

WRITTEN TESTIMONY OF ANTHONY J. PRINCIPI BEFORE
THE SUBCOMMITTEE ON ECONOMIC DEVELOPMENT, PUBLIC BUILDINGS, AND
EMERGENCY MANAGEMENT.

FEBRUARY 10, 2011

Mr. Chairman and Members of the Subcommittee. My name is Anthony J. Principi and I am pleased to appear this morning to provide you with my views as to the management of underutilized and underperforming assets in the federal inventory. My testimony today on creating value from underperforming federal capital assets is based on my experiences as Deputy Secretary of the U.S. Department of Veterans Affairs from 1989 – 1992 and then as Secretary from 2001 -2005. I also have served as Chairman of the 2005 Defense Base Realignment and Closure Commission (BRAC). The Commission was responsible for recommending to the President and Congress the realignment and closure of military installations throughout the United States.

When I assumed my responsibilities at VA, VA was the federal government's second largest department being comprised of a nationwide system of health care facilities and services, benefits programs, and national cemeteries for America's 25-million living veterans and dependents. The Department was and is now also a major land holding agency, with an extensive and diverse portfolio of properties with over 33,800 acres of land, 5,500 buildings, 146,920,000 square feet at approximately 270 locations nationwide. This is in addition to over 1,442 spaces leased nationwide totaling over 15,500,000 square feet.

While VA is one of the largest direct providers of health care in the world, it had an aging infrastructure with an average age of buildings over 50 years and given the dramatic changes in VA health care delivery, there was a significant amount of space that either was underutilized or simply vacant. In order to address these challenges and in an effort to encourage significant operating cost reductions and savings, I asked Michael Simmons who then was a senior legal counsel at VA and Tony Kushnir, who I brought to VA from the Navy (both of whom are now in private practice), to develop an approach that can be used as an additional tool in VA's management of its infrastructure. That approach was ultimately enacted by Congress and has become known as enhanced-use leasing.

As developed, the enhanced-use leasing concept was designed to:

- encourage program and facility managers to view Agency property holdings as program resources and potential revenue centers;
- attract other public or private sector investment into Agency facilities through broad-based market-based opportunities rather than upon reliance upon federal appropriations and programs;
- place available Agency property into more productive uses;
- enable the Agency to acquire otherwise unaffordable services or facilities; and
- allow the Agency to realign its property holdings to reflect program requirements in a way that provides the greatest return to the Government.

What is Enhanced-Use Leasing and How Does it Create Value from Unproductive Assets?

Although the authority to enter into enhanced-use leases is currently limited to VA, DoD and NASA, this concept, if extended to other agencies has the potential of providing the same benefits to those agencies as it has to VA. Simply, enhanced-use leasing is a cooperative arrangement for the development of underutilized or vacant property by which:

- property is made available to a public or private entity through a long-term ground lease;
- the leased property may be developed for compatible non-federal and/or federal uses, and
- in return for the ground lease, the Federal Agency obtains fair consideration which could be in the form of money, facilities, space, services, or other "in-kind" consideration.

Originally enacted in the fall of 1991, VA's enhanced-use leasing authority is now codified at Section 8161 through Section 8169 of title 38, United States Code. The technical elements of this authority are:

- the term of the ground lease may be up to 75 years;
- the site to be leased must be controlled by the Secretary;
- all uses must be consistent with and not adversely affect the mission of the Department;
- VA may use its "minor" construction funds (now up to \$10 million) as a capital contribution in connection with an enhanced-use lease;
- VA may purchase services, space or facilities in connection with an enhanced-use lease.
- VA must hold a public hearing at the location of any proposed enhanced-use lease to obtain veteran and local community input
- VA must provide notice to its congressional oversight committees prior to entering into an enhanced-use lease.

One of the major elements of the enhanced-use leasing authority is that unlike traditional federal leasing authorities in which generated proceeds must be deposited into a general treasury account, the enhanced-use leasing authority provides that all proceeds (less any costs that can be reimbursed) are returned to an appropriate agency mission. The ability to recycle proceeds creates an economic incentive for the agency and its property managers to fully utilize their existing capital assets and to begin to view these assets as potential resources to fund needed programs or facility requirements. To underscore Congress' intent to provide the agency with sufficient latitude to undertake and practice asset management, the authority must address several key legal issues commonly identified as critical to successful public/private transactions by:

- providing the Agency with the ability to enter into long-term agreements so as to enable the private sector with a degree of comfort that it should be able to amortize its capital investments;
- clarifying the ability of the Agency to undertake this authority from the myriad of other substantive and procedural laws relating to government procurement, management and disposal of property or services;
- enabling the Agency to enter into these agreements in a timely fashion to address market demands;
- providing the Agency with the flexibility to address a broad spectrum of market and financial conditions to address specific project requirements so long as the activity is within established statutory requirements and Agency mission.

Finally, central to the enhanced-use leasing authority is its close coordination with and reliance upon the local government and community as full partners in the development process. There are two aspects to this participation. First, in order to maximize project efficiencies and minimize development costs, the Agency must rely, to the greatest extent possible, upon local building codes, safety requirements, construction standards and local government inspection services as they pertain to any non-Agency development. If the project involves direct Agency control over the management and operation of a facility, the project is considered in the context of applicable Agency standards. In such instances, Agency requirements are reviewed in the context of how such standards integrate with applicable local codes and standards.

The second, and perhaps the more important reason why enhanced-use leasing stresses local government and local community involvement is to assure that the development is integrated in the local planning and development process. Close integration would enable the Agency to spot any potential community concerns (scope and intensity of the development, traffic impacts, business impacts, etc.) and to address those issues early on in the planning and development process.

What types of projects have worked and why?

Obviously, sound development economics are the foundation of enhanced-use projects. But some factors within an Agency's control can contribute to the likelihood of success.

Enhanced-use leasing worked best when the Agency's requirements were defined in private sector terms. For example: a VA administrative office building is not significantly different from a commercial office building. During my tenure at VA, among the various other projects undertaken, three major office buildings along with parking facilities were developed on VA campuses pursuant to the enhanced use leasing authority. These were the VBA Regional Office at Salt Lake City, Utah; the VBA Regional Office in Chicago, IL and the VBA Regional Office Building in Milwaukee. These transactions followed an earlier developed VBA Regional Office building at the VA Medical Center in Atlanta, GA. All four of these office building were privately

financed, developed, and operated on what was vacant land and are now being used as Regional Office Buildings for VA's Veteran Benefits Program. Prior to moving into these facilities, the Regional Offices occupied space in GSA and privately owned buildings in downtown locations and remote from the VA Medical Center campus. Through enhanced use leasing, VA was able to lease vacant land on its medical center campus to local developers who in turn developed the property and leased the facilities back to VA. In each instance, in addition to the program benefit of having VA Regional Offices collocated on VA Medical Center campus and thus allowing "one-stop shopping" for veterans obtaining medical care, VA was able to achieve significant cost savings in its lease-back of the office buildings as compared to all other alternatives including new construction or leasing off campus. I should note that the leasing commitments made by VA in each such transaction were no more than found in a standard GSA operating lease.

Based on our experiences, I believe that VA was able to achieve these significant savings in acquisition cost because while federal appropriations offer the lowest cost financing for federal construction, the structure of the VA transactions allowed the private sector to bring the full force of the efficiencies offered in the private sector, these being:

- Federal construction is designed and constructed on for the specific facility being sought. Private development relies upon building standards and design criteria that has been used repeatedly and "honed" in millions of applications by building industry, resulting in a larger market base in all aspects of the industry (e.g., architects, construction contractors, trade contractors). This factor has a significant down-ward impact on pricing and on the time of construction.
- Since VA's lease of the buildings was based on a GSA operating lease, the financial sector was familiar with the commitment and treated the lease as a high investment grade transaction allowing the developer to keep its financing cost at a minimum and significantly below the cost normally found in commercial transactions.

Further, the VA transactions were structured so that the federal commitment to lease the facility was a completely separate transaction from the underlying ground lease. The ground lease, in turn, was negotiated to have a term in the range of 35 – 50 years depending on the amount of investment. As such, while VA could not subordinate the Government's fee interest in the property, the ground lease was of sufficient term so as to be comparable to similar ground leases in the commercial real estate market, thus allowing the developer/ground lessee the ability to secure financing.

In as the private facility was constructed on an underlying ground lease, the title to the facility passed to the federal government upon expiration of the ground lease by operation of law. This structure offered two distinct benefits. First, in as the facility would ultimately become VA property by operation of law, there was no need for VA to

negotiate or buy purchase options from the facility owner which kept VA costs at a minimum. Second, VA was able to capture the residual value of the building and thus unlike a pure government space lease scenario, the transaction left VA with an asset of value rather than with a file of rent receipts. I should note that in these transactions, the developer was required to fund and maintain over the term of the ground lease and facility lease a "funded maintenance reserve" to assure that the facility was properly maintained and refreshed while on VA property.

This structure and approach was successfully applied in the energy area as well where vacant VA property was leased on a long-term basis for the development of an energy plant that would generate electricity and in many instances steam and chilled water not only for use at the host VA Medical Center but to adjacent users and to the public utility. VA undertook four of these projects with much success with savings reported to its Congressional oversight committees in the scores of millions of dollars. In addition to the efficiencies noted in my discussion regarding office space, these energy centers generated revenues and off-set energy costs charged to VA.

While the enhanced use leasing authority can be effectively used to manage federal property in a manner to acquire required facilities or services at lower costs, the authority was not defined simply by that application. It also serves as a portfolio management authority. A good example is the Chicago Lakeside enhanced use lease. Using this authority, VA was able undertake and implement a much needed realignment of two underperforming VA Medical Centers in metropolitan Chicago. One VA Medical Center was an aging, high-rise facility located on in the heart of Chicago's "Gold Coast." It was expensive to operate and ill served a veteran patient base that had moved away from downtown and toward Chicago's suburbs. In 2005, VA signed a 75-year ground lease with Northwestern Memorial Hospital for the land underlying the VA facility and received \$28M at execution with another \$22M upon disposal of the facility to Northwestern, which was also allowed in the enhanced use leasing authority. The enhanced use lease did provide for the establishment of a correct sized, cost-efficient, outpatient VA clinic on the Lakeside site to service veterans in the community. Pursuant to the enhanced use leasing authority, the funds received by VA were used to off-set VA's costs in the construction of a new bed tower at the neighboring VA Medical Center.

The point here is that underperforming assets must be viewed in the overall context of the agency's programs and resources. Through the enhanced use leasing authority, VA had the ability to unlock the value of Lakeside and use that value to improve services to eligible veterans. It did so by allowing VA to offset the cost of implementing its realignment of resources and avoid the future cost of investing VA's limited capital funds into aging health care facilities while also assuring the continuation of quality health care for Chicago area veterans.

During my tenure as Chairman of the BRAC, I was able to observe that the military services were in the process of implementing a then recent change in the law which authorized enhanced use leasing transactions. Today, all of the military services have

active enhanced use leasing programs which look to maximize value of their underutilized, non-excess property.

Lessons Learned

I believe there are several key points to be made relative to developing a successful approach in maximizing value from underperforming assets. The single most important is that Agencies should have the ability to use best practices in managing their assets and resources, be it by the transfer of excess property to other Agencies who have requirements for such property, the disposal of surplus property, or entering into arrangements such as enhanced use leasing with other entities in the public or the private sectors. This authority must provide sufficient flexibility to allow the Agency to be innovative in its approach to secure private investment into its facilities. While preserving the integrity of governmental processes, that Agency's implementation procedures must be tempered so as to be responsive to the broad span of market, environmental, political, and legal issues that arise in any development of property. The Agency's officials involved in the process must be committed to the effort's success, and while attempting to be responsive to the legitimate demands of the private sector. Finally, the Agency must structure each transaction in a manner that will mitigate or minimize future appropriations and federal commitments so as to avoid encumbering future operational funds and thus reducing the availability of those funds in the long-term for needed activities.

Thank you for your invitation and interest. I will be glad to respond to any questions that you or Members of the Subcommittee may have.

Anthony J. Principi

During his four-year tenure (2001-2005) as Secretary of the U.S. Department of Veterans Affairs, New York-born Anthony J. Principi directed the federal government's second largest department, responsible for a nationwide system of health care services, benefits programs, and national cemeteries for America's 25-million living veterans and dependents. Commanding a budget in excess of \$71 billion, Mr. Principi led an organization of 230,000 employees in hundreds of VA medical centers, clinics, benefits offices, and national cemeteries throughout the country.

Mr. Principi is a 1967 graduate of the U.S. Naval Academy at Annapolis, Md., and first saw active duty aboard the destroyer USS Joseph P. Kennedy. He later commanded a River Patrol Unit in Vietnam's Mekong Delta. During his service in Southeast Asia, Mr. Principi was awarded the Bronze Star with combat "V" for valor and several other military decorations for valor.

Upon returning from Vietnam, Mr. Principi earned his law degree from Seton Hall University in 1975 and was assigned to the Navy's Judge Advocate General Corps in San Diego, Calif. In 1980, he was transferred to Washington D.C. as a legislative counsel for the Department of the Navy.

From 1984 to 1988, he served as Republican chief counsel and staff director of the Senate Committee on Veterans' Affairs, following three years as counsel to the chairman of the Senate Armed Services Committee.

Mr. Principi served as Deputy Secretary of Veterans Affairs, VA's second-highest executive position, from March 17, 1989, to September 26, 1992, when he was named Acting Secretary of Veterans Affairs by President George H.W. Bush. He served in that position until January 1993. Following that appointment, he served as Republican chief counsel and staff director of the Senate Committee on Armed Services.

Mr. Principi was chairman of the Commission on Service members and Veterans Transition Assistance established by Congress in 1996.

Mr. Principi was nominated by President George W. Bush on December 29, 2000, and was confirmed by the Senate on January 23, 2001 to serve as Secretary of Veterans Affairs...

Prior to his nomination as Secretary of Veterans Affairs, Mr. Principi was senior vice president at Lockheed Martin IMS, and a partner in the San Diego law firm of Luce, Forward, Hamilton & Scripps.

Mr. Principi was appointed by President George W. Bush to chair the 2005 military Base Realignment and Closure Commission (BRAC). The Commission was responsible for recommending to the President and Congress the realignment and closure of military installations throughout the United States.

Mr. Principi is Executive Chairman QTC Management, Inc., the nation's largest provider of disability medical evaluations.

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Pursuant to clause 2(g)(5) of House Rule XI, in the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include: (1) a curriculum vitae; and (2) a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by an entity represented by the witness. Such statements, with appropriate redaction to protect the privacy of the witness, shall be made publicly available in electronic form not later than one day after the witness appears.

(1) Name:

ANTHONY J. PRINCIPI

(2) Other than yourself, name of entity you are representing:

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YES

If yes, please provide the information requested below and attach your curriculum vitae.

NO

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Signature

Anthony J. Principi

Date

Feb 8, 2011