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LEASE REFINANCING

Observations on GSA's Proposed Master Leasing and Army's Lease Refinancing Programs

Statement of
Jeffrey C. Steinhoff
Director, Financial Management Systems Issues
Accounting and Financial Management Division

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Committee on Government Operations
House of Representatives

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Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss our initial assessment of the Master Installment Purchase System (MIPS) program proposed by the General Services Administration (GSA) and the related Army program of lease refinancings currently underway. As you requested, we assessed whether separating the purchasing and financing of equipment under a master lease, as called for by the MIPS and Army programs, could significantly reduce lease finance costs. This testimony is our interim report on the structure, scope, and objectives of the proposed MIPS and Army lease refinancing programs and the potential for these programs to reduce federal equipment leasing costs.

Both programs have the potential for reducing lease finance costs by obtaining financing from private investors based on borrowing rates available directly to the government rather than the rates available to equipment vendor/lessors. Finance costs can be high because, under current federal lease practices, the borrowing rates available to equipment vendors/lessors reflect their credit rating, rather than the federal government's. As a result, vendor/lessor borrowing rates are often higher than those available directly to the government.

A key reason why agencies lease equipment rather than purchase it outright is because budget constraints preclude them from obtaining the budget authority for outright purchases in a single fiscal year. Leases with purchase options allow agencies to acquire needed equipment while spreading out the budgetary impact of the acquisition cost over several fiscal years. The major additional cost to the government of spreading out the budgetary impact of equipment purchases through leasing is the difference between the rates tied to Treasury securities and those available from private sector borrowers. The MIPS and Army lease refinancing programs, which involve purchasing the equipment from the vendor/lessor and obtaining financing in the private sector financial markets, based on the government's credit rating, reduce total leasing costs by reducing the lease finance cost component.

My remarks today will cover five areas: information on equipment leasing, GAO's prior work in this area, the GSA and Army programs, and the proposed automatic data processing equipment pilot program included in the Committee's July 20 discussion draft of the Paperwork Reduction Act reauthorization.

EQUIPMENT LEASING REQUIREMENTS

The Federal Acquisition Regulation (FAR) contains guidance on the acquisition of equipment by lease or purchase. The FAR envisions two primary means for agencies to acquire needed equipment: (1) the one-time, outright purchase of equipment and (2) the lease (rental) of equipment.

Equipment should be purchased when there is an established, long-term need for it and the technology involved is not changing so rapidly as to render it obsolete in the short-term. The underlying premise is that outright purchases result in the lowest cost because financing would be based on interest rates on comparable Treasury securities.

On the other hand, equipment should be leased when the government has a short-term need for the equipment and/or the equipment is subject to rapid state-of-the-art changes and advances in technology. In this case, leasing would normally cost less than purchasing the equipment. However, since the federal budgetary environment and Gramm-Rudman-Hollings targets look at cost on a cash basis, an agency is not always in a position to make the most cost-effective or economical decision on whether to purchase or lease.

The FAR provides that if a lease is warranted, a lease with a purchase option is generally preferable. Such leases allow agencies to acquire equipment and to spread out the budgetary impact over a number of fiscal years. These leases, however, are more costly than outright purchases because they are financed at the lessors' generally higher borrowing rates and because lessors charge additional fees to compensate them in case agencies exercise clauses intended to protect the government's interest, such as the termination for convenience, right of offset, and risk of loss.

PRIOR GAO REVIEW ON LEASE FINANCING

In a 1985 report,[1] GAO addressed the issue of leases with high finance costs in relation to computer leasing practices. We pointed out that agencies generally lease ADP equipment from the manufacturer using the following three types of leases:

-- Rental lease. The lessor retains title to the equipment throughout the system life, and the leases are annual leases with options for annual renewals.

-- Lease with option to purchase. The lessor retains title to the equipment until agencies exercise lease purchase options. Under these leases, agencies earn rental or purchase option credits which are used to reduce the purchase price of the equipment. These are also annual leases, and agencies are under no obligation to continue the lease beyond each annual lease period.

[1] Effective Management of Computer Leasing Needed to Reduce Government Costs (GAO/IMTEC-85-3, March 21, 1985).

-- Lease-to-ownership plans. Title transfers to the agencies after payment of a predetermined number of lease payments. These are annual leases with annual options to renew. Agencies are not obligated to renew the leases.

GSA's proposed MIPS and the Army's current lease refinancing programs are both responsive to our 1985 report. Both initiatives use the principles of a sale/leaseback transaction discussed in our 1985 report to separate the purchase of the equipment from the acquisition financing to support the equipment purchase.

PROPOSED MIPS PROGRAM COULD REDUCE FUTURE EQUIPMENT LEASE COSTS

Conceptually, GSA's proposed MIPS program can reduce the government's leasing costs. However, there are still some issues to be resolved before the program can be implemented.

The MIPS program involves only new leases for information technology (IT) equipment. Under the MIPS proposal, an agency would solicit equipment purchase and lease prices from vendor/lessors. If the agency has sufficient budgetary authority, it would generally purchase the equipment. If not, it could agree to lease the equipment through the proposed MIPS program.

The MIPS proposal would separate equipment procurement from lease financing. Specifically, GSA would retain a private contractor to develop and implement the MIPS program under which GSA and the contractor would periodically pool equipment that agencies intend to acquire under a master lease. The contractor would purchase the equipment and raise the funds to support the purchases by selling financial interests in the master lease to private investors. GSA and the contractor would jointly develop a standard master lease that GSA would use when entering into a multiyear agreement with the contractor under the IT Fund's multiyear contracting authority. GSA would lease the equipment back to the agencies under an interagency agreement. Agencies would make lease payments to GSA's IT Fund from which one lease payment would be made to the contractor who would repay the investors. At the end of the multiyear lease term, GSA would own the leased equipment.

Under the MIPS program, potential savings result from arranging lower lease financing than is available from the equipment vendor/lessor. The proposed MIPS program facilitates the use of private financial markets to finance lease acquisitions by the creation of pools of leased equipment with aggregate dollar values large enough to attract investors and to allow offerings through established private securities markets. In addition, MIPS program pooling of equipment helps spread the financial risks investors may have on any one item of equipment that the government may lease because the government will be less likely not to renew an entire pool than it would be to fail to renew a single lease, thus making them more attractive investments.

MIPS-type master financing lease programs have been successfully used by states and large cities to reduce their leasing costs. Florida, Michigan, New York, and West Virginia have used master lease programs to fund the acquisition of capital assets.

The Office of Management and Budget (OMB) has objected to the MIPS program for two reasons. First, OMB views such programs as installment purchase contracts which are more costly than outright purchases and enable agencies to purchase equipment without fully disclosing the total acquisition costs. Second, OMB maintains that such programs may violate the Anti-Deficiency Act since agencies, in effect, would be entering into multiyear installment purchase contracts that commit the government to pay for the entire cost of the equipment acquisition while obligating only annual costs. Although all of the details of GSA's MIPS program proposal have not been finalized, we believe that GSA can develop a MIPS program consistent with the Anti-Deficiency Act.

PROPOSED PILOT TO TEST MIPS-TYPE PROGRAM FEASIBILITY

Section 203 of the Committee's discussion draft directs GSA to establish a pilot program designed to reduce the financing costs of leasing ADP equipment. We have two general comments to offer the Committee in connection with its consideration of this section.

First, section 203 mandates that GSA establish a MIPS-type program. As you may know, GSA in the past has considered various proposals to reduce ADP lease financing costs, most recently its MIPS proposal, but has not yet implemented a proposal. Section 203 would require GSA to implement such a program on a pilot basis.

Second, the language of section 203 of the discussion draft is not entirely consistent with the MIPS concept as we understand it. For example, the discussion draft appears to contemplate that GSA will only aggregate agency leases instead of either aggregating agency leases or new equipment under a master lease. Also, the discussion draft suggests that GSA would be performing several of the functions that under the MIPS proposal, as we understand it, would be performed by the third-party contractor.

To improve the technical precision of the Committee's proposal, we would be happy to work with the Committee to revise section 203 to more closely reflect our understanding of a MIPS-type program.

ARMY'S PROGRAM OF LEASE REFINANCINGS COULD APPRECIABLY REDUCE CURRENT EQUIPMENT LEASE COSTS

The Army program of refinancing existing leases could reduce the costs of such leases. Its program covers all types of equipment currently leased by the Army, including ADP and telecommunications equipment, vehicles, and construction equipment. The program entails

-- identifying equipment leases with purchase options and high finance costs;

-- establishing pools of high finance cost leases and exercising the Army's equipment purchase options;

-- financing the equipment purchases by selling financial interests in the pools of leases to private investors; and

-- leasing the purchased equipment back to the Army, at lower costs, under a standard master lease agreement.

The Army's program uses a master lease concept similar to the MIPS program, but it has several fundamental differences. Specifically, the Army's program:

-- Will not result in a multiyear contract. The master lease may be renewed on an annual basis at the option of the Army.

-- Is not an installment purchase program for new equipment, but instead is a program to exercise purchase options contained in existing equipment leases and lease the equipment back.

-- Makes existing leases more economical by reducing their finance costs.

Army does not have the requisite data for estimating how much could be saved by implementing its lease refinancing program. Army and Department of Defense (DOD) financial management systems for leases do not contain the detailed information needed to identify equipment leases with high finance costs. Army is in the process of identifying these leases. The time-consuming effort is still underway and must be completed before Army can pool these leases for refinancing and estimate cost savings.

While information is not available to estimate potential lease cost savings, lease financing concepts such as MIPS and the Army program have the potential for appreciable dollar savings.

OBSERVATIONS

The outright purchase of equipment, financed through issuance of Treasury debt, is the lowest cost method of financing equipment acquisitions. If, however, outright equipment purchases are not feasible, and a lease is selected as the means to finance equipment acquisitions, a MIPS-type program has the potential to reduce equipment leasing costs. If properly structured and implemented, a MIPS approach appears to be a reasonable compromise to fit equipment acquisitions within budgetary authority, outlay, and deficit reduction targets and to reduce the high financing costs associated with the current financing leases held by the government. A pilot program as envisioned by section 203 of the discussion draft provides a mechanism to test the feasibility and cost-saving potential of a MIPS-type program. The Army program of lease refinancings appears to be a reasonable remedial method to reduce the financing costs associated with existing lease purchase contracts.

The next phase of our review for the Committee will focus on assessing the feasibility and potential benefits of implementing MIPS or an Army-type lease refinancing concept DOD-wide.

Mr. Chairman, this concludes my prepared statement. I will be happy to answer any questions you or members of the Committee have at this time.