LFC HEARING BRIEF

AGENCY: General Services Department, Property Control Division

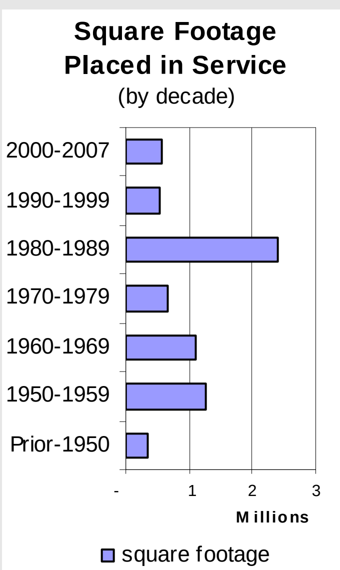
DATE: December 6, 2007

PURPOSE OF HEARING:
Review of Lease Purchase and Other Building Finance Mechanisms

PREPARED BY:
Tom K. Pollard, PhD, Consultant

EXPECTED OUTCOME:
Informational Only

Figure 1.



BACKGROUND

New Mexico state government is facing the need to replace an enormous number of facilities in the near future. Most state-owned facilities are well beyond a reasonable useful life. Some of these buildings may be “moth-balled” or turned into museums, but most are in active use and will have to be replaced and/or expanded to deal with future growth.

Age of State Buildings. The <u>median</u> age of state facilities under the control of the Property Control Division (PCD) of the General Services Department (GSD) is 41 years, according to their inventory records of when facilities were “placed in service.” This includes hospitals, prisons and warehouses, as well as offices.

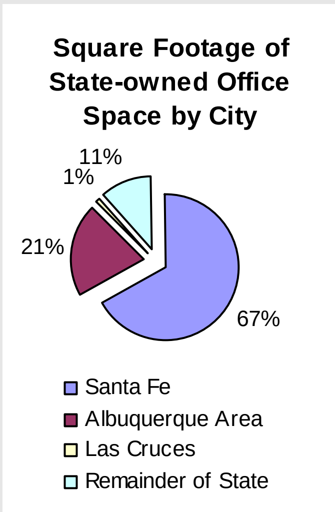
The “placed in service” figures shown in Figure 1 in the sidebar may significantly understate the actual age of many facilities, due to the manner in which GSD keeps records. For example, the Ft. Bayard Hospital, although built at the turn of the 20th century was transferred from federal to state ownership in 1966 and, therefore carries a date “placed in service” of 1966, still over 40 years old for purposes of this inventory.

Looking only at office space as shown in Figure 2, the picture is somewhat better. The average age of the approximately 2 million sq. ft. of state office buildings statewide is about 32 years. Santa Fe is home to about approximately 1.3 million sq. ft. (65 percent of the total) and that office space averages about 32 years of age. Albuquerque contains about 409,000 sq ft. of office space with an average age of 28 years. The 224,000 sq. ft. of office space in the remainder of the state has an average age of about 37 years.

State Building Maintenance Needs. GSD estimated the total need for maintenance of GSD-owned facilities at approximately $500 million in 2005, of which $200 million is for facilities in Santa Fe County and the Albuquerque Area (Bernalillo, Valencia and Sandoval Counties). A more current estimate would probably exceed $800 million, just taking into account only recent inflation in construction materials.

State Leased Space versus Owned Space. GSD records also indicate there has been a drop-off in new construction, acquisition or renovation since 1990, as the state depends more on leasing to deal with the need for new buildings, including prisons, warehouses and offices.

Figure 2.



Considering office space alone, the state leases almost 60 percent of the space it occupies statewide. However, in Santa Fe, which accounts for 43 percent of total office space statewide, the portion leased is 35 percent (See Table 1 below).

<u>More "Buy-versus-Lease" Analysis and Planning Needed</u>.

In many cases the leasing of buildings may be the most economical alternative. For example:

- The private sector may be able to act more quickly and to provide lower costs of construction and maintenance for buildings leased to the state.

- Leased space provides the state greater flexibility to reduce/shift overhead costs as the state reduces employment or moves employees from place to place.

Table 1.
Office Space: leased versus owned by location

	Leased (sq. ft.)	% Leased	Owned (sq. ft.)	% Owned	Total
Santa Fe	712,650	35%	1,299,902	65%	**2,012,552**
Albuquerque	959,561	70%	409,045	30%	**1,368,606**
Las Cruces	230,169	92%	19,937	8%	**250,106**
Remainder of State	875,901	80%	224,442	20%	**1,100,343**
Total State	2,778,281	59%	1,953,326	41%	**4,731,607**

Note: Data does not include buildings owned or leased by the following agencies: State Armory Board, Department of Cultural Affairs, State Fair Commission, Department of Game and Fish, Department of Transportation, Commissioner of Public Lands, state parks, judicial branch, Legislative Branch, higher education, School for the Deaf, School for the Visually Handicapped, property acquired by Economic Development Department and the Public Schools Facilities Authority

However, there can be advantages to state building ownership:

- The state gains equity in buildings it owns.

- No private owner profit is included in the cost of the building and, therefore, in the lease payments.

- The state can finance the construction or acquisition of a building at lower interest rates than those rates available to a private developer. First, the rates are lower because they are tax-exempt. Second the credit rating of the state is higher, and therefore the costs of borrowing lower, than that for a private developer.

- **Preliminary analysis indicates the state would substantially reduce recurring costs by owning a larger portion of its space needs, and leasing less.**

- The state may construct buildings with less space per employee than that generally available in the commercial lease market, especially if the state is promoting economies of scale by consolidating state employees from many small leased spaces into larger state-owned buildings.

- The state may gain additional efficiencies in serving the public by consolidating agencies from smaller separate offices into consolidated "campuses".

The bottom line is that each "buy-versus-lease" decision must be made independently with as much detail as is available about the cost factors involved. Given the tremendous need for new and/or renovated facilities, the state must take a more analytical approach.

In addition, more state resources should be devoted to the personnel and computer hardware and software required to adequately track and analyze the state's real estate inventory statewide, the real estate market statewide, construction costs, financing costs, and other factors that go into the master planning of facility requirements and project-by-project decision making on whether to buy or lease. The Property Control Division currently maintains only rudimentary databases on owned and leased space.

This analysis, known as "life-cycle costing", compares as many as possible of the costs of buying versus leasing as over the life of the asset (i.e., initial construction cost including financing, ongoing operating costs and periodic major renovation and repair costs during the building's economic life.)

Two Options for Financing Building Acquisitions.

For purposes of illustration a basic "buy versus lease" analysis is presented for two "real world" examples: the financing of two buildings to be built on state land as part of a health and human services "Super Complex", as envisioned in the Capitol Buildings Master Plan presented to the Capitol Buildings Planning Commission on August 3, 2005.

Although the model is simplified, the choice of variables is sufficiently conservative, that the cost savings should be considered, if anything, an understatement of estimated savings.

*Option 1: **Lease to Lease-Purchase***. The first buy versus lease comparison involves the relocation of the Human Services

Department (HSD) from leased to state-owned space. The HSD leases 100% of the 173,000 square feet it occupies in Santa Fe, and pays an average of $21.80 per square foot, approximately $3.8 million annually in lease payments, according to PCD (See Attachment A).

A substantial savings, discussed in more detail later, would come from the consolidation of HSD employees agencies from scattered private lease space into a newly constructed state lease-purchased building constructed on state-owned land:

- A 160,000 square foot building, costing approximately $40,000,000 (160,000 sq. ft. @$250 per sq. ft.), would be constructed on state land to consolidate HSD administration from approximately 173,000 sq. ft. in private lease space spread throughout Santa Fe at an average lease rate of $21.80 per sq. ft. (according to PCD).

- In addition to the original construction, the state would provide $6 per square foot annually for maintenance and would spend another $75 per square foot at the end of 20 years for substantial renovations to enable the building to last 40+ years.

- The financing of the HSD building could be accomplished through a redirection of current lease payments, totaling approximately $3.7 million annually, to a lease-purchase executed through the New Mexico Finance Authority (NMFA).

- No new state appropriations for building construction would be required for these buildings: federal and state revenues now going to private leases would simply be redirected to a lease-purchase of a building executed through the NMFA and financed through the issuance of tax-exempt bonds issued by the NMFA.

- Moving HSD from private leases to a state lease-purchase, could save the state approximately $47 million ($18 million, present value) in recurring revenue over the next 30 years, plus at least $40 million for the value (present value) of the new state building. This includes paying debt service on a 20-year bond issue for original construction, paying for annual maintenance and paying debt service on a 10-year bond issue for renovations at the end of twenty years.

Option 2: ***State Bonds for State Buildings.*** A second buy versus lease comparison examines "back-filling" state agencies currently in high-cost private lease space into state-owned space vacated by state health and human services agencies relocated to a newly constructed building at the "Super Complex" site (See Attachment B):

- Consolidate Aging and Long-Term Services Department (ALTSD); Children, Youth and Families Department (CYFD) and the Public Education Department (PED) from about 170,000 square feet of state owned spread across Santa Fe into approximately the same amount of newly built state-owned space at the health and human services "super complex." ALTSD is currently in the Anaya Building, CYFD in the Public Employees Retirement Association (PERA) building and PED in the Apodaca Building.

- A 170,000 square foot building, costing approximately $42,500,000 (170,000 sq. ft. @$250 per sq. ft.), would be constructed on state land to consolidate ALTSD, CYFD and PED administration. In addition to the financing the original construction, the state would provide $6 per square foot annually for maintenance and would spend another $75 per square foot at the end of 20 years for substantial renovations to enable the building to last 40+ years.

- The state would "back-fill" 170,000 square feet vacated in the Anaya, PERA and Apodaca buildings with state agencies currently in private lease space at or above $21 per square foot into the space. This would reduce recurring general fund expenditures for lease space by about $3.6 million annually.

- The buildings to house those employees relocated to the "Super Complex" from state-owned space would have to be financed through the appropriation of non-recurring funds, sale of severance tax bonds, general obligation bonds, state office building tax revenue bonds, NMFA bonds and/or other state revenue bonds, since there is no lease revenue stream to redirect to the bonds, just a recurring savings to the general fund.

- These state revenue bonds would, in general, carry lower interest rates and lower issuance costs than would lease revenue bonds. Lease-purchase financings are more complicated transactions, requiring more legal and financial consulting services, than state revenue or general obligation bond financings. The state's revenue and general obligation bond credit ratings are higher than the credit rating would be on bonds backed only by a public or private lease-purchase that is subject to annual legislative appropriation.

- State office building tax revenue bonds, for example, were authorized by the Legislature in 2001 and issued by the NMFA to finance the state's purchase of the PERA and NEA buildings and construction of the Tony Anaya Building.
- This "back-filling" could produce an additional recurring general fund savings, net of debt service requirements on building construction bonds, of approximately $33.5 million ($10.5 million, present value) over the next 30 years as this vacated state-owned space is "back-filled" by other agencies currently in leased space, plus at least $42.5 million for the value (present value) of the new state building.

The State's Menu of Financing Options

Although purchasing state buildings through either the issuance of state revenue bonds or lease-purchases produces savings, different interest rates and transaction costs are associated with each method (See Attachment C).

The lowest interest rates and issuance costs are on tax-exempt state general obligation (G.O.) and revenue bonds (Option 2, above). These bonds generally carry higher bond ratings and lower issuance costs than would tax-exempt, lease-purchase backed bonds (Option 1, above). Recent G.O. and severance tax bond issues have had issuance costs of less than $500,000 on $135 million in bonds sold due to their very simple and very well-understood financing structures.

The state constructed the Tony Anaya building and purchased the Public Employees Retirement Association and National Education Association buildings through the issuance of State Office Building Tax Revenue Bonds in 2002 by NMFA . These bonds, backed by an intercept of state gross receipts tax, carry the highest bond rating and lowest interest rates of any state bonds. Issuance costs on these bonds were about $432,000 on a $35 million bond issue, or about 1.2% of the total. The issuance costs, although very reasonable, were higher than would be the case on subsequent issues since this was the first issue of its type.

Lease-purchase backed tax-exempt revenue bonds carry higher interest rates than state revenue bonds due to their lower bond ratings, generally one or more credit rating steps below that for the state's G.O. bonds. The lower bond ratings are due to the fact that the debt service on the bonds is paid from lease-purchase payments, which are subject to annual appropriation by the Legislature. Interest rates on lease-purchase backed bonds range from a half to a full percentage point higher than that on state G.O. bonds.

Due to the relative complexity of the lease-purchase transaction backing the bonds, legal fees, financial advisory fees, underwriters fees and other issuance costs are substantially higher for lease-purchase backed bonds than for G.O. and revenue bonds, averaging about 2% of total bonds sold for a simple structure.

Lease purchases are most complex and costly when a local government is involved as a third party. The Town of Clayton recently sold Jail Project Revenue Bonds to construct a correctional facility that is to be privately operated. The bonds will be repaid using a portion of inmate per diem payments made by the state Department of Corrections to house inmates in the privately operated prison. A "capital cost" portion of the payment will go to Clayton for the repayment of the bonds. The town will own the facility, and the state will have an option to purchase the facility from Clayton once the bonds are paid off.

These lease-purchase backed bonds received a minimum investment grade bond rating on their own, which allowed Clayton to purchase bond insurance and, thereby, achieve a "AAA-insured" interest rate. However, the bond issuance costs were extremely high, exceeding $4 million on a $77.6 million issue, or over 5% of the total issue.

The state, given the recent constitutional amendment authorizing state lease-purchases, had it been in place at the time, could have accomplished this prison facility lease purchase transaction in-house utilizing the NMFA. Interest rates and issuance costs would have been substantially lower, and the state could have owned the facility outright once bonds were paid off.

The highest cost method of providing state facilities is through operating lease, under which the state pays the private developer's cost of taxable bank financing and never owns the facility--whether it be a prison, health care facility or office building. In the case where the private developer cannot guarantee a tax-exempt governmental tenant, the bank financing will be at taxable interest rates that are 2.5 to 3 percentage points higher than the rate on state-issued lease-purchase revenue bonds.

As the "buy versus lease" analyses in Options 1 and 2 above indicate, under a reasonable set of assumptions regarding the long-term facility needs of the state and the market for real estate, any of the purchase alternatives is superior to the operating lease option.

SUMMARY

Building booms in state prisons, health facilities and offices during the 1950s, 1960s and 1980s have left New Mexico state government with an aged facility inventory that will need replacement or substantial renovation in the near future.

Recently, the state has moved away from state ownership and toward leasing to deal with the need for new buildings, including prisons, health facilities, warehouses and offices.

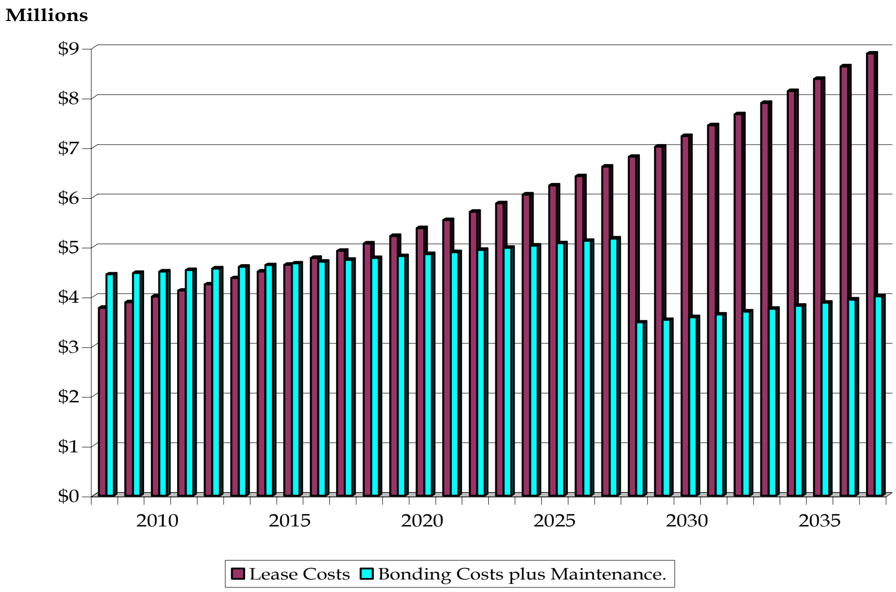
A basic analysis of state ownership versus lease options indicates that in today’s market the state would substantially reduce recurring costs by owning a larger portion of its space needs, and leasing less.

The state must approach the need to replace its huge facility inventory and deal with state growth, with a comprehensive “buy-versus-lease” analysis on each project and an overall facility plan for the state that yields the greatest long-term savings to the state’s taxpayers.

TKP/mt

Attachment A

Annual Cost: HSD Lease to Lease Purchase
30-Year Lease vs 20-Year Construction Bonds Plus Maintenance
and 10-year Bonds for Major Renovation in 20th Year



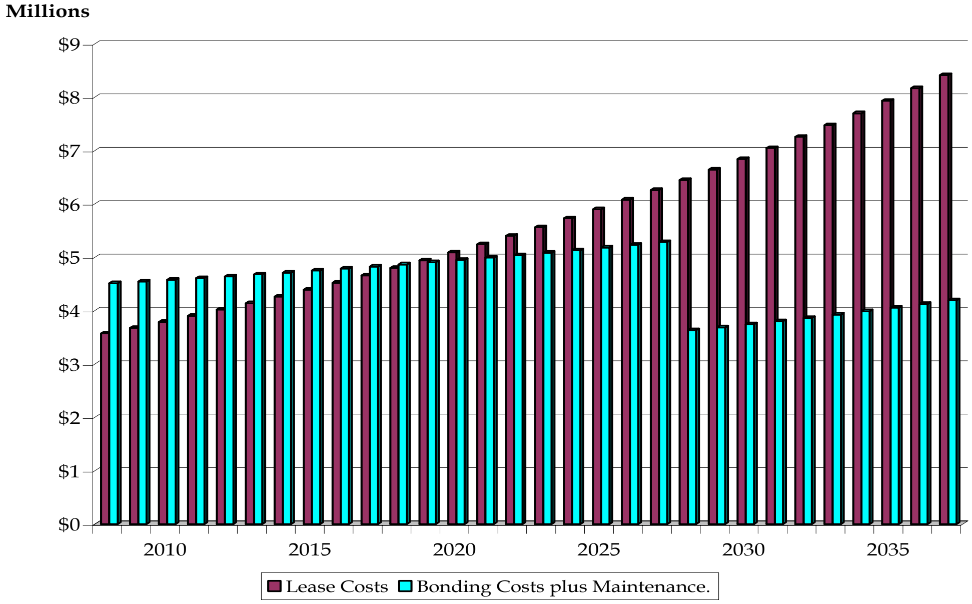
Lease Scenario	
Square Footage	173,000
Rate per Sq. Foot	$ 21.80
Annual Rate Inflation	3.00%

Construction Bonds		Renovation Bonds
Square Footage	160,000	
Cost per sq.ft.	$250	
Annual Rate Inflation	3.00%	
Discount Rate	4.00%	
Maintenance Rate / sq.ft.	$6.00	
Term of Bonds (yrs.)	20	10
Rate on Bonds	4.75%	4.75%
Cost of Building	$40,000,000	
Renovation @ 20 years	$75 / sq.ft.	$12,000,000
Costs of Issuance	2.00%	2.00%
Bond Funded Reserve	$3,485,677	$1,364,000
Issue Size	$44,375,000	$13,640,000

Cumulative Savings	
Cum. Savings: Bonding w/o building Value:	$46,589,378
Cum. PV Savings: Bonding w/o building Value:	$17,588,453
Cum. Savings: Bonding With Building Value:	$140,851,999
Cum. PV Savings: Bonding with building Value:	$57,588,453

Attachment B

Annual Cost: CYFD,ALTSD & PED Back-fill Project
30-Year Lease vs 20-Year Construction Bonds Plus Maintenance
and 10-year Bonds for Major Renovation in 20th Year



Lease Scenario	
Square Footage	170,000
Rate per Sq. Foot	$ 21.00
Annual Rate Inflation	3.00%

Construction Bonds		Renovation
		Bonds
Square Footage	170,000	
Cost per sq.ft.	$250	
Annual Rate Inflation	3.00%	
Discount Rate	4.00%	
Maintenance Rate /sq.ft.	$6.00	
Term of Bonds (yrs.)	20	10
Rate on Bonds	4.25%	4.25%
Cost of Building	$42,500,000	
Renovation @ 20 years	$75 /sq.ft.	$12,750,000
Costs of Issuance	1.00%	1.00%
Bond Funded Reserve	$3,494,714	$1,433,000
Issue Size	$46,460,000	$14,330,000

Cumulative Savings	
Cum. Savings: Bonding w/o building Value:	$33,534,883
Cum. PV Savings: Bonding w/o building Value:	$10,451,581
Cum. Savings: Bonding With Building Value:	$133,688,917
Cum. PV Savings: Bonding with building Value:	$52,951,581

Attachment C

Methods of State Facility Financing								
Financing Source	**New Mexico State G.O. Bonds (1)**	**New Mexico Severance Tax Bonds(2)**	**NMFA State Office Building Tax Revenue Bonds (GRT Intercept)(3)**	**NMFA Public Project Revolving Fund(4)**	**State Tax-Exempt Lease-Purchase Revenue Bonds(5)**	**Local Tax-Exempt Lease Purchase Revenue Bonds*(6)**	**Private Tax-Exempt Lease-Purchase Backed Bank Financing (7)**	**Taxable Operating Lease Backed Financing(7)**
Bond Rating (w/o Bond Insurance)	S&P: AA+ Moody's: Aa1	S&P: AA Moody's: Aa2	S&P: AAA Moody's: Aa1	S&P: AA+ Moody's: Aa2	S&P: A (estimated) Moody's: A (estimated)	S&P: BBB Moody's: Baa3	N/A	N/A
Estimated Interest rate, based on 20-yr. financing in Current Market	3.8% - 4%	3.8% - 4%**	3.8% - 4%	3.8% – 4%**	4% - 4.2% (est.)**	4 .5 - 5**	6% - 7%	7% - 8%
Estimated Bond Issuance Costs, based on prior financings*	$464,000 on $135 million issue: 0.3%	$346,000 on $135 million issue: 0.2%	$432,000 on $35 million issue: 1.2%	$671,500 on $61.9 million issue: 1.1%	$800,000 -estimated on $40 million issue: 2%	$4,349,000 on $77.6 million issue: 5.6%	1%-1.5% -estimated bank closing costs	1%-1.5% -estimated bank closing costs

*Issuance costs include legal and accounting fees, financial advisory fees, underwriters' costs, bond insurance premiums, rating agency fees, trustee fees, printing costs, electronic posting costs and other miscellaneous costs.
**Interest rate is on bonds that are guaranteed by a AAA-rated bond insurance company.

(1) Source: State of New Mexico, Capital Projects General Obligation Bonds, Series 2007, $134,870,000.
(2) Source: State of New Mexico, Severance Tax Bonds, Series 2006A, $135,000,000.
(3) Source: New Mexico Finance Authority, State Office Building Tax Revenue Bonds, Series 2002A, $34,695,000.
(4) Source: New Mexico Finance Authority, Senior Lien Public Project Revolving Fund Revenue Bonds, Series 2007E, $61,945,000.
(5) Source: Ratings, Interest Rates and Issuance Costs are estimated based on comparable issues in other states.
(6) Source: Town of Clayton, Jail Project Revenue Bonds, Series 2006, $77,585,000.
(7) Source: Terms are estimated, based on discussions with commercial lenders and financial advisors.