GAO

Report to the Subcommittee on Military Construction, Committee on Appropriations, House of Representatives

June 2002

MILITARY HOUSING

Management Improvements Needed As the Pace of Privatization Quickens

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GAO-02-624

United States General Accounting Office June 2002

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Highlights

MILITARY HOUSING
Management Improvements Needed As Privatization Pace Quickens

Highlights of GAO-02-624, a report to the Subcommittee on Military Construction, House Committee on Appropriations

Why GAO Did This Study

Renovating or replacing 168,000 inadequate military family housing units using traditional military construction methods would take over 20 years and cost about $16 billion. In 1996, to improve housing faster and more economically, Congress authorized the Military Housing Privatization Initiative to allow private-sector financing, ownership, operation, and maintenance of military housing.

At the request of the Subcommittee on Military Construction, House Committee on Appropriations, GAO examined the reliability of military housing needs assessments, as well as achievement of privatization financial goals and government protections in contract provisions.

What GAO Recommends

GAO recommends that DOD use a broader range of factors in defining its military housing requirements, modify its guidance for performing life-cycle cost analyses, and implement several changes to enhance government protections in the privatization program.

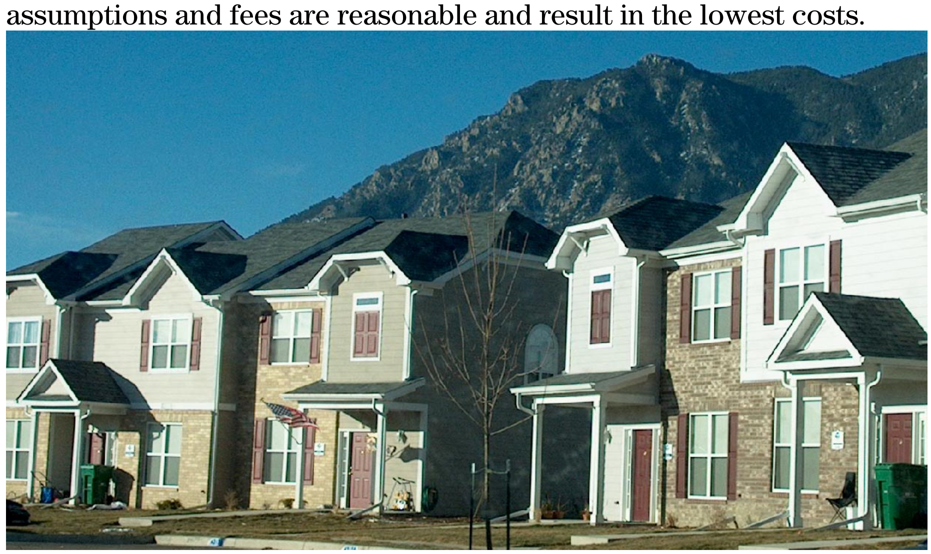
In commenting on a draft of this report, DOD generally agreed with the recommendations and outlined ongoing or planned management actions to address the concerns noted in the report.

What GAO Found

Privatization projects are not supported by reliable needs assessments, and the overall requirement for military housing is not well-defined. With uncertain requirements, the military may be entering into long-term privatization contracts to construct, replace, or renovate housing that may not be needed.

DOD exceeded its overall goal for leveraging government funds with private-sector financing. By investing about $185 million in the first 10 awarded projects, DOD should obtain housing improvements that would have required about $1.19 billion in military construction funds without private-sector contributions. However, it is not clear whether DOD will achieve its goal that each project's life-cycle costs be the same or less than that of an equivalent military construction project. Use of DOD guidance for performing the analyses shows that each of the first 10 projects will cost less. However, these results might not be reliable, because weaknesses in the methodology outlined in the guidance can make the privatization option appear more favorable than is justified.

Moreover, steps need to be taken to further protect the government's interests. In seven projects, developers will receive about $369 million more in profits and fees than anticipated because the contracts did not fully anticipate increases in servicemember housing allowances, which are used to pay rent in privatized housing. Furthermore, the department appears to have limited oversight of future project spending decisions. This could lead to unnecessary or inappropriate project spending. GAO also found no department guidance for contract assumptions and fees for services paid to developers. As a result, it is unclear whether contract assumptions and fees are reasonable and result in the lowest costs.



Newly constructed military family housing at Fort Carson, Colorado. A private developer was contracted to renovate 1,823 existing units, construct 840 new housing units on base, and own, operate, and maintain all 2,663 units for 50 years.

This is a test for developing Highlights for a GAO report. The full report, including GAO's objectives, scope, methodology, and analysis is available at www.gao.gov. For additional information about the report, call Carol Schuster at (202) 512-4013. To provide comments on this test *Highlights*, call Keith Fultz at (202) 512-3200 or send an email to HighlightsTest@gao.gov.

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Abbreviations

DOD	Department of Defense
GAO	General Accounting Office

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Accountability * Integrity * Reliability
United States General Accounting Office
Washington, DC 20548

June 21, 2002

The Honorable David L. Hobson
Chairman
The Honorable John W. Olver
Ranking Minority Member
Subcommittee on Military Construction
Committee on Appropriations
House of Representatives

The Department of Defense (DOD) estimates that about 168,000 military family housing units are inadequate, lacking modern amenities, and in need of major renovation or replacement. According to DOD, completing this work using traditional military construction methods would take more than 20 years and cost about $16 billion. To improve housing faster and more economically than could be achieved if only traditional military construction funds were used, the Congress, at DOD's request, enacted legislation in 1996 to authorize the Military Housing Privatization Initiative.[1] This program allows private-sector financing, ownership, operation, and maintenance of military housing.[2] Under the program, the department can provide direct loans, loan guarantees, and other incentives to encourage private developers to construct and operate housing either on or off military installations. Servicemembers, in turn, may use their housing allowance to pay rent and utilities to live in the privatized housing. Department financial goals for the program state that (1) government funds should be leveraged with private sector investment to obtain at least three dollars in military housing improvements for each dollar that the

[1]This report does not include two Navy projects (589 total units at three locations: Corpus Christi and Kingsville, Texas, and Everett, Washington) approved under a prior legislative authority which gave only the Navy authority to test the use of limited partnerships in order to meet the housing requirements of naval personnel and their dependents (see section 2803 of Public Law 103-337). The authority to use limited partnerships is now available to all services under the 1996 law establishing the privatization initiative. The Kingsville and Everett privatization projects mentioned throughout the remainder of this report refer to separate projects that were subsequently approved under the privatization initiative.

[2]The National Defense Authorization Act for Fiscal Year 1996 (P.L. 104-106, 110 Stat 186). This legislation also provides authority to facilitate private sector financing, ownership, operation and maintenance of unaccompanied housing, commonly referred to as barracks. However, due to the services' mandatory assignment policies for single junior enlisted personnel and the lack of funds to pay housing allowances for these servicemembers, DOD has not undertaken any privatization projects for unaccompanied housing. Thus, this report focuses on DOD's use of privatization to improve family housing.

government invests, and (2) the government's estimated total costs for a privatization project should be equal to or less than the total costs for the same project financed by military construction funding. The services perform a project life-cycle cost analysis to estimate and compare these costs prior to solicitation as part of a project's approval process.

In response to your request, this report addresses the following questions: (1) Are privatization projects based on reliable assessments of housing requirements? (2) Is DOD achieving its financial goals for the privatization program? (3) Do DOD's privatization contracts protect the government's interests? In addition, as requested, we address the differences between the Office of Management and Budget and the Congressional Budget Office over budgetary scoring for the privatization program (see app. I).

Our analysis included site visits, reviews of DOD data, and consultations with military and civilian officials. A more detailed description of our scope and methodology is included in appendix II.

Results in Brief

Although DOD has awarded contracts to construct or improve about 16,000 units and has plans to privatize an additional 96,000 units by the end of fiscal year 2006, privatization projects are not supported by reliable or consistent needs assessments, and the overall requirement for military family housing is not well-defined. Accurate requirements determinations can help DOD to construct and maintain government housing, whether privatized or not, only at installations where the local communities cannot meet the military's family housing needs. Yet, DOD has failed to fix this longstanding problem. Our current and past work, as well as the work of others, including the DOD inspector general, has shown that the services use inconsistent methodologies to determine the availability of private-sector housing for military families in communities surrounding military installations, and these methodologies often underestimate the ability of the private sector to meet housing needs. As a result, the requirement for government housing is often overstated. Further, although an initiative to increase housing allowances should make community housing more affordable and reduce the need for government housing, DOD has not analyzed on an installation basis the potential impact of this initiative on military housing requirements. Finally, contrary to DOD's stated policy of relying on community housing, a disparity exists between on-base and off-base housing standards that creates an incentive for servicemembers in lower enlisted pay grades and with larger families to seek government housing rather than community housing. DOD has not assessed the effect of these different standards on housing requirements or the merits of a program that would adjust housing allowances according to family size. With its housing requirements uncertain, the department may be entering into long-term privatization contracts to construct additional housing or replace or renovate existing inadequate military housing that may not be needed.

The department has generally achieved two key financial goals for the privatization program—leveraging of government funds and lower project life-cycle costs. First, DOD exceeded its overall goal for leveraging government funds with private-sector financing in the first 10 privatization projects awarded under the military housing privatization initiative.[3] In the aggregate, by investing about $185 million in the 10 projects, DOD should obtain housing improvements that would have required about $1.19 billion in military construction funds had only government funds been used. This is a leveraging ratio of 6.4 to 1. On an individual project basis, only 1 of the first 10 projects did not achieve DOD's leveraging goal of at least 3 to 1. Second, it is not clear whether DOD will achieve its goal that each project's life-cycle costs be the same or less than that of an equivalent military construction project. Use of DOD guidance for performing life-cycle cost analyses shows that each of the first 10 privatization projects will cost less than the equivalent military construction projects.[4] However, this guidance can make the privatization option appear more favorable than justified because it does not expressly state that government contract oversight costs should be included and uses methods that can result in overstated operation and maintenance costs for the military construction option. On the other hand, DOD officials pointed out that the guidance also excludes other costs that can make the military construction option appear more favorable than justified. Changes in the guidance could improve the accuracy and reliability of life-cycle cost analyses and provide for more informed decisions on future privatization proposals.

While DOD has included provisions designed to protect the government's interests against adverse events, we found some areas where DOD could further enhance protections to the government. First, some contracts did not fully anticipate the increased rent that will be paid to project developers as a result of a DOD initiative to increase housing allowances

[3]Appendix III contains a description of the first 10 privatization projects.

[4]See *Memorandum for House Privatization Points of Contact, Subject: Final Housing Privatization Life Cycle Cost Policy*, Office of the Under Secretary of Defense (Feb. 11, 2002).

for servicemembers. As a result, project revenue may increase by about $1.3 billion over the life (up to 50 years) of seven projects, and developers may receive $369 million more in profits and fees than DOD anticipated. On a cumulative basis, most of the additional rental revenue is not expected to go to the developers. Second, although military installation officials will participate with developers in making project improvement decisions valued at about $3.9 billion over contract terms of nine projects, DOD and service headquarters oversight of these decisions appears limited. A lack of oversight could lead to unnecessary or inappropriate spending on project improvements. Third, we found wide variation in the privatization contracts regarding assumptions and fees for services paid to developers. As a result, it is unclear whether DOD is minimizing its costs. Finally, although DOD has developed a semi-annual report to help it monitor and evaluate financial and management data and assess the performance of individual projects, the reports have not been completed in a timely manner, do not include all relevant information, and are not subject to independent verification.

We are recommending that DOD revise its housing requirements determination process by taking into account greater use of community housing to fulfill housing needs and the potential impact of the housing allowance initiative on military housing requirements. We are also recommending that DOD improve privatization implementation by modifying its guidance for performing life-cycle cost analyses and making several changes to enhance government protections in the program. In comments on a draft of this report, the department generally agreed with the report's findings and recommendations and outlined management actions to address the concerns noted in the report. The department also provided technical clarifications, which we incorporated as appropriate.

Background

DOD plans to spend over $11 billion in fiscal year 2002 to provide housing for families of active-duty military personnel. DOD's policy is to rely on the housing in local communities near military installations as the primary source of family housing. About two-thirds of all military families in the United States live in community housing and receive a cash housing allowance to help defray the cost of renting or purchasing a home. Until 2001, the housing allowance covered an average of 81 percent of the typical housing costs, and servicemembers paid the rest out of pocket. The remaining military families live in government-owned or privatized housing. These families pay no out-of-pocket costs for housing or utilities. Families in government housing receive no housing allowance, while families in privatized housing use their housing allowance to pay rent and normal utility costs. DOD plans to eliminate this inequity in out-of-pocket costs between servicemembers who live in local community housing and those who live in government-owned or privatized housing. An initiative started in 2001 is intended to increase housing allowances and reduce average out-of-pocket costs to zero by 2005.[5] As a result, more existing local community housing will be affordable to military families, families already living in local community housing should be better able to cover their housing costs, and developers of privatized housing will receive higher rents.

According to DOD, the quality of government-owned housing has declined for more than 30 years, primarily because maintaining the housing was not a priority. Concerned that poor-quality housing could cause servicemembers to leave the military, DOD proposed a privatization initiative aimed at solving its housing problem faster and more economically by taking advantage of the private sector's investment capital and housing construction expertise. The resulting Military Housing Privatization Initiative, enacted in 1996, authorized DOD to enter into a variety of arrangements with private-sector entities to build and renovate military housing both on and off military bases. With private-sector investment, DOD planned to obtain at least three dollars in military housing improvements for each dollar that the government invested, thereby reducing the amount of government funds initially required to revitalize housing and accelerating the elimination of inadequate housing. DOD's Competitive Sourcing and Privatization Office, which reports to the Deputy Under Secretary of Defense (Installations and Environment), provides oversight of this program, but the primary responsibility for implementing it rests with the individual services.

Although implementation of the privatization program started slowly, DOD has picked up the pace and plans to use the program as the primary means to meet a revised goal of eliminating inadequate military family housing by 2007, instead of the original goal of 2010. Also, to bring additional attention and priority to achieving this goal, the Bush administration has increased emphasis on the program by making privatization of military housing 1 of 14 key initiatives for improving government management and

[5]For 2002, servicemembers' average out-of-pocket share is 11 percent of typical housing and utility costs in each geographic area of the country. DOD's plans call for additional increases in the housing allowance so that the average out-of-pocket share falls to 8 percent in 2003, 4 percent in 2004, and to zero in 2005.

performance. Appendix IV includes details about DOD's privatization implementation status and plans.

Since 1998, we have issued three reports on DOD's military housing program—two about the military housing privatization initiative and one about DOD's process for determining military housing requirements. In July 1998, we reported several concerns. These included (1) whether privatization would result in significant cost savings and whether the long contract terms of many projects might result in building housing that will not be needed in the future, (2) whether controls were adequate to protect the government's interests in the event developers might not operate and maintain the housing as expected, and (3) whether DOD would face certain problems if privatized housing units were not fully used by military members and were subsequently rented to civilians, as the contracts permit.[6] In March 2000, we reported that initial implementation progress was slow, the services' life-cycle cost analyses provided inaccurate cost comparisons because DOD had not issued standardized guidance for preparing the analyses, and DOD lacked a plan for evaluating the effectiveness of the program.[7] Subsequently, DOD implemented several key recommendations, such as issuing life-cycle cost analysis guidance and developing a privatization program evaluation plan. In an August 2001 report, we noted that despite earlier recommendations, DOD had not implemented a standard process for determining military housing requirements.[8] In that report, we pointed out that the initiative to increase housing allowances heightened the urgency for a consistent process, because the initiative could lessen the demand for military housing by making housing in local communities more affordable. This effect is possible because personnel surveys have consistently shown that military personnel would prefer to live in surrounding communities rather than in military housing if they did not incur additional out-of-pocket costs.

[6]For example, if civilians rented privatized housing units on base, would security concerns be increased at some installations and would the government be required to pay education impact aid to the community for each civilian child? See U.S. General Accounting Office, *Military Housing: Privatization Off to a Slow Start and Continued Management Attention Needed*, GAO/NSIAD-98-178 (Washington, D.C.: July 17, 1998).

[7]U.S. General Accounting Office, *Military Housing: Continued Concerns in Implementing the Privatization Initiative*, GAO/NSIAD-00-71 (Washington, D.C.: Mar. 30, 2000).

[8]U.S. General Accounting Office, *Military Housing: DOD Needs to Address Long-Standing Requirements Determination Problems*, GAO-01-889 (Washington, D.C.: Aug. 3, 2001).

Military Family Housing Requirements Assessments Are Unreliable

Fundamental to the success of DOD's housing program is a process that consistently and accurately determines the services' housing needs and the ability of the local community to meet those needs at each installation. Accurate requirements determinations can help DOD to construct and maintain government housing, whether privatized or not, only at installations where the local communities cannot meet the military's family housing needs, as specified by DOD policy. Yet, DOD has failed to fix this longstanding problem. Our current and past work, as well as the work of others, including the DOD inspector general, has shown that the services use inconsistent methodologies to determine the availability of community housing and often overstate the amount of housing DOD should provide. Complicating the task of determining housing requirements is the uncertainty about future demand for government-provided housing caused by the initiative to increase housing allowances. Moreover, DOD housing standards for servicemembers differ—depending on whether they live in government-owned or privatized housing or in community housing—and may be boosting the demand and requirements for government-owned or privatized housing, which is inconsistent with DOD's stated policy of relying to the maximum extent on community housing.

Services Use Inconsistent Methods to Determine Housing Requirements

The DOD Housing Management Manual 4165.63M states that a housing market analysis should be performed at installations where acquisition of housing is programmed. This market analysis should help to determine military housing needs and the ability of the local communities to meet those needs. Each analysis normally includes a detailed estimate of the installation's housing requirements, taking into account servicemembers' pay grades and bedroom needs relative to family size. The services compare these military family housing requirements with the inventory of government-owned housing units and with the estimated number of available community housing units that meet the military's criteria for suitability and affordability.[9] The process is intended to predict whether an installation will have a housing surplus or deficit in the near future. Predicted deficits can form the basis for justifying a privatization project to construct new—or replace or renovate existing—military housing.

[9]To be considered suitable by DOD's criteria, a dwelling must be located within a 1-hour commute of the installation, meet minimum net square-footage requirements, be well maintained, and pose no health, safety, or fire hazard. The criteria for affordability considers a dwelling's rental cost in comparison with the servicemember's housing allowance.

Predicted surpluses can indicate a need to close government-owned units when they are no longer useful.

As we have reported since 1996, the services use inconsistent methodologies to determine the availability of private-sector housing for military families in communities surrounding military installations, and these methodologies often underestimate the ability of the private sector to meet housing needs. As a result, the requirement for government housing is often overstated. For example, the housing market analyses for some installations first matched military family housing requirements with existing government housing units before considering community-housing units. In other cases, the analyses required a minimum number of government housing units regardless of the community's ability to meet needs. These procedures are inconsistent with DOD's policy of relying first on community housing and can lead to unjustified support for retaining government-owned housing units. Another problem is that some of the services' analyses assumed that only small portions—in some cases less than 12 percent—of a community's vacant rental units were available for military families to occupy. As a result, the analyses underestimated community housing availability because they excluded from consideration hundreds of suitable vacant units.

Without a reliable, consistent process for determining military family housing requirements, DOD cannot know with assurance how many housing units it needs, where it needs them, whether its housing investment decisions are justified, and whether its overall housing costs are minimized. Constructing and maintaining military family housing, whether financed through military construction funding or privatization, costs more than paying housing allowances and relying on local community housing. Past studies have reported that DOD annually saves from $3,200 to more than $5,000 per family by providing a housing allowance instead of using military construction funds to build and maintain a government-owned house.[10] Even when compared to privatization financing, providing housing allowances and relying on community housing is less expensive. We compared the life-cycle costs of the first 10 privatization projects using DOD's life-cycle guidance with

[10]See Congressional Budget Office, *Military Family Housing in the United States*, (Washington, D.C.: Sept. 1993); U.S. General Accounting Office, *Military Family Housing: Opportunities Exist to Reduce Costs and Mitigate Inequities*, GAO/NSIAD-96-203 (Washington, D.C.: Sept. 13, 1996); and RAND, *An Evaluation of Housing Options for Military Families*, MR-1020-OSD (1999).

housing allowance costs, assuming all servicemembers included in the projects could have lived in the local communities. The analysis showed that reliance on community housing would cost about $315 million, or 6 percent, less than privatization. This is not to say that the local communities could have met the housing needs included in these 10 privatization projects, nor that suitable community housing within reasonable commuting distances is available at all locations. But costs can only be minimized through accurate analyses of housing requirements and aggressive application of DOD's policy of relying on community housing.

DOD agrees that it needs a framework for a single, consistent process for determining housing requirements that relies first on civilian community housing. DOD housing officials stated that they have been developing a new process that should be finalized this year. However, even after the new process is in place, the officials stated that it will take years to update housing requirements DOD-wide, because new housing market analyses must be performed base by base. In the meantime, DOD risks investing in privatization projects to build or improve housing that may not be needed. Also, notwithstanding DOD's plans for finalizing a new process by the end of 2002, DOD has reported such plans for several years and each time failed to reach a consensus with the services on a new requirements determination process.

Impact of Housing Allowances Initiative on Requirements Not Fully Assessed

The initiative to increase servicemember housing allowances and reduce their average out-of-pocket costs to zero by 2005 will have a significant impact on the military housing program. First, increased allowances should result in an increased number of community housing units that are affordable to servicemembers. This should decrease the requirement for government-owned or privatized houses by making housing in local communities more affordable. Second, over time, increased allowances could result in private housing developers building new housing near military installations as developers see opportunities to profit from renting to servicemembers at market rates. This would increase the supply of community housing available to military families and could decrease the requirement for government-owned or privatized housing. Third, increased allowances should allow DOD to better satisfy the preferences of most servicemembers to live off base and result in reduced demand for government housing. We previously reported that, based on the results of DOD's 1999 Survey of Active Duty Personnel, military members prefer civilian housing if costs are equal. Of those currently receiving a housing allowance or living in military housing, about 72 percent said they would prefer community housing if costs were equal, while 28 percent said they would prefer military housing.[11] In 1999, RAND reported that only about 20 percent of military members prefer military housing, and that the predominant reason servicemembers live in military housing is that they do not need to pay any money out of pocket, as they would if they lived in the local community.[12] Although some families may still elect to live in military housing, by 2005 the allowance initiative should eliminate the economic incentive to do so by eliminating the need for those living in the local community to pay money out of pocket for their housing.

Despite these significant impacts of the allowance initiative, DOD has not conducted detailed studies and analyses on an installation basis to determine how the initiative will affect the requirement for government-owned or privatized housing. Thus, DOD plans call for replacing or renovating most of its existing housing inventory by 2007, even though some of this housing may not be needed after community housing becomes more affordable for military families. Further, if increased allowances result in servicemembers' reduced use of privatized housing located on base, surplus housing could be rented to civilians, thereby raising concerns about civilians living on military installations.

Differences in Housing Standards Inflate Demand for Military Family Housing

The difference in DOD's housing standards for servicemembers living in government-owned or privatized housing and for those living in community housing inflates the demand for military family housing. DOD considers family size when determining military housing requirements and assigning servicemembers to government housing, but ignores family size when determining housing allowances for servicemembers living in local communities. As a result, many servicemembers are entitled to a larger residence in government or privatized housing than they are able to afford in the local community.

DOD's current standards for community housing were determined in 1998, when it developed a new method for establishing housing allowances. Under this method, servicemembers' housing allowances are based on the costs of housing typically occupied by civilians with comparable incomes. To determine allowances, DOD identified six housing standards, ranging from a one-bedroom apartment to a four-bedroom single-family detached

[11] U.S. General Accounting Office, *Military Personnel: Higher Allowances Should Increase Use of Civilian Housing, but Not Retention*, GAO-01-684 (Washington, D.C.: May 31, 2001).

[12] RAND (MR-1020-OSD, 1999).

house. DOD then associated, or anchored, those standards to each military rank, or pay grade, matching them to the type of housing normally occupied by civilians with comparable incomes. The housing allowances do not vary by family size. For example, the housing allowance for a married servicemember in a lower enlisted pay grade is roughly equivalent to the cost of renting a two-bedroom apartment or a two-bedroom townhouse in the local community. The allowance is the same regardless of the number of people in the servicemember's family.

In contrast, DOD standards for servicemembers living in government or privatized housing consider family size and often provide for larger housing units. First, the services do not have typical apartment units on-base. Government housing units normally consist of townhouses, duplexes, and single-family units. Second, the services generally assign servicemembers with more dependents to housing units with more bedrooms. For example, a married junior enlisted member in pay grade E-4 with two children typically would be assigned to a three-bedroom townhouse or single-family detached house. However, if this same servicemember lived in community housing, the housing allowance would only cover the cost of a typical two-bedroom apartment or townhouse.

The disparity in housing standards creates an incentive for servicemembers in lower pay grades and with larger families to seek government housing. This is because the servicemember can secure a larger home for his or her family in government or privatized housing without having to pay any out-of-pocket costs, as the servicemember would be required to do to secure comparable housing in the community. This situation creates demand for government housing that might not exist were it not for this incentive. The standards disparity can also result in increased government housing requirements because the services' housing market analyses consider family size, and, as a result, fewer housing units in the local community are considered affordable. Eliminating the standards disparity could result in reduced demand for government housing and increased reliance on local community housing. For example, if housing allowances for junior personnel increased with family size, more community housing with three or more bedrooms would become affordable. Thus far, DOD has not studied the benefits and costs of options to address the standards disparity.

Key Financial Goals Generally Achieved

DOD has generally achieved two key financial goals—leveraging of government funds and lower life-cycle costs—for the privatization program. DOD exceeded its overall goal for leveraging government funds with private-sector financing in the first 10 privatization projects, based on Office of Management and Budget's guidance. However, it is not clear whether DOD will achieve its goal that each project's life-cycle costs be the same or less than the military construction alternative. Although use of DOD's guidance for performing life-cycle cost analyses shows that each of the first 10 privatization projects most likely will cost less than an equivalent military construction project, use of the guidance causes some uncertainty in the accuracy of these estimates. Furthermore, project leveraging ratio calculations and estimated life-cycle costs do not include the value of some government contributions to privatization projects because certain contributions are not required to be included in these analyses. Thus, the value of many DOD contributions to privatization projects was not apparent during our review of these program assessment tools.

Most Projects Exceed Goal for Leveraging Government Funds, Based on the Office of Management and Budget's Guidance

According to DOD, a key advantage of privatization is the ability to leverage available government funds with private-sector financing to improve military housing faster than would otherwise be possible. DOD incurs certain costs to secure each privatization project, such as making cash contributions, loans, or loan guarantees. DOD's goal is for each project to result in at least three times as much housing improvement as government funds alone would have produced. In leveraging government funds by a minimum ratio of 3 to 1, DOD officials state that the military can revitalize three times as many housing units as it could with a military construction project for the same initial amount of money, thus solving the housing problem three times faster.

The leveraging ratio is calculated by dividing the estimated cost of an equivalent military construction project by the privatization project's budgetary scored amount—defined as the amount of appropriated funds the Office of Management and Budget determines should be recorded as an obligation at contract award. As shown in table 1, all but 1 (Everett) of the first 10 privatization projects exceeded DOD's 3-to-1 leveraging goal, based on Office of Management and Budget's guidance. In aggregate, by investing about $185 million in the 10 projects, DOD should obtain housing improvements that would have required about $1.19 billion in military construction funds had only government funds been used. This is a leveraging ratio of 6.4 to 1. As discussed in appendix I, the Congressional Budget Office estimated higher budgetary scoring amounts than the Office of Management and Budget, which would have affected whether the projects would have achieved the leveraging goal.

Table 1: Leveraging Ratios for the First 10 Projects

Dollars in millions

Project	Military construction alternative cost	Budgetary scored amount	Leveraging ratio
Fort Carson	$196.9	$10.2	19.3
Fort Hood	273.5	52.0	5.3
Lackland	50.0	6.2	8.1
Robins	50.1	12.6	4.0
Dyess	50.3	16.3	3.1
Elmendorf	135.3	23.4	5.8
Kingsville	20.4	6.2	3.3
Everett	47.8	17.5	2.7
Camp Pendleton	87.3	19.4	4.5
San Diego	274.5	20.9	13.1
Total	**$1,186.1**	**$184.7**	**6.4**

Source: GAO analysis of DOD cost data.

The overall average leveraging ratio of 6.4 achieved in the first 10 projects would have been closer to 3.9 had the budgetary scored amounts included the government's costs to pay utilities for military families occupying privatized housing at DOD's first two projects, at Fort Carson and at Lackland Air Force Base. Normally, the Office of Management and Budget would have included the government's estimated utility costs over the life of the 50-year contracts as part of each project's budgetary scored amount. However, the Office allowed an exception for these projects because the budget scoring rules for the privatization program were not finalized at the time the projects were awarded. Had utility costs been included in the budgetary scored amounts, neither project would have met the 3-to-1 leveraging goal. Specifically, Fort Carson's leveraging ratio would have been 1.7 instead of 19.3 and Lackland's ratio would have been 2.5 instead of 8.1.[13] With these ratios, however, DOD might not have approved the projects.

Results from Life-Cycle Costs Analyses Are Uncertain

According to DOD, although the amount of government funds needed to initiate housing projects under the privatization option can be substantially less than needed under the military construction option, the government's long-term total costs for the projects will not necessarily be less under privatization because annual costs differ under each option. The services prepare life-cycle cost analyses to estimate and compare the government's long-term costs for proposed projects financed through privatization and through military construction. They then use the results to help decide whether proposed privatization projects should be approved. Because life-cycle cost analyses use numerous assumptions and estimates, actual costs from implemented privatization projects will vary from the results of the analyses. Nevertheless, the analyses are an important tool to evaluate the merits of proposed projects.

We used two methods to estimate and compare the life-cycle costs for the first 10 privatization projects with the military construction alternative. First, we computed the life-cycle costs for each project using DOD's February 2002 guidance. Then, we recomputed these costs, deviating from DOD's guidance to include contract oversight costs in the privatization estimates and apply an alternative method for determining operations and maintenance costs in the military construction estimates. We deviated from the guidance on these two points to compensate for two areas where use of the guidance can make the privatization option appear more favorable than justified.

Life-Cycle Cost Analysis Based on DOD Guidance

The February 2002 DOD guidance lists the assumptions and types of costs that the services are to use in performing the analyses. For example, among the costs to be included in the analysis of the privatization option are cost estimates for project planning, housing allowances, and the budgetary scored amount. These costs are to be offset by any expected project monetary returns to the government. Among the costs to be included in the analysis of the military construction option are cost

[13]After our analysis was completed, DOD officials told us that the developer of the Fort Carson project recently agreed to begin reimbursing the government for the cost of utilities for the military families occupying the privatized housing. Under this scenario, the Office of Management and Budget's original budgetary score for the project would have been in line with normal budgetary scoring rules for privatization projects.

estimates for initial construction, out-year revitalization, and annual operation and maintenance costs.

Using this guidance, and considering current DOD cost information such as the increased housing allowances resulting from the allowance initiative, we estimated that each of the 10 projects will most likely cost less than the military construction alternative. The cost differences averaged about 17 percent and ranged from 2 percent in the San Diego project to 42 percent in the Kingsville project.

The services had previously estimated that each privatization project would cost from 6 to 27 percent less than the military construction alternative (see appendix V for details). However, our estimates differed from the services' estimates for several reasons. First, our analyses use current cost estimates, whereas the services used cost estimates available when they prepared their analyses months or years prior to project approval. Second, our analyses considered the increased costs of privatization resulting from the housing allowance initiative, which increases allowances by about 19 percent between 2000 and 2005. Because allowances are used by servicemembers to pay rent for privatized housing, the initiative will significantly increase privatization costs over the long terms of the projects. Only three of the services' analyses had considered the impact of the allowance initiative. Third, the services' analyses did not use DOD's guidance, because it was not issued until February 2002. As a result, the services' analyses were inconsistently prepared, and many did not include all relevant costs.

Life-Cycle Cost Analysis Based on Modified Assumptions

We recomputed the life-cycle costs of the 10 privatized projects after making two adjustments to DOD's guidance. First, we included costs that will be incurred to oversee the project contracts in the privatization estimates. Second, we used an alternative method to determine operation and maintenance costs in the military construction estimates. The alternative method used conventional apartment data—instead of federally assisted apartment data as called for in the guidance—and excluded the cost of real estate taxes from the data. Based on these two adjustments, we estimated that privatization will likely cost less than military construction in seven of the projects and cost more in the other three projects (Lackland, Elmendorf, and San Diego), as shown in table 2.

Table 2: GAO Alternative Life-Cycle Costs Estimates for the First 10 Projects

Dollars in millions

Project	Privatization option	Military construction option	Difference	Percentage difference
Fort Carson	$895	$929	$-34	-4
Fort Hood	1,638	1,970	-332	-17
Lackland	130	127	3	2
Robins	151	189	-38	-20
Dyess	87	105	-18	-17
Elmendorf	376	354	22	6
Kingsville	30	40	-10	-25
Everett	86	91	-5	-5
Camp Pendleton	207	227	-20	-9
San Diego	1,289	1,094	195	18
Total	**$4,889**	**$5,126**	**$-237**	**-5**

Note: Life-cycle cost analyses estimate all costs—including future costs—in current dollars to consider the time value of money.

Source: GAO analysis of DOD cost data.

We believe that this recomputation is a more accurate reflection of relative costs. First, costs will be incurred to monitor contract implementation and developer performance adequately, and the services are already paying consultants to help with this oversight. Yet, DOD's guidance does not specifically require that such costs be included as a cost of the privatization option. Second, for simplicity and consistency in estimating operations and maintenance costs for the military construction option, the guidance directs the services to use operations and maintenance data for federally assisted apartments published annually by the Institute for Real Estate Management. The institute also publishes this data for conventional apartments. We did not determine whether use of institute data is the best method for estimating military construction operations and maintenance costs, and DOD provided little support to show that use of this data was the best choice. We also did not evaluate the relative merits of using these two respective data sets. However, incomes of most military families may be more like those of civilian families renting conventional apartments than those of families in federally assisted apartments; consequently, we used the conventional apartment data. Further, the institute's data includes expenses for real estate taxes normally paid by private-sector developers but which would not be paid under the military construction alternative. Using this data without making an adjustment for real estate taxes increases the cost of the military construction alternative inappropriately and makes the privatization option appear more favorable than it should. On the other hand, DOD officials pointed out that the guidance also excludes other costs, such as capital repair and replacement costs, from the military construction option. Excluding these costs from an analysis makes the military construction option appear more favorable than justified.

The bottom line is that the many assumptions and uncertainties in the estimates used to determine life-cycle costs make it difficult to achieve reliable estimates of costs over the terms of the contracts. Thus, complete and precise guidance for performing these analyses would increase the likelihood that the analyses contribute to informed decisions about future privatization proposals. In cases where military construction appears to be the less costly alternative, privatization may still be DOD's preferred option because, according to defense officials, annual military construction funding would need to increase substantially over current levels—and beyond what Congress might consider acceptable—to finance an equivalent number of housing units.

Some DOD Contributions to Projects Are Not Included in Financial Analyses

Although DOD often conveys existing government-owned housing to privatization developers and leases or conveys government land to the developers at no cost, the value of these contributions is not included in most financial analyses for the privatization projects. DOD is permitted to convey or lease existing property and facilities to developers as part of the agreements to obtain improved housing. Because such conveyances or leases do not require government expenditures and do not affect the federal budget, there is no requirement that the value of property conveyed or leased be included in project budgetary scored amounts, leveraging ratio calculations, or life-cycle cost analyses.

DOD made conveyances of housing and land that were not included in the scored amounts of 7 of the first 10 projects, as shown in table 3. For 5 of the projects, DOD also leased land to developers at no cost over the contract terms but did not estimate the value of the leases.

Table 3: DOD Property Conveyances Not Included in Budget Scored Amounts

Dollars in millions

Project	Number of housing units conveyed	Acres of land conveyed	DOD estimate of conveyance value
Fort Carson	1,823	0	$69.7
Fort Hood	5,622	0	53.3
Robins	670	270	6.5
Elmendorf	584	0	38.0
Kingsville	244	30	0.3
Camp Pendleton	512	0	7.6
San Diego	2,660	0	97.1
Total	**12,115**	**300**	**$272.5**

Source: GAO analysis of DOD data.

DOD officials stated that its contribution to a privatization project, whether included in the project's scored amount or not, is a key ingredient that makes the project financially feasible for private-sector developers. Also, most of the housing units conveyed were the inadequate units that the developers will replace or renovate. Our point is only to note that the value of many DOD contributions to privatization projects is not apparent from a review of the normal financial tools used to assess the program. Also, DOD's valuation of some contributions is subject to question. For example, the Navy estimated that the value of its conveyance of 244 housing units and 30 acres of land was $300,000 in the Kingsville project. Navy officials stated that the estimate only included the value of the land, because the conveyed housing was old, dilapidated, and not up to current codes. Yet, the developer has recently begun placing newspaper advertisements offering the housing for rent starting at $600 monthly for each unit.

Privatization Program Includes Government Safeguards, but Improvements Are Possible

DOD has required the private sector to bear most of the financial risks in the first 10 privatization projects and has designed privatization contracts to help protect the government's interests. During our visits to Fort Carson, Lackland Air Force Base, and Kingsville Naval Air Station, we discussed project implementation results with local officials. In each case, the officials stated that implementation was proceeding on or ahead of schedule, the quality of the housing improvements exceeded expectations, and the developers added some upgrades to units at no cost to the government. The officials stated that military families occupying privatized units were very satisfied with the developers' operation and maintenance of the housing, and this was supported by our observations. The officials added that they knew of no examples of poor developer performance, although contract provisions were available to deal with poor performance, if needed. Still, we found DOD could further enhance protections to the government with contract provisions for unanticipated events, required oversight of future project reinvestment decisions, guidance for contractual assumptions and fees paid to developers, and improvements to the privatization program evaluation report.

Private Sector Bears Most Financial Risks

Private sector equity and loans provided $1.03 billion, or 82 percent, of the $1.26 billion in initial development costs for the first 10 privatization projects, as shown in table 4. DOD's cash and loans provided the remaining $231 million, or 18 percent. DOD's contributions in cash and loans to the individual projects ranged from zero percent at Fort Carson to 79 percent at Dyess Air Force Base, where DOD provided the first mortgage loan.

Table 4: DOD and Private Sector Contributions to Project Development Costs

Dollars in millions

	Private equity and loans		DOD cash and loans		
Project	**Amount**	**Percentage of total**	**Amount**	**Percentage of total**	**Total project development cost**
Fort Carson	$228.6	100	$0	0	$228.6
Fort Hood	223.3	81	52.0	19	275.3
Lackland	31.3	75	10.6	25	41.9
Robins	34.2	61	22.3	39	56.5
Dyess	7.5	21	28.9	79	36.4
Elmendorf	61.9	56	48.0	44	109.9
Kingsville	7.8	54	6.7	46	14.5
Everett	30.1	71	12.2	29	42.3
Camp Pendleton	53.9	65	29.4	35	83.3
San Diego	346.6	94	20.9	6	367.5
Total	**$1,025.2**	**82**	**$231.0**	**18**	**$1,256.2**

Source: GAO analysis of DOD data.

The government's total financial exposure in the first 10 projects is greater than its $231 million contribution in cash and loans. This is because in 4 of the projects—Fort Carson and Lackland, Robins, and Elmendorf Air Force Bases—DOD provided loan guarantees to private lenders in the event of project financial failure caused by base closure, downsizing, or significant deployment.[14] According to DOD officials, loan guarantees are provided in some cases to improve the availability of private-sector financing or obtain a lower interest rate. Thus, with the guarantees, the government's total financial exposure would be significantly higher in a worst-case scenario where (1) these four bases closed and the developers defaulted on their loans and (2) the remaining six projects failed financially, leaving the government unable to recover its cash contributions and not receive repayment for its loans. In such a case, the government's maximum financial exposure would be about $481 million for all 10 projects, or about 38 percent of the total development costs for the projects (see table 5).

Table 5: Government Financial Exposure in the First 10 Projects

Dollars in millions

Project	Total project development costs	Government financial exposure		
		Cash and loans	Loan guarantee	Total
Fort Carson	$228.6	$0	$147.0	$147.0
Fort Hood	275.3	52.0	-	52.0
Lackland	41.9	10.6	29.4	40.0
Robins	56.5	22.3	25.6	47.9
Dyess	36.4	28.9	-	28.9
Elmendorf	109.9	48.0	48.0	96.0
Kingsville	14.5	6.7	-	6.7
Everett	42.3	12.2	-	12.2
Camp Pendleton	83.3	29.4	-	29.4
San Diego	367.5	20.9	-	20.9
Total	**$1,256.2**	**$231.0**	**$250.0**	**$481.0**

Source: GAO analysis of DOD data.

Some Contracts Did Not Adequately Provide for Unanticipated Increases in Project Revenue

Because privatization contracts cover long periods of time—often 50 years—contract provisions cannot be written for every event that could affect the operations or financial performance of the projects. Yet contracts without provisions for unanticipated events that significantly change planned project revenues and expenses can result in unanticipated profits or losses to the developers. Although the privatization program is

[14]With the enactment of the National Defense Authorization Act for fiscal year 2002, Congress authorized DOD to conduct another round of base realignments and closures beginning in 2005.

relatively new, DOD has already experienced the impact of one such event—implementation of the housing allowance initiative.

DOD's initial contracts did not include adequate provisions to minimize potential unanticipated profits accruing to developers from unanticipated revenue increases. As a result, for some projects, the increased rental revenue from the allowance initiative will flow in part or in total to the developers in the form of extra profits and fees. For example, in 1998, when the Lackland Air Force Base project was awarded, few would have anticipated an initiative to increase housing allowances by 19 percent to eliminate out-of-pocket costs. The Lackland project did not include a provision to capture unexpected revenue increases or to compensate the developer for any revenue decreases. As a result, all extra rental revenue resulting from the allowance initiative will flow to the developer. We estimated that the allowance initiative will increase Lackland's rental revenues by approximately $64 million over the contract term, all of which will go to developer profits or fees.

The contracts for 7 of the first 10 privatization projects did not consider the increased rental revenue that will result from the housing allowance initiative. For these projects, table 6 shows the extra rental revenue expected from the allowance initiative and the amount of this extra revenue projected to go to the developers in profits and fees.

Table 6: Projected Extra Rental Revenues, Profits, and Fees Resulting from the Housing Allowance Initiative

Dollars in millions

		Developer's portion of extra rental revenue			
Project	**Extra rental revenue**	**Extra profit**	**Extra fees**	**Total extra profit and fees**	**Percentage of extra rental revenues**
Fort Carson	$317.2	$51.9	$12.7	$64.6	20.4
Fort Hood	516.4	5.1	20.7	25.8	5.0
Lackland	63.9	62.0	1.9	63.9	100.0
Robins	52.0	40.2	1.7	41.9	80.6
Elmendorf	168.9	73.1	10.3	83.4	49.4
Kingsville	7.0	4.4	.8	5.2	73.4
Camp Pendleton	175.6	79.2	5.3	84.5	48.1
Total	**$1,301.0**	**$315.9**	**$53.4**	**$369.3**	**28.4**

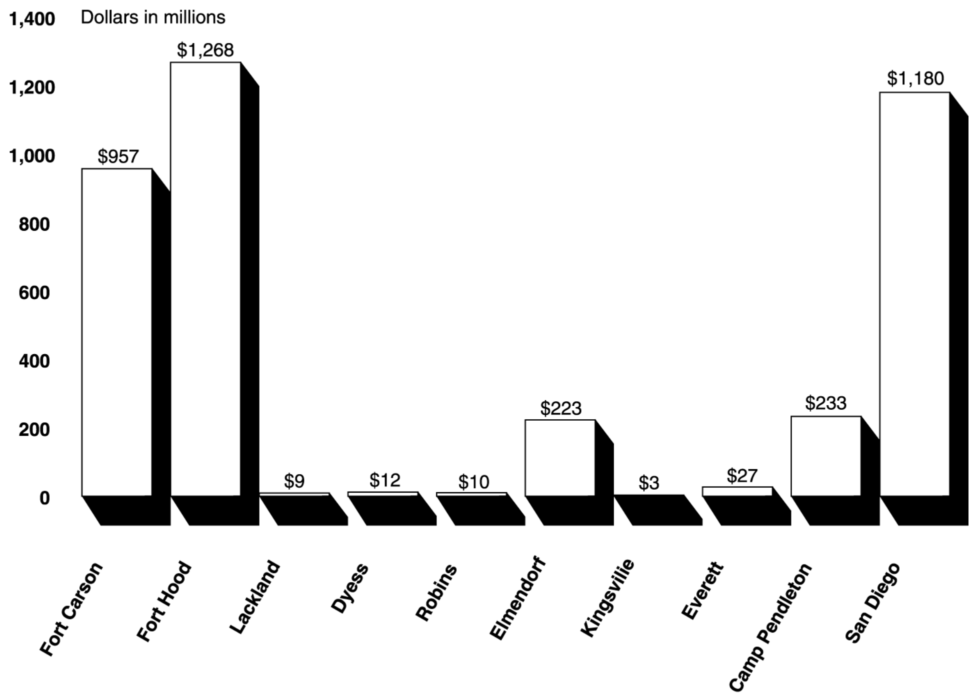
Source: GAO analysis of DOD data.

Table 6 also shows that, on a cumulative basis, most of the additional rental revenue is not expected to go to the developers. This is because, except for Lackland, the projects included contract provisions designed to capture at least a portion of any unanticipated rental revenues that exceeded project expenses and expected developer profits. Controlled by contract provisions, the captured funds will accumulate into project reinvestment accounts and can be used to pay for future renovations, improvements, and amenities for the projects during their contract terms. In accordance with the contract provisions of some projects, such as Fort Hood, relatively little of any unanticipated revenue increases or expense reductions is expected to go the developers. DOD officials stated that DOD expects that all future project contracts will include reinvestment account provisions to capture a portion of extra revenues or reduced expenses. However, DOD has not issued guidance requiring this or providing parameters for establishing the amounts needed in the reinvestment accounts to meet future project needs.

Required Oversight of Reinvestment Decisions Appears Limited

Projects with reinvestment accounts normally include contract provisions stating that the accumulated funds can only be used to benefit the project and that service officials and the developer decide how to spend the funds. Generally, rental revenue funds flow into the reinvestment account in accordance with the contract provisions after payment of normal project expenses and developer profits. Reinvestment funds are supposed to be used to pay for future renovations and major improvements. Large sums are expected to be deposited into the reinvestment accounts of some projects, particularly with the increases caused by the housing allowance initiative. For the first 10 projects, we estimate that about $3.9 billion will be deposited to the reinvestment accounts over the terms of the contracts (see figure 1).

Figure 1: Projected Cumulative Amounts Available for Reinvestment in the Projects



Note: Amounts shown do not include reserves for routine project maintenance.

Source: GAO analysis of DOD data.

Normally, military installation officials and project developers make joint decisions on how to spend money from the reinvestment accounts. Fort Carson officials stated that they will work with the developer to make these decisions on their project. Navy officials stated that they are usually partners with the developer in their projects, and, as such, will participate in decisions to spend reinvestment money. According to service officials, amounts remaining in the reinvestment accounts at the end of the contracts will, as a rule, be returned to DOD and be available to help finance other privatization projects. However, it is questionable how much money might actually revert to DOD, since incentives exist for local service officials and developers to spend all funds accumulated in the reinvestment accounts. For example, local officials want the privatized housing to offer the highest possible quality of life to military families occupying the housing. They also know that funds not spent by the end of the contract will revert to DOD and be unavailable for use in the project. Developers also want to provide the best housing possible so that military families will continue to choose to live in the housing. Also, the developers can benefit from decisions for additional construction or renovations and earn additional fees and profits when they perform the work.

For these reasons, required oversight of major reinvestment spending decisions is important to add assurance that the decisions are appropriate. For example, inadequate oversight could result in decisions to use reinvestment funds to add improvements and amenities to privatized housing to the point that the housing exceeds typical community housing standards. Contrary to encouraging servicemembers to live in local communities, this could result in creating artificial demand for the privatized housing because servicemembers could not secure the same housing in the local community without paying out-of-pocket amounts. Further, inadequate oversight could result in using reinvestment funds to construct housing units beyond the number approved in the original project scope without following the normal justification and review process. Yet oversight procedures for major reinvestment decisions have not been clearly defined, and there is no requirement that service headquarters and the Office of the Secretary of Defense review and approve expenditures.

Widely Varied Contractual Assumptions and Fees Can Affect DOD Costs

Contractual assumptions and fees can affect DOD's privatization costs, and thus it is important that the services have guidance to help establish appropriate assumptions and fees. Although several nationally recognized organizations publish private-sector data that could be used to help establish suitable benchmarks, DOD has not provided such guidance for the services' use. During our review of the first 10 privatization projects, we found wide variation in some assumptions used to estimate project revenues and expenses, expected developer internal rates of return, and the types and ranges of project fees charged.

Developers make certain assumptions—such as the expected vacancy rate in privatized housing and allowances for unpaid rents—to estimate project revenues and expenses. The accuracy of these assumptions is important because they affect the estimated amount of project revenue that will be available for expenses, profits, and reinvestment accounts. Yet the vacancy rate assumptions for the first 10 projects varied from 2 to 5 percent, and only one project included an assumption for unpaid rents—1 percent.

Another area of concern is related to the expected internal rate of return on the developer's equity in the project. A developer's expected internal rate of return is known at the time of contract award because privatization contracts include forecasts of expected project revenue, expenses, and profits. The actual internal rate of return will vary depending on the performance of the project and the effects of any unanticipated changes in revenue and expenses. DOD officials stated that the normal internal rate of return for similar housing projects in the private sector ranges from 12 to 14 percent. For the first 10 projects, the expected internal rate of return at contract award varied from 1.6 to 16.7 percent. However, the increased rental revenue resulting from the housing allowance initiative has increased the expected internal rate of return for 7 of these projects. Considering the impact of the allowance initiative and the terms of the individual contracts, and assuming no other changes in expected revenue and expenses, we estimate that the developer's internal rates of return will actually range from 3.3 to 25.7 percent.

Finally, most contracts included fees to be paid to the developers during operation of the privatized housing over the contract terms. For example, all contracts included a property management fee, which is designed to pay for the daily management and oversight of the housing project. The fee is normally assessed as a percentage of rental revenues. In the first 10 projects, this fee varied from 2.5 to 5.1 percent. Because revenues are significant in some cases, a difference of just 1 percent can result in increasing the property management fee by over $400,000 each year. In 4 of the 10 projects, the services also included a property management incentive fee to be paid on the basis of specified criteria. This incentive fee ranged from 1.0 to 2.0 percent. In 2 of the 10 projects, the services included payment of an asset management fee. This fee covers services to monitor and oversee financial aspects of the projects, and, according to a national association representing large multi-family housing owners, the fee normally ranges from 2 to 3 percent. However, for one project, the fee was 4.5 percent of net operating income, and for another project the fee was 60 percent of net cash flow up to a maximum of $80,000 annually (averaging about 10 percent of net operating income over the contract term).

Program Evaluation Report Has Not Met Its Potential

In our March 2000 report on the privatization program, we noted that DOD had not developed an evaluation plan to consistently measure the progress and effectiveness of the program from project identification through the end of each contract.[15] We recommended development of an evaluation

[15]See GAO/NSIAD-00-71.

plan that would be used by all services, include performance measures to help officials determine whether the program is meeting goals, provide a means to evaluate the merits of the individual authorities, compare the estimated and actual costs of each project, assess key aspects of developer performance, collect statistics on the use of the housing, and assess servicemembers' satisfaction with the housing.

DOD agreed with our recommendation, and on January 10, 2001, issued final reporting requirements for a new privatization program evaluation report. The services are required to summarize and report semi-annually on many financial and management aspects of each awarded project, and DOD officials have stated that the report will be used to oversee the program's implementation and overall financial management.

Although the report is an extensive and potentially useful tool for monitoring and evaluating program implementation, the value of the report has been limited because (1) the report has not been completed in a timely manner—the report for the period ending June 30, 2001, was due by September 15, but was not completed until February 2002; (2) the report does not include information on funds accumulated in project reinvestment accounts; and (3) key elements of the report are not subjected to periodic independent verification to check accuracy. As a result, the report has not been as useful to decisionmakers as originally envisioned in helping to evaluate program effectiveness, address questions and concerns, and identify whether program modifications are needed.

Conclusions

DOD appears to be positioned to significantly increase its use of privatization to eliminate inadequate military family housing over the next several years. Yet, because of inconsistent housing needs assessments, significant uncertainty exists in both the number and location of housing units that will be required in the future. This could lead DOD to enter into long-term contracts for privatized housing, some of which might not have been needed in areas where local communities might have provided housing at lower costs. Also, although DOD's stated policy is to rely on community housing to the extent possible, officials have acknowledged that the disparity in on-base and off-base housing standards creates an incentive for servicemembers in lower enlisted pay grades and with larger families to seek government housing rather than community housing. Further, increased housing allowances will result in increased life-cycle costs for privatization projects. As a result, the long-term savings from privatization may be less than estimated, although accurate estimates of life-cycle costs are hindered by use of DOD's guidance for performing the analyses. Improved DOD guidance for performing life-cycle cost analyses—that is, including privatization contract oversight costs in the analyses and validating the types and sources of data used to estimate military construction operations and maintenance costs—would lead to more accurate analyses and better informed approval decisions on proposed privatization projects.

Although privatization contracts have included provisions designed to protect the government's interests, contract provisions could be strengthened to better protect any extra revenues generated from unanticipated financial results. Without such provisions, developers stand to gain unanticipated profits from money that might more appropriately be channeled into reinvestment accounts for possible future project improvements. Furthermore, projects with reinvestment accounts have limited required oversight of spending decisions. Thus, DOD and the services' headquarters do not know precisely how the funds are used or whether spending decisions made at the installation level are appropriate. Inappropriate spending decisions could waste money and result in privatized housing with amenities far beyond typical community housing standards, leaving less money available to DOD to help finance other privatization projects. DOD's approval of expenditures over an established threshold would provide more control over such expenditures. Privatization contracts vary widely owing to a lack of guidance to establish appropriate contract revenue, expense, and reinvestment assumptions and project fees. Assumptions and fees outside of normal ranges may result in hundreds of thousands of dollars in extra payments to developers. Providing contract guidance for the services' use would establish a common framework for arriving at appropriate revenue and expense assumptions and project fees. Opportunities also exist to strengthen DOD's privatization program evaluation report. Currently, the value of the report as a tool for monitoring and evaluating program implementation is diminished because it is not being completed on time, it omits critical data, and its contents are not independently verified.

Recommendations for Executive Action

We recommend that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to revise the department's housing requirements determination process to take into account greater use of community housing to fulfill needs and the projected impact that the housing allowance initiative might have on military installation housing requirements. As part of the effort to revise the department's process, the Deputy Under Secretary should also determine the effect of the difference in the department's housing standards for servicemembers living in government-owned or privatized housing and for those living in community housing on the requirement for military family housing. This should include identifying the benefits and costs derived from a program that would provide increased allowances based on the number of family members and determining the extent to which such a program could reduce requirements for government-owned or privatized housing. In addition, we recommend that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to take the following steps to improve implementation of the military housing privatization program:

- improve the guidance for performing life-cycle cost analyses by requiring the inclusion of privatization contract oversight costs and validating the types and sources of data used to estimate military construction operations and maintenance costs;
- require provisions in all future privatization contracts to direct the benefits from unanticipated increased revenues or reduced expenses to flow, in total or in part, into a project reinvestment account for possible future use in the project;
- require service headquarters and the Office of the Secretary of Defense to review and approve privatization project reinvestment account expenditures over an established threshold;
- provide guidelines to help establish appropriate privatization contract revenue, expense, and reinvestment assumptions and project fees; and
- improve the value of DOD's privatization program evaluation report by completing the report on time, including information on funds accumulated in project reinvestment accounts, and obtaining periodic independent verification of key report elements.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD generally agreed with the report's findings and recommendations and outlined ongoing or planned management actions to address the concerns noted in the report. Although DOD believes that our report undervalues the strides the department has made thus far in the program, we believe the report accurately describes the progress made to date and the success it has achieved in meeting financial goals. In particular, DOD believes that the Everett project met the leveraging goal of 3.0 rather than our calculated ratio of 2.7. The details of our respective calculations are contained in a note to DOD's comments (see app. VI).

DOD noted that it partially concurred with three of our recommendations. First, in responding to our recommendation to improve the guidance for performing life-cycle cost analyses, DOD stated that existing guidance requires the services to include all costs for both the privatization and military construction alternatives. However, the guidance does not specify that privatization oversight costs should be included in the analysis. DOD stated that it would modify the guidance and also validate the data used to estimate operations and maintenance costs under the military construction alternative. We believe that the planned actions will meet the intent of our recommendation and improve the department's guidance for performing life-cycle cost analyses.

Second, concerning our recommendation that the military services and the Office of the Secretary of Defense review and approve privatization project reinvestment account expenditures over an established threshold, DOD stated the services and the Office of the Secretary of Defense should have oversight of these expenditures but that only the services should review and approve specific project expenditures. We agree that the military service level is the appropriate review level for most project reinvestment spending decisions. However, in some cases, reinvestment decisions could involve substantial amounts, such as a decision to use reinvestment funds to construct housing units in addition to the number initially approved (follow-on projects). We continue to believe that major reinvestment expenditures over an appropriately determined threshold should be reviewed and approved by the Office of the Secretary of Defense and have retained our original recommendation.

Third, in response to our recommendation that guidelines should be provided to help establish appropriate privatization contract assumptions and fees, DOD noted that the key to getting the best housing at the lowest cost is through competition among developers and that reliance on strict government guidelines—instead of the market's determination of risk and return—is not likely to create financially sound projects. We agree that competition is a key to successful privatization projects and that each project is unique. However, we believe that the services could benefit from guidelines that provide ranges for normally expected contract assumptions for revenues, expenses, reinvestment amounts, and fees. Such guidance would provide a framework to identify project proposals that fall outside of normal ranges. This could help focus management attention during the project review and approval process to ensure that each proposal is appropriate and in the best interest of the government. Accordingly, we have retained our original recommendation.

DOD's comments are included in this report in appendix VI. We have also incorporated DOD's technical comments as appropriate.

We are sending copies of this report to the appropriate congressional committees; the secretaries of Defense, the Army, the Navy, and the Air Force; and the Director, Office of Management and Budget. We also will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

Please contact me at (202) 512-3958 or Mark Little, Assistant Director, at (202) 512-4673 if you have any questions concerning this report. Major contributors to this report are listed in appendix VII.

Carol R Schuster

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and Management

Appendix I: Differences Over Budgetary Scoring for DOD's Military Housing Privatization Program

As requested, this appendix addresses differences between the Office of Management and Budget and the Congressional Budget Office over budgetary scoring for DOD's Military Housing Privatization Program. This issue is important because the budgetary scored amount directly affects the amount of appropriated funds needed to secure a privatization contract, and high budgetary scores might make proposed privatization projects financially unattractive to DOD.

Each privatization contract that DOD enters into must be scored for budget purposes. Scoring seeks to determine the cost that should be recognized and recorded as an obligation of DOD at the time the contract is signed. The Office of Management and Budget is responsible for determining the amount to be obligated, and its Circular A-11 provides guidelines on how obligations should be recorded in the budget. The guidelines are designed to ensure that the budget records the full amount of the government's commitments when it obtains capital assets.

As part of its fiscal year 2001 budget review, the Congressional Budget Office assessed the budget scoring amounts for the first four privatization projects. It reported that the methods used by the Office of Management and Budget to determine the projects' budget score amounts (estimated obligations) were at odds with government-wide standards and that the budget scores were too low.[1] Officials at the Office of Management and Budget disagreed.

Scoring guidelines state that when an asset is for a "special purpose of the government," an obligation should be recorded up front. Further, the guidance provides criteria to determine if a project is for a government purpose. One criterion states that if the project is constructed or located on government land, it is presumed to be for the special purpose of the government. Congressional Budget Office officials concluded that since all but two of DOD's housing projects were located on military bases, they are for the special purpose of the government, and the obligations should be recorded up front. Although less clear, Congressional Budget Office officials believe that up-front obligations were also justified for the two projects located off the bases. Another major factor in determining if a project is for the special purpose of the government is the question of whether DOD guarantees occupancy of privatized housing units. Officials

[1]Congressional Budget Office, *Cost Estimate, S. 2549 National Defense Authorization Act for Fiscal Year 2001* (Washington, D.C.: May 23, 2000).

of both offices agreed that if DOD guarantees occupancy, then the cumulative value of the rents to be paid on the housing over the contract term must be included in the scored amount. This would significantly increase the amount of appropriated funds needed to secure a privatization contract, and, as a result, many proposed projects would no longer be financially attractive for DOD. However, the offices disagree on whether DOD is, in fact, guaranteeing occupancy.

Office of Management and Budget officials stated they did not include the value of the rents in the obligated amounts because DOD told them project contracts do not include rental guarantees. Rather, the contracts include provisions for civilians to rent privatized housing if military families choose not to live there. Still, Congressional Budget Office officials contend that for at least some projects—especially those located on military bases—DOD provides an implicit occupancy guarantee and, therefore, the expected rents should be included in the obligated amount. To support its position, the Budget Office officials noted that (1) a majority of the on-base privatized units are replacing units once occupied by servicemembers and their families, which indicates the units have a special governmental purpose; (2) DOD will likely restrict privatized on-base housing to use by military families because of security concerns; and (3) DOD refers servicemembers to the privatized housing rental offices and therefore is essentially committing itself to provide tenants for the projects.

Although it is true that privatization contracts do not provide explicit DOD guarantees of occupancy, some service officials told us that their service would take any necessary actions to make their projects successful. Also, the contract terms for the Fort Hood project stated that in the event of declining occupancy, the Army could try to avoid or minimize renting to civilians. The contract stated that the "Army shall have the option, in its sole discretion, to make mandatory housing assignments… and/or to pay the applicable rents due on unoccupied housing units."

Appendix II: Scope and Methodology

We performed work at the Competitive Sourcing and Privatization Office and at other DOD offices responsible for housing management and housing allowances. We also performed work at Air Force, Army, and Navy headquarters offices responsible for implementing the privatization program. At each location, we interviewed responsible officials and reviewed applicable policies, procedures, and documents. In addition, we discussed various aspects of the program with officials at the Air Force Center for Environmental Excellence and the National Multi Housing Council, a private organization that represents the interests of larger apartment firms and conducts apartment-related research. To discuss budgetary scoring for the privatization program, we met with officials from the Office of Management and Budget and the Congressional Budget Office.

To determine whether privatization projects are based on reliable assessments of housing requirements, we reviewed prior reports from GAO, RAND, and others that discussed problems with DOD's housing requirements determination process. We held discussions with, and reviewed documents from, DOD housing officials about the status of plans to improve the process. We also discussed with them potential impacts on housing requirements from the initiative to increase housing allowances and analyzed data showing the expected housing allowance increases through 2005 in total and in the local communities surrounding the first 10 privatization projects. Further, we discussed with DOD housing and housing allowance officials the differences in housing standards for servicemembers living in government and civilian housing.

To determine whether DOD is achieving its financial goals for the privatization program, we reviewed DOD criteria for two key financial goals—leveraging of government funds and reducing life-cycle costs. To measure achievement of the leveraging goal, we computed the leveraging ratio by dividing DOD's military construction cost estimate for each project by the budgetary scored amount for each project. We then compared the results with DOD's ratio goal. To measure achievement of the life-cycle cost goals, we reviewed DOD's guidance for performing life-cycle cost analyses and used this guidance to estimate and compare the life-cycle costs of the first 10 privatization projects and the comparable military construction alternatives. We also computed alternative life-cycle cost estimates for the 10 projects after making adjustments to the assumptions in the guidance to include privatization program oversight costs and to remove real estate taxes from the military construction operations and maintenance cost estimates in order to achieve more accurate estimates of relative costs. In both analyses, we used current

DOD cost estimates and projected the increase in privatization costs from the housing allowance initiative to eliminate out-of-pocket costs. We shared the results of our life-cycle cost analyses with service officials and revised the analyses on the basis of their comments.

To evaluate whether DOD's privatization contracts protect the government's interests, we reviewed contracts and other project documentation for the first 10 privatization projects. For each project, we summarized DOD project cost data and other financial details from each contract, such as the value of (1) government loans, loan guarantees, and equity contributions, (2) developer equity, and (3) private-sector loans. We then compared the extent of financial exposure assumed by the government, the developer, and the private-sector lenders in each contract, and compared contract assumptions, fee structures, and expected internal rates of return. We also estimated the impact from the housing allowance initiative on developer fees and profits and on amounts available for reinvestment in the projects. Also, to discuss implementation details and view privatized housing units first hand, we visited three installations where privatization projects were underway—Fort Carson, Colorado, and Kingsville Naval Air Station and Lackland Air Force Base, Texas. At each installation visited, we reviewed housing conditions and occupancy statistics, discussed the status of privatization implementation, obtained opinions on the project from local service officials, obtained information on the satisfaction of military tenants living in privatized units, and toured new and renovated housing units completed by the developers.

We conducted our review between May 2001 and April 2002 in accordance with generally accepted government auditing standards.

Appendix III: Description of First Ten Privatization Projects

We reviewed the first 10 projects awarded under the Military Housing Privatization Program. Details of these projects follow.

Project	Housing units	Contract award date	Description
Fort Carson, Colorado	2,663	Sept. 1999	Government to (1) convey all existing units; (2) lease 777 acres of land; and (3) provide first mortgage guarantee against developer default due to base closure, downsizing, or deployment. Developer to (1) renovate 1,823 existing units; (2) construct 840 new housing units on base; and (3) own, operate, and maintain 2,663 units for 50 years.
Fort Hood, Texas	5,912	Oct. 2001	Government to (1) convey all existing units; (2) lease the underlying land; and (3) provide an equity investment and become a limited partner. Developer to (1) renovate 4,624 units; (2) convert 630 two-bedroom units to 315 four-bedroom units; (3) construct 973 new units on base; and (4) own, operate, and maintain 5,912 units for 50 years.
Lackland Air Force Base, Texas	420	Aug. 1998	Government to (1) lease 96 acres; (2) provide a second mortgage; and (3) provide first mortgage guarantee against developer default due to base closure, downsizing, or deployment. Developer to (1) demolish 272 existing units; (2) construct 420 new housing units on base; and (3) own, operate, and maintain 420 units for 50 years.
Robins Air Force Base, Georgia	670	Sept. 2000	Government to (1) convey 670 existing units and 270 acres of land; (2) provide a second mortgage; and (3) provide first mortgage guarantee against developer default due to base closure, downsizing, or deployment. Developer to (1) demolish 370 existing units; (2) construct 370 new units on conveyed land; (3) renovate 300 units; and (4) own, operate, and maintain 670 units for 30 years (may be extended for two additional 10-year periods).
Dyess Air Force Base, Texas	402	Sept. 2000	Government to provide a first mortgage loan. Developer to (1) construct 402 new housing units on private land off base; and (2) own, operate, and maintain the units for 40 years.
Elmendorf Air Force Base, Alaska	828	Mar. 2001	Government to (1) convey 584 existing units; (2) lease 219 acres of land; (3) provide a second mortgage loan; and (4) provide first mortgage guarantee against developer default due to base closure, downsizing, or deployment. Developer to (1) demolish 176 units; (2) construct 420 new housing units on base; (3) renovate 200 units; and (4) own, operate, and maintain 828 units for 50 years.
Kingsville Naval Air Station, Texas	150	Nov. 2000	Government to (1) convey 244 existing units and 30 acres of land; (2) provide an equity investment and become a limited partner; and (3) provide a second mortgage loan. Developer to (1) construct 150 new housing units on developer-provided land off base; and (2) own, operate, and maintain 150 units for 30 years (Navy option to terminate contract anytime after 15 years).
Everett Naval Station, Washington	288	Dec. 2000	Government to (1) provide an equity investment and become a limited partner and (2) provide over a 15-year period limited lease payments in addition to the servicemembers' rental payments. Developer to (1) construct 288 new housing units on private land off base and (2) own, operate, and maintain the units for 30 years (Navy option to terminate contract anytime after 15 years).

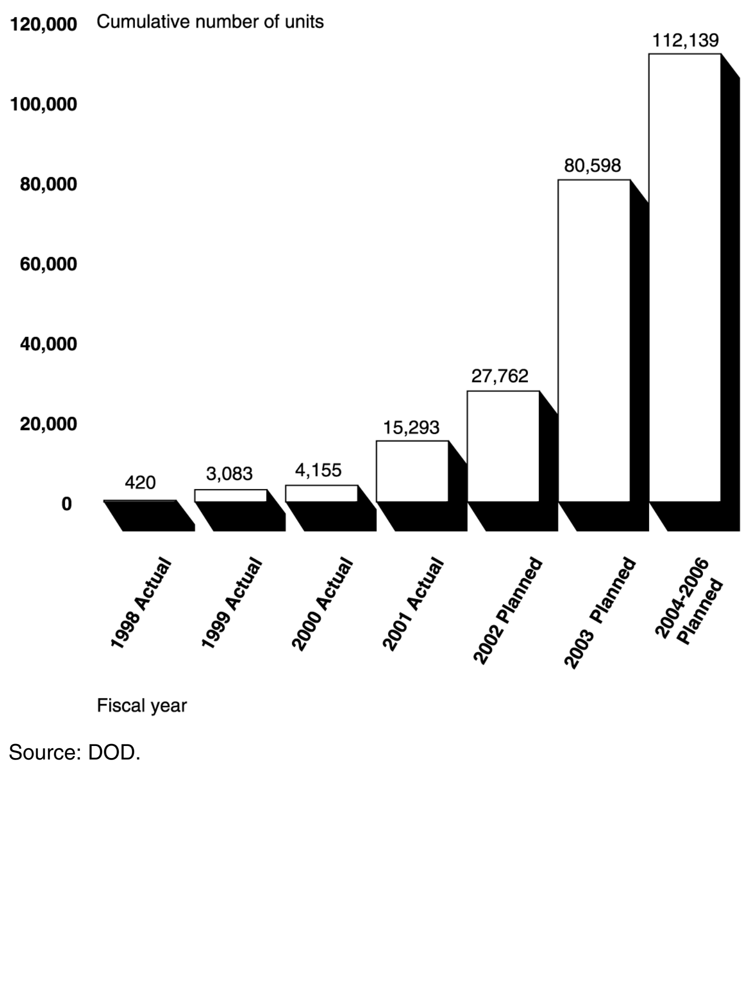
Project	Housing units	Contract award date	Description
Camp Pendleton Marine Corps Base, California	712	Nov. 2000	Government to (1) convey 512 existing units; (2) lease 132 acres of land; and (3) provide a second mortgage loan. Developer to (1) demolish and replace 312 units; (2) renovate 200 units; (3) construct 200 additional new housing units on base; and (4) own, operate, and maintain 712 units for 50 years.
San Diego Naval Complex, California	3,248	Aug. 2001	Government to (1) convey 2,660 existing units; (2) lease the underlying land; and (3) provide an equity investment and become a limited partner. Developer to (1) demolish 812 units; (2) construct 1,400 new housing units on the leased land; and (3) own, operate, and maintain 3,248 units for 50 years.

Source: DOD.

Appendix IV: DOD's Military Housing Privatization Program Implementation Status and Plans

DOD's pace for implementing the privatization program has quickened, and its plans for future privatization are aggressive. As of January 1, 2002, DOD had awarded 11 privatization projects involving 16,228 housing units. Figure 2 shows, on a fiscal year basis, the cumulative number of housing units DOD actually privatized and DOD's plans for privatization through fiscal year 2006. Developers had completed new construction and renovation work on 1,740 units as of December 31, 2001.

Figure 2: Cumulative Number of Housing Units Under Contract



Source: DOD.

Appendix V: Services' Life-Cycle Cost Estimates

Table 7 shows the results of the services' life-cycle cost analyses for the first 10 projects awarded under the Military Housing Privatization Initiative. The services' analyses were completed prior to the projects' approval, and many costs—such as those for housing allowances—have changed significantly since then. Their analyses show the military construction alternative to be more costly in each case. For comparison purposes, our estimates of life-cycle costs for these projects—made using current information and adjustments to DOD's life-cycle cost guidance—are included in table 2 in the body of the report.

Table 7: Services' Estimates of Life-Cycle Costs

Dollars in millions

Project	Privatization option	Military construction option	Difference	Percentage difference
Fort Carson	$640.7	$693.2	$52.5	7.6
Fort Hood	1,514.9	1,886.3	371.4	19.7
Lackland	83.2	97.9	14.7	15.0
Robins	114.0	157.0	43.0	27.4
Dyess	68.0	75.0	7.0	9.3
Elmendorf	269.3	308.7	39.4	12.8
Kingsville	31.1	42.3	11.2	26.5
Everett	71.6	98.2	26.6	27.1
Camp Pendleton	163.4	210.1	46.7	22.2
San Diego	1,041.4	1,103.9	62.5	5.7
Total	**$3,997.6**	**$4,672.6**	**$675.0**	**14.4**

Source: DOD.

Appendix VI: Comments from the Department of Defense

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON, DC 20301-3000

ACQUISITION, TECHNOLOGY AND LOGISTICS

Ms. Carol R. Schuster
Director, Defense Capabilities Management
U.S. General Accounting Office
Washington, D.C. 20548

Dear Ms. Schuster:

This is the Department of Defense (DoD) response to the GAO draft report GAO-02-624, "MILITARY HOUSING: Management Improvements Needed As Privatization Pace Quickens," dated May 3, 2002 (GAO Code 350074). Thank you for allowing us to comment on your draft report. I consider the report a very important contribution to our development and implementation of the Military Housing Privatization Initiative (MHPI). While I generally concur with your recommendations, I believe you have undervalued the strides we have made thus far.

The GAO was asked to look at three program areas: financial goals, government protections, and requirements determination. The Department has been overwhelmingly successful in achieving its financial goals of leveraging appropriations and obtaining lower life cycle costs for privatization than for military construction. Every project examined by GAO leveraged appropriations beyond the three-to-one objective (the table on page 12 of the draft report erroneously lists the Everett leveraging ratio as 2.7, rather than the 3.0), and every project met the goal that privatization be cheaper than military construction. The life cycle cost adjustments recommended by the report are relatively minor and are unlikely to alter the fact that all projects have met the goal.

See comment 1.

I am also encouraged by your findings that the private sector is bearing most of the risk in our projects. Developer profit is not guaranteed, but is dependent upon high occupancies through attracting service member tenants to private housing. The private opportunity for profit and the risk of loss are fundamental to the MHPI. This private risk/return mechanism also weakens the position of the Congressional Budget Office that the projects are governmental and that budget scores are too low. Bearing this in mind, the Department is striving to structure deals that are as private as possible, but which protect the government's interests and ensure good housing well into the future.

The requirements determination policy is now in coordination within the Department. Considerable time and effort have gone into developing a policy that will provide a reliable assessment of our housing requirements. We anticipate that the policy will be signed in July 2002.

Again, I appreciate GAO's review of the housing privatization program. Thank you for your very valuable assistance. Our responses to your specific recommendations are enclosed.

Raymond F. DuBois, Jr.
Deputy Under Secretary of Defense
(Installations and Environment)

Enclosure:
As stated

GAO CODE 350074/GAO-02-624

"MILITARY HOUSING: MANAGEMENT IMPROVEMENTS NEEDED AS PRIVATIZATION PACE QUICKENS"

DEPARTMENT OF DEFENSE COMMENTS TO THE RECOMMENDATIONS

RECOMMENDATION 1: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to revise the Department's housing requirements determination process to take into account greater use of community housing to fulfill needs and the projected impact that the housing allowance initiative might have on military housing requirements. (Page 28/Draft Report).

DoD RESPONSE: Concur. The Military Services and the Office of the Secretary of Defense (OSD) have spent significant time and effort developing a proposed housing requirements determination process that will rely primarily on the private sector to meet the department's housing needs and which will include increases in the housing allowance. OSD has issued a draft requirements policy document which is currently in coordination throughout the Department. Issues resulting from the coordination process will be addressed prior to forwarding the draft policy to the Deputy Secretary. We anticipate issuing the signed policy in July 2002.

RECOMMENDATION 2: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to determine the effect of the difference in the Department's housing standards for service members living in government-owned or privatized housing and for those living in community housing on the requirement for military family housing. This should include identifying the benefits and costs derived from a program that would provide increased allowances based on the number of family members and determining the extent such a program could reduce requirements for government-owned or privatized housing. (Page 28/Draft Report).

DoD RESPONSE: Concur. The Department has become aware that an inconsistency exists for some military members between the size of government housing provided and the units that the housing allowances would afford in the private sector. This issue will require careful study and consideration as the average out-of-pocket costs for our military members reaches zero. If the size differential continues into the future, it could influence military families to seek government housing over available private sector units.

RECOMMENDATION 3: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to improve the guidance for performing life-cycle cost analyses by requiring the inclusion of privatization contract oversight costs and validating the types and sources of data used to estimate military construction operations and maintenance costs. (Page 28/Draft Report).

See comment 2.

DoD RESPONSE: Partially concur. The Department will modify its guidance for performing life-cycle cost analysis. The revised guidance will specifically include contract oversight costs. The existing guidance requires preparers to include *all* costs for both the Milcon and privatization alternatives; however, it does not specifically identify privatization contract oversight costs.

We will also validate the data used to estimate military construction and operations and maintenance (O&M) costs. The existing policy uses IREM (Institute of Real Estate Management) costs, adjusted to reflect differences in costs incurred by the Department and the private sector. The policy is intended to provide a simple, accurate, and consistent methodology for ascertaining Milcon operations and maintenance costs. We concur that IREM includes real estate taxes which could overstate Milcon estimates in some cases. However, eliminating taxes from the analysis would require life cycle preparers to research and add back in the department's cost of providing services attributable to local property tax revenues. It is not at all certain that the department's costs of providing such services would be less than those of the locality in question. And the additional research might decrease the consistency of the analysis given inaccuracies in accounting for O&M costs. Nonetheless, we will examine the three sites identified in the report and validate the accuracy of the IREM estimates. We will refine the adjustment factor to the IREM cost, based on the results of this examination.

RECOMMENDATION 4: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to require provisions in all future privatization contracts to direct the benefits from unanticipated increased revenues or reduced expenses to flow, in total or in part, into a project reinvestment account for possible future use in the project. (Page 28/Draft Report).

DoD RESPONSE: Concur. The department requires all projects subsequent to the DOD initiative to increase housing allowances to include mechanisms to capture such unanticipated increases in project revenues. Increased revenues from *reduced expenses* on the other hand naturally flow into the reinvestment account at the bottom of the lockbox "waterfall" of funds.

RECOMMENDATION 5: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to require Service headquarters and the Office of the Secretary of Defense to review and approve privatization project reinvestment account expenditures over an established threshold. (Page 28/Draft Report).

See comment 3.

DoD RESPONSE: Partially concur. Service headquarters and the Office of the Office of the Secretary of Defense should have oversight over reinvestment account expenditures. However, service headquarters are the appropriate offices to review and approve specific project expenditures from privatization project reinvestment accounts. The Office of the Secretary of Defense will continue to approve expenditures or transfers of funds outside the project, for example approval of follow-on project phases, or returns to and expenditures from the family housing improvement fund.

2

See comment 4.

RECOMMENDATION 6: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to provide guidelines to help establish appropriate privatization contract revenue, expense, and reinvestment assumptions and project fees. (Page 28/Draft Report).

DoD RESPONSE: Partially concur. The Department concurs that guidance regarding the reasonableness of contract revenue, expenses, reinvestment assumptions, and project fees is useful for benchmarking individual projects. However, the key to getting the best quality housing construction and management for the least cost to the Military Service remains maximizing competition among developers. Such competition drives down project expenses and fees and drives up construction quality and management commitments. Privatization deal structures differ significantly from project to project. Reliance on strict governmental guidelines--instead of the market's determination of risk and return--will be unlikely to create financially sound projects. For example, developers differ organizationally one from another. A fully integrated firm may identify less fees or expenses than a development *team*, but may demand a greater overall return. It is the job of service source selection teams to analyze such critical financial factors as part of its source selection evaluation. Attempting to shoe-horn cost assumptions from one project into another across the program would not result in the best projects for the government.

RECOMMENDATION 7: The GAO recommended that the Secretary of Defense direct the Deputy Under Secretary of Defense (Installations and Environment) to improve the value of DoD's privatization program evaluation report by completing the report on time, including information on funds accumulated in project reinvestment accounts, and obtaining periodic independent verification of key report elements. (Page 28/Draft Report).

DOD RESPONSE: Concur. We consider the PEP to be the key program management tool. We concur with the need for timely reports and improving reporting of such items as project reinvestment accounts. We will also obtain periodic independent verification of key report elements.

3

The following is our response to the Department of Defense's (DOD) letter commenting on our draft report.

GAO Comments

1. Concerning the leveraging ratio for the Everett project, the project's budgetary scored cost was $17.5 million and the Navy originally estimated $47.8 million, or $166,000 per unit, would be required to build the project under the military construction alternative. Thus, the project's leveraging ratio is 2.7 to 1. However, the Navy later revised its military construction cost estimate to $52.3 million, or $182,000 per unit. This estimate results in a 3.0 ratio. In comparison, the Navy's military construction unit cost estimates for new units in the Camp Pendleton and Kingsville projects were $153,000 and $136,000, respectively. Because the $47.8 million estimate was based on a per unit construction cost that appears more in line with other Navy projects and because the Navy used the $47.8 million estimate in its life cycle cost analysis for the Everett project, we believe that using this estimate to calculate the 2.7 leveraging ratio is reasonable and results in the most accurate estimate.

2. See our response in the Agency Comments section of the letter on page 29.

3. See our response in the Agency Comments section of the letter on page 29.

4. See our response in the Agency Comments section of the letter on page 29.

Appendix VII: GAO Contacts and Staff Acknowledgments

GAO Contacts

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Mark Little (202) 512-4673

Acknowledgments

In addition to the individuals named above, Gary Phillips, James Ellis, Janet Keller, Sharon Reid, James Vitarello, and R. K. Wild made key contributions to this report.

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