Military Family Housing Privatization

by Major Randall B. Howard

This article introduces the Air Force financial management community to this challenging program.

Tight budgets, combined with an increased level of operations, have created many challenges for today's military leaders. We, in the comptroller career field, play an important role in these challenges. We are increasingly being asked to analyze new ways to meet Air Force objectives within the limited budget we have. In short, we must make sure we spend our dollars in the most efficient manner possible. This task often involves looking at completely new ways to meet our objectives. A prime example is the Military Housing Privatization Initiative (**MHPI**) for improving the quality and quantity of housing available for our military personnel. This article introduces the Air Force financial management community to this challenging program. First, I provide a brief overview of the housing privatization program. Then, I discuss the privatization process, concentrating on the unique role and contributions of the financial management community. Finally, I conclude by discussing some of the challenges ahead.

The Program

This section provides you a quick overview of the military family housing privatization program. First I will answer the question: **why should the Air Force privatize its housing?** Then I will give a brief overview of the legislative authorities making the program possible, the steps involved in the privatization process, and the key players. Finally, I'll discuss the Air Force financial management community's future challenges in supporting other functional offices to make projects happen.

Why Privatization?

Quality of life is one of the Air Force's top priorities, and quality housing for our troops and their families is one of the most important and visible quality of life issues. The Department of Defense (**DoD**) owns over 300,000 family housing units and most of these were built in the 1950s and 1960s. The Air Force has over 60,000 houses (out of a total 110,000) that require major renovations or replacement. With the standard military family housing construction (**MILCON**) process it would take about 30 years and over six billion dollars to achieve the Air Force's goal of updating all of our housing. Moreover, if you use 30 years as the "economic life" of housing, you'll never get caught up with the MILCON approach. (Actually, military family housing construction is a different appropriation than general military construction (**MILCON**); however, as is common in the field, I refer to military family housing construction as **MILCON**.)

OSD policy is primarily to rely on the local community for adequate housing. Accordingly, most of our troops live off base in local communities and receive a basic allowance for housing (**BAH**) which is supposed to cover 80 to 85 percent of their housing costs. Since the member must pay the remaining 15 to 20 percent of their housing costs out-of-pocket, many, if not most, military members would prefer to live on base in military housing. Even with BAH, many junior members have a hard time finding suitable housing within a reasonable distance of their workplace, especially in cities with a high cost of living. Also, many of our bases are in rural areas with depressed economies and very little construction. Combine these reasons with the unique benefits of military housing (e.g., added security, convenience to base facilities, esprit de corps, etc.) and it is easy to see why waiting lists, even for (at times) substandard housing, are so high.

The National Performance Review, along with the Defense Performance Review, noted the problems the military was facing with its family housing and identified family housing as a prime candidate for privatization. Subsequently, in 1995 the Marsh Task Force looked at military housing and recommended ways to improve the quality of life for service members. Their primary recommendation was to use private capital and expertise to accelerate the military family housing program. Congress took note of these recommendations and the 1996 National Defense Authorization Act contained powerful new authorities for the Services to use in achieving their housing goals.

One key point to remember as you read through this is that financial expertise is needed from day one—don't wait until it's time to do an economic analysis to become involved!

In simple terms, the Air Force cannot rely on standard MILCON procedures to solve our housing problem. It would simply take too much time (i.e., 30 years) and cost too much money. Instead, the Air Force has decided to solicit private capital and allow private developers to own, operate, and maintain housing for our military members. Essentially, the private sector becomes a "MILCON and Housing Maintenance" organization.

In order to maintain the benefits of military housing, the Air Force limits the amount of rent developers can charge their military tenants. The goal is that the military member's BAH will cover both rent and utilities. This means that the developer must accept below-market rent and the Air Force will probably have to subsidize the deal in some manner. Without subsidies the developer would not be able to secure adequate financing and make a reasonable return on his investment. The new authorities act as these subsidies and are intended to help the military services solve their housing problems in a timely fashion by attracting private investment. This new strategy is a "win-win" situation: The Air Force gets good, quality housing in a timely manner, and a private developer gets a good return on investment.

Authorities

Now that we've discussed the benefits of privatization (timeliness and cost savings), let's look at the specific legislative authorities or tools Congress has given DoD. From a financial standpoint the authorities entail different costs and risks. The Credit Reform Act requires that all government projects be scored. In simple terms, scoring refers to the calculation process to determine the funding requirement associated with the potential long term obligations of the government which must be set aside at the beginning of a project. I like to think of the scored amount as the risk adjusted present value of all of the possible government expenditures. (Present value looks at cash flows from the viewpoint of the time value of money: a dollar today is worth more than a future dollar in view of the interest that could be earned on today's dollar.) The Office of Management and Budget calculates the scored value for each housing privatization project on a case-by-case basis. Think of the scored amount as the total cost of all the specific authorities which a particular project uses. A key role of the financial management community is to determine which combination of tools offers the least risk and keeps the project scoring within the available amount of funding.

Military Family Housing Privatization (Continued...)

Broadly speaking, the authorities fall into five categories: 1) guarantees, 2) direct loans, 3) conveyance or lease of existing property and facilities, 4) differential lease payments, and 5) investments. An authority can be used either alone or in multiple combinations of authorities. Each of these categories of authorities is briefly discussed below.

Guarantees under this program can take many forms. This authority allows the Air Force to guarantee a commercial loan financing the purchase or construction of housing. The guarantee can cover all risks or be limited to certain risks (e.g., the losses due to a particular event such as a base closure). The Air Force can also guarantee occupancy or rental income. Both occupancy and rental income guarantees carry a prohibitively large cost as OMB scores them at 100 percent of the net present value (**NPV**) of the full guaranteed amount over the entire term of the deal. Limited loan guarantees, on the other hand, are relatively inexpensive. The Air Force generally guarantees economic losses due to base closure, significant downsizing, or a long-term deployment of a large portion of the eligible population.

The *direct loan* authority allows the Air Force to lend money directly to a private individual or corporation. The loan can be at below-market rates and allow for deferral of payments. The cost of a direct loan includes a credit subsidy and the estimated loss in the case of default. The credit subsidy is a measure of how generous the loan terms are. The Air Force borrows from the Treasury at the 30 year T-Bond rate. Any deferrals or below-market rates offered to the developer will result in a cost to the Air Force.

Leasing or conveyance give the Air Force additional possibilities for developing deals with the private sector. There are two primary types of leases. In the first case, the Air Force could lease housing units that are constructed by a private developer. In the second type, the Air Force could convey or lease land, existing housing, and ancillary facilities to a private developer. As with rental guarantees, if the Air Force leases housing from a developer it is scored at 100 percent of the full amount of the lease for the term of the lease. There is no scoring impact when the Air Force leases or conveys land and property.

Differential lease payments are a payment made by the Air Force directly to the owners of a housing project to subsidize the amount of money they receive in rent from the military member. They can be in any amount and for any duration. Unfortunately, they also are scored at 100 percent of their NPV over the life of the project.

The final category of authorities is *direct investments*. The Air Force can invest as a limited partnership, or invest in the equity or debt instruments of any enterprise that agrees to own, operate, and maintain housing for our troops. The scored amount is equal to the government's total investment.

The Air Force, based on lessons learned from previous housing programs involving the private sector and fiscal limitations imposed by the Credit Reform Act, has tailored its housing privatization projects to use those authorities that offer the most housing at the least risk for our limited dollars. The typical Air Force program involves some combination of a limited loan guarantee, a direct loan, and the conveyance or lease of property and or facilities. Additionally, the Air Force will not involve any of their funds until construction is complete. Of course, the Air Force may use any of the authorities and part of the unique challenge of the program is to choose those authorities that make the most sense for each specific deal.

The Process

Military Housing Family Privatization is still in its infancy. The process is continually changing as everyone involved looks for ways to improve and quicken the process. Also, as some of OSD's roles are shifted to AF/ILEI, there will be some changes in the process. AF/ILEI has identified a five-step process: 1) project identification, 2) project definition, 3) project acquisition, 4) project management, and 5) project closeout. The time span for these deals is very long—somewhere in the 30- to 50-year range. The following paragraphs will briefly discuss each of these steps and discuss some of the critical issues in the financial arena. One key point to remember as you read through this is that financial expertise is needed from day one—don't wait until it's time to do an economic analysis (**EA**) to become involved!

Step 1: Project Identification

Project identification is the first stage and currently takes about three to six months, but will eventually almost go away as the housing master plan will help identify projects Air Force wide. The first critical task in this stage is for a base to identify its housing requirement. This takes into account items such as current inventory and condition, waiting lists, housing market analysis, and any known future actions that might affect the base's eligible population. After determining the requirement, a preliminary analysis is conducted to make an initial determination as to the financial feasibility of the project. Even though consultant support for these steps is available, the local FM community should be involved for several reasons. First, their expertise in conducting EAs for other programs (even those unrelated to housing) will be of great benefit. Secondly, this is the time to become involved and get a basic understanding of the program. Too many times this step is accomplished without FM office involvement, and then time can be wasted bringing them up to speed in the next step.

Step 2: Project Definition

After a base has conducted their preliminary analysis and concluded that they want to proceed, they then move on to more formally define the project. Eventually, this stage should last between six months and one year, but currently it is taking a little longer. This stage is where the FM community becomes heavily involved. Part of this stage involves a formal concept approval from OSD. One of the first steps is a formal site visit resulting in a report that details which authorities might best be used to meet the requirements defined by the MAJCOM in the first stage. This report will explain which options are preferred based on their life cycle cost and efficient use of government funds (i.e., those that provide the most housing for the least investment).

The EA is one of the most important documents as its comparison of life cycle costs is used in making a determination as to whether or not to proceed with the project.

The MAJCOM then reviews the report and chooses which, if any, of the options they wish to pursue. If they choose to pursue an option, the next step is to seek formal concept approval. Prior to obtaining concept approval a preliminary EA must be completed. SAF/FMCE has issued guidance, available on their EA home page on the SAF/FM web site, for completing these preliminary EAs.

The EA is one of the most important documents as its comparison of life cycle costs is used in making a determination as to whether or not to proceed with the project. The cost for the privatization alternative is relatively easy to identify. The scored amount is an outlay in the first year, and can be taken directly from the pro forma. (The pro forma is a software program developed by OSD to screen projects by analyzing the feasibility of financial data.) The remaining outlays are generally limited to BAH and impact aid. It is challenging to identify all of the costs that go into the MILCON alternative and the FM representative must work closely with the civil engineering community to identify and capture all the costs. Examples of costs that should be included, but often are forgotten, are reductions in operating expenses for the military housing office, BAH expenses associated with normal vacancy, and other saved personnel costs (e.g., security police).

The purpose of the preliminary EA is to evaluate the reasonableness of the proposed project. A benefits analysis is an integral part of an EA and takes into account many of the intangibles associated with housing privatization. Benefits are important because housing privatization need not be cheaper to offer a better value to the Air Force. Of course, the hopes are that it is both cheaper and more beneficial. Most importantly, the MILCON alternative probably is not feasible since, in most cases, the amount of money necessary is simply not there. So one key benefit of the privatization alternative is that it is feasible and will result in housing in a much quicker time frame. Other benefits to consider are location, safety, costs to the member, morale, and amenities.

After receiving concept approval, the next step is to develop a project plan which basically is a document which integrates the steps that have already been taken with a road map for accomplishing the remaining actions (e.g., acquisition strategy). When the project plan is reviewed and approved the base is ready to move on to the acquisition phase.

Step 3: Project Acquisition

This is the most crucial phase of the project and involves extensive support from the FM community. The entire step lasts about one year. The FM community should take an active role in the preparation of the source selection documents, the source selection evaluation standards and criteria, and in the actual source selection. Some of the critical areas are discussed below.

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As with any Air Force source selection, proposals have to be evaluated based on the standards and criteria given to the offerors in the request for proposal (**RFP**). One of the most crucial tasks is coming up with the criteria that will allow the team to pick the proposal that truly does represent the best value to the government. With the limited number of deals so far, it is hard to draw definitive conclusions about what works best. However, we have learned several things thus far.

One of the first lessons learned was that it is beneficial to standardize how material should be presented. For example, it is beneficial to provide offerors with blank pro formas so they can simply fill in the numbers; and to ask them to compare their fees and costs with those of similar housing in the local area. The key here is making sure that the deal is actually a good value for the type of house we are getting. Also helpful toward ensuring a good deal is to carefully compare offerors' qualifications. Past financial statements should be examined to make sure that the company has the financial ability to perform.

These deals are typically funded by three primary funding sources (commercial mortgage, government mortgage, and equity). Equity can be defined in several manners (e.g., the amount of cash a developer contributes, the difference between the value of the project and the amount of debt, etc.). Equity is good because it represents a direct financial stake for the offeror and reduces the debt burden. However, equity is expensive because developers demand a high rate of return, and too large of an equity requirement could scare off potential bidders. The advantage of commercial mortgages is that they cost the Air Force very little in terms of scoring and, if the developer goes into default (for any reason other than those covered under the limited guarantee), the Air Force does not lose money. However, the commercial mortgage will generally have a higher interest rate than the government loan, and thus will cause higher monthly payments. If these higher payments cause him to go into default, the commercial lender gets control of the assets and gets paid off first. Government debt is inexpensive, but also puts the Air Force at high levels of risk in the case of default. Also, excessively high levels of Air Force debt may go against Congress' mandate to maximize private sector participation. Ideally the government looks for a balanced approach that has as much commercial debt as can be reasonably paid off by the project's earnings. Financial evaluation criteria should steer the government toward choosing the deal with the best combination of funding.

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Another issue involving the government loan is the terms. While scoring accounts for the impact of below-market rates and deferrals, these issues should also be considered individually. These deals will be scrutinized at many levels within the government and by the public (e.g., bidders who did not win). Loan terms that are excessively generous (e.g., zero percent with deferrals) may not pass the "common sense" test for lending. It may be preferable to lend $15 million at four percent interest versus only $10 million at zero percent interest.

Once the proposals are received, the FM community should take a lead role (working with the source selection evaluation team) in evaluating the financial/business proposal. Three key areas to consider are the risk involved in the: 1) proposed corporate structure, 2) development period, and 3) operating period. For the corporate structure many deals will involve limited partnerships. Limited partnerships by their very nature limit the ability of the Air Force to seek recourse in the event of default. The limited partners probably will be from larger parent companies (e.g., regional and national development, construction, and management firms); parent companies that offer to guarantee the obligations of the limited partnership are highly desirable. During the development period the major risk is not having enough funds to complete the project. For the operating period, the government evaluation should consider whether the developer has the ability to service the debt over the life of the loan. The evaluation should also key in on the ability of the firm to adequately maintain and renovate the property over the term of the deal.

One last lesson learned involves the role of the lenders. It is imperative that the offerors have firm financing. We do not want to make an award only to find out that the developer is unable to obtain the commercial mortgage. The government should ensure that the lenders are aware of the deal, the controlling documents, and the offeror's proposal. It may even be beneficial to meet with the developers and their lenders prior to selecting the winning offeror.

Step 4:
Project Management

Although much of the emphasis in housing privatization has been on the first three phases, we need to keep in mind that these are usually long term deals (generally thirty to fifty years long). A lot can happen during this time period and it is important to begin to think about the role of the financial community during this period. Most importantly someone will have to review financial statements on a periodic basis. This review probably should occur at the local level (base housing office with FM support) and at a centralized level (such as the Air Force Auditor General or DFAS). This is necessary to make sure that the developer is proceeding as planned and is not running into financial problems. The project will involve numerous accounts, some of which the Air Force or an independent trustee may have control over. For example, the capital replacement reserve account should be monitored to ensure it is being funded at the level proposed.

Step 5:
Project Close-Out

The final stage is project close-out. Depending on the actual authorities used, this phase may involve simply turning over the project completely to the private sector (e.g., when land was conveyed) or it may involve restoring leased land to its original condition. Accordingly, the time required for this step could vary between virtually no time and several months.

Key Players

Housing privatization is complex and involves numerous parties working together to ensure a successful effort. It's not possible in a short article to discuss every office which has a role in housing privatization, but it is beneficial to at least mention the key players and those from the financial community within DoD, the Air Force Secretariat, the Air Staff, and the local level.

The Deputy Under Secretary of Defense for Industrial Affairs and Installations (**DUSD IA&I**) is the approval authority for military housing privatization initiatives. OSD established the Housing Revitalization Support Office (**HRSO**) to coordinate and support all of the Services' housing privatization efforts. Recently OSD has decided to shift some of HRSO's responsibilities to the individual services. HRSO has subsumed some other areas of responsibility (e.g., utilities privatization) and changed its name to Competitive Sourcing and Privatization (**CS&P**). OSD will still maintain an approval, policy, and oversight role in the process. CS&P will manage the Family Housing Improvement Fund (**FHIF**) which is the source of funding for the program. Funds can be transferred to the FHIF from MILCON projects or directly appropriated in the normal budget cycle.

There are several other organizations within DoD that play some role. For example, the Defense Finance and Accounting Service (**DFAS**) is responsible for servicing any direct loans. The Under Secretary of Defense (Comptroller) establishes policy for controlling housing privatization funds and the Office of the Deputy Comptroller (Program/Budget) is responsible for notifying Congress about the transfer of FHIF funds.

At the Air Force level, project approval lies with the Deputy Assistant Secretary of the Air Force for Installations (**SAF/MII**). A cross-disciplinary group of five senior level officials, one of whom is the Principal Deputy Assistant Secretary of the Air Force (Financial Management), advises SAF/MII on proposed projects. Also at the Secretariat level, SAF/FMC and SAF/FMB are heavily involved. SAF/FMC establishes policy for housing privatization EAs and also assists in developing source selection financial evaluation criteria for proposals. SAF/FMB handles budget actions required for projects and coordinates on all funding actions necessary for the program.

At the headquarters level, AF/XPMS chairs the competitive sourcing and privatization panel which is the conduit to the corporate structure for competitive sourcing and privatization issues. At both the headquarters and local level there are integrated process teams (**IPT**) which bring the players together. These IPTs are critical since many of the issues involve more than one area of expertise. For example, the IPT might contain representatives from personnel, legal, civil engineering, housing management, security police, acquisition, and, of course, financial management. The Air Force housing IPT is chaired by AF/ILEI (the Outsourcing and Privatization Division within the DCS for Installations and Logistics).

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MAJCOMs and the local installations are perhaps the two most important players. They are responsible for preparing the solicitation and providing project management for the entire life of the project. The MAJCOM and installation also form a housing privatization IPT to coordinate their efforts. The Air Force Center for Environmental Excellence (**AFCEE/DC**) is another key player. This organization is rapidly becoming a pocket of expertise in housing privatization. AFCEE is heavily involved in the solicitation process for many Air Force housing privatization projects.

Finally, consultants under contract to CS&P, AF/ILEI, and in some cases the MAJCOM and base support the privatization process. These consultants provide valuable insight into areas the government is not used to working in—e.g., banking consultants provide expertise in the area of financing and business arrangements. However, it is critical that the FM community take an active role when consultants are involved. Consultants' advice should be taken seriously, but final decisions must remain with the government. Also, consultants may not be aware of public financing policies required by OMB (e.g. budget scoring rules). Successful privatization projects require a knowledge of both private sector financing and real estate practices, on the one hand, and government finance, on the other hand. As a result, government employees must work together with contractors to develop projects which are beneficial to both the Air Force and private sector developers.

Future Challenges

The military family housing privatization initiative is very exciting. A process has been identified and the Air Force has already awarded one successful project at Lackland AFB TX. The Air Force hopes to issue solicitations for programs at Robins AFB GA and Elmendorf AFB AK later this year. Several other bases are also well into the project definition phase (e.g., Dyess AFB TX, Kirtland AFB NM, Mt. Home AFB ID, Patrick AFB FL, Dover AFB DE, and Wright-Patterson AFB OH). However, the program does face numerous challenges.

The legislation enacting the Authorities is only for a five-year test period. After that period, Congress will review the program and determine whether to extend the legislation. Congress appears to be excited by the potential of this program but apprehensive about the speed with which projects are being awarded. Quite simply, the Congressional perception is that the program is moving too slowly. Therefore, one of DoD's most important challenges is to look for ways to speed up the process. One way the financial management community can help is to become involved early and be responsive to requests for assistance. Project proposals should strive for standardization when possible. Granted, every deal is unique and in no way should we apply a "cookie-cutter" mentality to this process. However, some areas can be streamlined. For example, RFP evaluation criteria for projects with similar authorities and structures should be very similar.

From a headquarters level the financial community needs to attract more interest from key private financial sectors. As more lending institutions become involved and understand the nature of the program, the process will become easier. We also need to attract long-term players with relatively low costs of capital. For example, pension funds, insurance companies, and Real Estate Investment Trusts (**REITs**) would be beneficial players.

To support future housing privatization efforts, we should think about problems that might be encountered so that we are better prepared to solve them when they do arise. One issue that comes to mind is utilities privatization. What would happen if energy from base utilities is privatized? If the developer based his deal on energy provided at DoD rates and all of a sudden the rates increase, it could cause financial distress.

Most importantly, the biggest challenge is to become involved. If your base or MAJCOM is thinking about a housing privatization deal, you need to be involved from the beginning. MAJCOMs which are going to participate in many deals are encouraged to provide specialized training for their FM personnel. SAF/FMCE can recommend appropriate courses and provide consulting support. You should also network with peers from other bases and MAJCOMs that have already begun the process.

Family housing privatization is an exciting, yet challenging, program. The financial management community has a great chance to make a direct impact on the quality of life for our personnel. The key to success is to become involved!

About the Author

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