# Successful Development and Privatization of Energy Plants through Enhanced Leasing

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## SUCCESSES AT THE DEPARTMENT OF VETERAN AFFAIRS

In June 2001, Deputy Secretary Dr. Leo Mackay formally dedicated the "Mountain Home Energy Center," Department of Veterans Affair's (VA) first privately financed and operated energy development and operation. The energy center was also a "first" in the federal government in that it was developed and financed with minimal, short-term federal commitments in lieu of the traditional long-term leaseback or energy purchase arrangements. This state-of-the-art cogeneration facility, designed in harmony with the historic Beaux Arts campus architecture at the James H. Quillen VA Medical Center (Mountain Home) in Johnson City, TN, will not only serve the energy needs of the VA Medical Center, it will also produce and sell energy products to the neighboring East Tennessee State University's James H. Quillen College of Medicine, as well as to others in the local community for many years to come.

This arrangement produced immediate and substantial program and financial benefits to the Department, veterans, and to the local community. From a Departmental perspective, it enabled VA to realize more than $16 million in discounted recurring cost savings and more than $26 million in life-cycle (20 years) cost savings from the higher energy efficiencies put into place from the new plant. Further, the local VA Medical Center will also receive a percent of the revenues from energy sales to non-VA customers. Projected revenues from this plant are expected to be in excess of $5 million. Veterans benefited from the arrangement in that the local VA Medical Center plans to use the savings and revenues from this project to fund improvements to its primary care and community-based outpatient clinics. Finally, although the underlying land was still federal property, the energy facility was subject to local taxes and resulted in an increased tax-base for the local community. From a legal and real estate management perspective, the results were equally impressive. VA leveraged over $26 million of financial benefits from a parcel of vacant VA property that was appraised at $300,000. More importantly, other than leasing the site, the Department made no long-term commitments or obligations regarding the purchase of energy products or services. There were no long-term VA purchase guarantees or termination liabilities.

On May 21, 2002, VA used this authority again to close a transaction that provides for the development of a privately financed and operated energy center on the campus of the VA Medical Center in North Chicago, Illinois. This center includes 5 MW of electric generating capacity and 150,000 lb/hr of steam generating capacity which will serve not only the VA Medical Center but also some Navy activities at the Great Lakes Naval Training Center and a neighboring medical school as well. Other third party users will be added as the market allows. This project will yield immediate cost avoidance and savings of $13.6 million in development costs, as well as substantial operational savings (estimated in the area of $800,000 yearly after year two of the operation) and revenues to VA. More importantly it guarantees that the users will obtain needed energy at the most cost-effective rate and on terms that provide future flexibility. The terms for this transaction did not vary significantly from those in the Mountain Home transaction. The new energy center will begin operations in April 2004.

A third energy transaction is (at the time of this writing) underway using this same approach and was scheduled to close August 2002. This project is located on a VA Medical Center that is situated in the Illinois Medical District in Chicago, Illinois. Like its other siblings, this project, when executed, will provide for a privately financed, developed and operated cogeneration plant that will provide electricity, steam and chilled to the VA Medical Center, a VA office building and other potential users in the Medical District. VA will be able to obtain energy upgrades and meet its energy requirements from a state-of-the-art facility without obligating scarce construction funding, while at the same time lowering its operating budget. Projected date to begin operations is June 2004.

The department was able to achieve these benefits through the use of an asset management tool called the "enhanced-use leasing authority" and a unique legal and financing structure specifically developed to implement this legal authority. Using this two-step approach, VA is able to develop and then incorporate a capital asset management program into its strategic mission objectives. This capital asset management program relies upon a central principle that each VA-controlled property must be managed in a manner that promotes or enhances a VA program or mission. Such management may be either by direct VA-use or by its redevelopment by non-VA (public or private) users.

## BACKGROUND

VA, the second largest agency in the federal government in number of employees, has as its unique mission the delivery of comprehensive assistance and benefits to the nation's veterans and their families. VA, through its Veterans Health Administration, is one of the largest direct providers of health care in the world. The Department is also a major land holding agency, with an extensive and diverse portfolio of properties including over 23,000 acres of land and over 4,600 buildings at approximately 270 locations, in addition to over 550 leased spaces nationwide.

To manage its property, VA uses all of the traditional authorities available to federal agencies. However, in many instances these authorities do not adequately address the needs of specific mission or developmental issues. Because of these limitations, exacerbated by on-going budgetary constraints, privatization and income-generation programs have become increasingly important to the Department. In an effort to obtain significant operating cost reductions and pursue alternative funding sources for veterans programs, VA is constantly developing and implementing new programs, such as enhanced-use leasing.

Traditionally, VA properties have been viewed as cost centers. In contrast, the enhanced-use leasing concept was designed to:

- Encourage VA program and facility managers to view VA property holdings as program resources and potential revenue centers;

- Attract other public or private sector investment in VA facilities through broad-based market-based opportunities rather than upon reliance upon current or future federal programs;

- Redirect VA's capital budget program toward facilities that are involved in the delivery of veteran services by encouraging private sector development and operation of non-core functions and uses (e.g., energy production, parking, administrative office space, etc.);

- Enable VA to acquire otherwise unaffordable services or facilities; and

- Allow VA to realign its property holdings to reflect current and projected program requirements.

## WHAT IS ENHANCED-USE LEASING AND WHAT MAKES IT WORK?

Enhanced leasing, otherwise known as enhanced-use leasing within VA and other federal agencies, is a cooperative arrangement for the development of public property under which that property is made available to a public or private entity through a long-term lease. At VA the leased property may be developed for non-VA and/or VA uses, and in return for the lease, the Department obtains fair consideration in the form of revenue, facilities, space, services, money or other consideration.

VA has specific authority to enter into these types of arrangements. Originally enacted in August 1991, the enhanced-use leasing authority is now codified at Section 8161 through Section 8169 of Title 38, United States Code. The technical elements of this authority are:

- The term of an enhanced-use lease may be up to 75 years;
- The site to be leased must be controlled by the Secretary;
- All uses must be consistent with and not adversely affect the Department's mission;
- VA may use "minor" construction funds (up to $4 million) as a capital contribution in connection with an enhanced-use lease;
- VA may purchase services, space or facilities in connection with the lease;
- VA must hold a public hearing at the location of any proposed enhanced-use lease to obtain veteran and local community input;
- VA must provide two notices to its congressional oversight committees prior to entering into an enhanced-use lease.

One of the major elements of VA's enhanced-use leasing authority is that unlike traditional federal leasing authorities in which generated proceeds must deposited into a general treasury account, the enhanced-use leasing authority provides that all proceeds (less any costs that can be reimbursed) are returned to medical care appropriations. The ability to keep proceeds creates an economic incentive for VA and its property managers to fully utilize their existing capital assets and to begin to view these assets as potential resources to fund needed programs or facility requirements.

To underscore Congress' intent to provide VA with sufficient latitude to undertake and practice asset management, the statute addresses several key legal issues critical to successful public/private transactions by:

- Providing the Department with the ability to enter into long-term agreements so as to enable amortization of private sector capital investments;
- Clarifying the ability of the Department to undertake this authority from the myriad of other substantive and procedural laws relating to government procurement, management and disposal of property or services;
- Enabling the Department to enter into these agreements in a timely fashion to address market demands;
- Providing the Department with the flexibility to address a broad spectrum of market and financial conditions to address specific project requirements so long as the activity was within established statutory requirements and Department mission.

In addition, close coordination with and reliance upon the local government and community as full partners in the development process is a key element of project success.

While the enhanced-use leasing authority provides that any development on VA property can be based on VA building and development standards in lieu of local requirements, the Department has used this authority very cautiously. There are two reasons for this caution.

First, to maximize project efficiencies and minimize development costs, the Department relies, to the greatest extent possible, upon local building codes, safety requirements, construction standards and local government inspection services as they pertain to any non-VA development. If the project involves direct VA control over the management and operation of a facility or if VA occupies a significant portion of the enhanced-use development, the project is considered in the context of applicable VA standards. In such instances, VA requirements are reviewed in the context of how such standards integrate with applicable local codes and standards.

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

For energy projects, this means that, notwithstanding that federal property is involved, the project will likely be subject to the same or similar state and local environmental and development requirements that would be otherwise applicable if the project occurred on non-federal lands. However, the flexibility to use federal or local development standards does provide opportunity to negotiate project development issues including site development, building and safety code compliance, and building codes. As such, the agency must assume a leadership role in coordinating and negotiating with applicable state and local authorities. The energy developer/provider serves a critical supporting role by furnishing the necessary project development information and taking an active role in establishing relationships with the applicable local authorities. Environmental issues such as obtaining state and federal permits as well as dealing with hazardous materials are strictly complied with and incorporated into the project planning process.

The last "piece of the puzzle" for a successful project is developing a "project structure" that enables the project to secure private financing yet comply with the strict federal budgetary and fiscal rules governing capital leasing and long-term federal commitments. Federal fiscal policy directs that if a VA project is solely or substantially based on the public funding to accomplish predominately public sector capital objectives, the venture should be treated as a "public venture" and that project be accomplished through federally appropriated funds rather than by private financing. This result, of course, frustrates the very reason for public/private ventures such as the enhanced-use-leasing program. Further, because the project by definition involves federal property, VA cannot subordinate the fee title to the property. While there is no single "magic bullet" that addresses the federal fiscal policy mandates, the legal and financial structures developed for the VA energy projects have not only complied with these strict federal fiscal policy requirements they have also successfully secured low-cost, private financing. These elements include securing the participation of an investment grade energy developer/provider, avoiding long-term federal commitments, and crafting contractual protections to the financing source that are comparable to those in the private sector. Great care must be exercised in structuring these types of transactions. Recent experiences by other federal agencies indicate that federal fiscal rules will be strictly interpreted for compliance. This year, $300 million were scored against the budget authority of the Tennessee Valley Authority (TVA) by the Office of Management and Budget (OMB) on the basis that lease payments TVA is making, under a complex leasing transaction involving a natural gas plant in western Tennessee, are obligations that should be treated as a capital debt under the above-mentioned fiscal rules.

It should be noted that the energy projects developed for VA have secured OMB's review and approval as being in compliance with federal fiscal policy.

## WHAT TYPES OF PROJECTS HAVE WORKED AT VA?

Obviously sound development economics are the foundation of enhanced-use projects. But some factors within VA's control can contribute to the likelihood of success. Enhanced-use leasing works best when government requirements can be defined in private sector terms. Energy plants are excellent examples. VA's objective in this transaction is simply to secure a reliable source of energy for its requirements. This allows the private sector to design, construct and operate the facility in its customary manner. VA then benefits from the efficiencies of organization and delivery processes that have been honed over time by the developer/lessee. VA can also improve the value of its projects by working to reduce project uncertainties, private sector risk and the cost of borrowing capital. This can be achieved through a variety of means such as use of local building codes, VA participation in entitlement discussions with local authorities, or addressing the concerns of potential financing sources early in the development process.

In addition to the energy plants, VA has successfully completed a number of other projects, including office buildings, research facilities, medical space, senior living residential facilities, medical facilities, child development centers, elder day care centers, single room occupancy housing (homeless shelters), and management and operation of VA golf courses.

## WHO MAY BENEFIT FROM ENHANCED-LEASING?

While VA has been at the forefront of successfully developing and implementing its enhanced-use leasing authority, it is not the only entity with the ability to take advantage of the benefits of enhanced-use leasing. Several other federal departments are seeking similar authority, and others have been granted such authority recently. The enhanced leasing concept provides public agencies (federal, state, municipal, and local), not-for-profit entities, universities and colleges (domestic and foreign), and others the ability to utilize the value in their existing capital assets to secure consideration in the form of cash, or construction and management benefits without the need to totally divest themselves of the asset—and to successfully secure the necessary financing.

## LESSONS LEARNED

In implementing its enhanced-use leasing authority VA has discovered several key points to developing a successful public/private development program. The single most important is the enabling statute itself. This authority must provide sufficient flexibility to allow the agency to be innovative in its approach to secure private investment into its facilities. While preserving the integrity of governmental processes, that public agency's implementation procedures must be tempered to be responsive to the broad span of market, environmental, political, and legal issues that arise in the development of federal property. The agency officials involved in the process must be committed to the effort's success and, while attempting to be responsive to the legitimate demands of the private sector, they must remain committed to structuring each transaction in a manner that will not obligate future appropriations and federal programs. To accomplish this objective, the agency must participate fully as an equal partner with the developer/lessee in a project's development, financing and local community review. Finally securing a qualified and experienced team of professionals in structuring and developing the project is necessary to address the multitude of legal, fiscal, and program issues that arise from such development. Successful implementation is dependent not only on a strong agency commitment but also on securing a strong development team that not only has the management and financial resources to execute the project but also has the necessary experience in, and understanding of, the fundamental issues, disciplines and responsibilities involved in project development on federal property.

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ABOUT THE AUTHORS

**Michael R. Simmons**, is a partner in Patton Boggs' privatization practice where he structures complex financial transactions, supporting innovative, public-private venture/asset management programs, focusing his efforts on loan and real estate privatization. Prior to joining the firm, Mr. Simmons was with the Department of Veterans Affairs (VA), Office of General Counsel, privatization programs. There he served as the

principal architect and author, of the VA's "enhanced-use leasing" program—an innovative program in which under-utilized real estate is privatized through leases, to private entities in exchange for cash, improved space, goods or services. Mr. Simmons was responsible for developing and implementing a unique and innovative financing structure, adopted by VA for all of its projects where the VA retains considerable involvement with the privatized activity. He also structured all complex financial transactions, such as financing the projects through public bond offerings, traditional construction and take-out lending. This structure was so successful that Mr. Simmons was awarded the National Performance Review Award in 1995, 1999 and 2000. In the years since Mr. Simmons' involvement with the program, over $300 million in private investment has been successfully placed in VA facilities and properties. Mr. Simmons may be reached at msimmons@pattonboggs.com.

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**Bob Eidson** is currently the federal business director for Energy Systems Group LLC, of Evansville, IN, where he leads a sales and technical staff in pursuit of energy development and performance contracting projects with various federal customers. ESG is the only energy service company, which has successfully privatized the development, operation and maintenance of energy facilities and energy infrastructure, on federal property, through innovative and low risk financing and ownership business models. ESG is also one of DOE's Biomass and Alternative Methane Fuel (BAMF) Super Energy Savings Performance Contractors.