Audit Report

OFFICE OF THE INSPECTOR GENERAL

DOD LEASING OF FAMILY HOUSING

Report Number 92-006

October 16, 1991

Department of Defense

The following acronyms are used in this report.

AFB..Air Force Base
FAR..............................Federal Acquisition Regulation
GAO...............................General Accounting Office
NPV.....................................Net Present Value
OMB.............................Office of Management and Budget
P.L..Public Law
MILCOM......................................Military Construction

INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
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October 16, 1991

MEMORANDUM FOR ASSISTANT SECRETARY OF DEFENSE (PRODUCTION AND LOGISTICS)
COMPTROLLER OF THE DEPARTMENT OF DEFENSE

SUBJECT: Audit Report on DoD Leasing of Family Housing (Report No. 92-006)

We are providing this final report for your information and comments. Management comments on a draft of this report were considered in preparing the final report.

DoD Directive 7650.3 requires that all audit recommendations be resolved promptly. Therefore, we request that the Assistant Secretary of Defense (Production and Logistics) and the Comptroller of the Department of Defense provide final comments on the unresolved recommendations and potential benefits by December 16, 1991. See the "Status of Recommendations" section at the end of the finding for the unresolved recommendations and the specific requirements for your comments.

DoD Directive 7650.3 also requires that comments must indicate concurrence or nonconcurrence in the finding and each recommendation addressed to you. If you concur, describe the corrective actions taken or planned, the completion dates for actions already taken, and the estimated dates for completion of planned actions. If you nonconcur, you must state your specific reasons for each nonconcurrence. If appropriate, you may propose alternative methods for accomplishing desired improvements.

If you nonconcur with the estimated monetary benefits (Appendix E) or any part thereof, you must state the amount you nonconcur with and the basis for your nonconcurrence. Recommendations and potential monetary benefits are subject to resolution in accordance with DoD Directive 7650.3 in the event of nonconcurrence or failure to comment. We also ask that your comments indicate concurrence or nonconcurrence with the internal control weaknesses highlighted in Part I.

The cooperation and courtesies extended to the audit staff are appreciated. If you desire to discuss this final report, please contact Mr. Wayne K. Million, Program Director, at (703) 614-6281 (DSN 224-6281) or Mr. Gary R. Padgett, Project Manager at (703) 614-3459 (DSN 224-3459). Copies of the final report will be distributed to the activities listed in Appendix G.

Robert J. Lieberman

Robert J. Lieberman
Assistant Inspector General
for Auditing

Enclosure

Office of the Inspector General, DoD

AUDIT REPORT NO. 92-006 (Project No. 0CG-0006) October 16, 1991

DOD LEASING OF FAMILY HOUSING

EXECUTIVE SUMMARY

Introduction. The fiscal year 1984 Military Construction Authorization Act (Public Law 98-115, Section 801) authorized a program for build-to-lease family housing projects. The program is available to installations with a valid housing shortage that can be satisfied economically through a 20-year lease. Since the program's inception, Congress has authorized 19,500 family housing units under Section 801.

Objectives. The audit objectives were to determine if the Services acquire family housing under build-to-lease arrangements in compliance with Public Law 98-115, if leasing of family housing is an economical long-term alternative to military construction, and if internal controls over the build-to-lease program are effective. During the audit we expanded our objectives to also determine if the family housing requirements were computed accurately. We will issue a separate report on the methods used to compute family housing requirements.

Audit Results. Implementation of the build-to-lease program did not ensure that family housing was acquired in the most economical manner. The audit showed that Office of Management and Budget guidance used to justify Section 801 housing was inappropriate. Estimates for the military construction alternative included property taxes, which the U.S. Constitution prohibits state and local governments from imposing on the Federal Government, while other costs that the Government will incur were excluded from the analysis. Moreover, DoD's economic analysis was designed to show that leasing was always the most cost-effective alternative and to establish a ceiling price. In addition, contracting procedures did not ensure that adequate housing was obtained at the least possible cost and that the Government's interests were adequately protected. Revising the methodology for justifying and awarding contracts could reduce costs by about $56.5 million over a 20-year lease period for 9 family housing projects (3,708 units) scheduled for award by September 30, 1991. Costs can be reduced for 3 other family housing projects (792 units), for which cost data have not been finalized, that were also scheduled for award in FY 1991. Also, a family housing project (300 units) for which cost data were not finalized should be canceled because the project was for an installation that was identified as a base closure candidate by the Secretary of Defense.

Internal Controls. The audit identified internal control weaknesses. Specifically, contracting procedures did not ensure that family housing was obtained at the least possible cost or that the Government's interests were protected. See part 1, page 2 and the finding in Part II for additional details on our review of internal controls.

Potential Benefits of Audit. Revision of the methodology for computing leasing costs will result in potential monetary benefits of about $56.5 million over a 20-year period on nine Section 801 housing projects (Appendix D). About $20.6 million of the potential monetary benefits will occur in the initial 6 years of the nine projects (Appendix E). An unidentified amount of monetary benefits will result from revising the methodology for three projects on which cost data were not finalized and canceling two projects at installations scheduled for closure. Implementing internal control recommendations calling for a termination for convenience clause in lease agreements and discontinuing DoD's practice of advertising the lease ceiling amount in solicitations should ensure economical lease housing and flexibility in contract administration practices.

Summary of Recommendations. We recommended changes in the methodology for making lease-versus-buy decisions on family housing and in soliciting and awarding family housing lease contracts under Section 801. We also recommended that guidance on conducting economic analyses for Section 801 build-to-lease be revised.

Management Comments. The Principal Deputy Assistant Secretary of Defense (Production and Logistics) partially concurred with recommendations to change the methodology for making lease-versus-buy decisions and nonconcurred with the recommendation to change procedures for soliciting and awarding family housing lease contracts. The Comptroller, Department of Defense did not comment on the recommendation that DoD economic analysis guidance be revised. A full discussion of the responsiveness of management comments is provided in Part II of the report, and the complete text of the management comments provided is included in Part IV of the report.

Audit Response. We request that the Assistant Secretary of Defense (Production and Logistics) reconsider, and provide additional comments on, his position that property taxes be included in a build-to-lease economic analysis and that lease housing contracting practices do not need changes to ensure that lease housing is obtained in the most economical manner. Also, we request that the Comptroller, Department of Defense respond to the final report. Accordingly, we request that the Secretary and Comptroller provide comments to the final report by December 16, 1991.

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This report was prepared by the Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD. Copies of the report can be obtained from the Information Officer, Audit Planning and Technical Support Directorate, (703) 693-0340 (DSN 223-0340).

PART I - INTRODUCTION

Background

Public Law (P.L.) 98-115, Section 801, "Military Family Housing Leasing Program," authorizes DoD to consider build-to-lease projects. Build-to-lease projects are those in which DoD leases newly constructed housing projects for up to 20 years from a private developer. Under the law, the following conditions and restrictions apply to the Section 801 program.

- The project is to be constructed on or near a military installation.

- Units are to be assigned rent-free to eligible military members.

- Contracts are to be awarded through public advertising, competitive bids, or competitively negotiated contracting procedures.

- Contracts may provide for the contractor to operate and maintain the facility during the term of the lease.

- The units are to be constructed to DoD specifications.

- The lease may not exceed 20 years after the completion of construction.

- The Government has the right of first refusal to acquire the project after the lease period.

- DoD must submit an economic analysis, demonstrating that the project is cost-effective compared to other means of providing housing, to the appropriate congressional committees.

Since the program's inception in FY 1984, Congress has authorized 19,500 family housing units under Section 801. As of January 7, 1991, 25 projects (8,923 units) were completed, under construction, or under contract. The 20-year lease payments total about $86 million per year for the 25 projects. The remaining Section 801 housing projects (10,577 units) were in various stages of project review and approval.

Objectives

The objectives of the audit were to determine whether:

- the Services acquire family housing under build-to-lease arrangements in compliance with P.L. 98-115;

• leasing of family housing is an economical, long-term alternative to military construction; and

• internal controls over the build-to-lease program are effective.

During the survey phase of the audit, we expanded the scope of our objectives to determine whether family housing requirements were computed accurately. A separate report will be issued on the methods used to compute family housing requirements.

Scope

Locations and projects reviewed. The audit was performed at the Section 801 program office within the Office of the Assistant Secretary of Defense (Production and Logistics) (ASD [P&L]), at the Office of Comptroller of the Department of Defense, and at the activities shown in Appendix F. We reviewed the methodology for justifying Section 801 family housing and related costs for 7 completed and 12 proposed projects. In addition, we discussed with Office of Management and Budget (OMB) representatives the economic analysis procedures used to justify Section 801 housing. We also reviewed contracting procedures and the eight contracts for the eight completed projects.

Auditing standards. This program audit was performed from October 1989 through December 1990 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. Accordingly, the audit included such tests of internal controls as were considered necessary. To verify the reliability of computerized data generated to justify Section 801 housing, we reviewed the process for determining military construction cost for selected projects. We compared the standard cost factors, such as average "cost per square foot" provided by the Deputy Assistant Secretary of Defense (Installations), with the actual factors used by the program office. These factors were used to independently verify the accuracy of the military construction estimate. In addition, we verified the accuracy of property tax rates by contacting local governments. We computed the net present value of the imputed property taxes using the discount rates provided by the program office.

Internal Controls

The audit evaluated internal controls relating to the oversight and submission of proposed Section 801 projects to Congress as required by P.L. 98-115. We also evaluated contracting procedures for awarding 20-year lease contracts.

The audit identified material internal control weaknesses as defined by P.L. 97-255, OMB Circular A-123, and DoD Directive

5010.38. DoD complied with the laws and procedures authorizing family housing leasing projects. However, the practice of advertising the lease ceiling in contract solicitations did not ensure that contracts were awarded at the lowest cost. Also, contracts for Section 801 housing did not contain termination for convenience clauses, which are required to protect the interests of the Government in the event of unforeseen circumstances. Recommendations 1.d. and 1.e., if implemented, will correct these weaknesses. Monetary benefits associated with these recommendations are not readily identifiable. A copy of the final report will be provided to the senior official responsible for internal controls within the Office of the Secretary of Defense.

Prior Audits and Other Reviews

The General Accounting Office (GAO) issued Report No. GAO/NSIAD-87-13BR (OSD Case No. 7040), "Military Family Housing: Observations on DoD Build-to-Lease and Rental-Guarantee Housing Programs," to Congress on October 9, 1986. GAO concluded that DoD generally complied with the laws authorizing family housing leasing projects, and that economic analyses provided to Congress were generally in accordance with OMB guidance. However, GAO questioned the DoD practice of setting a ceiling for proposals, which ensured that all successful bids would be less costly than military construction. As a result, there was no assurance that the winning proposal would provide adequate housing at the least possible cost. GAO made no recommendations, and DoD did not revise the practice.

Other Matters of Interest

OMB Circular A-11, "Preparation and Submission of Budget Estimates," dated July 1990, revised the funding guidance for capital assets. Circular A-11 requires that, beginning on October 1, 1991, agencies are to fully fund in the initial lease year an amount equal to the estimated annual payments on the lease. Further, where these leases are privately financed and backed by the Government with an unconditional promise to make payments, the leases are to be treated as a direct Federal purchase, which requires agencies to have sufficient funds for the total cost of the lease when the contract is signed. The change in OMB funding requirements for capital leases cancels the advantage of the Section 801 family housing program, which allows DoD to amortize the total lease cost over a 20-year period.

United States Code, title 31, section 1552 has recently been amended to require the write-off of obligated balances 5 years after the expiration of the appropriation. Beginning in FY 1992, the 20-year lease amount of a Section 801 housing project will be considered as budget authority and will be obligated in the year in which the Government enters into the agreement. The obligated balance will be written off over the term of the lease. As a result of Section 1552 legislation, the cost of Government indebtedness could be distorted and, under certain circumstances, could cause the DoD to count leasing costs twice. When we brought this matter to the attention of the Comptroller of the Department of Defense, management action was initiated, in coordination with OMB officials, to seek legislative relief for the expenditure limitation.

PART II - FINDING AND RECOMMENDATIONS

FAMILY HOUSING BUILD-TO-LEASE PROGRAM

Implementation of the build-to-lease program did not ensure that family housing was acquired in the most economical manner when compared to military construction. The methods used to perform the economic analysis justifying the leasing of family housing were flawed because of OMB evaluation guidelines. The costs in the economic analysis for three projects were inflated by $34.8 million because property taxes, which the U.S. Constitution prohibits state and local governments from imposing on the Federal Government, were improperly added to the estimated costs of military construction. Also, the cost of educational impact aid was not considered in the economic analysis. The economic analyses were primarily designed to establish a pricing mechanism for selecting bids. By revising the methodology for justifying and awarding lease contracts, DoD would have a more realistic basis for selecting the most cost-effective housing alternative. Also, the potential cost of leasing could be reduced by about $56.5 million over a 20-year lease period for 9 family housing projects (3,708 units) scheduled to be awarded by September 30, 1991. About $20.6 million of the potential cost reductions will occur in the initial 6 years of the nine projects. Additional costs can be reduced for 3 family housing projects (792 units), for which costs have not been finalized. The practice of advertising the lease ceiling in contract solicitations did not ensure that contracts were awarded at the lowest cost, and excluding termination for convenience clauses in contracts did not protect the Government's interests. Further, on April 12, 1991, the Secretary of Defense identified an installation with a housing projects (300 units) as a base closure candidate. Therefore, the project should be canceled.

DISCUSSION OF DETAILS

Background

P.L. 98-115, Section 801, "Military Family Housing Leasing Program," authorizes the use of private capital to provide housing and to eliminate the Government investment necessary for military construction. The program is available to installations with a valid housing shortage that can be satisfied economically through a 20-year leasing agreement. The Office of the Assistant Secretary of Defense (Production and Logistics) provides policy oversight, reviews the economic justifications, and obtains the necessary approvals for each Section 801 family housing project. Contracts for the housing projects cannot be awarded until 21 days after the Secretary of Defense has sent economic justification to the appropriate congressional committees.

To demonstrate that leasing family housing is cost-effective when compared with other means of furnishing the same facilities, P.L. 98-115 requires an economic analysis based on accepted life-cycle costing procedures. P.L. 98-115 does not prescribe specific guidance for preparing economic analyses. However, DoD prepares its economic analyses in accordance with OMB Circular A-104, "Evaluating Leases of Capital Assets," June 1, 1986. An economic analysis is intended to determine whether leasing or buying an asset would cost less. The leasing alternative includes the total lease payments. The cost elements of the purchase alternative include:

- purchase costs, including the costs of construction, installation, site design, management, and any other costs associated with acquiring the property and preparing it for use;
- repair and improvement (if included in lease payments);
- operation and maintenance (if included in lease payments);
- property taxes (excluding foreign taxes on overseas acquisitions, unless actually paid);
- insurance premiums; and
- cost offsets, such as residual value at the end of the lease period, subtracted from the purchase cost.

According to a separate agreement with OMB officials and congressional committees, DoD's economic justification must show that Section 801 family housing will cost 5 percent less than military construction. The estimated cost of military construction is multiplied by 95 percent, which sets the lease ceiling. Appendix A gives an example of the methodology used to demonstrate that Section 801 family housing costs less than military construction.

Housing Authorization

DoD is authorized a maximum of 19,500 family housing units under Section 801. As of January 7, 1991, contractor bids had been received on 2 projects (550 units), and 17 additional projects (6,848 units) were in various stages of project review and approval for FY 1991. OMB will waive its revised full-funding policy for contracts awarded by September 30, 1991.

Decisions on Leasing Versus Military Construction

The DoD application of Circular A-104 did not provide a sound basis for making cost-effective decisions on acquiring Section 801 family housing. The prescribed economic analysis included cost factors that the Government has no legal obligation to pay, but excluded other appropriate costs. Moreover, the DoD application of Circular A-104 resulted in an inflated lease ceiling, which became the pricing mechanism for selecting a successful bidder.

Property taxes. In comparing lease-to-buy alternatives, Circular A-104 states that certain costs associated with the Government's purchase of an asset do not involve any direct Federal payment. According to OMB, such costs should include imputed state and local property taxes on federally owned facilities in preparing the economic analysis. DoD follows Circular A-104 by adding property taxes to the estimated cost of military construction.

Circular A-104 guidance on the treatment of taxes conflicts with legal realities for acquiring family housing under Section 801. The Federal Government is exempt from state or municipal real estate taxes under the Constitution of the United States. Numerous Comptroller General decisions have consistently upheld this principle. Further, DoD maintains federally owned off-base family housing for which municipal services are not charged. For three projects built under Section 801 at two activities (Ellsworth Air Force Base (AFB) and Fort Drum, New York), property taxes included in the military construction alternative caused overstatement of the maximum allowable lease ceiling by $34.8 million (net present value). The actual contract award amount for the three projects exceeded the allowable ceiling by $33.2 million.

As the result of our audit, program management officials have taken action to exclude property taxes in the analysis for projects proposed on-base. For example, the justification for a Section 801 project (366 units) at Eielson AFB, Fairbanks, Alaska, was reduced by $10.5 million. However, property taxes are still included for projects proposed off-base. Management's rationale is that property taxes are a real cost to a contractor and should be included in the economic analysis. We agree that a contractor would have to pay property taxes. However, taxes are not paid on Government-owned off-base housing and, therefore, should not be included in the military construction alternative. An example of the effect of excluding property taxes on the lease ceiling is provided in Appendix B.

Educational impact aid. The economic analysis did not include the estimated cost of educational impact aid. The Department of Education provides local school districts with educational impact aid for children of military members who work on military installations and reside in the community, or who reside and work on military installations. Actual entitlements vary from region to region and are based on a statutory formula administered by the Department of Education. The amount of educational impact aid is substantially higher for children who reside on the Federal property and has a significant effect on the decision to lease or construct family housing. For three Section 801 projects reviewed at Cannon AFB, Naval Air Station (NAS) Pensacola, and NAS Whidbey Island, the estimated net present value of educational impact aid for children residing on-base was about $11 million compared to about $1 million for children residing off-base. An example of the effect of educational impact aid on the economic analysis is provided in Appendix C.

Guidance. The justification for acquiring family housing should support the most economical alternative for DoD. Public Law 98-115 requires an economic analysis based on accepted life-cycle costing procedures, but does not specifically prescribe the use of OMB Circular A-104. We believe that the justification for Section 801 family housing should be a two-step process. The first step should be determining whether leasing or military construction is the most cost-effective alternative. If leasing is cheaper to the Government, step two should involve establishing the appropriate lease ceiling. The lease ceiling should be 5 percent less than the military construction alternative (without State and local taxes) and should exclude the cost of education impact aid funded by the Department of Education. Examples of how the two-step process should work for Section 801 projects are provided in Appendixes B and C. The two-step process for making lease-versus-military construction decisions for Section 801 housing should also be delineated in DoD Instruction 7041.3, "Economic Analysis and Program Evaluation for Resource Management," dated October 18, 1972.

Contracting Procedures

Maximum lease ceiling. The practice of advertising the lease ceiling in contract solicitations did not ensure that contracts were awarded at the lowest cost. For three Section 801 family housing projects reviewed, contracts awarded were between 98 and 100 percent of the ceiling. GAO reported the same condition in 1986. GAO (Report No. GAO/NSIAD-87-13BR) observed that successful bids on seven Section 801 family housing projects were between 95 and 100 percent of the ceiling. In leasing facilities for the Government, the General Services Administration prohibits advertising lease ceilings because such practices constitute an auction technique. The Section 801 program office was requested but could not provide the administrative or legal basis for advertising a lease ceiling. In any event, excluding the lease ceiling from the solicitation provides greater assurance that family housing under Section 801 is acquired at the least cost.

Termination for convenience clauses. Only one of eight contracts reviewed for Section 801 family housing projects contained a termination for convenience clause. The Federal Acquisition Regulation (FAR), subparts 49.502 and 49.503, requires a termination for convenience clause in solicitations for award of fixed-price and cost-reimbursement contracts. Program management officials stated that the termination for convenience clauses were excluded from solicitations in order to enhance a contractor's ability to secure financing at a lower rate. For example, a contractor who obtained a firm commitment from the Government for a 20-year project could secure financing more easily than a contractor without such a commitment.

The purpose of the FAR provision is to protect the Government's interest in the event of unforeseen circumstances. Our Report No. 90-104, "Audit of DoD Leasing of Family Housing at Ellsworth Air Force Base," August 24, 1990, reported that 2 separate Section 801 contracts (1,028 units) were awarded costing about $102 million (net present value) without housing personnel determining the availability of adequate private sector housing. We recommended that the Air Force conduct the required private sector market analysis to identify the number of available houses that could be used to reduce Section 801 contracts. In response to our report, Air Force management stated that a new housing market analysis was not needed because construction of 200 housing units was complete and the project for 828 units was well underway. In addition, the contracts contained no provisions to reduce the number of units being built, and any attempt to reduce the size of the 828-unit project would result in substantial termination costs. DoD should retain its flexibility by incorporating termination for convenience clauses in long-term leases for family housing, especially when considering current efforts being made to reduce and realign military forces.

Conclusion

The economic analysis for Section 801 housing did not provide the most accurate basis for making an informed decision on acquiring family housing. At Ellsworth AFB, the economic analysis, if properly prepared, would have shown that the military construction alternative was about $22.4 million (net present value) less than the Section 801 housing (828 units) built on-base. In addition, Section 801 housing was built to replace existing substandard housing on-base, and the requirement for housing will likely extend beyond the 20-year lease agreement causing additional housing costs to be incurred. By including property taxes in the advertised lease ceiling, we estimated that about $56.5 million (net present value) could be improperly incurred over a 20-year period on 9 Section 801 family housing projects (3,708 units) scheduled to be awarded by September 30, 1991 (Appendix D). About $20.6 million of the potential cost reductions will occur in the initial 6 years of the nine projects. In addition, changing the methodology for the economic analysis will affect costs by an unknown amount for 3 family housing projects (792 units) scheduled for 1991. The cost data for the 3 projects had not been finalized at the time of our review. A family housing project (300 units) planned for Long Beach, California, did not have finalized cost data. On April 12, 1991, the Secretary of Defense identified this installation as a base closure candidate. Therefore, the project should be canceled.

The advertisement of lease ceilings amounts and the lack of termination for convenience clauses in contracts for leasing family housing projects are considered material internal control weaknesses. These weaknesses should be reported and tracked until resolved in accordance with DoD Instruction 5010.38, "Internal Management Control Programs."

RECOMMENDATIONS, MANAGEMENT COMMENTS, AND AUDIT RESPONSE

Recommendation 1. **We recommend that the Assistant Secretary of Defense (Production and Logistics):**

a. Issue guidance on conducting economic analysis for the Section 801 build-to-lease program. Specifically, this guidance should:

(1) Exclude imputed property taxes from the military construction alternative for housing projects proposed for either on-base or off-base.

(2) Include the appropriate cost of educational impact aid in both the leasing and military construction alternative.

(3) Exclude the cost of educational impact aid from the lease ceiling computation, if the analysis shows that it is cheaper to lease family housing units.

Management comments. The Principal Deputy Assistant Secretary of Defense (Production and Logistics) (ASD(P&L)) partially concurred with Recommendations 1.a.(1) through 1.a.(3), and stated that procedures used for Section 801 economic analysis conform to the requirements of OMB Circular A-104. The Principal Deputy disagreed, however, with excluding imputed property taxes from the purchase alternative. The Principal Deputy stated that in order to realistically compare a proposed Section 801 lease (subject to property taxes) to a military construction project on Government land (not subject to property taxes), OMB Circular A-104 prescribes that local property taxes should be imputed against the military construction project to "ensure valid comparisons." The Principal Deputy agreed that one ambiguity exists in current economic analysis procedures that needs to be clarified. The OMB Circular A-104 was designed primarily for comparison of a direct Federal purchase versus leasing a privately owned capital asset. When the leased asset is to be constructed on Government property, the appropriateness of imputed property taxes is less certain. The Principal Deputy stated that proposed projects of this type will be reviewed on a case by case basis to ensure that the economic analysis model accurately reflects the true cost picture. See Part IV for a complete text of management responses.

Audit response. We do not agree with the ASD (P&L) position on Recommendation 1.a.(1) that imputed property taxes should be included in the military construction alternative when evaluating proposed Section 801 leasing projects. The current economic analysis model, used to evaluate the leasing of capital asset, evaluates a military construction housing project on Government property located off a military installation with a Section 801 build-to-lease project located in the private sector. DoD has Federally owned off-base family housing where community services, provided by the local municipality, are not reimbursed by the Federal Government because they are not subject to taxation by the state or local governments. Since community support services are not a cost to the Government for off-base Federal housing, by strictly following OMB Circular A-104, DoD will overstate the military construction alternative in the economic analysis used to develop the project's maximum lease ceiling amount (price). OMB personnel responsible for OMB Circular A-104 stated that the circular was not intended to circumvent legislative or legal requirements. The ASD (P&L) did not provide comments, actual or planned actions, and estimated completion dates for Recommendations 1.a.(2) and 1.a.(3). Therefore, we request that the ASD (P&L) reconsider his position on Recommendation 1.a.(1) and also address Recommendations 1.a.(2) and 1.a.(3) when providing comments to the final report.

b. Apply the guidance in Recommendation 1.(a) to Section 801 family housing projects under consideration.

Management comments. The Principal Deputy nonconcurred with the recommendation for the same reasons as stated in management's comments to Recommendations 1.a.(1) through 1.a.(3).

Audit response. We do not agree with the ASD (P&L) position that imputed property taxes should remain in Section 801 housing projects under consideration for procurement for the same reasons as stated in the audit response to Recommendation 1.a.(1). We request that the ASD (P&L) reconsider his position on Recommendation 1.b. and provide additional comments in reply to the final report.

c. Reduce the lease ceilings for the nine Section 801 projects shown in Appendix D by about $56.5 million to account for imputed property taxes attributed to the military construction alternative.

Management comments. The Principal Deputy nonconcurred with Recommendation 1.c. to reduce the lease ceiling for nine proposed Section 801 projects by about $56.5 million. The position for not removing imputed property taxes for the military construction alternative, which is used to calculate the lease ceiling amounts, is based on the same reasons as stated in management comments to Recommendation 1.a.(1) through 1.a.(3). The Principal Deputy stated that procurement action has been canceled on three Section 801 projects in Appendix D (Dahlgren, Virginia, New London, Connecticut, and Warminster, Pennsylvania), and property taxes have been eliminated from the one on-base project (Eielson AFB).

Audit response. We do not agree with the ASD (P&L) position to Recommendation 1.c. DoD will incur about $33 million in excess leasing costs for the remaining five proposed Section 801 projects by improperly including imputed property taxes in the project's maximum lease ceiling amount. The elimination of property taxes from the Eielson AFB project (366 units) is considered responsive to the recommendation although monetary benefits associated with the action was not addressed in the comments. We request that the ASD (P&L) reconsider his position on Recommendation 1.c. and also address the monetary benefits when responding to the final report.

d. Prohibit the Military Departments from advertising the maximum lease ceiling amount in contract solicitations for Section 801 family housing.

Management comments. The Principal Deputy nonconcurred with the recommendation and stated that the premise of Section 801 procurements should not be the lowest lease housing cost, but to get quality construction for the lowest life-cycle cost. The Principal Deputy also stated that Congress requires that the lease ceiling be disclosed to four separate subcommittees, which effectively puts the information in the public domain. Also, by letting competitors know price restrictions and quality requirements on a project up front, potential contractors can decide whether to bid, and if so, what to propose in order to be competitive. In addition, public advertisement of Section 801 solicitations results in free market forces of full and open competition driving quality up and life-cycle cost down.

Audit response. We do not agree with the ASD (P&L) position that the maximum lease ceiling should be included in solicitations for Section 801 family housing. P.L. 98-115 states that a Section 801 contract may not be entered into until DoD submits to the appropriate committees of Congress an economic analysis that demonstrates the proposed contract is cost-effective when compared with alternative means of furnishing the same housing facility. The law does not require the Government to disclose the maximum lease amount that can be incurred for a Section 801 project and still be in compliance with the intent of P.L. 98-115 as being cost-effective. Advertising a Section 801 project's maximum lease ceiling only gives prospective contractors the opportunity to determine if they wish to bid based on the maximum amount the Government is willing to pay for the project. The quality of housing should not be affected since all competitors should submit bids based on construction specifications provided in a project's solicitation, rather than their best computative estimate just under the maximum amount that the Government is willing to pay. Clearly, excluding the lease ceiling from the solicitation provides greater assurance that leased family housing is acquired at the least cost for a given quality. We request that the ASD (P&L) reconsider his position to Recommendation 1.d. when commenting on the final report.

e. Require the Military Departments to include termination for convenience clauses in contracts awarded for Section 801 family housing projects.

Management comments. The Principal Deputy nonconcurred with Recommendation 1.e. and stated that the decision to not include termination for convenience clauses in Section 801 contracts was a calculated business decision. It was also stated that the termination for convenience clause would needlessly add cost to the Section 801 lease agreements as offerors would add additional costs in order to cover the additional financial risk accompanying such a provision. The Principal Deputy stated that this DoD practice is consistent with the General Services Administration leasing practice, which requires a termination for default provision, but not a termination for convenience in real estate solicitations.

Audit response. We do not agree with the ASD (P&L) position that a termination for convenience clause should be omitted from a Section 801 housing project's solicitation or lease agreement. It is recognized that DoD can always cancel a lease agreement whether or not a termination for convenience clause is incorporated as required by FAR, subparts 49.502 and 49.503. However, based on DoD's current strategy to reduce and realign military forces, it is in the Government's best economical interest to retain its flexibility by incorporating clauses that recognize all liabilities for each party in the agreement rather than imply such liabilities. Therefore, we request that the ASD (P&L) reconsider his position on Recommendation 1.e. when responding to the final report.

f. Cancel proposed Section 801 housing project at the Naval Station, Long Beach, CA, which was recommended for closure by the Secretary of Defense.

Management comments. The Principal Deputy partially concurred with Recommendation 1.f. The Principal Deputy agreed that new construction contracts should not be awarded at installations with an uncertain future. However, the Principal Deputy did not agree that planned lease housing projects should be summarily rescinded as the result of the host installation being a nominee for closure. The Principal Deputy put Section 801 housing projects under solicitation at NAS Whidbey Island and Castle AFB on indefinite postponement and stopped the project for Naval Station Long Beach before the solicitation was issued. The Principal Deputy stated that when the future of the host installation is certain, these projects will either be canceled or allowed to proceed.

Audit response. At the time the draft report was issued, two installations with proposed Section 801 housing projects, NAS Whidbey Island and the Naval Station, Long Beach were recommended for base closure. Since the draft was issued, NAS whidbey Island was removed from the base closure list. Accordingly, we modified the recommendation to reflect this change. The ASD (P&L) comments are considered to be responsive; however, comments were not provided on potential monetary benefits or estimated completion dates for actions already taken. As required by DoD Directive 7650.3, we request that comments to the final report provide the additional information.

Recommendation 2. We recommend that the Comptroller of the Department of Defense revise DoD Instruction 7041.3, "Economic Analysis and Program Evaluation for Resource Management," to incorporate the revised guidance on conducting economic analyses for the Section 801 build-to-lease program outlined in Recommendation 1.a.

Management comments. The Comptroller of the Department of Defense did not submit comments on Recommendation 2.

Audit response. We request that the Comptroller of the Department of Defense respond to the final report, indicating concurrence or nonconcurrence with the recommendation, as required by DoD Directive 7650.3.

STATUS OF RECOMMENDATIONS

		Response Should Cover			
Number	Addressee	Concur/ Nonconcur	Proposed Action	Completion Date	Related Issues*
1.a.	ASD(P&L)	X	X	X	
1.b.	ASD(P&L)	X	X	X	
1.c.	ASD(P&L)	X	X	X	M
1.d.	ASD(P&L)	X	X	X	IC
1.e.	ASD(P&L)	X	X	X	IC
1.f.	ASD(P&L)		X	X	M
2	Comptroller DoD	X	X	X	

* M = monetary benefits; IC = material internal control weakness

PART III - ADDITIONAL INFORMATION

APPENDIX A - Example of Current Methodology Used to Justify Section 801 Family Housing

APPENDIX B - Example of Proposed Methodology for Section 801 Housing Built On-Base

APPENDIX C - Example of Proposed Methodology for Section 801 Housing Built Off-Base

APPENDIX D - Computation of Potential Monetary Benefits

APPENDIX E - Summary of Potential Monetary and Other Benefits Resulting from Audit

APPENDIX F - Activities Visited or Contacted

APPENDIX G - Report Distribution

APPENDIX A - EXAMPLE OF CURRENT METHODOLOGY USED TO JUSTIFY SECTION 801 FAMILY HOUSING

DoD's economic justification always shows that leasing is the most cost-effective alternative when comparing military construction (MILCON) versus leasing family housing as illustrated in this example. Total MILCON costs were derived for 200 units by estimating construction and support costs using the Tri-Service Cost Model; adding the cost of land, imputed property taxes, and imputed liability insurance costs; and subtracting the residual value of the project using a 45-year economic life. Total net MILCON cost is $19,319,462 after adjustment for the residual value of the assets.

A. MILCON Cost Factors	Amount
Construction -- Housing Units	$13,737,600
Construction -- Support Facilities	4,962,500
Contingency/Overhead	1,131,400
Subtotal	$19,831,500
Land	70,000
Imputed Property Tax (20 years)	19,694,680
Imputed Insurance (20 years)	803,320
Subtotal	$40,399,500
Less: Residual Value (25-year Remaining Life)	21,080,038
Total MILCON Cost	$19,319,462

APPENDIX A - EXAMPLE OF CURRENT METHODOLOGY USED TO JUSTIFY SECTION 801 FAMILY HOUSING (Continued)

The total MILCON cost when stated in net present value (NPV) terms is $24,968,228. The NPV of lease costs ($24,968,228 x .95) is converted to an annual rent ceiling of $2,470,447. The rent ceiling is the maximum amount that will be paid by the Government each year, plus increases in property taxes and insurance costs that the contractor may incur after the second year.

B. MILCON Versus Lease Alternative	Amount
MILCON Cost Converted to NPV for 20 years	$24,968,228
Lease NPV for 20 years ($24,968,228 x .95)	$23,719,817
Annual Rent Ceiling (Current Dollars) */	$ 2,470,447

*/ The Annual Rent Ceiling is computed by multiplying the Lease NPV ($23,719,817 minus $1,168,222 for the estimated accumulative annual increase in property taxes and insurance) by an interest rate to borrow money, then dividing the total principle and interest payments by 20 years.

APPENDIX B - EXAMPLE OF PROPOSED METHODOLOGY FOR SECTION 801 HOUSING BUILT ON-BASE

Ellsworth Air Force Base (AFB) originally justified building Section 801 housing (828 units) as the most economical alternative. However, including property taxes in the MILCON alternative inflated the lease ceiling by about $22.4 million in net present value terms.

The revised financial analysis (step one - evaluating alternative) shows that the estimated cost of the MILCON alternative should have been about $99.5 million compared to about $119 million for leasing. In order for leasing to be more cost-effective (step two - establishing lease ceiling), the Section 801 lease ceiling should have been set at about $55.7 million as illustrated below.

STEP 1. MILCON VERSUS LEASE ALTERNATIVE

	Amount (000)	Amount (000)
Milcon Cost Alternative		
Construction Costs	$82,166	
Less Imputed Taxes	23,541	$ 58,625
Educational Impact Aid		40,929
Total		$ 99,554
Section 801 Alternative		
Lease Ceiling ($82,166 x .95)		$ 78,058
Educational Impact Aid		40,929
Total		$118,987

STEP 2. LEASE CEILING

Actual Lease Ceiling Advertised	$ 78,058
Less: Revised Lease Ceiling ($58,625 x .95)	55,693
Amount Overstated	$ 22,365

APPENDIX C - EXAMPLE OF PROPOSED METHODOLOGY FOR SECTION 801 HOUSING BUILT OFF-BASE

The revised financial analysis (step one - evaluating alternative) shows that the proposed Section 801 housing (300 units) to be built off-base at Naval Air Station Whidbey Island, Washington, would cost less than the MILCON alternative. In step two - establishing lease ceiling, the lease ceiling should be lowered by about $2.2 million to offset the effect of including imputed property taxes in the original MILCON cost alternative.

STEP 1. MILCON VERSUS LEASE ALTERNATIVE

MILCON Cost Alternative	Amount (000)	Amount (000)
Construction Costs	$19,878	
Less Imputed Taxes	2,318	$17,560
Educational Impact Aid (On-base housing)		5,100
Total		$22,660
Section 801 Alternative		
Lease Ceiling ($19,878 x .95)		$18,884
Educational Impact Aid (Off-base housing)		634
Total		$19,518

STEP 2. LEASE CEILING

Lease Ceiling Advertised	$18,884
Less: Revised Lease Ceiling ($17,560 x .95)	16,682
Amount Overstated	$ 2,202

APPENDIX D - COMPUTATION OF POTENTIAL MONETARY BENEFITS

Potential savings will be realized by eliminating property taxes from the MILCON alternative, which is used to establish the lease ceiling.

Location	Units	Net Present Value of Property Taxes in MILCON Alternative 20-year Period (In Millions)
Fort Stewart, Georgia	200	$ 2,191,729 1/
Dahlgren, Virginia	150	1,248,772 6/
New London, Connecticut	300	9,342,529 6/
Pensacola, Florida	300	2,972,251
Twentynine Palms, California	600	6,598,713
Warminster, Pennsylvania	200	2,465,930 6/
Cannon AFB, New Mexico	350	2,370,607 1/
Eielson AFB, Alaska	366	10,458,829 2/ 6/
Bolling/Andrew AFB, Washington, DC (Navy)	1,242	18,894,653
Fort Bragg, North Carolina	250	3/
San Diego, California	398	3/
Long Beach, California	300	4/
Whidbey Island, Washington	300	
Cannon AFB, New Mexico	144	3/
Total	5,100	$56,544,013 5/

See footnotes on following page.

1/ Request for proposal contained property taxes in the advertised maximum lease ceiling.

2/ The Section 801 Program Office took action to eliminate property taxes from on-base Section 801 family housing projects during the audit. This amount represents the estimated value of property taxes that would have been included in the MILCON alternative (e.g., property tax rate .0134 percent x facility value).

3/ Economic analysis for the project was not received by the Section 801 Program Office.

4/ The Secretary of Defense recommended facilities for closure on April 12, 1991. According to August 12, 1991, comments from the Assistant Secretary of Defense (Production and Logistics) (Page 39), this project was placed in suspension until the status of the host facility is resolved.

5/ Monetary benefits amounting to $20.6 million are identified with the 6-year period commencing FY 1992 (see Appendix E).

6/ According to comments from the Assistant Secretary of Defense (Production and Logistics) (Page 37), procurement action was canceled for the projects at Dahlgren, New London, and Warminster. Also, property taxes were eliminated from the Eielson AFB project and this reduced costs by an unknown amount.

APPENDIX E - SUMMARY OF POTENTIAL MONETARY AND OTHER BENEFITS RESULTING FROM AUDIT

Recommendation Reference	Description of Benefit	Amount and/or Type of Benefit
1.a.(1) 1.a.(2) 1.a.(3)	Economy and Efficiency These recommendations will improve the evaluation of lease-versus-buy alternatives for the acquisition of Section 801 build-to-lease family housing.	Nonmonetary
1.b.	Economy and Efficiency Implementation of improved lease-versus-buy analysis procedures will result in the reduction of the maximum lease ceiling amount the Government will pay for leased family housing.	Nonmonetary
1.c.	Economy and Efficiency Reduce lease ceilings for projects shown in Appendix D for imputed property tax attributed to the military construction alternative.	A total of $20.6 million of Operations and Maintenance funds will be put to better use over a 6-year period commencing in FY 1992 (Appendix D).
1.d.	Internal Control Eliminating the advertisement of the maximum lease ceiling amount from solicitations for build-to-lease family housing projects will ensure that contracts are awarded at the lowest cost to the Government.	Nonmonetary
1.e.	Internal Control Incorporation of termination for convenience clause in family housing lease contract will protect the Government's financial interest.	Nonmonetary

1.f.	Economy and Efficiency Cancel proposed project at the base recommended for closing by the Secretary of Defense.	At the time of this report, an unidentified amount of potential monetary benefits will result from canceling this housing project.
2.	Economy and Efficiency Revision of DoD Instruction 7041.3 to incorporate Recommendations 1.a.(1), 1.a.(2), and 1.a.(3) will improve the lease-versus-buy analysis process.	Nonmonetary

APPENDIX F - ACTIVITIES VISITED OR CONTACTED

Office of the Secretary of Defense

Assistant Secretary of Defense (Production and Logistics), Washington, DC

Comptroller of the Department of Defense, Washington, DC

Department of the Army

Office of the Assistant Secretary of the Army (Installations, Logistics and Environment), Washington, DC

Office of the Chief of Engineers, Washington, DC

Army Corps of Engineers, Washington, DC

Army Corps of Engineers, Real Estate Division, New York, NY

Fort Drum, Watertown, NY

Department of the Navy

Office of the Assistant Secretary of the Navy (Manpower and Reserve Affairs), Washington, DC

Naval Facilities Engineering Command, Alexandria, VA

Naval Facilities Engineering Command, Atlantic Division, Norfolk, VA

Department of the Air Force

Office of the Assistant Secretary of the Air Force (Manpower, Reserve Affairs, Installations and Environment), Washington, DC

Office of the Deputy Chief of Staff Logistics and Engineering, Washington, DC

Eielson AFB, Fairbanks, AK

Ellsworth AFB, Rapid City, SD

Headquarters, Tactical Air Command, Langley AFB, Hampton, VA

Cannon AFB, Clovis, NM

Other Government Agencies

Department of Education, Washington, DC

General Services Administration, Regional Office, Washington, DC

Office of Management and Budget, Washington, DC

APPENDIX G - REPORT DISTRIBUTION

Office of the Secretary of Defense

Assistant Secretary of Defense (Production and Logistics)
Assistant Secretary of Defense (Public Affairs)
Comptroller of the Department of Defense
Director of Defense Procurement
Deputy Assistant Secretary of Defense (Installations)

Department of the Army

Assistant Secretary of the Army (Financial Management)

Department of the Navy

Assistant Secretary of the Navy (Financial Management)
Auditor General, Naval Audit Service

Department of the Air Force

Assistant Secretary of the Air Force (Financial Management and Comptroller)
Air Force Audit Agency

Defense Agencies

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, Defense Logistics Studies Information Exchange

Non-DoD

Office of Management and Budget
U.S. General Accounting Office, NSIAD Technical Information Center

Congressional Committees:

- Senate Committee on Appropriations
- Senate Subcommittee on Defense, Committee on Appropriations
- Senate Committee on Armed Services
- Senate Committee on Governmental Affairs
- Senate Ranking Minority Member, Committee on Armed Services
- Senate Subcommittee on Military Construction, Committee on Armed Services
- House Committee on Appropriations
- House Subcommittee on Defense, Committee on Appropriations
- House Ranking Minority Member, Committee on Appropriations
- House Committee on Armed Services
- House Committee on Government Operations
- House Subcommittee on Legislation and National Security, Committee on Government Operations
- House Subcommittee on Military Construction, Committee on Appropriations
- House Subcommittee on Military Installations and Facilities, Committee on Armed Services

PART IV - MANAGEMENT COMMENTS

Assistant Secretary of Defense (Production and Logistics)

regard is unclear. If the suggestion is that we can reduce Federal spending by building housing projects within local communities and requiring those communities to provide us with support services without reimbursement, it is doubtful the concept would be popular for long. If the point is that because we don't pay taxes we should therefore deduct from an otherwise "fair and reasonable" contract price that portion the vendor will subsequently use to pay taxes, we fail to see the logic. Taxes are a fact of life in the private sector, and are indirectly reflected in everything the Federal Government buys or leases from the private sector. Further, it is important to recognize that all Section 801 contracts are procured through full and open competition, and that awards are made only to those competitors who offer the Government best value for the contract dollar - at a price that is "cost effective" (i.e., no more expensive than the alternative of military construction). Whether or not the contractors have to use some of the lease proceeds to pay property taxes is not relevant to the more fundamental question of whether the contracts represent good value to the Government.

However, there is one ambiguity in our current procedures that we do agree needs to be clarified. We recognize that OMB Circular A-104 was designed primarily for the comparison of a direct Federal purchase to the alternative of leasing a privately owned capital asset, and in situations where the asset to be leased will be constructed on Government property, the appropriateness of imputed property taxes can be less certain. We therefore intend to review each proposed project of this type on a case by case basis to assure that the economic analysis model accurately reflects the true cost picture.

RECOMMENDATION 1 (b): Apply the guidance in Recommendation 1.(a) to Section 801 family housing projects under consideration.

P&L RESPONSE: Nonconcur.

We do not agree with this recommendation for the reasons stated above.

RECOMMENDATION 1 (c): Reduce the lease ceilings for the 9 Section 801 projects shown in Appendix D by about $56.5 million to account for imputed property taxes attributed to the military construction alternative.

P&L RESPONSE: Nonconcur.

We do not agree with this recommendation for the reasons stated above. As an update to the 9 projects listed in Appendix D, please note that procurement action has been cancelled on three (Dahlgren, New London, and Warminster), and that property taxes have been eliminated from the one on-base project included on the list (Eielson AFB).

RECOMMENDATION 1 (d): Prohibit the Military Departments from advertising the maximum lease ceiling amount in contract solicitations for Section 801 family housing.

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Assistant Secretary of Defense (Production and Logistics) Comments

THE ASSISTANT SECRETARY OF DEFENSE

WASHINGTON DC 20301-8000

PRODUCTION AND LOGISTICS

August 12, 1991

MEMORANDUM FOR DEPARTMENT OF DEFENSE INSPECTOR GENERAL

SUBJECT: Draft Audit Report on DoD Leasing of Family Housing (Project No. OCG-0006)

Thank you for the opportunity to review and comment on the subject report. As explained in the enclosed comments, we can only partially concur with the report's recommendations.

Our current procedures for conducting economic analyses are consistent with Administration policy and Congressional intent, and provide a rational basis for making lease vice purchase decisions. We agree with the policy guidance OMB has published in its Circular A-104 on this subject, and see no reason to pursue deviations from it. Our procurement procedures assure "best value" contracts and adequately safeguard the Government's interests. We do not agree that advertising the price ceiling for each solicitation and avoiding unnecessary "termination for convenience" clauses in the resultant contract constitute weaknesses with internal controls for this program. We do agree that care must be taken to avoid awarding contracts at installations that are going to close, and have safeguards in effect to minimize this possibility.

The Section 801 build-to-lease housing program has been tested and proven over the past several years as a viable means of providing desperately needed family housing at many locations, more quickly and economically than the traditional military construction approach. The procedures we use to acquire these contracts evolved from Congressional direction, OMB guidance, and consultation with other federal agencies and private industry. I believe these procedures are sound, and that they support our objective of taking care of our people.

I request that you amend the subject report to incorporate the enclosed comments.

David J. Berteau

Attachment

David J. Berteau
Principal Deputy

COMMENTS ON DRAFT REPORT
AUDIT OF DOD LEASING OF FAMILY HOUSING
(PROJECT OGC-0006)

RECOMMENDATION 1: We recommend that the Assistant Secretary of Defense (Production and Logistics):

a. Issue guidance on conducting economic analysis for the Section 801 build-to-lease program. Specifically, this guidance should:

(1) Exclude imputed property taxes from the military construction alternative for housing proposed for either on-base or off-base.

(2) Include the appropriate cost of educational impact aid in both the leasing and military construction alternative.

(3) Exclude the cost of educational impact aid from the lease ceiling computation, if the analysis shows that it is cheaper to lease family housing units.

P&L RESPONSE: Partially concur.

The procedures we use for these economic analyses conform to the requirements of OMB Circular A-104. We agree with OMB's guidance for using imputed property taxes as a means of ensuring a valid comparison of the lease alternative with the purchase alternative, and therefore do not agree that we should pursue a policy that would be at variance with this.

Law (10 USC 2828(g)) requires that Section 801 contracts may not be awarded until "the Secretary of Defense submits to the appropriate committees of Congress, in writing, an economic analysis (based upon accepted life cycle costing procedures) which demonstrates that the proposed contract is cost effective when compared with alternative means of furnishing the same housing facilities." The Office of Management and Budget (OMB) Circular A-104 is prescribed for use by all agencies in the Executive Branch of the Federal Government for evaluating lease-versus-buy options for capital assets. The economic analyses we prepare in support of proposed Section 801 projects are in full compliance with the standards of Circular A-104.

In order to realistically compare a proposed Section 801 lease (subject to property taxes) with a military construction project on Government land (not subject to property taxes), OMB Circular A-104 prescribes that local property taxes should be imputed against the military construction project to "ensure valid comparisons". This policy recognizes that although the Government may not be paying taxes for the on-base project, it nevertheless incurs equivalent costs for services (e.g., police, fire, etc.) or in-kind aid payments (e.g., Impact Aid to Education paid to local school districts, or "payments in lieu of taxes" for community provided services) which otherwise would be supported through property taxes. Since the real differential costs of some such services are difficult to estimate, OMB has prescribed imputed taxes as the appropriate way to place the lease-versus-buy comparison on a level playing field.

The Federal Government is not subject to direct taxation by state or local governments, but the point of the report in this

P&L RESPONSE: Nonconcur.

We do not agree with the premise that the objective of our procurement should be the lowest housing lease cost. Since we also have to pay for the maintenance and utilities which support the leased housing, our real objective is achieving a quality living environment for our people at the lowest life-cycle cost. This means getting quality construction in order to lower maintenance and energy costs, or in other words, contracting for the best value to the Government. That is precisely what our current procedures are designed to do.

We include the lease ceiling in our contract solicitations for several reasons. First, Congress requires that we disclose the ceiling to four separate subcommittees before we solicit a project, effectively putting this information into some parts of the public domain. We insure that all potential competitors have equal access to this information by publicizing the lease ceiling in the solicitation. Second, because we emphasize the need for quality (e.g., energy efficiency and maintainability) with design proposals, the natural inclination of competitors would be to over price the job rather than under price it. By letting them know the price restrictions on the project upfront, competitors can decide whether to propose, and if so, what to propose in order to be competitive. Without this focus on the interrelationship between quality and price, the probability of receiving truly competitive proposals would be greatly diminished, to the detriment of the Government. Finally, public disclosure of the lease ceiling in no way compromises the Government's ability to insure the best value for the contract dollar. All solicitations are publicly advertised and unrestricted, and the free market forces of full and open competition drive quality up and life-cycle costs down. Only that proposal offering the best combination of product and price results in contract award; all others lose.

RECOMMENDATION 1 (e): Require the Military Departments to include termination for convenience clauses in contracts awarded for Section 801 family housing projects:

P&L RESPONSE: Nonconcur.

The decision to not include termination for convenience clauses in Section 801 contracts was a calculated business decision. Inasmuch as the Government is protected from contractor nonperformance by the inclusion of the termination for default clause in each such agreement, it was decided that the termination for convenience clause would needlessly add cost to the 801 lease agreements as offerors accommodated the additional financial risk accompanying such a provision. Although the draft report disagrees with that business decision, it should be noted that the General Services Administration, the Government agency with the greatest leasing responsibility, does not in its supplement to the FAR require a termination for convenience provision in real estate lease solicitations, while the termination for default provisions are required. Consequently, Final Report

the Department of Defense practice for leasing Section 801 housing is consistent with the leasing practices of GSA.

In support of its recommendation that termination for convenience clauses be included in all 801 projects, the I.G. cites Section 801 housing projects at Ellsworth AFB as an example of projects that were not needed but could not be terminated or reduced. This is not accurate. The Air Force documented a housing deficit well in excess of the proposed project, and therefore saw no need to reduce or terminate the awarded contracts. Had there been such a need, however, the liabilities of the parties to the agreements could have been resolved and the agreements modified accordingly, notwithstanding the absence of termination for convenience clauses.

RECOMMENDATION 1 (f): Cancel the Section 801 housing projects at the installations recommended for closure by the Secretary of Defense.

P&L RESPONSE: Partially concur.

We agree that new contracts should not be awarded at installations with an uncertain future, but do not agree that a planned project should be summarily rescinded as the result of the host installation being a nominee for closure.

We have never initiated contract action for any Section 801 project which was to be at an installation that was known to have an uncertain future. When the recommended base closure list was recently announced, we immediately placed the two projects that were under active solicitation (NAS Whidbey Island and Castle AFB) on indefinite postponement, and stopped the third (Naval Station Long Beach) before the solicitation was issued. These projects will remain in a state of suspension until the future of the host installation is certain, at which time the project will either be cancelled or allowed to proceed as may be appropriate.

Deleted

RECOMMENDATION 1 (g): Report the lack of internal controls over the advertising of the lease ceiling amounts and the lack of termination for convenience clauses in contracts for family housing projects to the Secretary of Defense and track the status of corrective actions until the problems are resolved.

P&L RESPONSE: Nonconcur.

As discussed in the preceding responses, we believe our practice of advertising lease ceilings and avoiding unnecessary termination clauses in our contracts enhances the objective of achieving the best product for the least life-cycle cost, while allowing us to retain an ability to terminate contracts at some future date should circumstances dictate. Accordingly, we do not regard these issues to be weaknesses in the management of this program, and therefore see no reason for change.

RECOMMENDATION 2: We recommend that the Comptroller of the Department of Defense revise DoD Instruction 7041.3, "Economic Analysis and Program Evaluation for Resource Management," to incorporate the revised guidance on conducting economic analyses

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for the Section 801 build-to-lease program outlined in Recommendation 1.a.

P&L RESPONSE: Nonconcur.

As explained above in the response to Recommendation 1.a, we disagree with the recommended changes to our current procedures for the economic comparison of a proposed private sector facility lease with the alternative of direct Government purchase, and hence, we see no need for the DoD instruction to be changed. Further, OMB Circular A-104 is prescribed for use by all Executive branch agencies, and the recommended changes would make the DoD instruction inconsistent with that document.

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