

STUDY OF  
LEASE PURCHASE AND OTHER PRIVATE FUNDING MECHANISMS  
FOR CAPITAL IMPROVEMENTS

REPORT BY:  
BUDGET AND CONTROL BOARD  
JOINT BOND REVIEW COMMITTEE

January 1987

REPORT OF  
 THE BUDGET AND CONTROL BOARD AND THE JOINT BOND REVIEW COMMITTEE  
 ON A STUDY OF  
 LEASE PURCHASE AND OTHER PRIVATE FUNDING MECHANISMS FOR CAPITAL IMPROVEMENTS

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**PART 1**  
**FRONT PAPERS**

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March 1987

President, The Senate  
Speaker, House of Representatives

Gentlemen:

A proviso included in the 1986-87 Appropriations Act (Act 540 of 1986) in Part I, Section 16 (at page 195) reads as follows:

Provided, Further, That the Budget and Control Board and the Joint Bond Review Committee shall together conduct a thorough study and submit to the General Assembly by January 1, 1987, a report regarding lease purchase and other private funding mechanisms for capital improvements.

Our report in response to that proviso is attached.

In the course of preparing this report, we identified the private funding mechanisms for capital improvements which we believe have application to what the South Carolina State government does. We also defined the circumstances in which we believe the use of those private funding mechanisms to be appropriate. Finally, we examined how the State government now makes decisions on the use of private funding mechanisms for capital improvements and we have suggested changes in those processes.

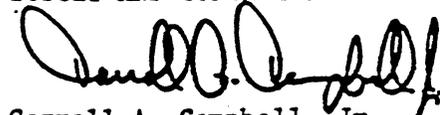
We believe our report responds to the assignment. It says some things which need to be said about the State government's use of private funding mechanisms. We also believe that what we say about how the State government now makes decisions in this area and how it ought to make those decisions is the most important part of our report.

Much information on various facets of the subject was gathered in preparing this report which may be useful to the General Assembly as it considers this subject. Please let us or our staffs know if we might make that collection of materials available and how we might assist you further in this regard.

JOINT BOND REVIEW COMMITTEE

  
Horace C. Smith  
Chairman

BUDGET AND CONTROL BOARD

  
Carroll A. Campbell, Jr.  
Chairman

## FOREWORD

The proviso which prompted this report directed the Budget and Control Board and the Joint Bond Review Committee to "...conduct a thorough study and submit to the General Assembly by January 1, 1987, a report regarding lease purchase and other private funding mechanisms for capital improvements."

We understood that this study was prompted in part by a concern over what appeared to be a growing use of lease purchase agreements to acquire major buildings by State agencies and institutions. That increased use of lease purchase agreements for facilities was occurring in the face of considerable uncertainty about what approvals State agencies and institutions were supposed to secure before entering into such agreements. Beyond that, it was not clear what process for securing those approvals should be followed.

It also was our impression that interest in this study stemmed from a belief that lease purchase agreements and other private funding mechanisms represent a less costly way of financing needed State improvements. There also has been a hint that, even though their costs clearly represent long-term financial obligations, lease purchase obligations somehow were not debt.

We do not argue with the legal technicalities which, as is found in an opinion of the Attorney General's Office, lead to a conclusion that a lease purchase agreement which includes an appropriately drafted non-appropriations clause would not constitute debt within the meaning of existing constitutional and statutory provisions. But, we hasten to add that the practicalities of the situation are that the bond rating services do view these sorts of obligations as debt and that, under generally accepted accounting principles, they would be classed as debt also.

Just as the Reorganization Commission apparently concluded in its examination of the use of the lease purchase approach to the replacement of the Central Correctional Institution, we found no evidence to support the belief that financing improvements through any private funding mechanism would be less costly than paying for those improvements using cash from current revenue income or from State general obligation bond proceeds. We concluded

that any decision to use private funding mechanisms must be based on considerations other than the cost of making needed improvements available.

We did find that certain private funding mechanisms probably must always be used in making available the wide variety of improvements needed by the State government, regardless of the higher cost which would be involved. For example, we considered the acquisition of the use of office space on a true lease basis, with no intention or option to acquire ownership of the space being leased, to be use of a private funding mechanism. We believe true leases to be one private funding mechanism which the State government, for a variety of reasons, always would want available.

We defined the "capital improvements" of interest in the proviso to mean real property (land and buildings) and personal property (equipment) needed by the various agencies to carry on the work of the government. But, we have devoted much more time and effort to the real property side of the issue.

We appreciate the help of many individuals who contributed materials and ideas to this effort. In particular, we thank the persons named to a study committee by the Board which included William A. McInnis, Board Deputy Executive Director, who chaired that group's efforts, J. Michael Ey, Deputy State Treasurer, and attorney J. Craig Bower, of the Adams, Quackenbush, Herring & Stuart firm in Columbia, and those named by the Bond Committee which included Scott R. Inkley, Ways and Means Committee Director of Research, Susan K. Hooks, Ways and Means Committee Research Analyst, Robert C. Toomey, Assistant Clerk of the Senate, and William Jordan, Senate Finance Committee Director of Research.

## KEY CONCLUSIONS

In essence, we have concluded that:

1. Lease purchase arrangements create debt.
2. The use of lease purchase arrangements to acquire real property is not likely to be the least expensive means of financing, but other factors may argue for their use in very limited situations.
3. Lease purchase arrangements, in many cases, are more advantageous for the State than long-term true leases.
4. Lease purchase arrangements are very likely more costly than general obligation financing.
5. No standard procedure exists for General Assembly approval of lease purchase arrangements for real property. One should be established.
6. Bonded debt plus the debt in other long-term State obligations now outstanding is about 4% of the estimated general fund revenue for 1986-87.

## EXECUTIVE SUMMARY

The State government obviously is a very large and varied enterprise. As such, its operations require the availability of a great deal of real and personal property.

Most of the real property (land and buildings) and the personal property (equipment) used by the State government is owned by the State government. And, most of it was purchased outright over the years using cash appropriated by the General Assembly from then-current revenue income or from bond proceeds.

However, in recent years, private funding mechanisms, including true leases, have been used extensively to provide the land, buildings and equipment (used here also to mean capital improvements) needed in the operation of the government.

A 1975 study of non-State-owned real properties leased by State agencies and institutions by the State Auditor's Office reported that some 93,000 acres of land (exclusive of about 1.4 million acres of leased game management areas) and 1.8 million square feet of building space of all sorts were being leased by the sixty-six entities included in the survey at an annual cost of about \$4 million. About 600,000 square feet of office space in the Columbia area at an annual cost of about \$2 million were included.

Eleven years later, at September of 1986, the Property Management Unit of the Division of General Services reports the existence of 559 leases covering over 2.2 million square feet of building space of all sorts by all agencies and institutions at an annual base rental cost of \$14.8 million.

These figures and other data reported by the Division of General Services offer evidence that the use of true leases to obtain building space for State agency use is not only extensive but also that it has persisted at a significant level for at least the past ten years.

It can be said that the availability and the use of the true lease private funding mechanism is essential to the operation of the State government.

However, a compelling case for the use of the lease purchase mechanism cannot be made and the study recommends very limited use only of it. This

study finds lease purchase mechanisms to be a more costly method of financing needed facilities than acquiring them by outright purchase with cash from current revenue income or with cash from general obligation bond proceeds. There are instances, however, in which building space could be provided through a lease purchase arrangement at less cost to the State than under a true lease agreement.

We also note the belief that lease purchase arrangements under which a facility is built by a private contractor for a private developer and then made available to the State under a lease purchase arrangement, because of savings resulting from the strictly private transaction as opposed to being subject to various public procurement requirements, may be cost competitive.

The study also finds that lease purchase agreements are most often used by other states as a way of escaping one or another of the limitations or the approval processes imposed by those states on their financial operations. That approach has been suggested here also. One of the arguments being advanced is that the payments required under lease purchase agreements are not debt in the strict Constitutional limitation sense. One implication of the "not debt" argument is that the cost of such agreements does not count against the debt service/issue limitation and that there should, therefore, be less concern with their use. Because no clear approval process exists on them, lease purchase projects are outside of the priority schedule on the availability of capital improvement bond funds which is the nearest thing the State has to a formal capital budget. The result is that the means of financing winds up giving certain projects a much higher standing in implementation priority than they likely could have gotten otherwise.

On this point, the study concludes that resorting to methods of financing needed State improvements to get around self-imposed rules, limitations and disciplines is the wrong course to take. It concludes also that that approach is to be viewed with heavy skepticism and that the wisdom and energy required to devise escape routes from self-imposed restraints would better be invested in making the case to change the restraints which prompted the look for alternates in the first place. The simple truth is that, regardless of how State financial obligations are classified (and the bond rating houses and

accounting standards organizations do consider lease purchase obligations debt), they necessarily must find their place in an appropriations act or in an act which authorizes the issuance of bonds. The issue then, as so often is the case, is what choices are to be made from among virtually unlimited needs/wants and the limited resources available to meet them.

The study was focused to a degree on private funding mechanisms and on their possible application to the situation faced by the State government. But, perhaps of much more importance is the study's examination of the processes for deciding which permanent improvements are needed and when. Serious shortcomings were found in this area.

Processes for making decisions on the use of private funding mechanisms for capital improvements, at worst, do not exist. At best, they are inadequate and incomplete.

Even though, once executed, lease purchase agreements clearly become long-term financial obligations of the State, no general procedure now exists for getting such agreements approved. Their use to acquire real property has been sanctioned by the General Assembly in specified circumstances, however, as in the possible relocation of the Central Correctional Institution. The General Assembly, in the 1986-87 appropriations act, also has expressed its intention to appropriate sufficient funds on an annual basis to enable the Budget and Control Board to meet the required lease payments and other necessary expenditures associated with any sale/leaseback agreement involving real property.

Much the same point can be made about multi-year true lease agreements which also become, as a practical matter, long-term financial obligations when they are executed. The difference with true leases is that, under existing law, Budget and Control Board approval is required. But, the present law does not specify how long such lease agreements may cover nor does it convey any sense of the overall policy the Board should follow in approving leases.

The study concludes that a standard annual decision process for considering State government capital improvements, especially the real property aspects, is needed. That standard process should be the channel for considering all real property (land and building) matters whether they involve

requests for bond funds to build office or other facilities or requests for additional appropriations to pay for leasing such facilities.

The proposed process should build on the permanent improvements planning process already in place which requires the agencies and institutions which manage their own facilities to have an overall, five-year facilities plan. In essence, the proposal simply is to add to that process the provision of space by means other than building it.

The study proposes that legislation be enacted to require the Budget and Control Board annually, as a part of its budget recommendations, to present its comprehensive report and recommendations on the State government's then-current real property situation and needs.

This Board annual report, in addition to detailing current and projected building space needs, would present the Board's recommendations on the most cost-effective ways of meeting those needs which could include bond authorization recommendations as well as appropriation recommendations. A detailed analysis of the space being provided under true lease agreements would be required each year. The report also would be required to include an analysis of the cost of building or buying the space necessary to convert the space then leased (and proposed to be leased) to State-owned space and of the savings, if any, the conversion to State-owned space would produce. Thus, the General Assembly each year would have before it the Board's estimates of the costs and savings involved in converting the leased space to State-owned at various levels.

The study proposes that the legislation required to place the responsibility for administering the standard decision process on the Budget and Control Board include a clear expression of legislative intent in doing so and that it also give clear authority to the Board to do what is intended.

The legislation also should require that the Joint Bond Review Committee review the Board's standard decision process annual report to the General Assembly and make recommendations on it. The study also recommends that the Committee monitor the standard process and evaluate its effectiveness annually.

**PART 2**

**WHAT CAPITAL IMPROVEMENTS?**

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## PART 2: WHAT CAPITAL IMPROVEMENTS?

The proviso under which this study is undertaken does not define what capital improvements are of interest or concern. It simply calls for "...a report regarding lease purchase and other private funding mechanisms for capital improvements."

We chose to define the phrase "capital improvements" very broadly. We defined it to mean the real property (buildings and land) and the personal property (information technology equipment, mostly) needed to carry out the diverse and numerous responsibilities of the several agencies and institutions which comprise the State government.

We believe that the authors of the proviso may well have had in mind a focus on major capital improvements such as large office buildings or complexes of prison facilities. Acting on that belief, we examined the real property side of the issue in some detail while dealing with personal property (equipment) in only a most limited fashion. However, we did not limit the scope of the study in any way as it relates to real property.

Using a very broad definition of capital improvements means that the study recommendations apply to facilities ranging in type and significance from the large office buildings in the Capitol Complex in Columbia to picnic shelters in State parks to the dormitories and stadiums of USC and Clemson and to the Central Correctional Institution in Columbia.

That definition also means that various sorts of personal property, mostly equipment (which we narrowed to information technology types), used in doing the work of the State government technically are included. However, as noted, most of our efforts were focused on the real property issues because we believed them to be more significant and more troublesome.

**PART 3**

**SCOPE: WHAT PRIVATE FUNDING MECHANISMS?**

### PART 3: SCOPE: WHAT PRIVATE FUNDING MECHANISMS?

In the course of this study, a lot of literature on the general subject of "privatization" was examined. Also reviewed was a long list of private funding mechanisms to which reference often is made in the on-going commentary on "privatization."

We came to view "private funding mechanisms" as arrangements under which the State government obtains the use of assets (capital improvements) which are owned by someone else while they are being used by the State government in return for periodic payments to the owners for that privilege.

As we indicate later in this report, State ownership of the assets made available through a private funding mechanism may (and often does) occur.

After looking at the many different forms "private funding mechanisms" may take, we concluded that they differ mostly in matters having much more meaning to and impact on the lessor involved in a transaction than on the lessee (which the State would be).

We felt that the State's focus in these considerations should be on such bottom-line matters as:

- (a) the term (length in years) of any such agreements entered into;
- (b) what those agreements cost the State annually and in aggregate over the life of the agreement; and on
- (c) what residual or ownership interest, if any, is acquired by the State under the terms of such agreements.

Because we did not feel that an examination of the many nuances which can be involved in the use of private funding mechanisms would contribute much of value to our study, we decided to focus attention on only two types or categories of such mechanisms, i.e., (1) "true lease agreements" and (2) "conditional sales lease agreements" or "lease purchase agreements."

First, we defined "true lease" contracts to mean agreements under which the use of personal property (equipment) and/or real property (land and buildings) is allowed for a specified period in return for a periodic payment and, under which, while acquisition of ownership of the property by the lessee is not contemplated at the time the lease agreement is entered into, an ownership option at or near fair market value may be provided.

Second, we defined "conditional sales lease" and "lease purchase" contracts to mean agreements under which the use and acquisition of title to personal and/or real property is allowed in return for specified periodic payments plus a purchase option price which usually is nominal and, under which, lessee acquisition of ownership of the property involved is contemplated in most instances at the time the agreement is entered into (and, in some cases, may occur at that time).

Although it is doubtful that the proviso drafters had this view, our definitions mean that capital improvements which are simply rented (leased under a "true lease" contract) are considered as having been made available through the use of a private funding mechanism. We feel strongly that this broader view is essential if a comprehensive approach to the process of making decisions in the provision of capital improvements is to be taken. It was our thinking that true lease contract private funding mechanisms could not be left out of the study because that could be construed as an indication that we are satisfied with the uneven and incomplete true lease agreement decision-making processes which now exist.

**PART 4**

**CURRENT SOUTH CAROLINA SITUATION**

## PART 4: CURRENT SOUTH CAROLINA SITUATION

### REAL PROPERTY (LAND AND BUILDINGS)

Inventories of the real and personal property used by the State government presently are available in the several parts in which the property subject has been viewed traditionally. As a result, there are separate inventories of State-owned land and buildings, of State-owned personal property, separate listings of real property and personal property covered by lease agreements and so on.

While we felt very strongly that a comprehensive approach to the issue of supplying and maintaining the capital improvements needed by the State government is essential, we did not believe that assembling all of these details was our assignment. Thus, we did not attempt to assemble a comprehensive inventory of capital improvements.

However, we felt that some perspective on the existing real and personal property situation should be provided including an awareness of:

- what the State government owns;
- what the State is in the process of buying; and
- what the State is simply leasing.

We have attempted in the following pages to give a feel for the current capital improvements situation within the State government using the information readily available.

#### State-owned Buildings and Land

Some help in understanding the great number and variety of existing State-owned facilities is found in the inventory information in the Statewide Permanent Improvement Reporting System (SPIRS) maintained by the Board's Budget Division. While that inventory is not yet complete and is in need of detailed review by the agencies which provided the data in it, it indicates that some 6,000 facilities of all sorts are owned by the State.

The 1,007 currently-active permanent improvement projects listed in the SPIRS report are evidence that State facilities and their maintenance are

significant matters. The aggregate budget for these projects is \$907.7 million of which some \$490.8 million are capital improvement bond funds. Since 1968, \$975 million of these bonds have been issued for various facilities. The authorized balance of these bonds due to agencies and institutions at the end of September 1986 was some \$330 million. Of that total, about \$255 million had not yet been issued.

About 1.5 million square feet of State-owned office space, most of which is in the Columbia area, of course, is reported by the Division of General Services.

The Division also reported on about 50 facilities under its purview, located in the Columbia area, which are those used by the central State government. Such diverse structures as the Statehouse, the DHEC Laboratory, the Calhoun, Wade Hampton, Gressette, Dennis, Blatt and Brown Buildings, and the State Library are included. They account for some 2.4 million gross square feet of space (including the 1.5 million square feet of office space mentioned previously). The replacement cost of these facilities is considered to be about \$172.7 million.

The Citadel's inventory includes 70 facilities with about 1.4 million square feet of space with a replacement value of some \$96.7 million.

PRT's inventory identified some 2,870 facilities within parks located throughout the State and included everything from houses for park rangers to rental cabins, picnic shelters, restroom facilities, parking areas and waste treatment systems.

#### Leased Space

The Division of General Services reported that about 2.2 million square feet of office and other space are being leased throughout the State from commercial and other sources in 559 lease agreements at a cost of about \$15 million annually. Included here, although they technically are lease purchase agreements, are leases between State institutions and affiliated foundations.

### Leased Space Persists

As noted, extensive use of true lease agreements is made by the State government to gain the use of real and personal property. Data from General Services indicate that the State government has leased 1,250,000 square feet or more of building space for at least the past ten years.

### Terms of September 1986 Lease Agreements

As of the end of September 1986, the State was obligated to pay rent under the terms of 559 real property lease agreements. As is indicated below, two-thirds of these leases are for terms of three years or less. Lease agreements are included in the list maintained by General Services during the time the State is obligated under their terms to pay rent. The terms of the agreements on the September list are as follows:

<u>Total Leases</u>	<u>Terms Three Years or Less</u>	<u>Terms Over Three Years</u>
559	375 (67%)	184 (33%)
		<u>Term</u> <u>#</u> <u>%Total</u>
		3+ to 5 years    15 ( 8%)
		5 to 10 years    77 (42%)
		10 years plus    92 (50%)

### 1.9 Million Square Feet Leased for \$13.8 Million In "Non-exempt" Leases

Of the 559 real property leases on which the State was obligated to pay rent at the end of September, 368 under Board policy were subject to formal approval by Board staff under the terms of Code Section 1-11-65. These agreements covered about 1.9 million square feet of building space. As reported by staff of the Division of General Services which handles these matters for the Board, the current annual base rent for this space is about \$13.8 million.

### 300,000 Square Feet Leased for About \$1 Million In "Exempt" Leases

The remaining 191 real property leases, under Board policy, have been exempted from formal Board staff approval because the lease periods involved in them is short and the cost is less than \$5,000 per year. These are reported to the Board by the agencies involved and they cover some 300,000 square feet of building space (to bring the total leased space to the 2.2

million square feet referenced previously). Many of these involve land for sites for towers, recreation, and various other purposes. The current annual base rent for these leases in September was somewhat under \$1 million (with the \$13.8 million referred to above, to bring the total to the nearly \$15 million mentioned previously).

#### List of September 1986 Leases In Report Annex

A list of these true leases dated September 25, 1986, is included in the Annex to this report. Also there is a listing of 191 leases exempted by the Board from the formal approval requirements of Code Section 1-11-65.

Our conclusion is obvious. The State government, which is the largest single enterprise operating within the State, with over 59,000 employees (full-time-equivalents) and with a presence in each of the State's forty-six counties, requires (and has) a great many capital improvements of various types to carry out its many responsibilities.

And, as has been noted, by no means are all of the facilities used by the State government owned by the State government. Historically, they have been provided mostly through outright cash purchase using funds from current revenues or from bond proceeds or through true leases paid for using current revenues. In recent years, however, dramatic increases have occurred in the use of lease purchase agreements for the acquisition of equipment and, more recently, for the acquisition of buildings.

#### In-Process Lease Purchase Projects

Three major projects are underway in the Columbia area which will result in the provision of additional building space for use by State agencies. Under the terms of the lease purchase agreements under which they are being developed, the prospect is that these facilities will be owned by the State at a future time. Some 512,000 square feet of space are involved including 368,000 in the former Mt. Vernon Mill building, 90,000 in the Robert Mills Building located on the State Hospital property on Bull Street, and 54,000 square feet to be constructed in the Adjutant General's Office building to be located on Bluff Road.

### Mt. Vernon (Columbia Mills) and Robert Mills Projects

The first two of these (Mt. Vernon and Robert Mills) are cases in which efforts were directed at making use of significant facilities which were not being used or were being underused. Because of their unusual status, these two facilities offered unusual tax benefits to the developers of these properties which are not available to other projects.

The Mt. Vernon Mill property, which is on the National Register of Historic Places, was donated to the State and a determination was made that the State Museum could be housed there. As the effort to locate the Museum there progressed, it became evident that the nearly 400,000 square feet of space in that building far exceeded even the long-term future needs of the Museum. It also became clear that the funding then available to the Museum Commission to renovate the space for museum purposes was not nearly enough to do the renovation needed of just part of the building and also provide parking, utilities and other required facilities.

A study of the feasibility of developing an agri-business center in part of the Mill building found the facility not suited for that purpose.

The Board in August of 1984 met with the Joint Bond Review Committee to discuss the possibility of a sale leaseback approach to the Mt. Vernon Mill building project. Following that meeting, the Board decided to take charge of the entire project although project funding was not at all assured since legislative leadership offered little hope that substantial authorizations of capital improvement bonds for this project would be made in the near future. The Board by then had identified the Tax Commission as a major tenant of the building, one whose requirements would match well with the open landscaping opportunities the Mill structure offered. That agency's decision to relocate also will make it possible to move the Court of Appeals from commercial leased space into the Calhoun Building (following its renovation) in the Capitol Complex.

The Robert Mills Building, also on the National Register of Historic Places, had been underused for many years and it did not fit well with plans of the Department of Mental Health for the State Hospital campus.

Adjutant General's Office Building Project

A 54,000 square foot building is to be provided in the Bluff Road area. It is to provide the space necessary to house the Adjutant General's administrative functions in one location. The agreement provides an option to the State to purchase the facility for \$1.00 at the end of a 20-year term. It also provides that the State can purchase the facility for predetermined prices during years ten through nineteen.

A summary of these three in-process lease purchase projects is shown on a following page. A narrative description of each of these projects which includes additional detail is included in the Annex.

These agreements are summarized as follows:

	Mt. Vernon Mill	Robert Mills Building	Adjutant General's Office Building
Facilities (sq ft)	368,711	90,000	54,000
Lease Period, years	20	20	20
State Sale of Existing Improvement	Yes \$760,000	Yes \$300,000	No
Ground Lease includes ground lease payment of \$56,200	Yes	Yes	Yes
Annual Payment Base	12.1488% times cost not to exceed \$25,000,000: (exclusive of taxes, insurance, operation and maintenance) \$3,037,200	\$862,514.67 (escalates yearly) includes taxes and insurance for 1st year w/increases passed to State and \$56,200 per year ground lease payment; excludes operation and maintenance	\$486,702.00 (exclusive of taxes, insurance and operation and maintenance)
Purchase Option	(1) Museum (60.39% of space) At end of 10 years, for appx \$11,800,000 or continue payments for another 10 years and reduce this balance to zero. (2) Non-Museum (39.61% of space) Can purchase in 10th year for amount determined by capitalizing total costs at 2.875% per year (maximum would be \$13,147,505).	Purchase in year 15 for lesser of fair market value or \$5,591,898; or in year 20 for lesser of fair market value or \$5,571,308.40	Option to purchase at expiration of 20 year term for \$1.00.  State can purchase the property in years 10 - 19 at predetermined prices.
Special Feature	Tax benefits to developers which will not be available to other projects.	Tax benefits to developers which will not be available to other projects.	None

### Projected Building Needs

In the 1984 update of their five-year permanent improvement plans (the last one done), State agencies and institutions reported a need for additional land and buildings which they estimated would cost in excess of \$1.1 billion. Against that total "need" as perceived by the agencies and institutions, about \$260 million of bonds were authorized in 1985 and 1986, leaving an unmet "need" of nearly \$900 million. While that figure undoubtedly includes a number of proposals which will not be funded and which will have a very low priority, it also does not include much needed funding for asbestos abatement in State facilities the cost of which has been estimated roughly at \$100 million. Not included either are funds for three additional prison facilities proposed by the Department of Corrections at a cost of about \$90 million.

### Decision-making Process: True Leases

#### General Assembly Role

The General Assembly's role in true lease agreements is somewhat indirect in that, while it appropriates the funds for this purpose, it does not have a direct role in the many details which are involved after the funding has been approved. Under current procedures, the General Assembly has opportunities to know the details involved in each agency's request for funds for lease payments but the process does not make that an easy task.

A major problem in the General Assembly's role in making appropriations for true leases is that the standard budget classifications do not readily fit what has come to be a major State expenditure. If the present budget classifications are followed, the resulting base data on the true lease situation do not describe well really what is being proposed.

Under the budget classification "Fixed Charges and Contributions," seven rental classifications are listed (i.e., office equipment; photocopy equipment; data processing equipment; medical, scientific, and lab equipment; non-State owned real property; State owned real property; and other). Lease purchase interest payments is a separate classification but lease purchase

principal payments are not separately identifiable in the budget structure. However, lease purchase expenditures are sorted now to a degree by the Comptroller General's Office. That Office expects to have the needed codes in place by the end of next year to distinguish among aspects of lease purchase transactions.

Twenty classifications are listed under the budget classification "Equipment." The presumption is that the funds requested would be expended for the purchase of the equipment involved but no mention is made of the lease purchase possibility.

Thus, one useful budget classification approach would be to require agencies to distinguish between expenditures which are outright purchases of equipment and those which represent some sort of installment payment. Questions apparently persist regarding the legal basis on which individual agencies enter into installment pay arrangements and thereby incur this sort of debt.

A similar problem exists under the budget classification "Capital Outlay." Lease purchase payments apparently can be classed such that they are not distinguishable from outright purchase payments.

#### Budget and Control Board: Central Broker for Leases

The Budget and Control Board is designated by statute (11-35-1590) to be the central broker for the leasing of real property for all State agencies and institutions.

#### Board's Lease Approval Process

In performing the central broker role, the Board's Division of General Services responds to requests by State agencies and institutions. Formal agency requests are not required for any lease for a term of less than three months in a year or for space costing less than \$5,000 per year. The agencies must have the funds to pay the rental due in the then-current fiscal year. This availability of funds is attested to by Budget Division staff before lease agreements are executed but any future year funding question is left to be resolved in the budget process during the following cycle.

Carrying out its statutory responsibilities, the Division of General Services screens space requests and, after going through the process, approves the formal lease agreements on behalf of the Board.

The "Request for Space" form used by the Division is a device agencies are to use in estimating staff space required by applying accepted basic space standards per employee category. It also sets out standards for use in estimating commonly-required non-staff space. Agency estimates for special items are used.

The Division attempts first to locate the needed space in the building in which the requesting agency is located, whether it is State or commercial space. If it is determined that the needed space is not available at the agency's current location, the availability of State-owned or State-controlled space is reviewed. If no State space is found, the Division then checks the availability of commercial space.

The Division, in seeking commercial space, advises commercial real estate providers of the agency's requirements via a mailing to a list of vendors who previously expressed interest in providing space.

When the agency finds acceptable space, the Division assists in the negotiations and it must approve the execution of each lease.

It appears fair to describe the Board's approach to the central State broker role for the leasing of real property for all State agencies and institutions as reactive, stemming from a somewhat uncertain grant of authority and an inclination to view the role as a service to be provided to the using agencies rather than as a control mechanism. We conclude that a more aggressive posture should be taken in the handling of this important function and that an effort should be launched to determine, as a matter of State policy, the most cost-effective mix of State-owned and leased facilities.

### Decision-Making Process:

#### Conditional Sales Lease Agreements and Lease Purchase Agreements

No general procedure now exists for gaining formal approval of the use of conditional sales lease agreements or lease purchase agreements in the acquisition of real property. Certain equipment acquisitions, mostly in the information technology area, are subject to processes devised by the Board.

#### General Assembly Sanction of Lease Purchase Agreements

In Code Section 1-11-400, the General Assembly has authorized the Board to use the lease purchase mechanism for the replacement of the Central Correctional Institution, provided several specific conditions are met.

In addition, a broader authorization, presumably enacted to sanction the use of lease purchase mechanisms though it is not explicit and also limited to correctional facilities, is found in Code Section 1-11-175, which authorizes the Board "...to finance the construction of correctional facilities by the issuance of capital improvement bonds or other methods of financing approved by the Board."

Also, as noted previously, the General Assembly, in a proviso in Part I, Section 16 of the 1986-87 appropriations act, indicates its intention to appropriate sufficient funds to enable the Board to meet the required lease payments on any sale/leaseback agreement involving real property.

#### Board Actions on Lease Purchase Agreements

Decisions on the use of conditional sales lease or lease purchase agreements for real property thus far have been made by the Budget and Control Board as in the three instances (Mt. Vernon Mill, Robert Mills Building and Adjutant General's Office building) described previously. In each of those cases, the Board recognized the multi-year financial commitments involved and, before they were approved, its staff made special efforts to advise the members of these bodies and to seek the concurrence in those projects by the House Ways and Means Committee, the Senate Finance Committee and the Joint

Bond Review Committee. Although that procedure was admittedly awkward and of doubtful legal import, none of the groups contacted on these projects expressed opposition to them. General agreement was reached in the course of those efforts that capital improvement bond funds could not be made available soon for these projects in view of the heavy Department of Corrections requirements.

There clearly is a need for a standard process for making decisions regarding the use of lease purchase agreements in the acquisition of facilities. The need also is there in connection with the acquisition of equipment but that need is less pressing. It is very important that this standard process not be isolated from the overall process for deciding on capital improvement needs generally.

Decision-making Process:  
Real Property Purchase or Build

The General Assembly, by appropriating funds in an appropriations act or by authorizing bond funds, makes the basic decision to approve the acquisition of capital improvements which are to be purchased outright or which are to be built. In both ways, the land, the buildings, or the equipment involved are being acquired in exchange for cash. The cash is provided in the first instance, however, from current revenue income and, in the second, from bond issue proceeds (borrowings).

Real Property Decision Process Not Yet Well-Established Ritual

The processes through which requests for real property capital improvements are considered are not nearly so well established as are those relating to operating budget appropriations. "Required" reviews or steps in the real property processes can be circumvented easily.

### Bond Requests Supposed to Follow Act 179 of 1981 and Code §2-47-40 Steps

Bond authorization requests which are supposed to get to the General Assembly for consideration through the steps outlined in Section 5 of Act 179 of 1981 and in Code Section 2-47-40. (See report Annex for a copy of those requirements.) Those processes involve, principally, the requesting agencies and -- in review and recommendation roles -- the Commission on Higher Education (where institutions of higher learning are involved), the Budget and Control Board and the Joint Bond Review Committee. The 1979 law which is relied upon as the basis of authority for the required planning for permanent improvements, incidentally, is in the Part I portion of a bond act. It is considered by the Legislative Council to be a temporary act as is the entire Act 1377 of 1968 against which about \$1.25 billion of capital improvement bonds have been authorized.

### Board and Bond Committee To Approve Plan Before Recommending Bonds

Act 179 requires that the Board and the Bond Committee must have approved an agency's permanent improvement plan before the Board or the Committee may recommend to the General Assembly that bond authorizations be approved for the agency requesting such funds.

### General Assembly Freedom To Act Is Understood

That the General Assembly reserves its prerogatives in this area is understood completely. Although Act 179 and Section 2-47-40 suggest otherwise, it is possible, therefore, for bond authorizations to be made without review or comment by the Board, the Commission on Higher Education or the Bond Committee. However, the demoralizing effect which such out-of-channel actions have on the organizations and persons throughout the system who administer the required processes is worthy of consideration by the General Assembly. If those required processes are regarded as positive helps by the General Assembly in discharging its decision-making responsibilities (if they aren't they shouldn't be required!), then the General Assembly should find ways to discipline itself to review the comments and recommendations of those it has designated to perform those functions before it acts on these

matters. That the General Assembly is completely free not to heed the advice and counsel which might come out of the review processes it requires, we believe, is understood by system participants but uncertain and uneven application of system requirements isn't.

The decision processes are such now that funds can be (and are) appropriated for capital improvements in response to requests which have not been reviewed or recommended by any of the groups designated by the General Assembly in Act 179 of 1981 and in Section 2-47-40 to perform that function.

The hope, of course, would be that the standard decision process would gain such credibility that no member of the General Assembly would want to take a request before that body without favorable reviews from all parts of the system.

We conclude that a standard process for making decisions on constructing and/or buying building space should be put into place with the full expectation that participants in that system and its output will be used to the fullest extent (but not necessarily followed) throughout the decision-making course. This part of the larger process also should be connected with the other elements to ensure that all building space decisions — whether to build, to buy outright or via lease purchase, or to rent under a true lease — are evaluated together.

## PERSONAL PROPERTY (EQUIPMENT)

### Existing, In Process, Projected

Agencies with 100 or more employees maintain their own inventories of personal property. Agencies with fewer than 100 employees are required to submit an inventory of personal property, which includes all sorts including primarily office equipment and furniture, to the Division of General Services which is to maintain that record. At the end of 1985-86, 68 entities had reported a total of 44,390 personal property items which were valued at \$29.4 million. Fifty-eight percent of these items, valued at \$7.4 million, were reported as being over five years old, while 42% of them, valued at \$21.9 million, were then reported as being less than five years old.

The 1986-87 appropriations act includes some \$116.3 million for equipment acquisition. It cannot be determined from the data available what of those funds are for outright purchases of equipment or for installment payments on the purchase. Under present practices also, those decisions on the use of the funds appropriated are left to agency discretion.

As noted previously, the classifications in the budget roll-up are not descriptive with over \$107.5 million of the \$116.3 million total are on a line called "0600 Equipment" while, at the other extremity, a total of \$5,000 are on a separate line designated as "0635 Communications Equipment."

The Division of Information Resource Management reports that information technology (IT) plans received from 81 State entities in September of 1986 included some \$139.8 million of IT equipment for 1986-87. Those plans also showed about \$38.2 million of new IT equipment was projected for 1987-88.

Use of Private Funding Mechanisms

The State Treasurer's Office reports that its records show the following lease purchase obligations were outstanding as of October 1, 1986:

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Computer Equipment	\$16,518,523.93	\$ 2,169,845.24	\$18,688,369.17
Office Equipment	1,322,630.19	157,377.82	1,480,008.01
Other Equipment	<u>-36,830,377.15</u>	<u>10,441,771.74</u>	<u>47,272,148.89</u>
Total	<u>\$54,671,531.27</u>	<u>\$12,768,994.80</u>	<u>\$67,440,526.07</u>

As can be seen in more detail in the schedule presented in the next section of this report, entitled "Financial Considerations," the annual amounts due on these long-term obligations on equipment plus those on the three real property lease purchase agreements discussed in this report, are equivalent to less than one percent of the general fund revenue. The repayment schedule on these funds also is shown in the next section.

Included in the "Other Equipment" category, above, is outstanding portion of the some \$30 million of telecommunications equipment being acquired by the Division of Information Resource Management.

Not included in the State Treasurer's Office figures are the \$28 million of office, telecommunications, medical, and data processing equipment acquired through financing provided by the State-financed (from Insurance Reserve Funds) Installment Purchase Program.

Decision-making Process:

Personal Property (Equipment)

No formal approval process now exists which covers all forms of equipment except as occurs as a part of the appropriations process. A large portion of the subject is covered to some degree, however, by the information technology (IT) equipment plan review requirement administered by the Division of Information Resource Management (IRM).

The IT equipment review process requires that all requests for data processing, office automation, telecommunications, and printing equipment must

go to IRM before an appropriation increase may be requested or before such equipment is acquired under lease purchase agreements. IRM's role is to address the need for the requested equipment instead of approving or disapproving the purchase itself. That Division reports that it approves about 75% of the data processing and office automation requests; about 25% of the printing equipment requests; and that requests involving millions of dollars of telecommunications equipment have not been approved.

Up until fairly recent years, State agencies acquired the equipment they needed by buying it outright or by leasing it under agreements which could be terminated within a year. Now, much of this sort of personal property is acquired through leases which extend over several years. These agreements usually provide that the agency will get title to the property for a nominal payment at the end of the term. Lease payments are treated as current liabilities for the first year, under generally accepted accounting principles, while the payments made in subsequent years are treated as long-term debt. Thus, if an agency enters into a lease agreement covering more than one year, an escape (or non-appropriations) clause must be included.

As noted previously, a question exists on the legitimacy of such long-term agreements under constitution Article X unless the payments they require are declared to be general obligation debt.

**PART 5**  
**FINANCIAL CONSIDERATIONS**

PART 5: FINANCIAL CONSIDERATIONS

General Obligations Subject To Debt Service Limitation:

Bonded Debt Status

\$904.7 Million Outstanding June 30, 1986

The outstanding general obligation debt subject to the debt service limitation at June 30, 1986, is that represented by capital improvement bonds and school bonds. The amount of those bonds outstanding then, including interest, was \$904.7 million. Of that total amount outstanding, \$606.2 million of it was principal and \$298.5 million of it was interest.

\$255.5 Million Authorized But Not Issued

Capital improvement bonds authorized but not issued at June 30, 1986, amounted to \$255.5 million of which \$243.8 million were authorized in 1986.

No school bonds are now authorized but not issued. They represented about \$22.5 million of the \$904.7 million of general obligations subject to the debt service limitation which were outstanding on June 30, 1986.

The 1986-87 limitation on the issuance of capital improvement bonds and school bonds (general obligations which are dependent on the General Fund) is 5% of the 1985-86 General Fund revenue (the fiscal year next preceding) less debt service transfers.

1986-87 Debt Service Appropriation Is 3.8% Of 1985-86 Revenue

For 1985-86, a revenue figure of \$2,494,747,113 is used. Five percent of that amount results in a figure of \$124,737,355 which is the amount available for debt service under the limitation. The appropriation for 1986-87 for debt service on the bonds subject to the limitation outstanding as of June 30, 1986 is \$95,585,804. That figure is 3.8% of the 1985-86 revenue.

#### 1986-87 Margin Is \$29.2 Million

Thus, the 5% debt service limitation for 1986-87 of \$124.7 million less the \$95.5 million for debt service on bonds outstanding leaves a margin of \$29.2 million. If that margin had been appropriated for that purpose, it could have been used to pay the debt service on additional bond issues. But, that possibility in future years should be approached with caution in light of other long-term financial obligations now outstanding as they relate to the present 5% debt service limitation. A review of that situation is presented in the paragraphs immediately following this look at the bonded debt status.

#### \$75 To \$85 Million Of Bond Proceeds To Be Available Annually

As a result of understandings between the Budget and Control Board and the Joint Bond Review Committee, the amount of capital improvement bond proceeds to be made available annually for the various authorized purposes is now set at a level of between \$75 million and \$85 million.

It should be noted that the funding level of the capital improvement bond program increased from \$60 million annually about three years ago to \$75 million to accommodate needs of the Department of Corrections resulting from the Nelson suit consent decree. The level again was increased to between \$75 million and \$85 million in 1986-87 primarily to meet Department of Corrections needs. That agency in the past five fiscal years, beginning with 1981-82 and continuing through 1985-86, accounted for about 19%, 13%, 15%, 17%, and 39%, respectively, of the total capital improvement bond funds drawn by all agencies. Capital improvement bond authorizations for that Department are 17% of all such bonds authorized since that bond program began in 1968.

#### \$255.5 Million Of Capital Improvement Bonds Authorized But Not Issued

The \$255.5 million of capital improvement bonds authorized but not issued at June 30, 1986, have been scheduled tentatively by the Bond Committee and the Board and they represent a claim against available issue capacity. That capacity limit, as noted, technically is a function of the preceding year revenue and it is evaluated regularly by the State Treasurer's Office.

### 5% Limitation Discipline

It is important to bear in mind that the 5% limitation "test" is an abstraction, in a sense, which gets translated into reality in the course of the appropriations process when the amount of funding for debt service is considered. This question of whether or not the funds are available and if the General Assembly is willing to appropriate them for debt service purposes can be viewed as another test within the 5% limitation discipline. On the question of how the current \$85 million annual cash program fits with the 5% discipline, it does appear that annual issues of \$85 million could be made (assuming a 15-year maturity and an interest rate of 9% and with a 5% annual growth in revenue) with the resulting debt service being 4% or less of general fund revenue.

We conclude that the technical general obligation bond issue capacity under the current 5% discipline is adequate even under relatively slow revenue growth expectations to provide cash draws of up to \$85 million annually which is the level now scheduled by the Bond Committee and the Board. This capacity appears adequate to handle further increases in the annual cash draw level.

### Other Long-Term Financial Obligations

We have pulled together the information available on other long-term financial obligations which are not now classed as bonded debt. Included are those related to the Mt. Vernon Mill, Robert Mills and Adjutant General's Office projects which total about \$92.8 million. The annual payment on these projects in 1987-88 is estimated to be about \$4.5 million.

As noted, the State Treasurer's Office records reflect another \$57.1 million of outstanding equipment lease purchase obligations. Of that total which is to be repaid in seven years, some \$14.1 million is payable in 1987-88.

### Bonded Debt and Other Long-term Obligations Versus 5% Limitation

The obvious question which almost always is asked but rarely is answered during any discussion of the 5% limitation and its relation to other long-term State obligations is: Where do we stand? If we were to combine the bonded debt service schedules for the outstanding general obligations which are subject to the limitation with what we know about other long-term financial obligations of the State which are not now classed literally as debt, what percent of general fund revenue would those annual aggregate payments be? We noted earlier that bond rating services already do this sort of analysis as they assess issuer debt capacity.

We conclude that the debt represented by outstanding general obligation bonds which are subject to the 5% limitation plus that represented by equipment lease purchase agreements plus that represented by the Mt. Vernon Mill, the Robert Mills, and the Adjutant General's Office projects for fiscal year 1987-88 is about 4% of the 1986-87 general fund revenue estimate of \$2.6 billion.

Using the figures on the following page, the \$18,567,998.86 of other long-term State obligations due in 1987-88 is less than 1% of the \$2,668,000,000 general fund revenue estimated for 1986-87. That debt actually represents 0.007 of the revenue.

The bonded debt service now due in 1987-88 is \$90,133,492.50. That figure is about 3.4% of the estimated 1986-87 revenue.

Thus, the bonded debt and long-term obligations together represent 4.1% of the general fund revenue.

A schedule which presents the detail in support of these conclusions is presented on the following pages.

FISCAL YEAR	BONDED DEBT		OTHER LONG-TERM STATE OBLIGATIONS							TOTAL BONDED DEBT AND OTHER OBLIGATIONS
	CURRENT OUTSTANDING	GENERAL OBLIGATION DEBT SUBJECT TO STATUTORY LIMIT	LEASE PURCHASE EQUIPMENT	ESTIMATED MT. VERNON MILL	ESTIMATED ROBERT MILLS	ADJUTANT GENERAL <sup>8</sup>	SUBTOTAL OTHER OBLIGATIONS			
1988	90,133,492.50		14,115,864.19	3,037,200.00	862,514.67 <sup>4</sup>	552,420.00	18,567,998.86	108,701,491.36		
1989	83,954,052.50		12,643,824.46	3,037,200.00	879,816.87	554,040.00	17,114,881.33	101,068,933.83		
1990	81,055,362.50		9,969,458.02	3,037,200.00	897,119.07	555,600.00	14,459,377.09	95,514,739.59		
1991	77,267,547.50		6,697,305.18	3,037,200.00	914,421.27	557,280.00	11,206,206.45	88,473,753.95		
1992	65,501,482.50		5,512,228.16	3,037,200.00	931,723.47	558,900.00	10,040,051.63	75,541,534.13		
1993	65,409,667.50		5,444,309.97	3,037,200.00	949,025.67	560,520.00	9,991,055.64	75,400,723.14		
1994	63,034,505.00		2,717,576.05	3,037,200.00	966,327.87	562,140.00	7,283,243.92	70,317,748.92		
1995	60,546,520.00		.00	3,037,200.00	983,630.07	563,760.00	4,584,590.07	65,131,110.07		
1996	53,573,570.00		.00	3,037,200.00	1,000,932.27	565,380.00	4,603,512.27	58,177,082.27		
1997	47,170,630.00		.00	3,037,200.00 <sup>1</sup>	1,018,234.47	567,000.00 <sup>7</sup>	4,622,434.47	51,793,064.47		
1998	35,286,000.00		.00	3,037,200.00 <sup>2</sup>	1,035,536.67	568,620.00	4,641,356.67	39,927,356.67		
1999	22,050,000.00		.00	3,037,200.00	1,035,536.67	570,240.00	4,642,976.67	26,692,976.67		
2000	20,709,000.00		.00	3,037,200.00	1,035,536.67	571,860.00	4,644,596.67	25,353,596.67		
2001	15,354,500.00		.00	3,037,200.00	1,055,434.20	573,480.00	4,666,114.20	20,020,614.20		
2002	7,619,500.00		.00	3,037,200.00	1,081,387.50 <sup>5</sup>	575,100.00	4,693,687.50	12,313,187.50		
2003	7,196,000.00		.00	3,037,200.00	1,124,643.00	576,720.00	4,738,563.00	11,934,563.00		
2004	.00		.00	3,037,200.00	1,167,898.50	578,340.00	4,783,438.50	4,783,438.50		
2005	.00		.00	3,037,200.00	1,211,154.00	579,960.00	4,828,314.00	4,828,314.00		
2006	.00		.00	3,037,200.00	1,254,409.50	582,120.00	4,873,729.50	4,873,729.50		
2007	.00		.00	3,037,200.00 <sup>3</sup>	1,297,665.00 <sup>6</sup>	584,280.00	4,919,145.00	4,919,145.00		
TOTAL	795,861,830.00		57,100,566.03	60,744,000.00	20,702,947.41	11,357,760.00	149,905,273.44	945,767,103.44		

See footnotes on following page.

- 1 Mt. Vernon Mill: The State has the option to purchase the Facility at the end of the tenth year for \$24,946,918.00. The museum portion of the Facility will be given to the State at the end of year ten. The State then will have the option of purchasing that portion of the Facility or continuing to pay lease payments on it for the next ten years. The total purchase price stated in this Note would pay off the entire mortgage on the facility in which event the Tenant Lease would be terminated.
- 2 Mt. Vernon Mill: Annual rent in years eleven (11) through twenty (20) is subject to adjustment dependent upon the effective interest rate charged on the developer's mortgage loan.
- 3 Mr. Vernon Mill: The State has the option to purchase the Office Portion of the Facility for \$17,455,883.
- 4 Robert Mills: The annual rent for all years is currently being reduced as a result of the Developer's refinancing. While not complete, it is anticipated that the annual reduction will be between \$70,000.00 and \$80,000.00. In addition, if property taxes are not payable on the Facility, then annual rent will be reduced approximately \$70,000.00 per year.
- 5 Robert Mills: The State has the option to purchase the Facility at the end of year fifteen (15) for the lesser of \$5,591,898.02 or the fair market value of the Facility. This amount will be reduced by the amount of the debt service reserve required in the Developer's refinancing.
- 6 Robert Mills: The State has the option to purchase the Facility at the end of year twenty (20) for the lesser of \$5,571,308.40 or the fair market value of the Facility. This amount will be reduced by the amount of the debt service reserve required in the Developer's refinancing.

7 Adjutant General: The State has the option to purchase the Facility as follows:

December 1, 1996	\$3,672,000.00
December 1, 1997	3,420,550.00
December 1, 1998	3,156,250.00
December 1, 1999	2,879,325.00
December 1, 2000	2,585,000.00
December 1, 2001	2,285,000.00
December 1, 2002	1,965,000.00
December 1, 2003	1,625,000.00
December 1, 2004	1,260,000.00
December 1, 2005	870,000.00
December 1, 2006	450,000.00
December 1, 2007	1.00

8 Adjutant General: Includes taxes, insurance and fees.

**PART 6**  
**EXPERIENCES OF OTHER STATES**

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## PART 6: EXPERIENCE OF OTHER STATES

### Use of Private Funding Mechanisms

#### Private Mechanisms Used To Avoid Restrictions

Several states were contacted directly to find what they were doing currently in the way of financing capital improvements. These contacts were in addition to experience information garnered from the literature.

Private funding mechanisms are being used in a variety of ways in the states surveyed.

While not true in every case, we found numerous instances in which states cannot issue general obligation bonds because of:

- (1) limitations on the amounts of such bonds which may be issued;
- (2) debt service limits; or
- (3) the inability to convince the electorate to approve the issues.

#### State Building Authorities/Issuance of Revenue Bonds

Without the ability to issue general obligation bonds, several states we looked at have tried to overcome that problem by establishing an entity known as a central building authority. Such an authority is authorized by statute to issue revenue bonds to make funds available for various projects. The central building authority enters into lease purchase agreements with the other state entities involved in a project under which they make payments to the authority which are used to pay the debt service on the bonds. The payments made by the agency are collected from various sources depending on the nature of the project. The sources may include dormitory rentals paid by students or appropriations by the legislature. Revenue bonds, of course, do not involve a pledge of the state's full faith, credit and taxing power and thus have no impact on any limitations on the issuance of general obligations. Usually, revenue bonds carry higher rates of interest than do general obligations.

### Direct Lease Purchase Authorization

In other cases, direct legislation authorizing a particular agency to enter into lease purchase arrangements has been enacted. This technique has been used especially for prison construction financing. While it is claimed that debt does not result from these sorts of arrangements, we are inclined to be suspicious that that is not the case.

It is apparent that, because of self-imposed restrictions on incurring general obligation debt (that backed by full faith and credit), states are creating ways of evading most of their own limits by allowing extensive use of lease purchase arrangements. Concern for the expense involved does not seem to be the central issue in most cases. Rather, the fact that the needed improvements are being funded by some means is the central concern rather than what the means are.

### Decision-making Processes

Although a number of states have devised methods to finance capital improvements which avoid their own limitations of one sort or another, in each case there exists a formal approval process for each major project.

#### California

California, for example, includes capital improvements (those involving in excess of \$200,000) in the appropriations process. That means that both executive and legislative approval of each project is required. In addition, their "State Public Works Board" (a central building authority) must approve the improvements.

#### Florida

Florida has done extensive space assessment studies to determine a basis for choosing between state-owned buildings and leasing space from commercial vendors. One of the Florida studies concluded that the state would be better off financially by owning more space instead of leasing it. The report also

recommended the use of revenue bonds as the means of financing that additional construction work.

### Michigan

Michigan created a "State Building Authority" which is to fund needed capital improvements. Most improvements require approval by both the executive and legislative branches. All lease contracts between the Authority and state agencies also must be approved by representatives of both branches.

**PART 7**  
**RECOMMENDATIONS**

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## PART 7: RECOMMENDATIONS

### A. ESTABLISH STANDARD DECISION PROCESS

We recommend the establishment, in permanent law, of a standard decision process on the use of true lease agreements and of conditional sales lease and lease purchase agreements by any State agency or institution in acquiring the use of any capital improvement (lands, buildings and equipment items).

The proposed standard decision process consists of Part 1 which deals with real property (land and buildings), which we emphasize, and Part 2 which deals with personal property (equipment). As was indicated earlier, we put less emphasis on personal property which means that the Part 2 process is not detailed here.

Probably less than fifty agencies and institutions would be required to prepare a Part 1 decision process plan. The Division of General Services, of course, would be a major participant in this process because of its central broker role in real property leasing and because of the Board's responsibilities for housing central State government functions generally. The General Services plan would cover the needs of agencies which are tenants in State-owned buildings or in commercial space.

### Part 1: Standard Real Property Decision Process

#### Annual Real Property Plan Required

The proposed Part 1 decision process would require all agencies and institutions which provide, maintain, approve leases of and/or manage real property (buildings and land) of any sort or which propose to do so to prepare and to update annually as required an overall plan for such real property in the detail described in Section 5 of Act 179 of 1981.

#### Plan Must Include All Real Property To Be Used

This plan must include all real property which the agency proposes to use. All real property requirements should be included regardless of the means of acquisition proposed (whether to be acquired by construction, outright cash purchase or exchange, conditional sales lease agreement, lease purchase agreement or by means of a true lease agreement). The significant change from the existing permanent improvements planning process is that all facility needs are to be addressed in this one plan document and one process including, in particular, the facilities which have been secured traditionally through true lease agreements.

#### Real Property Plans To Be Aggregated In Budget and Control Board Report

The required real property plans must be updated annually by the respective responsible agency on a schedule which ensures their submission in accord with the operating budget preparation cycle. It would be the responsibility of the Budget and Control Board to aggregate the plans of the individual agencies into a State government summary where appropriate and to make recommendations on the proposals presented within them. The summary and the Board's detailed recommendations on them should be presented in an annual report on the State government's then-current real property situation and outlook which the legislation envisioned would require the Board to prepare.

#### Board Report To Address State-owned/Vendor-supplied Space Mix Issue

The Board's annual report on real property, as a beginning effort to develop a State policy on the question, would be required to address specifically the question of what the appropriate mix of State-owned space and commercial vendor supplied building space should be. The Board would be required to present detailed analyses of the space being leased and that proposed for lease. The report would show how long the various leased properties have been leased by the State and what the pattern of leased space has been over the five years preceding the year covered by the report.

### Board To Estimate Cost Of Converting From Leased To State-owned Space

As a means of facilitating a review of the owned versus lease issue in financial terms, the Board's annual real property report also would be required to include an analysis of the estimated cost of constructing or buying the building space necessary to convert to state-owned space: (a) 25% of the space leased and proposed to be leased; (b) 50% of the space leased and proposed to be leased; (c) 75% of the space leased and proposed to be leased; and (d) 100% of the space leased and proposed to be leased.

This analysis also must show the Board's estimates of any cost savings, if any, the State might realize as a result of converting from leased to owned space at each of the levels (25%, 50%, 75%, 100%) indicated. The Board's recommendations on the appropriate mix of State-owned versus leased space would be required.

### B. SET REAL PROPERTY ACQUISITION POLICIES

Policies to govern the acquisition of real property through the use of (a) conditional sales lease agreements; (b) lease purchase agreements; or (c) true lease agreements should be included in the legislation. The following are proposed:

- (1) Each acquisition of real property through the use of a conditional sales lease agreement or a lease purchase agreement must be approved in concept or specifically by the General Assembly before any such agreement is executed. An appropriation for the agreement or the enactment of a proviso approving such agreements and addressing the question of funding for such agreements are the means through which General Assembly approval is signified.
- (2) Each true lease agreement covering real property, whether new or a renewal which covers a period of more than three years, must be approved in concept or specifically by the General Assembly before any such agreement is executed. An appropriation for the agreement or the enactment of a proviso approving such agreements and addressing the question of funding for such agreements are the means through which General Assembly approval is signified.

- (3) The requesting agency or institution must submit as a part of its annual real property plan:
  - (a) The following, in any instance in which a conditional sales lease agreement or a lease purchase agreement is proposed:
    - (1) evidence that the land upon which the proposed facility is to be located is owned by the State or that the State has a clear option to purchase such land;
    - (2) evidence that the land upon which the proposed facility is to be located has been approved for the proposed use by the Budget and Control Board; and
    - (3) a proposed amortization schedule which shows the maximum annual and aggregate payments (principal, interest and total), regardless of source, required;
  - (b) the proposed source(s) of funds for the payments required;
  - (c) the recommendation of the Budget and Control Board;
  - (d) the recommendation of the Joint Bond Review Committee; and
  - (e) the recommendation of the Commission on Higher Education if an institution of higher learning is involved.
- (3) If the General Assembly approves the proposal and appropriates or authorizes the funds required, the Budget and Control Board is thereby authorized to implement the project as it deems appropriate. If the funding approved for any particular agreement is not sufficient to cover its actual costs, the agreement must be adjusted so as to reduce the funding required or execution of the agreement must be delayed until additional funding can be made available by the General Assembly.
- (4) Compliance with requirements of the Procurement Code and regulations is required.

## Part 2: Personal Property Decision Process

Further study is suggested with regard to the personal property decision process. The proposed Part 2 decision process should require General Assembly approval of the acquisition by any State agency or institution of the use of personal property by means of a true lease agreement, a conditional sales lease agreement or lease purchase agreement under which the aggregate payment to be made in a specified time period exceeds a certain amount.

Under the preliminary proposal which needs further definition, to request General Assembly approval of those agreements under which the annual payment proposed exceeds a certain amount and under which the aggregate payment proposed over a specified period exceeds a certain amount, the requesting agency or institution would be required to submit:

- (a) a proposed amortization schedule which shows the annual and aggregate payments (principal, interest and total) required;
- (b) the proposed source(s) of funds for the payments required; and
- (c) the recommendation of the Budget and Control Board including any special conditions which should be observed to meet Procurement Code requirements.

The proposal would provide that, if the General Assembly approves the proposal and appropriates or authorizes the funding required, the Budget and Control Board is thereby authorized to implement the project as it deems appropriate.

### C. CIRCUMSTANCES:

#### A. TRUE LEASE AGREEMENTS

We recommend the use of private funding mechanisms in the form of true lease agreements (ownership not contemplated) to gain the use of capital improvements (for a period of less than three years in those instances in which real property is involved) when it is determined in the standard decision process that:

- (a) the technology involved (mostly with regard to equipment) is changing rapidly; or

(b) the State's need (in contrast to an agency's need) for the improvement is short-term; or

(c) service or maintenance advantages exist; or

(d) ownership is not authorized or sanctioned, for whatever reason, by State policy.

C. CIRCUMSTANCES:

B. CONDITIONAL SALES LEASE OR LEASE PURCHASE AGREEMENT

We recommend very limited use of private funding mechanisms in the form of conditional sales lease agreements or lease purchase agreements (in which ownership is contemplated) to acquire real property.

We first concluded that lease purchase agreements should be used in those instances in which determinations have been made in the standard decision process that all of the following conditions apply:

(a) the State's need for the improvement is long-term; and

(b) the need is high priority; and

(c) sufficient cash from current revenue or from bond proceeds cannot be made available to purchase it outright; and

(d) the improvement is of such priority importance that the additional cost entailed in the lease purchase approach is warranted; and

(e) where the alternative is to acquire the real property under a true lease, it must be demonstrated a lease purchase arrangement is less costly.

We came to view those conditions as being contradictory. We thought that, if the need for the improvement were truly long-term and high priority, it would surely be treated accordingly when decisions on the use of less costly alternatives (capital expenditure fund monies or bond fund authorizations) were being made.

As noted, if the choices are limited to true leases or lease purchase arrangements, we would urge that consideration be given to use of the latter mechanism in any instance it can be shown to be the less costly alternative.

D. DESIGNATE BOARD TO ADMINISTER DECISION PROCESS

We recommend that the General Assembly take action to designate the Budget and Control Board as the single State entity responsible for administering the proposed standard decision process and that it give the Board clear policy direction on the results expected from the process. The legislation should specify the accountability measures to be used by the General Assembly in evaluating the process and it should give the Board the authority necessary to implement and enforce the decisions which come out of that process.

E. DESIGNATE BOND COMMITTEE AS OVERSIGHT ARM

We recommend that the General Assembly take action to designate the Joint Bond Review Committee as its oversight arm in relation to the proposed standard decision process and that it charge the Committee to monitor and evaluate that process and its administration by the Board and to report annually on the results of these activities and on any recommended revisions of the process.

**PART 8**

**ANNEX** \_\_\_\_\_

A compilation of various documents referenced in this report is available.