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Rethinking the Lease vs. Buy Decision

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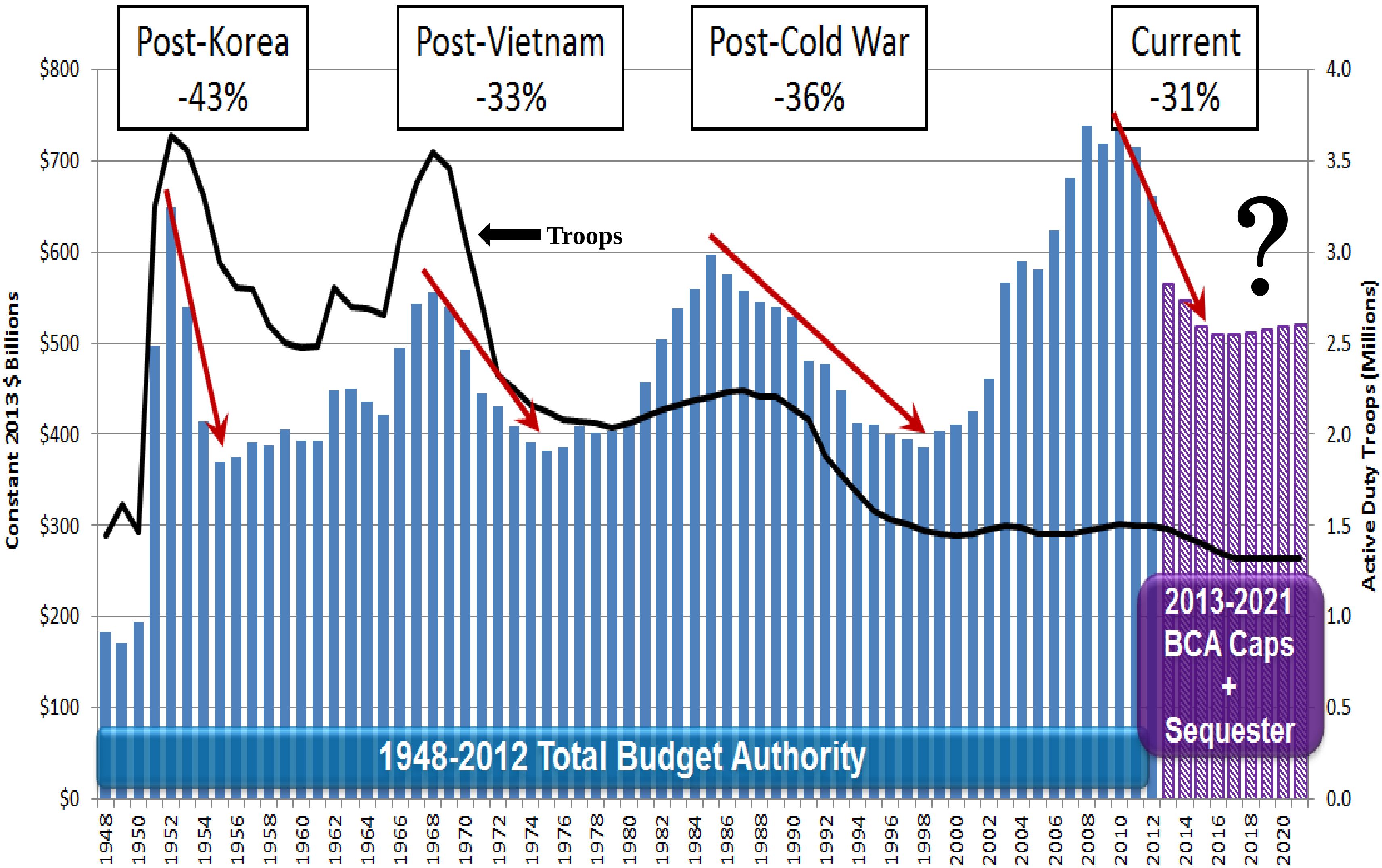
Shrinking and Uncertain Defense Budgets & Declining Force Structures



Acquisition in an Age of Austerity

- In 2012, the DoD began absorbing the $487 billion, ten-year cut in spending mandated by the Budget Control Act of 2011
- The Bipartisan Budget Act of 2013 provided some relief from sequestration, **but unless Congress acts, annual cuts are set to resume in 2016**
- At the same time, DoD expenditures for salaries, maintenance, and healthcare will continue to increase
  - Reducing available funding for the **recapitalization**, **modernization**, and **transformation** required
- Given today's shrinking budgetary environment, the DoD should keep all acquisition options on the table
  - **including a more innovative approach to leasing**

What is a Lease?

A lease is "a contract by which one conveys real estate, equipment, or facilities for a specified term and for a specified rent" (Merriam-Webster)

" I agree, money can't buy happiness, but we may be able to lease it."

Leasing in the DoD

- Leasing is common practice in the commercial world, for both economic and contingency reasons.
- **Why should the DoD lease?**
  - **When funds are unavailable to purchase mission-critical equipment**
    - Gain immediate access to assets, but spread outlays over the life of the lease, avoiding single-year funding spikes that compromise other programs
  - **In order to bridge capability gaps**
    - Need for an asset may be short-term or indeterminate, especially during periods of changing requirements
  - **When an urgent need arises**
    - When there is an immediate need, leasing commercial equipment to bolster military capability may be preferable to a lengthy acquisition

Types of Lease -- Operating Lease

OMB criteria for an operating lease:

- Ownership remains with lessor during lease term and is not transferred to the Government at, or shortly after, the end of the lease term.
- Lease does not contain a bargain-price purchase option.
- The lease term does not exceed 75% of the estimated economic life of the asset.
- The present value of the minimum lease payments over the life of the lease does not exceed 90% of the fair market value of the asset at the beginning of the lease term.
- Asset is a general-purpose asset that has a private-sector market

Continued →

Operating Lease (Cont.)

- With operating leases, risk of ownership remains with the lessor
  - Commonly used to acquire equipment on a relatively short-term basis
  - Protects the lessee from the risk of asset obsolescence, allows for systematic technology replacement
- DoD operating leases rely on <u>O&M funds</u>
  - The asset does not appear on lessee’s balance sheet
  - The asset is considered a rental and is deductible as a business expense

Types of Lease – Lease-Purchase & Capital Lease

- A lease-purchase is a lease in which ownership is transferred to the government at or shortly after end of lease term
- A capital lease is any lease other than an operating lease or lease-purchase, i.e.
  - Ownership is not transferred to the government, and
  - The duration of the lease exceeds 75% of the useful life of the asset and/or
  - The present value of lease payments is greater than 90% of the asset's market value, and/or
  - Asset is not general use/does not have a private market
- DoD capital leases and lease-purchases rely on procurement funds

The Navy Leases Maritime Prepositioned Ships

Controversy over MPS lease led to restrictions on leasing

Description

- 1970s: Navy proposed the capital lease of 13 cargo ships
  - Lift-on/Lift-off (LO-LO) and Roll-on/Roll-off (RO-RO) capabilities
  - Support equipment and supplies for rapid deployment
  - Financed by multiple private investors via 13 separate contracts
  - Built to commercial specifications
  - Navy held option to purchase ships
- Feasibility: Reagan defense build-up provided rationale
  - Congress - not a high priority, given the program's non-combat status
  - Navy - leasing provided upfront savings, preserving funds for high-priority programs
- 1980s: the Navy began its long-term lease of Maritime Prepositioned Ships
  - First peace-time attempt to fund a multi-billion dollar military program via leasing

Outcome

- Successful?
  - Yes, from "lease vs. do without" perspective—MPS had crucial role in Operation Desert Storm in 1991
- Concerns:
  - Concerns over committing Congress to 25 years of lease payments (or costly termination fees)
  - A Washington Post article described the lease as an "evasion of budgetary limits"
- Cost-effective? Depends on assumptions made
  - Do taxes paid by the MPS lessors offset the cost of the lease to the government?
    - Depends. Would these same investors have earned same level of taxable income in the absence of MPS?
- Current Status:
  - Following the 25 year lease term, the Navy exercised options to purchase many, though not all, of the ships.

Legislation Limits Long-Term Leasing

MPS lease prompted Congress to adopt new legislation that makes leasing more difficult

The Defense Authorization Act of 1984 mandated the following:

1. All DoD long-term leases (> five years) must be specially authorized by law;
2. A notice of intent to solicit such leases must be given to the appropriate committees in both houses of Congress;
3. A detailed justification for lease versus purchase must be submitted to, and that justification must be approved by, the OMB and Treasury; and
4. The OMB and Treasury must jointly issue guidelines as to when leasing may be appropriate

These laws discourage the use of long-term leases

Additional Restrictions

- 1991: OMB modified Circular A-11 requiring that government agencies **fully fund** long term (>5 years) **capital** **leases** and **lease** **purchases** in the year of initiation
- In addition, A-11 specifies that in order to be considered an **operating lease**, the asset:
  1. Must be general purpose rather than being for a special purpose of the government, and
  2. There must be a private sector market for the asset
- These two requirements deter agencies from "disguising" capital leases as operating leases

The 1984 NDAA and OMB restrictions effectively bar the use of long-term capital leasing

Unintended Outcomes

- Result: The DoD, GSA, VA, and others have a backlog of unfunded requirements
  - Postponement of required systems, facilities and modernization
  - BUT deferred investment is a bad strategy: it is more expensive to operate a poorly maintained facility, and the cost to fix the problems multiplies over time
- In addition: “A cottage industry has emerged in search of ways to get around the [OMB] A-11 rules” (Robyn, 2013)
  - Given limits on capital leasing, agencies pursue long-term operating leases
  - For example, DoT will spend $675 million via 15 year operating lease on new headquarters, but it will have no equity to show for it

Navy Leases Foreign Ships

The MV MAJ Bernard F Fisher (T-AK 4396) was built in Denmark. The initial short-term lease was renewed in 2006.

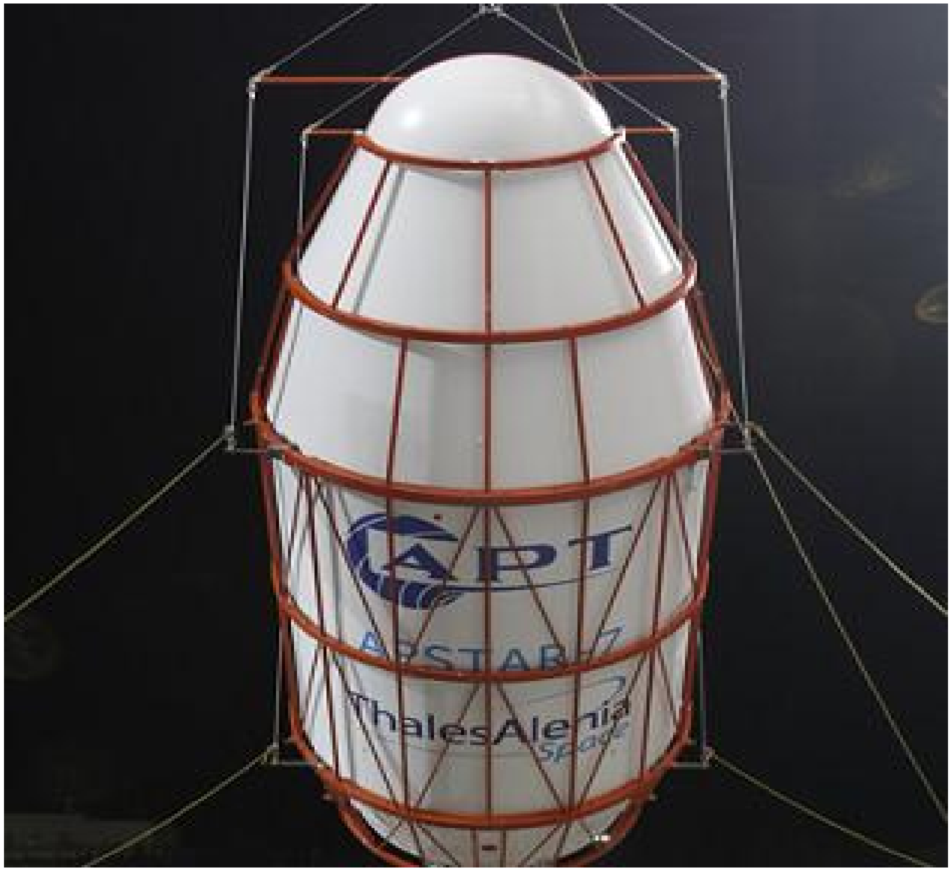
Description

- 1990s: Navy initiates and renews short-term leases of foreign-built cargo ships
  - Navy used 59 month (4.92 years) leases to comply with law
  - Navy used renews, with some of the ships being leased for just short of 10 years
  - Circumvents long-term lease prohibition and upfront funding requirement
- Concerns:
  - <u>American Shipbuilding Association</u>: "Results in de facto purchase of the ships"
    - Traditional procurement more appropriate?
  - <u>Congress</u>: Circumvents law that U.S. military ships be built in American shipyards
    - Officials worried about "dependence" on foreign-built ships, which might weaken domestic industrial base

Short-Term Leasing Also Restricted

- Concerns led to short-term leasing restrictions on vessels:
  - Leasing must be shown to be the more cost-effective option, and
  - there must be a plan for meeting the requirement upon the lease's termination
- These restrictions effectively promote the purchase (as opposed to lease) of new "purpose-built" (as opposed to commercially-acceptable) American-made ships.
  - The Navy began leasing foreign ships because there were "very few commercial ships built in the U.S. with high military utility"
- The Navy may find it increasingly difficult to respond to changes in the operational environment.
  - The foreign-built ships were leased precisely because the required "cost-effectiveness" of lease vs. purchasing and "plan for meeting the future requirement" could not be determined

DoD Leases Chinese Satellite



Some of the commercial satellite capacity used by the DoD is owned by offshore interests. China owns the Apstar 7 satellite used by AFRICOM

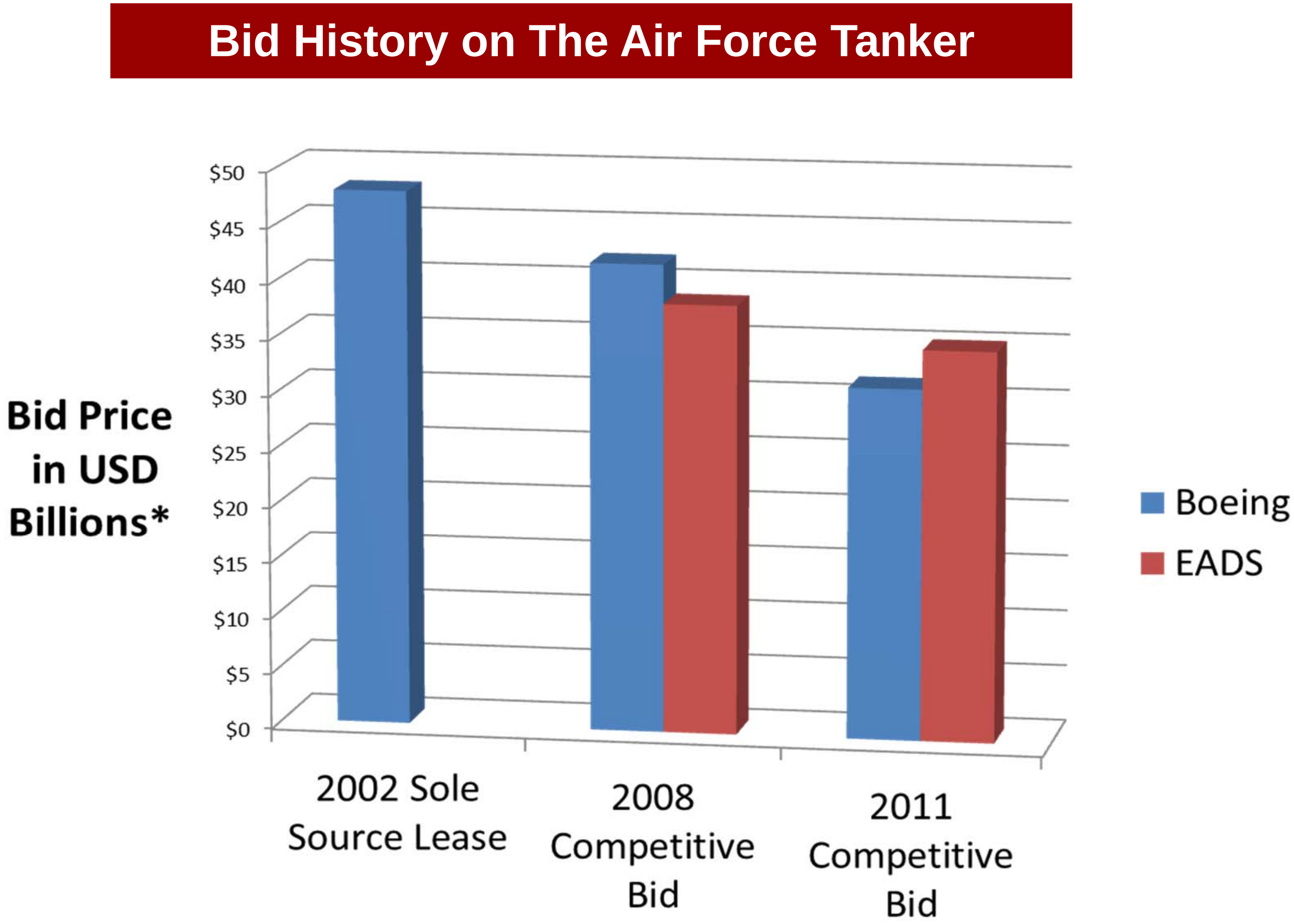
Description

- 2010s: Pentagon leases a Chinese satellite
  - provides urgently needed communications capabilities for Africa Command
- Rationale: The satellite provides superior performance
  - Not easily obtained from other providers (for Africa coverage)
  - Readily available in a time of urgent need
- Concerns: the move "sends a terrible message to our industrial base at a time when it is under extreme stress" (Mike Rodgers, R-MI)
  - Objections of this nature are voiced repeatedly within American defense industrial circles, wasting valuable time and resources

Leasing is Unpopular

- Because of the "loss of control" and the various legislative restrictions, leasing has fallen out of favor with Congress and military officials
- Recent attempts to lease major equipment have done little to improve government's perception
  - In 2001, Congress authorized the Air Force to lease one hundred KC-767 tankers from Boeing for six years starting in 2006
  - However, this agreement was nullified amidst allegations of improper and sole-source dealings between Boeing and Air Force officials
  - So the tankers were put up for competitive bidding

When Considering Leasing, Ensure there is Competitive Pressure



* Bid prices adjusted for escalation, changes in requirements, and aircraft quantities

Public-Private Partnerships – A different approach proves successful

- Within the context of PPPs, leasing is reconceptualized.
  - Traditional notions like “right-to-use” (operating lease) and “rent-to-own” (capital lease) need to be redefined
- PPPs offer advantages
  - privately owned infrastructure, technology, financing, and/or capabilities.
- Often, one entity is responsible for design, construction, and operation,
  - can result in efficiencies (and, thus, savings) that are not possible with traditional “design-bid-build” methods.
- In some types of PPP, capital investment is made by the private sector
  - In other instances, the PPP is funded through tax payer dollars or via a direct user fee.

DoD Leases Military Housing

Private partners own, develop, build, renovate, finance, and maintain military housing across the country via 50-year leases

Description

- Congress established the Military Housing Privatization Initiative (MHPI) in 1996 in the form of a public-private partnership
- MHPI addresses two significant problems concerning housing for military Service members and their families
  - The condition of DoD owned housing was poor
  - There was a shortage of quality, affordable private housing.
- The DoD leveraged private-sector capital, as well as housing industry expertise in construction and management

Outcome

- Result: housing delivered quickly and affordably
- As of 2012, there are 193,000 MHPI units
  - compared with 53,000 government-owned units
- The DoD considers family housing privatization its most important and cost effective effort to improve Service members' quality of life
- Service members' families are happier
- Criticism: The CBO publicly criticized the OMB for granting the DoD the waiver to engage in a long-term capital lease

Advantages to the DoD

- Private partner guarantees price and completion date
  - Eliminates the public sector construction risk
  - Financing and market also become the responsibility of the private partner
- Private partner may be able to achieve savings and efficiencies unavailable to DoD
- Long-term operating and maintenance contracts include performance guarantees
- Fixed lease payments remove uncertainty
  - and facilitate long-term planning.
- Private partner professionals bring experience and capabilities
  - particularly for large complex projects

The U.K. Leases Tankers

A private firm manages and maintains the U.K.'s aerial refueling capability.

Description

- 1990s: The United Kingdom approved a plan to lease aerial refueling capability via a private finance initiative, or PFI
  - With PFIs, the private sector is responsible for designing and building the asset, raising the necessary finance, and then operating a service that uses the asset
- Contract with AirTanker that includes permanent access to nine aircraft—and up to 14 aircraft during times of crisis
  - Deal also includes infrastructure, fuel, maintenance, ground services, cabin crew and sponsored reserve pilots, as well as training, through the year 2035
- AirTanker is able to earn extra revenue by using aircraft for commercial operations when not required by the RAF
  - Additionally, European partners can purchase spare capacity from AirTanker.
- These provisions effectively reduced the cost of the lease

MoD Criticized

- Recently, the National Audit Office published a report criticizing the MoD's approach. According to the report, the key evaluation criterion, "value for money" was measured inappropriately.
  - Competition was limited, requirements never stabilized, and there was limited cost visibility.
  - Moreover, there was no sound evaluation of other procurement approaches.
- Note that none of these criticisms impugns the procurement mechanism (i.e. PFI) so much as the process by which the procurement decision was reached.

In Summary…

- Lease-based PPPs capture private-sector efficiencies in financing, construction, and operation
  - which translate to lower program costs (relative to traditional procurement),
  - allowing the DoD to partially offset the higher cost of typical lease agreements (relative to outright purchase)
  - while gaining the benefit of faster delivery at reduced risk
- Lease-based PPPs should be used when the DoD requires near-term capabilities, short-term affordability, and long-term stability
  - allowing the DoD to avoid upfront costs, preserving funds for other needed programs

Recommendations

1. Given the current budgetary environment, the DoD must reconsider how it acquires needed capabilities quickly, effectively, and affordably
   - Leasing restrictions needlessly constrain program-specific evaluation of these three elements
2. The DoD must pursue the potential cost savings associated with newer, innovative leasing agreements that leverage the relative strengths of the public and private sectors
   - The DoD should eliminate the upfront funding requirement for long-term capital leases
     - Reduce incidence of capital leases "disguised as operating leases," which makes no economic sense

Recommendations (Cont.)

3. The DoD should lift restrictions on short-term vessel leasing
   - allowing the services to take advantage of private-sector equipment and systems to meet operational requirements of indeterminate duration
   - Requirement that short-term lease be more cost-effective than purchase makes little sense

4. The DoD should continue to rely on the global defense industry (via lease or purchase)
   - It is abundantly clear that reliance on foreign sources for production has allowed the DoD to achieve higher performance, while reducing costs and improving deployment times
   - The Government must dismiss parochial objections—i.e. those that do not focus on performance and value
   - The DoD must continue to rely on competition whenever possible
   - The lease of dual-use technologies reduces both upfront costs and long-term costs

Challenges

- The DoD must work to strike a balance between short-term affordability and long-term financial sustainability.
  - "Value for money"—not just "off balance sheet" considerations must guide the initiation of long-term lease agreements.
- There is no agreed-upon method for performing "value for money" calculations.
  - For instance, how does one capture, quantify, and verify the value of the risk that is transferred to the private sector?
- Perception that long-term lease agreements "tie the hands" of future Congresses.
  - Congress is reluctant to engage in multi-year procurements, let alone long-term leases.
    - Structure future lease agreements with appropriate off-ramps