer, it is a $2 billion project for us, $1 billion for DHS. Over 30 years, the net present value savings to the Federal taxpayers is three-quarters of a billion dollars.

Now, the prospectus, we sent——

Ms. NORTON. Now you are counting the savings from what?

Mr. WINSTEAD. I am sorry?

Ms. NORTON. Savings based on?

Mr. WINSTEAD. If you look at that lease approach for St. Elizabeths, we looked at the enhanced use lease approach. We looked at the Federal program.

Ms. NORTON. Is it enhanced use? Where is the 30-year?

Mr. WINSTEAD. No, no, no. The 30-year, three-quarters of a billion dollars savings is if we took that four million square feet, wherever we could find it, and I assure you it would be pretty far out, and we were to lease that under a standard.

Ms. NORTON. Yes. In other words, you are saying instead of leasing where we are leasing now.

Mr. WINSTEAD. That is correct.

Ms. NORTON. Okay.

Mr. WINSTEAD. That is correct. So our savings, looking at that project, looking at the free ground.

Ms. NORTON. Well, that is the savings that has nothing to do with building the project except we won't be paying other than we don't own. I am talking about on building the project, Mr. Winstead.

Mr. WINSTEAD. In terms of the lease construct projects themselves?

Ms. NORTON. Whatever. First of all, I want to break my question down.

Mr. WINSTEAD. Okay.

Ms. NORTON. When would you expect, let's say, because this would assume the competition had occurred, ground to be broken?

I know this is a guesstimate. Assuming all went well, we got the appropriation out this time, you have already begun to clean up,

what is the earliest you would expect ground to be broken on the headquarters for the first building?

Mr. WINSTEAD. Well, right now, as you know, we got the funding for the Coast Guard headquarters where a master plan is in process right now with ultimate action, we hope, by the beginning of the year, and I do think next year would be when we start seeing.

We had done restoration, but we would start seeing design and moving to construction of that first facility. I think end of fiscal year.

Ms. NORTON. So by next year?

Mr. WINSTEAD. By the end of fiscal year 2010, I would assume, yes.

Ms. NORTON. By the end of next year?

Mr. WINSTEAD. During fiscal year 2010.

Ms. NORTON. Sorry?

Mr. WINSTEAD. During fiscal year 2010.

Ms. NORTON. During fiscal year 2010.

Now looking toward fiscal year 2010 and assuming we are talking about the usual GSA processes—they have done the competition, they are breaking ground—what would you imagine will be the state of affairs for whoever gets that or wins that competition as it goes into the credit market at that time to build that first building?

Mr. WINSTEAD. Madam Chair, I do think—and I would look to our BOMA colleagues and others—the commercial, the construction market is in fact not financed. It is largely bank financed in terms of construction loans. We are not seeing a major impact on shortage of financing our construction projects.

Ms. NORTON. Right now?

Mr. WINSTEAD. Right now.

Ms. NORTON. We had testimony, earlier testimony about something that has been apparent for some time, and that is construction costs have escalated. Put that on the table first. Even if the economy were to come back, construction costs have tended to go up.

I am just trying to get a sense of whether you think we will be back to normal when ground is broken.

Mr. WINSTEAD. Well, I think that is more of an economic question for an AGC or BOMA.

But I would suspect that when we are ready, after this master plan, as you well know, gets approved and going out for the Coast Guard construction design effort, that there will be plenty of interest. There is no lack of interest.

Ms. NORTON. It is Mr. Purtell who says it is becoming increasingly difficult to acquire capital for new projects and renovations for public buildings.

I am trying to understand whether you think that is purely cyclical based on what we are going through now. Obviously, it has huge cyclical aspects to it such that when you break ground and when you go for what you see right up the road, you think that cost of capital for new projects for public buildings will be such that the government will not be surprised.

Mr. Purtell?

Mr. PURTELL. Clearly, it has been cyclical. To answer how long it will last, I think is a good guess.

But you touched on, a minute ago, something that we really didn't talk about that I think is important to this whole process, the construction costs. In the market I am in and the market that I understand, construction costs for tenant improvements alone have increased probably as much as 20 to 30 percent on steel products in the last year.

Ms. NORTON. I don't expect that to go down.

Mr. PURTELL. That is not going to go down. So that is my point.

Ms. NORTON. Given demand around the world.

Mr. PURTELL. And that is not going to change. So that is, obviously, a big impact on any project you are undertaking.

Mr. WINSTEAD. Madam Chair, again, I think the market. I totally agree.

I don't think that the material cost increases we are experiencing now, fiscal year 2009, are as high as they were back when we were costing out the L.A. courthouse, for example. I think they are moderating down, but they are going to be ever increasing because of development around the world and material needed for the kind of growth we are seeing in other countries as well.

But I think our efforts, as you know and I think I testified to earlier, we are having difficulty—I have provided evidence of that—in estimating and benchmarking these costs in these markets in terms of material available, in terms of the cyclical demand.

We know that in L.A. and San Diego, there are billions of dollars of public procurement going on in addition to ours. The L.A. School District and in San Diego, there is major development. All of that competes for material.

Ms. NORTON. As your testimony indicated, the Detroit FBI building, you said it was derailed due to tight credit?

Mr. WINSTEAD. Well, it was tight credit, and it was cost and materials. I mean both, both Charlotte and Detroit.

Our lease issues in Detroit were basically that back last October, October of 2007, nine months ago, the offeror there actually had difficulty getting financing for the project— part of the issues I raised earlier in terms of the credit crunch—but we also saw increased costs in terms of land that was available in that part of Detroit. I think we were requiring 10 acres. The combination made that deal unsupportable, and that is why we are back in the market.

Ms. NORTON. You see that is what scares me here.

Well, how many competitors did you see for the FBI border crossing building that some of them have apparently been competed already?

Mr. WINSTEAD. Yes, ma'am. We have actually had, if you look, we have had 34 of these construct projects completed. We have 38 FBI offices. Eight or I guess seven are going to be Federally owned, like the new one in Houston, but 31 are going to be leased.

We are seeing, obviously, some difficulty in the Charlotte situation and in the Detroit situation because of material cost increases, because of the financial situation that the former panel described. The deals, the prospectus approval rental rate and the financial

terms that were constructed as a result of that authority, the offeror could no longer essentially make work in the current market.

So what we are trying to do is we are recompeting these problem projects. Now there are only three some that we have completed.

We are value-engineering the projects to see whether costs could be taken off so that the financing pro formas work for those projects.

We are validating the financial aspects, working with, and obviously these are being recompeted but making sure they are viable under the prospectus limits, and we are reviewing all lease construct projects nationwide now because the impact we have seen with these three problem projects. So we are trying to react to it.

It is a subset of our overall. I mean the lease construct is still not the 170 million square feet. It is a small subset of that group, but it has all the issues.

Ms. NORTON. It is a subset, but I am trying to see what it tells us about the leasing market where, of course, you all have heavily leveraged.

What concerns me is that though we are experiencing a cycle, parts of the cycle are not going to go away. The parts that I mentioned, for example, are the construction costs which are going up continually. Even when we have had our much better circumstances, demand for these same materials has only increased.

So I am trying to analogize. It is not so much the build to suit but to the leasing market and to the government being in that market for an ever increasing need.

The cycle comes back, but certain kinds of costs— energy, materials—do not. I am trying to understand what GSA will find in that market when it has to deal not with cyclical change but with these rather indeterminate, seeming permanent increases because we are not to the end of them yet.

Mr. Grigg?

Mr. GRIGG. Well, I think the simple answer is that the private market in the case of these build to suit FBI field offices might be viewed as a canary, if you like, if the analogy is in a mine situation.

Ms. NORTON. That is what I am afraid of.

Mr. GRIGG. The cost of operating the buildings as well as the cost of delivering those buildings, when weighed against the long-term projections that were made by the builder-lessor to the government in an underwriting situation, became too risky or the margin wasn't left that was originally projected.

So the simple answer is that the cost of building the major facilities for Homeland Security and so forth will probably escalate more than people anticipated, unless they were sufficiently protective.

As well, the cost of operating those facilities and maintaining them over an extended period of time is going to be a lot higher than probably people anticipated if they were using historical measures for how things increase. We don't expect to see a rebound in the cost of power. We expect it to be growing not at the CPI but at some multiple of the CPI.

Historically, when we were in a regulated energy environment, because of regulation and because oil prices frankly weren't growing faster than CPI, the cost of those elements were really within,

everything was in a balance. We don't view that in a long-term basis as happening really in the conceivable future.

Energy prices are going to increase at some multiple of what we call the CPI, and we are going to have to live with that reality. Steel prices, unless production changes or technology changes, which we don't anticipate, we are into that being in a similar situation.

So costs are going to escalate, and we have been through this cycle before. In the past, because the underlying material costs rebounded, you had a different circumstance. I don't think that is going to happen again.

I think the reality is that we have seen a change in that and the change, as Mr. Winstead pointed out, is probably external to us as a Country and as an economy. We just need to be mindful of that.

Mr. WINSTEAD. Madam Chair, you know, obviously, our own clauses give us the authority on increasing the CPI, and Steve has certainly alluded to the fact it isn't going away. I mean I was horrified, reading some market data of energy costs, preparing for this hearing and predicting that next winter we are going to see maybe 30 percent higher electric bills.

So the landlords like Mr. Grigg, we are going to have to be very attentive to the increases that we provide in our lease largely through the O&M clause provisions. Undoubtedly, we are going to be paying higher rates through our lease negotiations.

Ms. NORTON. I am going to ask just a couple more questions.

There are some limitations on what we can do with these external factors, these costs that we have never seen go up and not go away. Everybody is experiencing those, but they don't have the same constraints the Federal Government has.

I have to ask you, Mr. Winstead. You seem to understand that we are in a wholly different environment. What is GSA doing to accommodate itself for the near certainty of the kinds of costs we were just talking about, not cyclical costs or the kinds that most disturb me? Energy costs, cost of material, for example.

I don't know how the Agency is positioned. Do you have regular meetings even with the private sector on the availability of space, on how this market is affecting them?

How are you positioning yourself for costs that you know the government has not taken into account?

I can tell you without fear of contradiction that we didn't take it in account when the President put the money in the budget for the Coast Guard building. I am trying to see how you are going to build that building now. He has had that in his budget for almost four years.

Mr. WINSTEAD. Madam Chair, I will tell you that our people in the OCA, the Office of Chief Architect, are looking very carefully. We have four national contractors that we updated and recompeted, that are really advising us on every project at every stage of development of the project on benchmarking of the cost of that project. We do our best to determine as we go through, from the authorization process through final opening of a facility, to make sure that we are building in the actual costs.

And, I agree with you. I think there has been a benchmark shift in the last three or four years. We have seen it in gas. We have seen it with steel costs. We will continue to see it.

It really is incumbent upon us to make sure we are getting the most accurate estimating information about material costs, that we are having benchmark verification during both the design cycle and the construction cycle on the viability and the competency of those estimates to be delivered on, and we have to hold our vendors, our contractors and our lessors accountable to our best judgment on behalf of the taxpayer of what those costs will be and what the best deal for the public will be.

But I will tell you the former panel talked about, which was interesting to me, about engagement of GSA and partnering. We will continue to do that. I think we are.

DCBIA, that Mr. Grigg represents, we have ongoing liaison with them, with BOMA. I sit on the National Advisory Council with BOMA. We are constantly working with them to try to anticipate where building operating costs are going and making sure we are, for own inventory, reacting to that as well as new construction or lease construct projects.

So it has been a very troubled market. I think we have good counsel. I think we have good contractors to give us the best estimates.

But the market is very volatile, and it is a difficult assignment. You saw it with the L.A. courthouse doubling in cost. You have seen it with the San Diego courthouse.

Ms. NORTON. Mr. Grigg, the canary is out of the coal mine. He just named two projects, FBI and the L.A. courthouse, way out of the mine.

I am asking Mr. Winstead questions which are not under his control, and some that I have asked you are not under your control, certainly the uncontrollable costs.

But I tell you what, I know what the appropriation is that is coming out of here, and I know they are going to start building with that appropriation, and I know that somehow I am going to have to go back to the government and say we don't have enough money. That bothers me to no end, and one thing I know I can't do anything about is the amount of money in the appropriation.

So then I have to look at GSA and say now maybe the lesson will be learned from what is happening in the first building. You have heard me say I am going to try to get some enhanced authority of some kind. Of course, GSA has some authority at its disposal, some of which it hasn't even used.

But when you look at where the wiggle room is, what bothers me is when the economy returns, I just don't understand where the wiggle room is, if it is more money from here or the more obvious answers.

I guess I am quoting from Mr. Grigg's testimony. I think GSA has to take it very seriously. "Space leased by the government used to be advantaged by steady, prompt payments for rent. The margins associated with rental income have declined as a result of problems in the timing and amount of reimbursements."

The operative words are things that GSA might be able to do something about. We know the things it can do nothing about:

"timing and amount of reimbursements for increases in real estate pass-throughs and operating expenses."

Then it says, of course, "which are indexed to CPI increases." I understand the problems you are under there.

But you know one has to begin very seriously if you are in GSA's position. You have already seen the colossal. Where are we on the L.A. courthouse, the debacle of the largest courthouse in the United States?

You see few competitors or too few competitors, rather, relative to what we expected in the border stations. You see the failure of the Detroit FBI building with the city saying it wants it so bad that it will see what it can do to be helpful.

Once you see that occur and you know what we are up against here, then it seems to me GSA has to begin to look at its, at the moment, rather small arsenal of tools to see what can be done to take the standards clauses, the standard way of operating and squeezing more out of it.

I suppose what I am looking for in this hearing are examples like some of the examples we have had from the private sector of how to do that or else, frankly, I see a crisis looming up there because we are so heavily in the leasing market and because much of it depends upon expansion and expansion opportunities.

Mr. WINSTEAD. Madam Chair, I certainly understand your concern and I think at the earlier hearing in June we did in response and I have reviewed them here briefly as to the actions we are going to take. So we have to be on this. We have to make sure that we have the right estimating crowd with us. We have to have the right relationship through our brokers, national brokerage contract, with the industry and directly DCBIA and ULI and BOMA and AGC and other groups. It is really incumbent on us bringing them in and making sure we understand how they view the market and their ability to compete for our business in the future.

I think we are doing a good job of that now, but I will get the Committee, again, accountability of what we are doing in all these areas and just making sure it is very clear, so you are all aware of it.

As this panel suggested ideas, we will continue.

Ms. NORTON. Well, I think GSA needs a five-year plan looking ahead at costs, some costs that will remain after the cycle and indeed will continue to go up which the average homeowner can see and certainly GSA can see. Look for a five- year plan.

If I were GSA, I would say: Look, Congress, this is what I see. You are heading for a crisis because you are in the leasing market, and this is what the private sector you depend upon is experiencing. We need some relief.

I mean who is in the best position to do this, of course, is GSA itself.

I leave you with a name, one of Norton's common, ordinary examples that don't apply here but ought to indicate how the private sector begins to deal with problems like this, particularly in real estate.

You will say what does Starbucks have to do with the rental of office space? I don't know how much of what Starbucks was in it owned or how much it rented. I know this, that the first thing it

off-loaded when it recognized that people weren't going to pay four bucks or whatever it is you pay for Starbucks was its real estate. That is the first thing it did. It is getting as much out of the real estate business as it can.

It is reducing what was one of the most profitable businesses in the world first. Of course, it is doing it in other ways inside, and it is doing the kinds of things you would expect an extraordinary business like that to do with respect to its own product, but the first thing it did was to close down a whole bunch of real estate was eating up its profit.

I hope you see what I am doing here. I am certainly not saying that rental market is like Starbucks. But guess what? It is.

It was up against the rental market and I doubt that they owned much, but they may have. They were up against costs that were out of their control. So they looked for ways to bring them down.

Now we see in the leasing market they are dealing with a major lessor, at least in this National Capital Region, who is constrained by an outside force, otherwise known as Federal regulation, in its bargaining ability.

My concern is that without some very candid five-year notion, we may have to get GSA to do this. It is best to do it from the Agency, of what leasing will look like nationwide, frankly, using the, I will say, totally unforeseeable.

I do not believe that L.A. was foreseeable. I don't believe that Detroit was foreseeable. But now that we have seen it, it seems to me that everything else is foreseeable.

Using those case examples to warn the Federal Government that this has to be seen as an ability to lease where necessary. You are in a better position to tell me what it would mean at other locations.

Mr. WINSTEAD. Madam Chair, I would be happy to, again, set this out in that five-year framework that this Committee can work with us on or we will provide that, so we do have a clear sense of how we are dealing with these market fluctuations and financing and credit issues and how we are responsive to the private sector's feedback to us.

For example, we had a lease construct workshop on June the 11th, and we had several feedbacks. They said we could do a better deal on these FBI field offices if we had a purchase option. They told us that it is better if GSA brings the site to the deal. They talked about prior to award, getting together with GSA and the contractor and the tenant to make sure requirements were fully understood and the risk allocation issue.

So we actually are taking, as you suggest, based upon the lease construct program the best practices and ideas. This June 11th workshop was directed to that.

Ms. NORTON. You intend to use some of those?

Mr. WINSTEAD. Yes, and I will make sure that we get back to the Committee how we anticipate because it is going to be five years before St. Elizabeths. It is going to be five years before a lot of these constructs how we are responding to market conditions and offeror's issues that they face to continue to get a good deal for the government.

Ms. NORTON. That would be very helpful. First, I would like to know how you are going to respond to the feedback from the private sector on the FBI type buildings.

Mr. WINSTEAD. Right.

Ms. NORTON. You listed four or five them.

Mr. WINSTEAD. Right.

Ms. NORTON. Then how are you going to respond, as you say, more generally to what you see up ahead and what the constraints are of responding?

We know much of this is not in your hands now, and you see the Committee probing to find how can we find ways to convince everybody this is not only safe to do. This is what you have to do, given the growth in the Federal Government and its need for indispensable space.

I think your two examples of the FBI buildings, the two FBI buildings make the point about indispensable space.

Mr. WINSTEAD. Right.

Ms. NORTON. Of course, those were being built. Both of them were being built to suit.

You will not find it difficult to make the appropriate analogies of what you will find in the lease market where they are building and where you are leasing and where you are, in fact, going to be looking for space most of the time.

Mr. WINSTEAD. I would be happy to get that back to you because I think.

Ms. NORTON. Would you get us that? I know we would like to receive that within 60 days.

Mr. WINSTEAD. All right. I will make sure you do.

Ms. NORTON. It would be very instructive to us.

If there is anything else that either of you would like to leave us with before I dismiss you from the table, I would be most pleased to hear.

I want to thank all three of you, and I particularly thank you for listening to one another so that you can get a sense of the dynamic that we think is most helpful to the Committee. Your testimony has been extremely helpful to us, and I thank each and every one of you for the testimony you have given here today.

Thank you, and the Committee is adjourned.

[Whereupon, 1:00 p.m., the Subcommittee was adjourned.]

STATEMENT OF CONGRESSMAN STEVE COHEN

Committee on Transportation and Infrastructure
Subcommittee on Economic Development, Public Buildings, and Emergency Management

July 30, 2008 Hearing
"Credit Crunch: Effects on Federal Leasing and Construction"

The current economic situation in our country has numerous downsides. The cost of gas and the housing crisis are the most visible problems. But among the myriad other problems that result from economic downturns is the "credit crunch" which creates reduced capital for private businesses to lease public buildings, the subject of today's hearing.

My home county, Shelby County, Tennessee, has thirty-five buildings owned and managed by the General Services Administration (GSA). These buildings have over 528,000 square feet of rentable space. According to the GSA's July lease inventory, these thirty-five buildings are leasing less than 50% of rentable space.

If these buildings lose tenants, it will negatively impact the GSA and my community. Twenty-nine of the GSA buildings in the 9th Congressional District in Tennessee are located in the central business district in Memphis. Numerous small businesses in Memphis rely on the employees working downtown and those who have business with those employees. Such is the case in communities across the country.

For these reasons and others, it is important to address this situation now before the economy worsens. I look forward to the testimony today of the distinguished panel before us to address how GSA and the business community will continue to fill the thirty-five buildings in Shelby County and the other 7,100 properties across the nation.

The Honorable Sam Graves, Ranking Republican Member
Subcommittee on Economic Development, Public Buildings and Emergency Management

Hearing on "Credit Crunch: A Hearing on the Effects on Federal Leasing and Construction"

July 30, 2008
[WHEN RECOGNIZED]

Thank you, Chairwoman Norton, for holding this hearing on the tightening of financial credit markets and the impact it may have on federal leasing and building construction.

I would also like to thank our distinguished witnesses for taking the time to help our committee understand how the turmoil in the credit markets may increase the cost or otherwise affect federal building acquisition.

The General Services Administration is the single largest building manager in the country. GSA owns and leases over 340 million square feet of space comprising 8,920 buildings in more than 2,000 communities nationwide.

In addition to office buildings, GSA properties include border stations, courthouses, laboratories, post offices, and data processing centers.

Because GSA leases slightly more than half of its office space from private real estate owners, it is reasonable to expect that the limited availability of capital and higher financing costs could result in higher lease prices for the federal government.

Even small rent increases could significantly impact the federal budget given the huge amount of space the federal government leases.

I look forward to hearing from Commissioner Winstead and the other experts to learn if there is cause for alarm. I am particularly interested in knowing if the cost of credit is driving up lease rates and by how much? If costs are increasing, do you expect this trend to get worse or better over the next few years?

As I have mentioned before in several of our earlier hearings, I believe the real problem is the federal government's increasing reliance on leasing to meet long-term office space needs.

If GSA was not forced to operate under these absurd scoring rules, then it could access the Federal Financing Bank to raise capital for government construction instead of relying on third party financing. This would lower financing costs considerably and result in government ownership, which would save American taxpayers billions of dollars over time.

Again, I want to thank our witnesses for being here today to discuss this important issue.

Thank you.

JULY 30, 2008

The Credit Crunch: A Hearing on the Effects on Federal Leasing and Construction

STATEMENT OF
THE HONORABLE ELEANOR HOLMES NORTON
CHAIR, SUBCOMMITTEE ON ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS AND EMERGENCY MANAGEMENT
HOUSE TRANSPORTATION AND INFRASTRUCTURE COMMITTEE

I welcome the witnesses to today's subcommittee hearing concerning the tightening credit market, which originated in the subprime mortgage crisis, and on other economic factors affecting federal leasing and construction in the commercial marketplace. GSA is perhaps the largest customer for office space in the real estate market in the United States. GSA leases slightly more space than it owns, approximately 176 million square feet of leased office space, housing over 700,000 employees compared with 175.5 million square feet of owned space, providing office space for 640,000 federal workers. The federal inventory ranges from 2,500 square foot border crossing stations, to million one square foot courthouse complexes in major metropolitan areas. GSA's stake in maintaining its strong market position is high, particularly in the leasing market, in light of the continuing shift to federal agency leased space.

At this hearing we seek to learn how developers, building owners, lenders, and construction companies, who are accustomed to unimpeded access to credit, position themselves in today's puzzling market. We have concerns, even though the strictly competitive system for federal commercial awards guarantees that only the most credit worthy need compete. When I began talking with experienced developers and building owners as the subprime mortgage crisis worsened, their strong credit standing with lenders and the lengthy time frames and lead time for construction or leasing left them pretty much unworried. However, since then, seven banks have closed, particularly IndyMac, which had significant home ownership loans. It seems doubtful that a departure as unprecedented as a mountain of bad, securitized subprime mortgages sold in an

unregulated global market, can be contained. Today, a year after the housing crisis became full blown, even the largest banks, whose customers also significantly include commercial real estate, are showing record profit losses. Although many of the players in today's commercial marketplace remain untouched for now, experts say that today's crisis is unmatched since The Great Depression. The nation's largest bank, the Bank of America, has experienced a large increase in bad small business-related loans and recently took a 41% reduction in profit. Some analysts have raised the possibility that commercial loans could be a "ticking bomb." Some also predict that this quarter may mark a turning point, with lending flat, down from record highs. However, the best evidence that something that cannot be ignored is afoot are recent actions of the Federal Reserve and of Congress, who have moved to quell the perfect storm of a housing downturn crisis, on which economic growth has been disproportionately dependent for years, double digit increases in many basic food products, and indeterminate gas increases. Driven by the economy itself rather than any piece of it, President Bush has thought better of his threat to veto the most far reaching housing bill in decades. This subcommittee has an obligation to look now at whether there is or could be a metastasis of the housing crisis and other economic problems that could surface in the commercial sector and what, if anything, could be done about it.

A credit crunch typically refers to factors that lead lenders to reduce the available credit by declining to make loans or doing so only at increased costs, or with special terms, even for those who are credit worthy. The uncertainty about the losses from the subprime mortgage crisis still playing out with mortgage lenders has caused the credit markets to shrink considerably. Although federal leases and construction contracts might be said to be "worth their weight in gold," private sector competitors don't have that assurance when they compete for a lease or construction contract. If credit becomes too difficult or costly, commercial office space available to the federal government could diminish or allow too few to take the risk of competing, raising costs to taxpayers.

GSA's reliance on the commercial office space market to house federal agencies ties the agency directly to commercial market conditions. The agency must begin to use its prime position in the commercial market place by leveraging its buying power, and capturing its great potential for reduced costs to taxpayers. For example, in FY 2005-2008, the FBI presented the subcommittee with 23 leases, its largest group of long term leases. As a result, the subcommittee has indicated that it wants GSA to look very closely at a comprehensive lease package for agencies like the FBI, which have long term viability in metropolitan areas. Almost all the FBI leases will be built to suit the agency, but already GSA has seen a reduction in competitors for these FBI leases. We must discover why this is so and whether it constitutes the beginning of a trend.

In today's atmosphere of soaring budget deficits and rising costs for all concerned, GSA also must work collaboratively with the private sector to reduce the cost of acquiring commercial office space. By working with our private sector partners to achieve the vision and know-how necessary to cut costs across the board, together we

have the potential to help stimulate the local and national economy while addressing the needs of the federal government.

Today we are pleased to hear from the GSA, and financial and economic experts on the commercial markets and office development

I am happy to recognize Ranking Member Graves for any opening remarks he may have.

STATEMENT OF
THE HONORABLE JAMES L. OBERSTAR
CHAIRMAN, HOUSE TRANSPORTATION AND INFRASTRUCE COMMITTEE
The Credit Crunch: A Hearing on the Effects on Federal Leasing and Construction
JULY 30, 2008

I would like to welcome today's panel of distinguished witnesses and thank them for testifying at today's hearing on "The Credit Crunch: A Hearing on the Effects on Federal Leasing and Construction."

The Capital Investment and Leasing program is of great concern to me in my role of oversight of GSA. As I have watched the GSA portfolio trend from mostly federally owned space to mostly leased space, I am genuinely alarmed that GSA is losing its ability to efficiently manage the federal real estate portfolio to ensure a proper balance of federally owned space to leased space. Funds generated by federally owned space are the lifeblood of the Federal Building Fund. Since rent paid by federal agencies in federally owned space supports the Federal Building Fund, it is essential that GSA manage with a goal of increasing owned space.

I have a growing concern on whether the Federal government will be able to rely on the commercial office space market to house federal agencies. Today's hearing properly focuses on the possibility of a credit crunch and if a credit crunch exists, the nexus between the crunch and the development of commercial office space which the federal government depends upon.

I strongly urge the members of this subcommittee to continue its vigorous oversight of the GSA Leasing Program. This committee will continue to push the GSA to use all the authority it has at its disposal to maintain the federal inventory and position itself to fulfill the federal government's expected long term need in the commercial office space market.

July 30, 2008

Testimony of

James Chessen

On Behalf of the

AMERICAN BANKERS ASSOCIATION

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Before the

Subcommittee on Economic Development,

Public Buildings and Emergency Management

Of the

Committee on Transportation and Infrastructure

United States House of Representatives

Testimony of James Chessen
On Behalf of the
American Bankers Association
Before the
Subcommittee on Economic Development, Public Buildings
And Emergency Management
Of the
Committee on Transportation and Infrastructure
United States House of Representatives
July 30, 2008

Madam Chairwoman and members of the Subcommittee, my name is James Chessen. I am the chief economist of the American Bankers Association (ABA). ABA brings together banks of all sizes and charters into one association, and works to enhance the competitiveness of the nation's banking industry and to strengthen America's economy and communities. Its members -- the majority of which are banks with less than $125 million in assets -- represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

ABA appreciates the opportunity to testify today on the current state of funding for commercial real estate, including properties leased by the federal government. It is a very timely topic as our nation is certainly facing difficult economic conditions which are affecting all businesses, including banks. In spite of the difficulties, I want to say at the outset that I am very positive about our nation's economic future. We have gone through these periods before and have emerged much stronger as a result.

One very basic point, however, should be stressed -- the core business of banking is lending. That is what banks do. Banks will continue to be the source of financial strength in their communities by meeting the financial needs of businesses and individuals in both good times and bad. In fact, at a recent meeting of bankers representing every state in the country, they made it clear that banks are actively looking for good loan opportunities. Even in a weak economy, there are strong borrowers, including developers and owners of government leased property, that merit bank funding.

I am also very positive about the banking industry. Before turning to my main points, I know that many committee members may be wondering about the health of the banking industry in light of the several recent bank failures. These well-publicized failures have led to headlines and news stories, some of which seem designed more to grab attention rather than to lay the facts out fully, clearly, and in context. Let me assure you that the industry remains fundamentally strong. Banks entered this current period with a very strong capital position and have continued to build capital over the last several quarters. In fact, the industry added $13.5 billion to capital in the first quarter – which increased the total capital of the industry to well over $1.3 trillion – and banks have set aside an additional $121 billion in reserves as a safeguard against possible losses. Moreover, as of the first quarter, 99 percent of banks are classified by the regulators as "well-capitalized," the highest designation given by the banking regulators. Simply put, the industry has the capital and reserves to continue to make the loans that are so vital to our communities.

In my statement today, I'd like to make three points:

- Commercial real estate lending has been and will continue to be a primary focus of banks, and banks will continue to be very supportive of loans to developers and builders involved with government building and leases;
- Banks are naturally being more cautious in the face of weak economic conditions, but are continuing to lend to creditworthy customers; and
- Over-zealous bank regulations pose the greatest risk that a credit caution will turn into a credit crunch that will affect all commercial real estate lending in particular and the economy in general.

I. Commercial Real Estate Lending Has Been and Will Continue to Be a Primary Focus of Banks

Commercial real estate lending represents a wide variety of lending, differing in purpose, structure, and terms. Commercial real estate lending – including loans to developers and builders involved with government building and leases – has always been an important lending area for banks. It is a lending focus where banking expertise has played a particularly important role for economic growth in our communities. Banks today finance more than 50 percent of commercial real estate debt outstanding. Since the late 1990s, banks have steadily increased the share of total assets devoted to commercial real estate, tailoring new and existing services to meet the individuals

needs of borrowers and our communities. Commercial real estate lending requires a high-touch strategy with borrowers and extensive knowledge of local markets.

Within the broad category of commercial real estate lending, the construction and development portion has shown the most dramatic changes over the last decade, rising then falling twice, first with the dot-com boom and bust and more recently with the last build-bust housing cycle. This recent downturn has meant that there are more builders, developers and owners of commercial real estate who are late in repaying their loans and banks have been forced to write off many of these loans as losses. While banks are willing and eager to work with distressed borrowers to resolve loan problems, prudential management concerns also require us to be active in recognizing losses when such resolutions are not possible. Current delinquencies and losses have focused considerable regulatory attention on the economic viability of any new construction and development projects, whether for residential or commercial properties. Such increased regulatory focus is appropriate where it results in improving underwriting standards; it becomes harmful when it prevents banks from providing or continuing financing to creditworthy borrowers.

II. Banks are Naturally Being More Cautious, But Continue to Lend

Like all specialized forms of lending, loans for the construction, development, and long-term funding of government leased property have unique elements. The long-term nature of government leases and the high credit quality of government tenants make loans to build and support such properties very attractive to lenders. There are certainly risks to be considered, however: the procurement process, special covenants in government contracts, restrictions on covering unexpected increases in operating expenses (such as the recent surge in energy prices), protection of collateral if the government refuses to vacate property at the end of the lease or condemns it, and added costs of special security features (which may not be considered an integral part of the initial economic calculation by the developer or fully amortized as part of the lease or loan facility), among others. All of these add risk to borrowers and must be considered by the bank in making loans available and pricing them correctly.

These unique features are factors that exist *regardless* of the economic cycle. The current economic situation adds an extra element that affects the availability and price of credit, in spite of the fact that the demand for government services is somewhat immune from, and often countercyclical to, the general business cycle. Against the backdrop of a very weak economy, it is only reasonable and prudent that all businesses – including banks – exercise caution in taking on

new financial obligations. Both banks and their regulators are understandably more cautious in today's environment. Bankers are asking more questions of their borrowers, and regulators are asking more questions of the banks they examine. This means that some higher-risk projects that might have been funded when the economy was stronger may not find funding today.

In this environment, we sometimes hear from individual businesses and developers that banks are not lending money. While overall bank lending continues to grow, that does not mean much to an individual borrower having difficulty obtaining financing. In many of these individual cases, however, upon further investigation, it appears that the primary reasons for not receiving funding was either (a) the borrower's financial condition is vulnerable (perhaps weakened by local economic conditions), or (b) the borrower expects to borrow money at pre-2008 terms when the risk of lending was considerably lower and funds available for lending were more accessible. One thing that has clearly happened is that banks are looking at the risk of a loan and re-evaluating the proper pricing of that risk. This is a prudent business practice and one expected by our bank regulators.

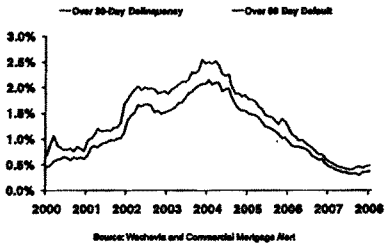
Any evaluation of the risk of any lending for government-leased properties must consider the market for office space as a whole. Thus, changes in the supply of and demand for office space generally would be considered in evaluating the overall risk of any project. We have now witnessed three consecutive quarters of rising office vacancies nationwide – consistent with a sluggish economy and job losses, particularly in areas that have higher concentrations of housing market problems. In this environment, banks are using more conservative assumptions on absorption of office space, rent growth and price appreciation.

In the Washington, D.C. region, construction of government properties is particularly important. It is also, of course, experiencing declining home values and rising office vacancy rates. For example, Colliers International reports that as of June 30, 2008, the office vacancy rate (for all classes of property) in downtown Washington, D.C. increased to 7.9 percent from 7.6 percent at the end of March. This does compare favorably to the average vacancy rate of 11.3 percent among central business districts that Colliers International tracks. This level is also below the suburban Maryland and Virginia vacancy rates, which increased from 10.4 percent to 10.7 percent and from 11.1 percent to 12.2 percent, respectively, over the same period. The national suburban office vacancy rate was 14.2 percent. Nevertheless, it is very important to note that the current office properties under construction in downtown Washington, D.C. – 9.1 million square feet – represents nearly *19 percent* of all downtown office construction in the 56 major metropolitan areas that

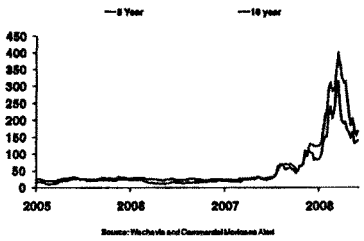
Colliers International tracks. This may lead to greater vacancy rates in the future as these properties come on line.

Another important factor affecting the volume of commercial real estate lending is the ability of banks to sell loans on the secondary market. Unfortunately, this market has been a victim of the housing market fallout. Even though few problems were apparent in commercial real estate loans, investors reacted to the problems in the residential mortgage-backed securities market and shunned new commercial mortgage backed securities (CMBS) or demanded higher risk premiums. This problem was exacerbated by mark-to-market accounting rules that pushed down the value of existing investments in these loans as market prices declined, which greatly undermined interest in this investment category. In fact, there was no new issuance of CMBS in January 2008, the first such occurrence in any month in the 20 years since the CMBS market began. This has dramatically affected the funding and cost for new loans for construction and development projects and other commercial real estate loans. It is particularly troubling that the adverse market reaction is at odds with the historical performance of CMBS loans (see the charts above). While the market will surely regain its footing, it will continue to affect how risk is priced for commercial real estate loans for some time to come.

CMBS Delinquency and Default Rates



5 and 10 year AAA CMBS Spreads
Basis Points



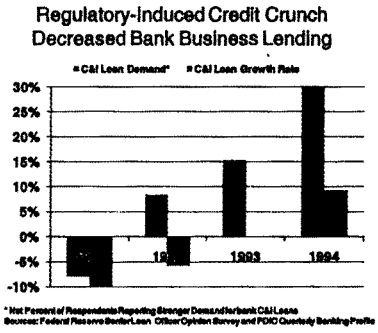
The weak economy and lack of secondary market funding will naturally slow the growth of commercial real estate lending. However, as many of these projects take years to develop and because there is still strong underlying demand in many metropolitan areas, credit continues to grow. According to estimates by the ABA's Economic Advisory Committee, lending to businesses will increase 15 percent this year and fall off to 7.8 percent next year in line with the slowing economy. Moreover, commercial mortgage borrowing has also been quite strong, in spite of the misperception

by some that banks have severely reduced their lending on commercial real estate. According to the Federal Reserve's Flow of Funds data, net commercial mortgage borrowing from banks for the first quarter, was on an annualized pace of $135 billion – $17 billion more than reported in 2007. If this pace holds, it will be the second largest increase, only exceeded by $143 billion in net commercial mortgages in 2006. Simply put, while banks are naturally more cautious in this economic environment, they still continue to seek out good loans as we invest in the future of our communities.

III. Over-zealous Bank Regulations Pose the Greatest Risk for a Credit Crunch

The current regulatory environment is unquestionably impacted by the regulatory concerns flowing from the housing market downturn. A natural reaction is to intensify the scrutiny of commercial banks' lending practices. However, we are very concerned that a regulatory over-reaction can quickly convert a credit caution into a credit crunch.

One needs only to look back at the early 1990s to see what can happen when there is a regulatory over-reaction to an economic recession with roots in residential and commercial real estate problems. At that time, whether intended or not, the loud and clear message that bankers received from the regulators and Congress was that only minimal levels of lending risk would be tolerated. On the surface, this might have seemed reasonable – there is little doubt that economic consequences of a banking system with too much risk are not acceptable. But just as too much risk is undesirable, a regulatory policy that discourages banks from making good loans to creditworthy borrowers also has serious economic consequences. Wringing out the risk from bank loan portfolios means that fewer loans will be made, and that only the very best credits will be funded.



The regulatory over-reaction in the early 1990s led to a credit crunch, as lending declined significantly. In spite of rising demand for bank loans following the recession of 1991, regulatory pressures restrained bank lending. In fact, total bank loans actually declined throughout this period and

the recovery was slower than it might have been (see the chart above). The regulatory-induced credit crunch was confirmed by academic work on the New England economy by Eric Rosengren (now the President of the Federal Reserve Bank of Boston) and Joe Peek (now the Gatton International Banking Chair, University of Kentucky) in their paper "Bank Regulation and the Credit Crunch." The authors concluded that: "Because so many bank loans are generated locally, and because informational and regulatory impediments deter the transfer of bank capital and credit across regions, our evidence suggests that New England did suffer from a regulatory-induced credit crunch."[1]

A comparable scenario may be developing in today's regulatory environment. Accounting rules and excessive regulatory demands are acting together to limit the ability of banks to make loans and in some cases to continue existing funding arrangements. For example, one of the major concerns of the industry is the prospect of bank examiners appraising banks into insolvency. This could occur from a number of interrelated causes. For example, we hear reports from our bankers of examiners demanding that banks obtain new appraisals on properties for fully performing loans, i.e., loans where the borrowers are current and meeting their obligations to the bank. Given existing market prices, it is not surprising to find that values are down, so that such appraisals could result in banks having to downgrade fully performing loans as being in some degree troubled, what many refer to as "non-performing performing loans." Together, the revaluations and downgrades discourage banks from lending for similar projects.

In other instances, we hear of examiners forcing banks to mark the value of collateral to current market values even though there is little expectation that the bank will be relying on the collateral for repayment of the loan. As these asset mark-downs are reflected on a bank's books, the bank's capital is reduced. A bank can reach the point (as many did in the 1980s and 1990s) where such actions significantly impair capital, reducing bank resources available to fund new loans. Thus, taking a snapshot of a bank's assets during the low point of an economic cycle and forcing the bank to reflect the worst-case scenario on its books runs the risk of bringing about the very consequences that the banks and their examiners are trying to prevent – causing the bank to retrench, reducing banking lending overall. To avoid this outcome, we have been urging the regulators to keep in mind that markets are cyclical and that not every worst-case scenario will occur if the market is left to function without inappropriately restrictive intervention.

[1] Peek, Joe, and Rosengren, Eric. "Bank Regulation and the Credit Crunch," February 1993, Working Paper No. 93-2, Federal Reserve Bank of Boston.

Fortunately, bank agency heads seem to be sensitive to this potential problem and have pledged to avoid a repeat of the early 1990s. For example, John Dugan, Comptroller of the Currency stated in April that: "At the OCC, we know that we made some mistakes during the last downturn. ... One of the most controversial issues associated with the last real estate downturn was the tendency for OCC examiners to make unilateral adjustments to real estate appraisals that had become outdated due to clear changes in the markets. We want to minimize the use of this approach during the current cycle."[2] This sentiment was also echoed by Sheila Bair, chairman of the Federal Deposit Insurance Corporation: "...the bottom-line purpose of the guidance [on commercial real estate lending] is to simply remind bankers that their risk management practices need to keep pace with increasing exposures to commercial real estate and construction activity. We do not intend to disrupt or limit the volume of commercial real estate lending that is prudently underwritten and well managed, nor should the guidance be interpreted as supporting a reduction in the current volume."[3]

The great challenge may be to ensure that the measured approach expressed by agency leadership is being applied by regulatory personnel out in the field. Increasingly, we are hearing troubling reports from our membership that regulatory mistakes of a decade ago are playing out again today. What the regulators want for the industry is what the industry wants for itself: the maintenance of a strong and safe banking system. To achieve that goal, we need to remember the vital role played by good lending in restoring economic growth and not allow a credit crunch to stifle economic recovery.

Thank you again, Madam Chairwoman, for the opportunity to present the views of the American Bankers Association in this hearing today.

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[2] Remarks by John C. Dugan, Comptroller of the Currency, before the Exchequer Club, Washington, D.C., April 16, 2008

[3] Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation before the California Bank Presidents Seminar, Santa Barbara, Calif., January 12, 2007

Raymond A. DiPrinzio's Testimony to the
U.S. House of Representatives Committee on Transportation and Infrastructure,
Subcommittee on Economic Development, Public Buildings, and Emergency Management
Credit Crunch: A Hearing on the Effects on Federal Leasing and Construction
July 30, 2008

Good morning Madam Chairperson, members of the Committee. My name is Raymond DiPrinzio. Thank for the opportunity to address the Committee on the impact of the current credit crisis on the development and financing of Federal real estate. I am currently Head of Project Finance for CIFG Assurance North America, Inc., a financial guaranty firm headquartered in New York. Financial guaranty providers are essentially proxies for retail and institutional investors in the capital markets (or lenders in the case of the bank loan market) since under the terms of their guaranty or credit protection contracts they are obligated to make principal and interest payments to investors and lenders in the event the borrower fails to do so. In this capacity, I am responsible for underwriting all forms of project financings for infrastructure, including transportation, energy, environmental and public use real estate facilities such as office buildings, military and student housing stadiums and arenas.

Federal project financing is a subset of the larger infrastructure market, a sector that is enjoying unprecedented levels of interest from institutional investors across the globe due to the deep levels of demand for financing infrastructure in the United States which is in need of replacement or for new facilities which must be built to accommodate growth. In my 24 years working as a finance professional, I have had the opportunity to work on Federal projects as an financial advisor and investment banker to Federal agencies as well as a provider of credit protection to investors in the capital markets. I have worked on financings for the Energy, Justice and Veterans Administration agencies in both GSA form as well as direct agency leases. Given my background, I am speaking today with the perspective of a practitioner in the capital and bank markets and more specifically, one who has perspective of the borrower as well as the lender.

Since assuming my role at CIFG, I have completed financings for the Energy and Defense Departments and have had the opportunity to review many other Federal financings. Most recently I have worked closely with the VA and their development team on an Enhanced Use lease financing of an office building and parking structure for the Louis Stokes Medical Center and with Pacific Northwest National Labs on new facilities in Washington State.

State of the Markets

The current difficulties in the financial market are unprecedented in both the breath and depth of its reach and it should come as no surprise that the market for Federal lease transactions has not escaped unharmed. While real estate projects involving Federal tenants under long term leasing arrangements are viewed more favorably relative to their commercial counterparts, the overall reduction in liquidity, repricing of risk and either the unavailability of credit protection from monoline bond insurers or the market's diminished view of the value they bring, has led to delays in completing financings, tighter credit terms and most importantly, dramatically increased credit spreads (i.e.

higher borrowing costs). Indeed, higher borrowing costs are making many transactions impossible to complete as it translates to rental rates outside of approved levels.

More specifically, financings that were able to get credit protection and complete a transaction saw spreads widen 70 to 100 basis points compared to pre-credit crisis levels. Without credit protection, spreads have widened to 200-300 basis points, levels not seen in the market for Federal leasing.

What Can be Done

While Federal lease financing is an accepted transaction type in the capital markets, in many respects, as a finance professional, I have often been struck by its obscurity and the lack of understanding of these transactions given the depth of the role of the Federal government in the real estate market and needs of the General Services Administration and other Federal agencies.

This is particularly striking given the current unprecedented levels of investor interest in public use infrastructure, one of the few truly bright spots in the current market landscape. Real estate property is a critical asset of government and we have seen strong demand in the UK and Canadian markets for public use buildings and other forms of social infrastructure under programs such as the Private Financing Initiative (PFI) and the public private partnership programs run by the individual Canadian provinces.

In many ways, Federal financing has significant untapped potential, which if properly harnessed, can result in broader market acceptance and higher levels of investor interest, lower borrowing costs and ultimately lower rental costs. In this regard I offer the following areas for consideration:

Market Education: As I've indicated, Federal financing is does not enjoy wider acceptance in the markets because it is understood by few finance professionals. Consideration should be given to increased outreach to include a wider reach of developers, bankers, financial advisors and rating agencies. Federal projects often need to tap the development and finance expertise of real estate, project finance and public finance professionals to successfully complete transactions. As with the current activity seen in financing public use infrastructure, firms in the market have responded by bring together multiple disciplines to finance transportation, energy or environmental assets. Similar approaches can be applied to Federal real estate tapping into the expertise in the markets which already understands essentially and appropriation risk (common elements present in many municipal financings), construction risk (typically found in project finance) and residual risk (a risk often found in real estate finance).

Programmatic Approach: Federal financing in its current state lacks the benefits which would flow from a comprehensive coordinated approach to the market. Viewed from the perspective of a finance professional, Federal real estate financing is notably decentralized making it difficult to understand needs of the Federal agencies. While GSA provides a level of coordination, many agencies pursue financing directly. While each Federal agency has its own needs and requirements, which should be accounted for, a coordinated approach to the market could significantly improve the level of market interest and investor demand. As a point of contrast, the Defense Department's comprehensive approach to financing military family housing, while maintaining distinctly different financing structures at the individual service level, has enjoyed wide market

acceptance attracting over $20 billion in capital since its inception in 1996. The Defense Department is building on that success as it pursues programs to finance unaccompanied housing, hospitality facilities (lodging) and commercial properties through its Enhanced Use Leasing Authority.

OMB Rules: While OMB quite rightly guards the Federal budget process and balance sheet, current approaches drive up financing costs and work to ultimately diminish the credit quality of the financing. Consideration should be given to revisiting these rules with an eye to appropriate levels of risk allocation between Federal agencies and the private sector developers and financial participants as well as the ultimate impact of financing structure and costs.

Enhanced Use Leasing (EUL): EUL authority as become an important tool for agencies such as the VA and the Defense Department has in recent years embraced its potential for commercial properties and energy facilities. Consideration should be given to a form of GSA EUL authority to link the development potential of the its vast real estate holdings and private capital.

In summary, while the current crisis in the credit markets is taking its toll on all players including Federal agencies, the dislocation in the market coupled with unprecedented levels of demand for properly structured infrastructure investments also provides opportunity to move the Federal government forward in its approach to financing real estate and other essential infrastructure. Steps should be taken to broaden the level of understanding of the Federal role as a user of facilities critical to the operation of government, streamline its approach to the market and address the rules and regulation which govern its role while maintaining a careful eye on the impact on risk and return.

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Testimony of
Steven A. Grigg, Executive Committee and Past President
District of Columbia Building Industry Association
5100 Wisconsin Avenue, NW, Suite 301
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"Credit Crunch: Hearing on the Effects on Federal Leasing and Construction"
Before the Subcommittee on Economic Development
Public Buildings and Emergency Management
Eleanor Holmes Norton, Chair

Wednesday, July 30, 2008, 10:00 AM
2167 Rayburn House Office Building
Washington, DC

Good Morning Congresswoman Norton and members of the Subcommittee on Economic Development, Public Buildings and Emergency Management.

I am Steven Grigg, President of Republic Properties Corporation. I am testifying today in behalf of the District of Columbia Building Industry Association (DCBIA) as past president and as a member of its Executive Committee. DCBIA is a not-for-profit organization, representing nearly 500 real estate development firms and related businesses in the District of Columbia.

As today's headlines make clear, the credit crunch is having a direct and broad impact on the development, leasing and management of commercial office space nationwide. The District of Columbia and the National Capital Region are neither distinct nor immune from those problems.

The collapse of conventional debt financing for development projects and the permanent financing market are working in tandem to make new development or major renovations of existing buildings much more difficult and expensive. With the collapse of securitized debt markets, and with the values of existing loan portfolios in doubt, lenders have become reluctant to assume any new risk, underwriting standards have tightened, and loan to value ratios have shrunk.

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The result is higher borrowing costs and higher levels of required equity participation – <u>if capital funding is available at all.</u> Meanwhile, equity investors are re-pricing their conceivable participation to reflect higher perceived risk.

The Federal Government ("Government") is a major user of office space and is not immune from the impact of this credit crunch. It is probable that the Government has not seen the impact of the credit situation thus far as existing vacant space is absorbed-up; however, that will inevitably change. Larger procurements, with prospectus level rents that were established some time ago, are going to see less competition now and going forward.

The Government is a special class of user for commercial office space; hence, Government leases are essentially "flat" for various terms. Space leased by the Government used to be advantaged by steady, prompt payments for rent. The margins associated with rental income have declined as a result of problems in the timing and amount of reimbursements for increases in real estate pass-thrus and operating expenses, which are indexed to CPI increases. Both of these business realities and underwriting standards have increasingly noted these changes in dealing with Federal Government leases and occupancies. Either the system has to change – or face rents will have to dramatically increase to reflect these conditions.

The Government's Prospectus rent levels and expectations of various tenant agencies will have to be adjusted upward in the future. While we believe that availability of financing will eventually be eased, the effective increased costs will become more predominant over the coming years.

Thank you for your attention. I would be pleased to answer any questions.

Statement of

Richard D. Purtell
Portfolio Manager, Grubb and Ellis Management Services, Inc.

On Behalf of the
Building Owners and Managers Association (BOMA)
International

Before a Hearing of the Subcommittee on Economic
Development, Public Buildings and Emergency Management
Committee on Transportation and Infrastructure
United States House of Representatives

"Credit Crunch: A Hearing on the Effects on Federal Leasing
and Construction"

July 30, 2008

Good morning Chairman Norton, Ranking Member Graves, and members of the Subcommittee. Thank you for holding this important hearing on the impact the current credit crunch is having on the leasing and construction of federal buildings. I am Dick Purtell, Portfolio Manager of Grubb and Ellis Management Services, Inc, and I am here today in my role as Chair and Chief Elected Officer of the Building Owners and Managers Association (BOMA) International.

With the rise in delinquencies and defaults on subprime mortgages over the past couple years, it is only inevitable that this financial crisis would ultimately have some impact on commercial real estate. In my testimony today, I will touch on how the current economic circumstance is affecting the renovation of buildings, build-to-suit leases, attracting and retaining tenants as well as rents and occupancy rates.

In general, much of the economic dynamics of the commercial real estate sector can vary due to local market forces. However, one thing our members all across the country acknowledge is that it's becoming increasingly difficult to acquire capital for new projects and renovations, for public buildings as well as those intended for private sector use. Lenders are making it more and more expensive for even the most economically-sound companies to borrow money. And for those

whose balance sheets aren't as healthy, it's nearly impossible. Consequently, this has negatively affected building owners wishing to refinance, sell existing buildings or plan for future renovations in which the financing for the project has not yet been secured. It could also become a factor in a building owner's ability to attract and retain tenants, by limiting the tenant improvement packages offered in the future.

An example of where access to capital has made it difficult to liquidate properties is in San Diego, where one BOMA member, who has responsibility for a municipal government's portfolio, has had a number of buildings on the market for over a year at what are considered bargain basement prices. But due to the increased borrowing restraints and cost of funds, he has had trouble finding buyers without having to reduce the price even further. In Philadelphia, we've received reports that building owners are currently moving forward with renovations and improvements that were more than likely already in the pipeline, however plans for renovations in 2009 do not appear to be in the budgets of most.

The increased difficulty to obtain capital for the purposes of developing commercial buildings has also negatively impacted build-to-suit leases. We are hearing that very few build-to-suit leases are being executed at this time. Stricter

under-writing requirements, skyrocketing construction costs, combined with the increasing vacancy rate, decreasing effective rent and economic slowdown, has eliminated any new construction. Currently, those build-to-suit leases that are in the works were either begun some time ago or are being financed largely through private equity.

From the federal government's perspective, in areas where there are owners or developers with large existing buildings or buildings under construction that are looking at the government as prospective tenants, current conditions may actually *help* the government, as their demand never goes down. However, it is adversely affecting large build-to-suits, even those for the federal government, due to the uncertainty of financing, capitalization rates, and buyers for the take out. Since in these times, the government is an even more important player in the building and construction industry than it is normally due to its demand for space continuing at a more constant rate than private industry, it becomes even more critical for the government to eliminate barriers and constraints to the government leasing space, especially in build-to-suits that were discussed in previous BOMA testimony before this Committee.

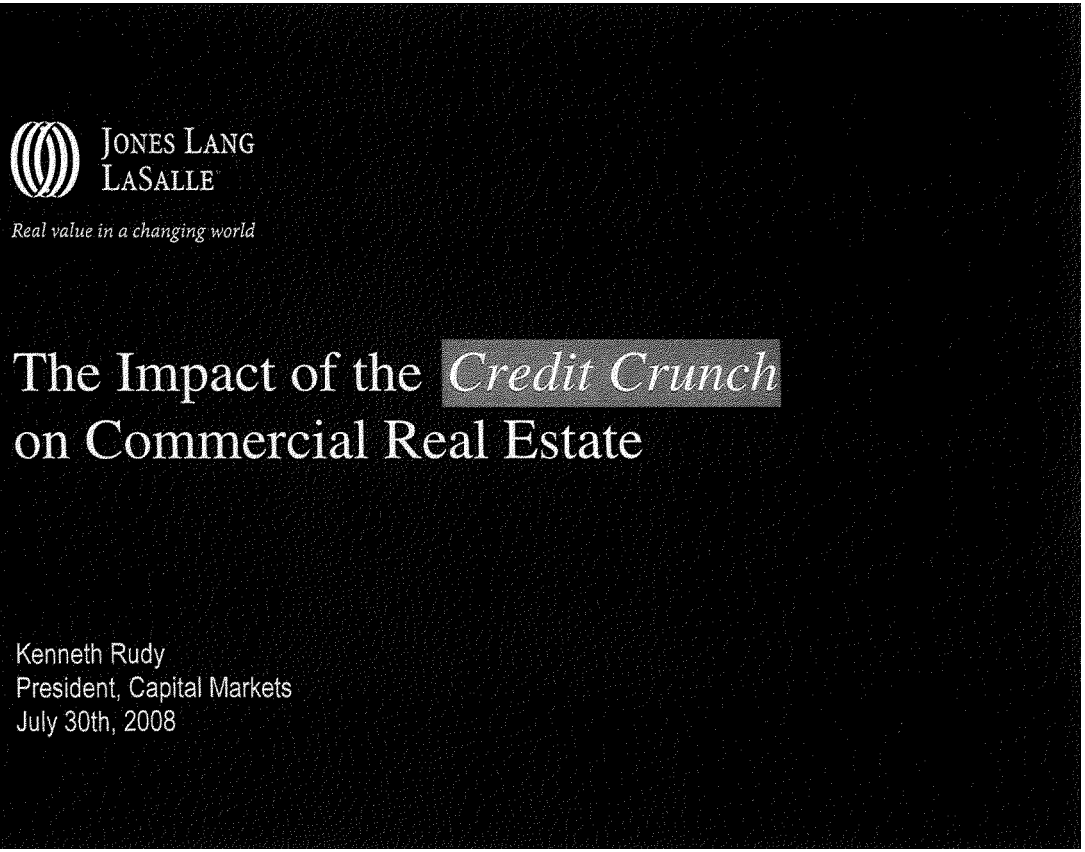
The ability of building owners to attract and retain tenants, as well as to stabilize rents and occupancy rates, are issues that appear to be more sensitive to the local area's supply and demand. Some reports from members have indicated that rents continue to be on the rise, but not quite as rapidly as in recent years, as is the case here in the District. In other markets, the economic slowdown has hurt overall occupancy levels as tenants are struggling to survive. Owners are still trying to maintain the same rental rates, but are now offering significant tenant and broker incentives. In these parts of the country, it is definitely a "tenant's market". In buildings with weak occupancy, owners are having even more trouble making mortgage payments. In some markets, owners are taking a wait-and-see approach to see if the slowing economy leads to tenants shedding unwanted space. Due to the nature of the industry, the possible negative effects in certain parts of the country may not be felt for several years.

If there is an upside to this, it is that the amount of supply coming on line over the next several years will be significantly less, which will have a positive impact on the market overall, from a landlord's perspective.

We thank the Subcommittee for holding this important hearing and hope this testimony has provided some insight on the affect the credit crunch has had on the commercial real estate industry. I welcome any questions you may have.

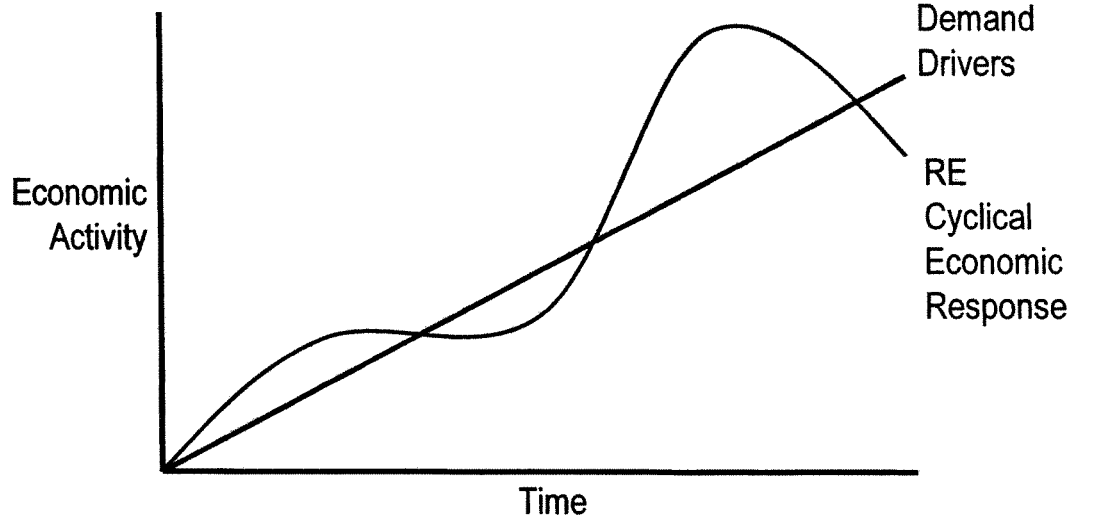
About BOMA International

Founded in 1907, the Building Owners and Managers Association (BOMA) International is an international federation of more than 100 local associations and affiliated organizations. BOMA International's members are building owners, managers, developers, leasing professionals, medical office building managers, corporate facility managers, asset managers, and the providers of the products and services needed to operate commercial properties. Collectively, BOMA's 17,000 members own or manage more than nine billion square feet of office space, which represents a $100 billion marketplace and more than 80 percent of the prime office space in North America.


JONES LANG
LASALLE
Real value in a changing world
The Impact of the Credit Crunch
on Commercial Real Estate
Kenneth Rudy
President, Capital Markets
July 30th, 2008

Why is there volatility?

Real estate, like all markets never move in a straight line…always under and over correcting to stimulus, confidence, supply and demand



That was then…this is now

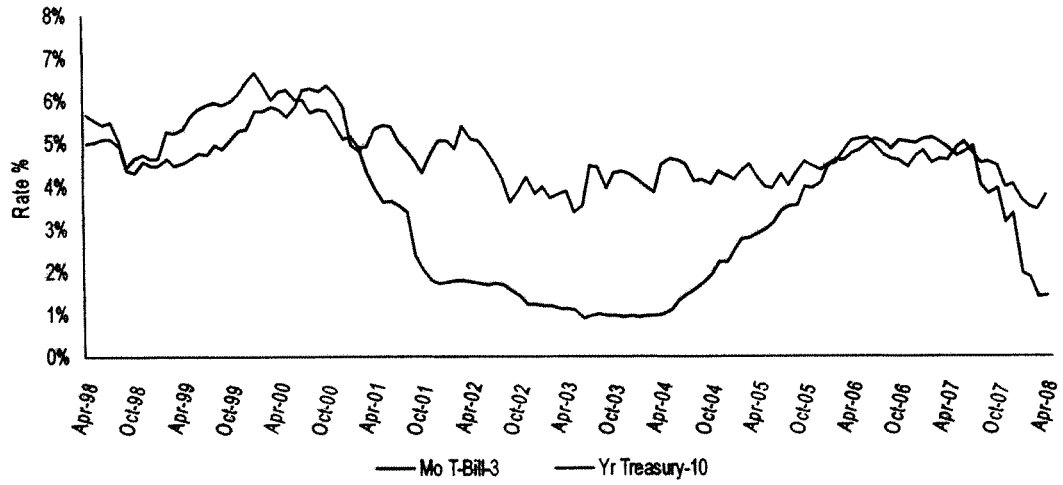
Comparison of the current environment to the most recent credit cycle

Then	Now
A Wall of Capital	The Capital Crunch
Perfect Calm	Perfect Storm
Irrational Exuberance	Irrational Fear
Subprime/Alt-A Credit	Junk Debt/Toxic Waste
Equity Priced as Debt	Debt Priced as Equity
Cap Rate Compression	Credit Spread Expansion
Highly Leveraged Returns	Return of Negative Leverage
Conduits/CMBS/Shadow Banking	Balance Sheet Lending
Covenant "Lite"/No-Doc Loans	Complete and Prudent Underwriting
Financial Engineers	Professional Investors/Operators

Real estate capital markets highlights

- Availability of debt has been greatly restricted
- Risk-free rates have dropped
- Credit spreads have surged and with much stricter terms required
- Cap rates have already risen 75-100 basis points since 2007
- Asset pricing remains in the midst of a correction with average values declining by 10-15% from their peak
- Transaction activity to be down 50% in 2008

Long term rates have dropped with credit crunch and weak economic outlook; rates are low historically



Source: Jones Lang LaSalle, Economy.com

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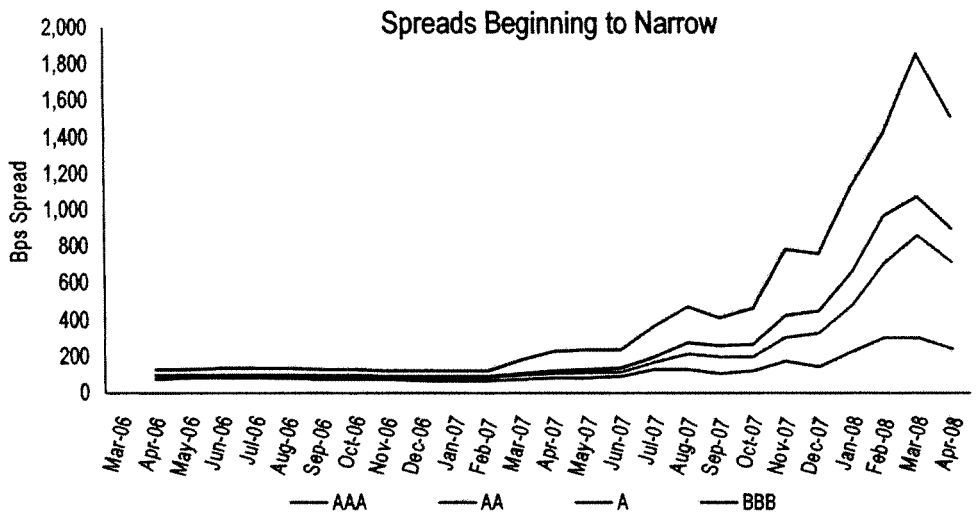
CMBS spreads over treasuries



Source: Jones Lang LaSalle, Commercial Mortgage Alert

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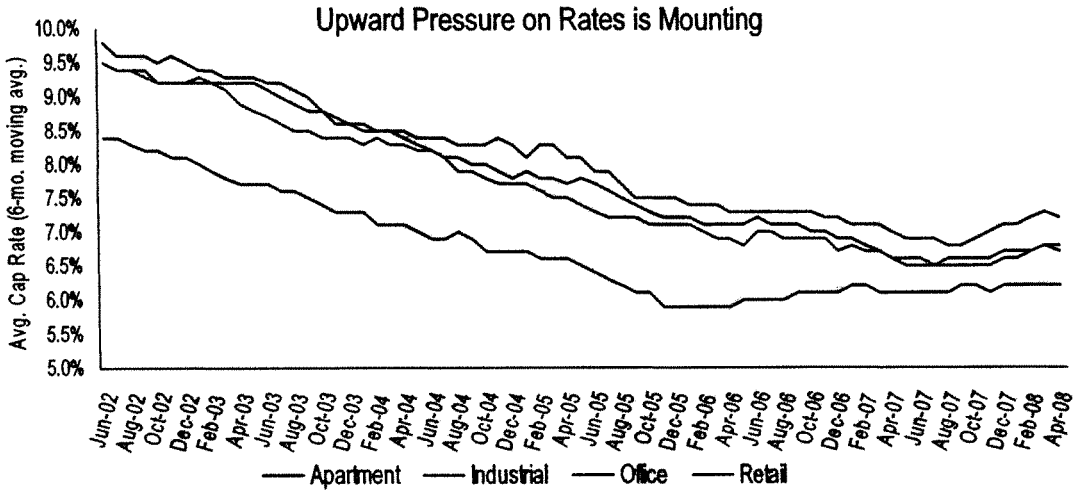
Cap rates on the move up



* Properties of at Least $5 Million
Source: Jones Lang LaSalle, Real Capital Analytics

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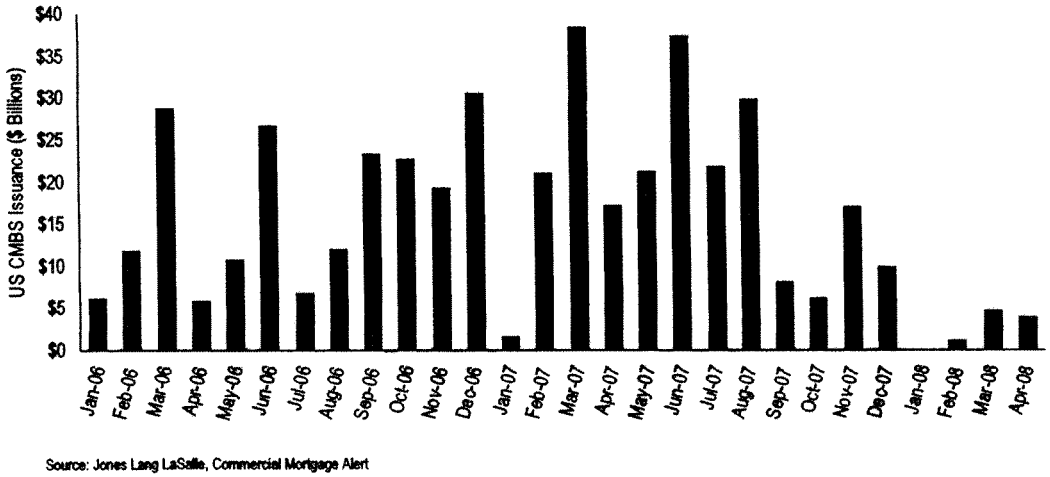
US CMBS issuance



Source: Jones Lang LaSalle, Commercial Mortgage Alert

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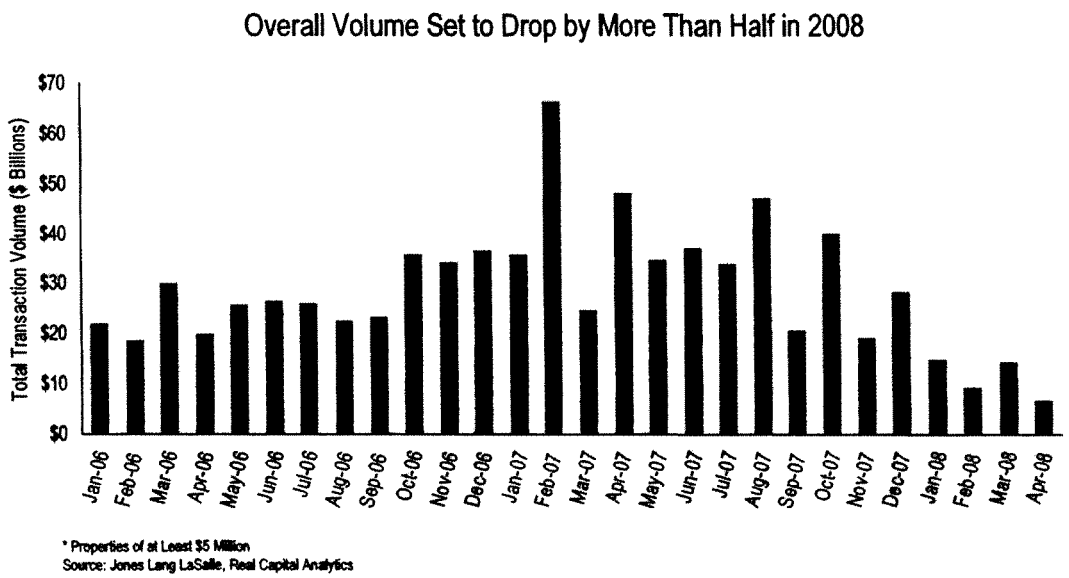
8

Total monthly transaction volume



* Properties of at Least $5 Million
Source: Jones Lang LaSalle, Real Capital Analytics

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Office fundamentals

- Demand has quickly downshifted in the face of the economic downturn, job losses and credit crunch
- Businesses are cautious and delaying space decisions
- Vacancies are poised to creep upward and concessions and incentive packages will begin to reappear
- Effective rents will face downward pressure in many markets
- However, with a starting point of generally below-equilibrium vacancy rates and restrained construction levels, many markets, especially top-tier CBD markets will have some economic insulation from a sharp pullback in leasing

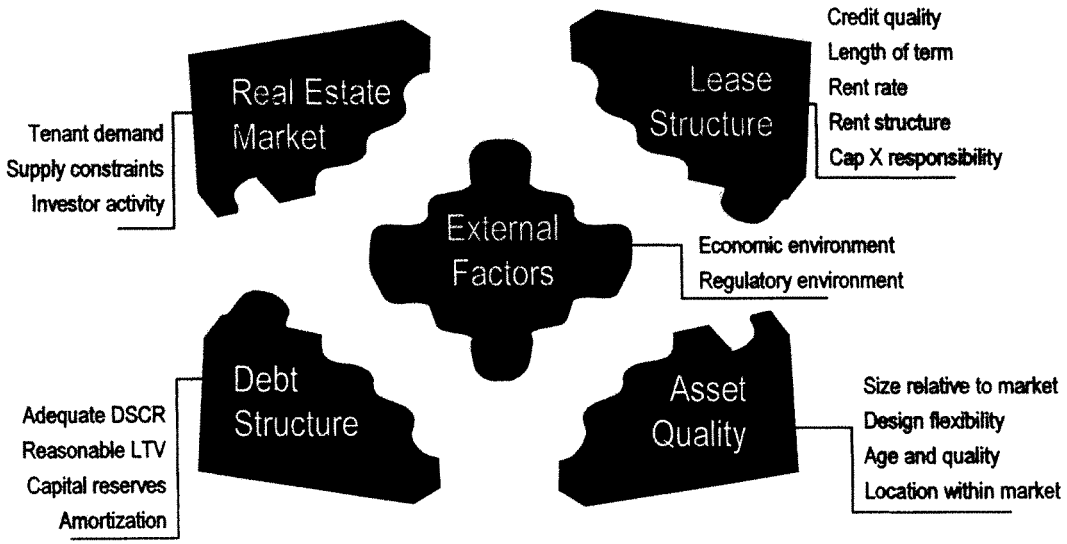
Capital markets recovery?

- Forces Aiding a Recovery
  - Interest rate cuts and consumer stimulus
  - Institutional and foreign buyers go on buying spree
  - Banking system has aggressively taken write-offs
  - Return of rational lending (to benefit over long term)
- Forces Thwarting a Recovery
  - Transaction paralysis
  - Looming recession
  - Additional write-offs
  - Return of rational lending (causing short term pain)

Pockets of opportunity

- Mezzanine debt is an attractive investment now
- Investors are beginning to buy properties with distressed debt and purchasing whole loans
- Apartments relatively strong as for-sale housing market continues to weaken
- Niche property types such as senior and student housing, and medical offices in which demographic trends provide much support
- Corporate-owned real estate opportunities including sale-leasebacks
- High-credit, high-quality real estate still in demand investors

What are the key pieces of a successful landlord and tenant transaction?



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Lease Structure: GSA lease clauses and credit quality

Lease Structure

- The Federal government's AAA credit quality can be a major attraction to the real estate debt and equity markets in today's environment
- However, the investment community requires market conformity on major lease issues in order to lower its risk assessment and pass along lower lease costs to the government:
  - Rights of assignment and substitution
  - Casualty and termination rights
  - Rental offset rights for maintenance and services
  - Maintenance self-help rights
  - Strict landlord default provisions for delivery, maintenance and services
  - Tenant alternation rights without notice or restoration obligations
  - Limitations on pass-throughs of actual maintenance and operating costs
  - Overly flexible tenant holdover provisions past lease expiration

Asset Quality: Market conforming buildings

Asset Quality

- The investment/landlord community cares about the long-term residual value of leased buildings
- The ability to re-tenant a property long after the expiration and departure of current tenants enhances the intrinsic value of a property, lowers the investors risk and should enable the occupier to enjoy a lower lease cost
- The Federal government's efforts to design, seek, lease and occupy buildings which are more market conforming has allowed the private sector to respond with lower occupancy cost leases in recent years

What does the future hold?

- Banks and life insurance companies are still lending
- Underwriting standards and lender requirements will be more stringent
- Eventually, seller motivation levels will increase...leading to
- Greater transaction activity and new equilibrium pricing...and
- A rebound in demand for investments in 2009
- A firm foundation for the next upward cycle?

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Real value in a changing world

Thank you

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DAVID L. WINSTEAD

COMMISSIONER

PUBLIC BUILDINGS SERVICE

U.S. GENERAL SERVICES ADMINISTRATION

BEFORE THE

**SUBCOMMITTEE ON ECONOMIC DEVELOPMENT,
PUBLIC BUILDINGS, AND EMERGENCY MANAGEMENT**

**COMMITTEE ON
TRANSPORTATION AND INFRASTRUCTURE**

U.S. HOUSE OF REPRESENTATIVES

JULY 30, 2008

Good morning, Madam Chair, Ranking Member Graves, and Members of the Subcommittee. My name is David L. Winstead and I am the Commissioner of Public Buildings at the U.S. General Services Administration (GSA). Thank you for inviting me here today to discuss the impact of the tightening of the credit markets on GSA's capital program.

New Construction and Modernizations

Because they are funded through appropriations, our new construction, modernization, and repair and alteration programs are not directly affected by any decreases in the availability of credit generally. GSA pays contractors and subcontractors for these projects periodically for work completed; they typically do not need to obtain third-party financing to complete these segments.

Leasing

Nationally, GSA is noticing some impact of the credit crunch on its leasing program. We asked each of GSA's regional offices whether GSA offerors were experiencing difficulty obtaining financing for GSA lease projects. Generally, the responses from the GSA regions suggest that successful GSA offerors are obtaining financing on more costly terms in comparison to previous years. More costly leasing terms, of course, generally result in higher rental rates for the Government. However, financing for Government deals (where leases are backed by the full faith and credit of the United States) has always been lower than that for more risky ventures. Therefore, when credit becomes more expensive or difficult to obtain, lessors of Government-leased buildings have typically obtained financing more easily and on less costly terms than other borrowers.

In a few instances, successful GSA offerors have been unable to obtain lease project financing and, as a result, have not been able to proceed with lease construction projects. Offerors have attributed this problem to the tighter credit market. For example, in 2005, GSA initiated a lease construction project for the FBI for up to

266,200 rentable square feet of space with 271 parking spaces in Detroit, Michigan. In May 2006, GSA finalized negotiations for a no-cost assignable option for a 10.2 acre site at 1200 6th Street in downtown Detroit, then used a two-phase, best-value source selection process to select a development team. We awarded the lease to a developer in February 2007. In October 2007, the developer indicated that, as a result of the tight credit market and the post-award addition of work to the project by the City of Detroit, it could not secure financing for the project at a rate that would support its expected returns and asked to withdraw. GSA and the developer completed a no-cost settlement agreement and GSA rescinded the contract in February 2008. While such an occurrence is not widespread for GSA, these projects are not going unnoticed.

Here testifying with us today is Jones Lang LaSalle, one of our national brokers. They will be able to tell you about the state of the real estate investment market generally.

As you may know, GSA uses credit tenant leases (CTL) in some of its larger lease transactions in order to gain better lease rates through the most effective financing available. The CTL has been used with varying degrees of success in several GSA regions. Following a U.S. Government Accountability Office report encouraging GSA to adopt a more businesslike leasing approach, GSA modified its General Clauses in the CTL to enable better lessor financing for large transactions. Using the CTL, successful offerors may be able to obtain higher loan amounts, at lower interest rates. Under the CTL, once the leased space is delivered according to the lease requirements, the Government compromises on some of its termination and set off rights against the debt-servicing portion of the rental payments in order to allow an uninterrupted rental payment stream to service the lessor's debt. The Government retains its rights to enforce the lessor's service obligations. In order to ensure that we are obtaining the value of these lease modifications, we encourage our regions to request pricing on both our standard lease and our CTL so that we can see the savings.

Energy Savings Performance Contracts

Increasingly, we are relying on Energy Savings Performance Contracts (ESPC's) to accomplish energy saving capital improvements. Through an ESPC, an Energy Service Company (ESCO) conducts a comprehensive energy audit, identifies improvements that will save energy at the facility, and arranges financing to pay for them. The ESCO guarantees that the improvements will generate savings sufficient to pay for the project over the term of the contract. We estimate that our potential for ESPC and Utility Energy Services Contract use in FY2009 is approximately $20 to 24 million. However, small and medium-sized ESCO's, who rely on bank or investor financing to fund ESPC's and do not have extensive track records, may find it increasingly difficult to obtain financing in this environment. ESPC financing is not traditional in that it is not asset-based; rather, it is backed by guaranteed energy savings resulting from the improvements. As a result, GSA and federal agencies generally may have to rely on larger ESCO's to perform ESPC contracts. This may affect other federal agencies more than GSA, since GSA's buildings tend to be large and therefore we tend to contract with larger ESCO's already.

Retail Leasing

Retail leasing amenities are an important consideration on several of our federal campuses - in particular, the Ronald Reagan Building & International Trade Center and the 8,000 square feet of restaurant and retail space adjacent to the new Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) headquarters building. Banks have begun tightening standards for loans to small businesses. We understand that this is making it harder to gain funding for anything from buying equipment to hiring new workers. So far, however, this more restrictive credit environment has had no discernable impact on GSA's retail leasing activities.

The Ronald Reagan Building & International Trade Center currently has full occupancy of all retail space. Three of the four retail tenants in the ATF headquarters building have

signed sub-leases and negotiations are currently being conducted with the fourth retail space. One establishment has already opened for business. The remaining businesses are slightly behind schedule because they must wait for Washington Gas to provide service to the facility; however they are on schedule to open by the end of August.

Conclusion

The tightening of the credit markets potentially affects GSA in three areas: leasing, energy savings performance contracting, and retail leasing. So far, none of these areas has been significantly affected. Credit is available to our lessors at relatively favorable rates with the Federal government as a major tenant. Federal agencies generally may experience an increased reliance on larger ESCOs for ESPC contracts because the financing for these is unconventional, backed solely by a stream of expected energy savings rather than an assets. Although some of the small businesses to which we lease our retail areas may experience difficulty due to a tightening of credit, we have not experienced a high level of vacancies so far.

Madam Chair, Ranking Member Graves, this concludes my prepared statement. I will be pleased to answer any questions that you or any other Members of the Subcommittee may have on the impact of the credit crunch on our capital program, or on any other aspects of the Public Buildings Service.

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

Questions for the Record

What is GSA's 5-year framework for responding to feedback from the private sector on FBI build-to-suits?

1. FBI-PBS Industry Days. GSA's Public Buildings Service (PBS) hosted an FBI Industry Day in Washington, DC, on June 19, 2007, and in San Francisco on February 6, 2008, to educate developers, architects and general contractors on the requirements for lease construction. Since September 2001, the FBI has increased facility security requirements in support of their specialized task forces and anti-terrorism initiatives. The Industry Days were designed to specifically educate GSA's industry partners on the FBI's latest construction requirements and GSA's two-phase source selection and lease construction bid process. In addition, FBI officials provided an overview of how facility design and layout plays a pivotal role in the FBI's new mission.

2. Lease Construction procurement best practices workgroup. This group is responsible for identifying best practices in managing lease construction procurement projects. In an effort to identify security costs, GSA changed the solicitation requirements with the issuance of the Security Unit Price list on August 22, 2008. Offerors must now quote unit prices on all security countermeasures identified in the Solicitation for Offers (SFO) as "Building Specific Security" or "Tenant Improvement" security requirements. For FBI lease construction, GSA is establishing a process to capture these security unit prices in order to develop benchmark cost estimates and a unit cost database for security countermeasures identified in the SFO. With access to this information, GSA realty associates will be able to educate customer agencies concerning the cost of security countermeasures early in the lease project to avoid budget issues and "bid busts" later in the project. Also, GSA will have reliable cost data to use as a basis for recommending changes to OMB on how lease security standards are addressed in lease prospectuses and to help agencies understand their financial contribution (i.e., payment obligations funded through GSA Reimbursable Work Authorizations).

   In addition, the lease construction group will examine successful prospectus level lease projects for the FBI and similar agencies to identify and recommend successful procurement strategies for GSA regions to follow. This group will also look at ways to increase competition for lease procurements with limited interest. Once these best practices have been identified, we will ask industry for feedback.

3. GSA is working with the FBI to procure a contractor to evaluate value-engineering opportunities in FBI field offices. The contractor will also evaluate each of the FBI projects with current approved prospectuses or submitted prospectuses to determine whether construction and other project cost estimates are still reliable in light of the change in financing and the general increase in construction costs.

GSA's 5-Year Framework For Responding To Feedback From The Private Sector On FBI Build-To-Suits
Tasks
FY 2009
1. Continue with project delivery for projects awarded under construction.
2. Continue work with FBI to review projects approved but where award has not been made to confirm viability of approved prospectus for purposes of construction costs and prospectus rent caps.
3. Task contractor to validate assumptions on approved prospectus projects as well as pending projects and to value engineer SFO for possible savings.
4. Consider alternatives to turnkey approach on a pilot project basis.
5. Educate/outreach for financing sources.
6. Review contractor findings on projects reviewed and adjust accordingly.
FY 2010
1. Continue to monitor projects and implement changes based on findings.
2. Continue with alternative delivery tool project.
3. Monitor progress.
4. Keep stakeholders informed.
5. Pursue prospectuses for next round of projects.
FY 2011 and Beyond
1. Continue with program.

What is GSA's 5-year framework for responding to private-sector feedback generally?

1. Lease Construction Industry Roundtable. GSA hosted a Lease Construction Industry Roundtable on June 11, 2008 in Washington, DC to obtain industry feedback on current and proposed lease construction procurement, construction, and financing practices. Approximately 90 private sector developers, architects and construction managers attended and actively participated by giving their feedback on questions asked by the presenters. Topics of discussion included the site selection process; procurement methods, the credit tenant lease, and

improving design and construction management quality in lease construction projects. Feedback from attendees indicates that the Roundtable was a success.

GSA is considering the industry comments received from this roundtable and is incorporating many of the proposals into its lease construction program.

2. Guidelines and Process for Consistent Implementation of Lease Construction Design Excellence Program. GSA organized a work group comprised of regional and central office subject matter experts to develop lease construction processes and tools, including lease construction SFO language to support those processes. GSA will obtain feedback from the private sector on the generic lease construction SFO language. The group began work in April 2008 and plans to issue standardized lease construction processes and tools by the end of the 1st quarter of Fiscal Year 2009. The work group is divided into the following subgroups:

   - Site selection subgroup. This subgroup is developing a sample site option agreement and a land market survey for use either with developer provided or assignable option sites.

   - Procurement subgroup. This subgroup is developing a source selection factor matrix as a discussion tool to use with customer agencies when planning lease construction procurements.

   - Finance subgroup. This subgroup is developing a scope of work to acquire financial advisor services to assist lease contracting officers in evaluating financing arrangements and capitalization rates and in developing negotiation strategies. This subgroup is also focusing on finalizing policy regarding the use of the credit tenant lease and evaluating other financing models. .

   - Construction subgroup. This subgroup is improving the construction excellence process and developing tools to aid in bidding and construction analysis.

   - Business process subgroup. This subgroup is mapping the overall lease construction process, mapping the supporting processes and meshing them together into an overall standardized lease construction process. In addition, the business process subgroup will support the National Program Management Team to develop plans to monitor the success of the standardized processes and resolve problems that arise in the processes following implementation.

3. Market Education. GSA intends to pursue meetings with lenders to educate them on federal lease transactions.

4. GSA is considering alternative means of project delivery and is continuing to engage private industry in these discussions.

GSA's 5-Year Framework For Responding To Private-Sector Feedback Generally
Tasks
FY 2009
1. Complete work on lease construction working group regarding standardized lease construction SFO with appropriate measures.
2. Brief PBS Regional Realty Services Officers (RSOs) and Assistant Regional Administrators (ARAs).
3. Issue applicable Realty Services Letter (which transmits changes in realty policy and procedures to GSA realty practitioners) and training.
FY 2010 and Beyond
1. Consider alternative delivery/acquisition approaches.
2. Outreach to financiers and lenders to educate them on GSA offerings.
3. Complete work on ePM (electronic project management tool).
4. Address training needs for realty specialists.
5. Assign GSA property development specialists to project teams as necessary.

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