Budgetary pressures have spawned a new approach to financing federal projects. Rather than relying on regular appropriations or other traditional forms of federal financing, agencies have arranged for private parties to fund various infrastructure projects, such as housing on military bases, government office buildings, and electric-power facilities. Agencies have been able to arrange such financing by making long-term commitments, either explicit or implicit, to use the resulting facilities (or related services, such as electric power). Since 1998, third parties have borrowed roughly $12 billion to fund federal projects, the Congressional Budget Office (CBO) estimates.

Third-party transactions are generally structured in such a way as to try to justify recording investment costs in the federal budget over the life of a project instead of in full when the investment is made—as would be the case with normal appropriations. Treating investment costs as an annual operating expense may make it easier to get projects funded by eliminating the need for substantial up-front appropriations. However, such budgetary treatment is at odds with established principles of federal budgeting, which require agencies to record the costs of government investments when they are made.

Third-party financing arrangements have a number of negative consequences. In general, projects are more costly to the government when they use such financing. In addition, if agencies do not initially record the full cost of governmental activities, the budget understates the size of the federal government and its obligations at the time when those obligations are made. Third-party arrangements may also skew decisions about how to allocate budgetary resources by giving preferential treatment to investment projects on the basis of their method of financing rather than their relative merits. Finally, third-party financing allows agencies to raise capital in private markets without the full scrutiny of the Congressional appropriation process and without reference to the statutory limits on borrowing that exist for some agencies (such as the Tennessee Valley Authority and the Bonneville Power Administration).

This brief describes some of the financing methods that agencies use to raise capital through third parties and discusses why, in most cases, the costs of the projects should be included in the budget when they are undertaken.

What Is Third-Party Financing?
The idea behind third-party financing is that an intermediary other than the U.S. Treasury can raise money in private capital markets on behalf of a federal program as long as private financiers are confident that they will be repaid—on the basis of some kind of long-term federal commitment. Agencies have used at least three different third-party methods, which provide different forms of security for investors:

- **Project financing**, which is based on the creditworthiness of a program’s cash flows and assets rather than on the backing of a company or the full faith and credit of the U.S. government (for example, when bonds are issued to raise capital to build military family housing or government office buildings);

- **Contractor financing**, in which a contractor arranges financing backed by firm contracts from a government agency (as when contractors fund energy-conservation improvements in federal buildings); and

- **Customer financing**, in which entities that buy services from an agency use the proceeds of tax-exempt bonds to pay for services in advance and then recoup that prepayment by receiving a credit on future purchases (as happens when municipal utilities prepay the Tennessee Valley Authority for electricity).

Such financing arrangements involve multiple parties. Sponsors usually create a special-purpose entity (SPE) for each project to serve as the locus of the agreements supporting the financing. Major investment firms typically manage the financing on behalf of the SPE, and various other firms—consultants, insurers, developers—provide additional support. Money is often raised by selling...
bonds (issued by states, localities, nonprofit organizations, or private parties) or other forms of debt.¹

Relying on third-party financing generally increases costs to the government. Each intermediary charges a fee for its services, which together can add at least 2 percent—and in some cases more than 50 percent—to the costs of a project.² Interest rates on projects’ debt usually exceed interest rates on Treasury bonds by anywhere from 1 to 3 percentage points, depending on the terms negotiated by the parties. Some agencies believe that they can realize savings through third-party financing by avoiding certain construction costs that would be incurred if the government undertook a project itself. If such savings are possible, they can be obtained through changes to federal construction practices without imposing higher costs on taxpayers through third-party financing.

Third-party financing arrangements are largely exempt from traditional spending controls—such as appropriation laws, which limit the amount, purpose, and time for which funds are available. The ability to use third-party financing depends instead on an agency’s broad statutory authorities to enter into various kinds of contractual agreements.³ Those contractual authorities are used to assemble a package of agreements that is sufficient to secure private funding. Because of the open-ended nature of such authorities, agencies have wide latitude in deciding what projects to undertake, how much to spend, and how and when to report the projects’ costs.

**Budgetary Principles for the Treatment of Projects with Complex Financing**

The way in which an activity should appear in the federal budget depends on the nature of the activity, not its method of financing. Under the principles that govern federal budgeting, budgetary treatment should be based on the answer to the question, Is the activity governmental (that is, initiated, controlled, and funded largely by the government for governmental purposes), or is it an initiative of the private sector (driven by market forces independent of the government)? An investment that is essentially governmental should be shown in the budget whether it is financed directly by the U.S. Treasury or indirectly by a third party that is borrowing on behalf of the government.

When budgetary classification is ambiguous, analysts often consult the 1967 *Report of the President’s Commission on Budget Concepts*. That report established a comprehensive conceptual framework for the federal budget, addressing what should be included and how costs should be measured. According to the commission, the budgetary treatment of a transaction should depend on its economic substance: who controls the program and its budget, who selects the managers, who provides the capital, and who owns the resulting entity. When doubt exists, the commission advised, “borderline agencies and transactions should be included in the budget unless there are exceptionally persuasive reasons for exclusion.”⁴ Likewise, spending financed by all forms of agencies’ borrowing, including debt not backed by the full faith and credit of the U.S. government, should appear in the budget.

The commission considered—and expressly rejected—the concept of treating spending on durable assets (such as infrastructure projects) differently from other federal spending. As a result, the commission intended that the costs of federal capital projects should be recorded in the budget when the investments are made.

In terms of third-party financing, the commission’s guidelines indicate that decisions about budgetary treatment should:

- Weigh all aspects of a program or project, not just selected features;
- Focus on the economic substance of the transactions supporting a project, not just their legal structure; and
- Ensure that all of the costs of governmental activities are recorded when investments are made.

Applying those guidelines means that activities do not have to be conducted by a federal agency to be classified as governmental and included in the budget. A number

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1. Developers often contribute some equity to the projects, but those contributions are usually small and are equivalent to debt because their repayment is guaranteed at preferential rates.


How to Tell Whether a Project Is Governmental

Federal agencies have used third-party financing to carry out hundreds of projects, including more than 40 military-housing privatization projects, numerous enhanced-use leasing projects, hundreds of performance-based contracts, and a variety of other leases, lease-leasebacks, and alternative arrangements (see Box 1, which starts on page 6, for examples). Given the extent of federal control over and economic support for such projects, most are not private endeavors; rather, they are governmental activities financed by private-sector intermediaries that act on behalf of the government.

Although individual examples of third-party financing vary in their details, they share some common features that suggest that the activities are governmental, not private-sector initiatives. In most cases, the government:

- Initiates the project, selects the developer, and specifies the project’s parameters;
- Has significant economic interests as an owner, beneficiary, or lessor;
- Retains substantial control over the project’s assets, business operations, and management; and
- Serves as the sole or primary source of capital backing the project’s financing.

As a general rule, the conditions that make projects viable for investors are usually some of the same features that suggest that the projects should be classified as governmental activities. To secure private financing, agencies must demonstrate the government’s long-term economic interest in the asset or service. Likewise, many of the contractual conditions that agencies seek in order to protect the government’s interests in a project give the government ultimate control over the activity.

Project Initiation and Selection

Projects undertaken with third-party financing usually start like other federal procurements: with an agency soliciting proposals to implement a project according to the agency’s specifications. In the case of third-party financing, the government typically couples a transfer of federal property with directives on how the property may be developed. Common parameters include specifications about the size, location, use, and potential customers for the facility. Agencies also negotiate the terms of the project’s legal structure, cost, and financing and help market the project by participating in meetings with private financiers and credit analysts to explain the government’s support for the project.

Economic Ownership Interest

In many instances of third-party financing, a project is created as a stand-alone entity, sustained by the cash flows generated by its assets. Such a project is generally not “owned” in the traditional sense of the word. Instead, it is a collection of agreements—usually signed concurrently—that ensure that the project can be developed, financed, and operated without legal recourse to the assets of the parties involved.

Developers typically create a limited liability company (LLC), partnership, or other special-purpose entity specifically for each project. In many cases, the government itself is a member of the LLC or the beneficiary of the SPE. That mixed-ownership structure has been used extensively by the Army and Navy for military housing projects and by the Department of Veterans Affairs (VA) for its enhanced-use leasing projects. Ownership interests may also derive from a long-term economic interest in the project, even if the legal ownership appears to reside with a private entity. When the government contributes or conveys assets at the start of a project in exchange for future compensation from the project’s operations (in the form of in-kind services, profit sharing, rental subsidies, the right to reacquire property, or other economic returns), it has an ongoing economic interest in the risks and benefits of the project.

Governmental Control

In most cases of third-party financing, the government exercises significant control by imposing conditions on the agreements used to implement a project. For example, the ground leases for military-housing projects usually obligate the developer to adhere to various govern-
ment-approved plans, including a construction management plan, rental rate management plan, unit occupancy plan, property operations and management plan, facilities maintenance plan, capital repair and replacement plan, and reinvestment plan. Agreements governing facilities built for VA and the General Services Administration have also included controls over a project’s construction, budget, uses, and management practices.

In addition, the government generally maintains control over the land and other assets of a project. Entities leasing federal property cannot sell, transfer, sublease, license, or grant any other possessory interest in the asset without the government’s approval. Similar restrictions have been imposed even when title to the land has been conveyed, in part because the government usually retains the right to repurchase the land. Moreover, the government usually owns or controls the disposition of any infrastructure improvements after the project’s debts have been repaid.

**Source of Capital**

The source of capital for such projects is the income that will be generated by their operation, which usually comes from federal spending. Bond proceeds or repayable equity investments are means of financing a project—not the ultimate source of capital. The assurance of future cash flows from the government is especially important for project financing because sponsors will not have recourse from federal spending. Bond proceeds or repayable equity will be generated by their operation, which usually comes to repurchase the land. Moreover, the government usually owns or controls the disposition of any infrastructure improvements after the project’s debts have been repaid.

For most of the third-party projects carried out so far, credit assessments make it clear that the government is the only or dominant user identified in the agreements—and hence, the only or dominant source of capital. Consequently, those assessments focus primarily on the essentiality of a project to the government, historical trends in appropriations for such activities, and other collateral agreements and management actions that demonstrate the government’s commitment to the project. Existing third-party projects have been rated as investment-grade, suggesting that sponsors have given lenders sufficient evidence of the government’s intention to use, and thus pay for, the projects.

**How to Show a Project’s Costs in the Budget**

Policymakers rely on budget estimates in making trade-offs among programs competing for federal funds. As they compare programs—whether financed through third parties or conventional means—decisionmakers need complete and consistent information about the long-term budgetary consequences of each one. The conceptual framework outlined above is meant to ensure the integrity and transparency of budget estimates.

When proposed legislation would authorize transactions involving third-party financing of governmental activities, CBO’s cost estimate for the legislation shows the full cost of the project up front and treats that cost as direct spending (since the authority for the full cost is not provided in advance in appropriation acts). That treatment reflects the types of transactions that agencies currently use to secure financing by third parties, which is equivalent to exercising borrowing authority for federal activities. Recent examples include CBO’s cost estimates for legislation authorizing the acquisition of aircraft-refueling tankers from Boeing, the construction of military housing, energy savings performance contracts, and various public/private partnerships.

Executive branch agencies, by contrast, classify virtually all of those projects as private-sector initiatives and treat the government’s use of the assets or services as an operating lease or other type of annual discretionary expense. Agencies often base their budgetary treatment on one or two features of a project instead of evaluating the project as a whole. For example, the Department of Defense characterizes military-housing projects as a landlord/

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5. See Standard & Poor’s *Ratings Direct* for assessments of some of the projects described in Box 1.

6. Projects have been rated as investment-grade prior to the agency’s purchase of “monoline” insurance. For a fee, bond insurers agree to guarantee the timely payment of principal and interest on the bonds. The fee, which is paid up front, is based on the difference between the project’s underlying rating and insurers’ AAA rating.

7. Estimates of the budgetary impact of legislative proposals are prepared by the Congressional Budget Office. Once a program has been enacted into law, responsibility for estimating and reporting its actual costs shifts to the executive branch.

tenant relationship between developers and individual service members, discounting the extensive contractual relationship between the developers and the government and the fact that the projects’ cash flows depend on an increase in appropriations for basic housing allowances for personnel living in “privatized” military family housing. Likewise, agencies commonly treat building projects as operating leases, discounting other contractual agreements that support the projects’ financing, such as federal debt guarantees, renewal options, use agreements, and penalties for cancellation. Viewing those transactions as operating leases ignores the government’s concurrent role as lessor or owner of the facilities.

In characterizing their projects, agencies also frequently focus on narrow legal constructs instead of on the economic substance of the transactions. In one instance, an LLC composed of the Army and a private developer circumvented statutory prohibitions on federal guarantees of agencies’ borrowing by creating another LLC to handle the financing. The Administration approved the guarantee to the parallel LLC although the project is being developed, managed, and operated by the Army’s LLC. Multiple layers of LLCs have also been used to secure various tax benefits. In another case, VA argued that its lease of a regional headquarters building did not include a renewal option because the SPE operating the project—of which VA was the sole beneficiary—could, in principle, reject the agency’s request for renewal.

Agencies often exclude investment costs from the budget because a private party shares some of the risk of a project. Sharing risk can blur distinctions between federal and private roles, but it may not materially change the governmental nature of an activity. Risk is just one of several factors that must be considered when deciding whether an activity is governmental. Moreover, projects pose different kinds of risk, many of which have a negligible effect on the economic substance of the transactions. Transferring risk to private parties generally increases a project’s financing costs, because investors seek a rate of return that is high enough to compensate them for whatever risk they take. Thus, the government—as the primary user and source of cash flow for the project—is likely to bear most of the cost of the risk.

Sometimes, third-party projects are characterized as privatization of a federal activity. True privatization, however, involves a genuine sale of assets and termination of a federal activity. In two cases of actual privatization—the sales of the United States Enrichment Corporation and the Elk Hills Naval Petroleum Reserve in the late 1990s—the government was paid several billion dollars for the assets, and the laws and regulations that governed their operations were repealed. In contrast, projects financed by third parties are being undertaken to fulfill ongoing missions of the government, and the government remains heavily involved in the projects. Furthermore, the federal assets being transferred for those projects are not truly being “sold” because the private parties cannot transfer, sell, or assign rights to the land or improvements without the government’s approval.

**Conclusion**

To properly measure the scope of the federal sector, the budget should record obligations and expenditures for projects financed by third parties the same way that it records costs for other federal programs. Thus, amounts obligated and expended by intermediaries on behalf of the government should be recorded in the budget when they occur. Such treatment would provide the most accurate and timely measure of the net costs to taxpayers and would discourage the use of costly third-party financing mechanisms.

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9. For example, most of the federal projects undertaken with third-party financing pose little construction or performance risk. Risks related to demand for the asset are usually mitigated by the essentiality of the federal mission or by contractual protections that cover most of a project’s debts. Likewise, contributions of equity by private parties are often small relative to the assets contributed by the government and present little risk when the agreements governing a project guarantee a specified rate of return.

Box 1.  
Examples of Agencies’ Use of Third-Party Financing

Military Housing. The Department of Defense (DoD) has raised roughly $6 billion through third-party financing since 1996 to construct or renovate housing on military bases. Although private companies build and manage the housing units, DoD selects the developers and managers for the projects, controls the assets and sets the guidelines for construction and operations, and is the source of the capital backing the investments.

In such projects, DoD often acquires an ownership stake in the venture and is the only owner with the power to remove or replace the other parties. The department influences construction and management of a housing project by prescribing the number and configuration of units to be built, retaining the right to approve the developer’s construction plans, reviewing and approving the property manager’s annual operating budgets, specifying property maintenance and management requirements, or requiring the developer to perform future renovations and improvements at specified dates. The developer cannot use the property as collateral for other debt or sell its interest in the venture without government approval, and any successors will be bound by the terms of the contract between the government and the original developer. The government is the beneficiary of most of the residual income from the project. In addition, it controls the project’s cash flows and the distribution of its revenues through a lockbox agreement (a type of escrow account). DoD also determines who is eligible to rent the housing and how much they can be charged.

Further, DoD is either the sole or the primary source of assets and income for such a project. It routinely contributes federal land and existing housing units at no cost to the developer. By reserving the units for military families, it ensures that most of the project’s income will come from funds appropriated to pay military personnel. Other forms of government support include cash contributions, low-interest direct loans, or loan guarantees in the event that a base is realigned or closed.

TVA’s Lease-Leaseback Ventures and Customer Financing. As of September 2004, the Tennessee Valley Authority (TVA) had entered into some $1.3 billion worth of lease-leaseback arrangements to refinance electricity-generating and transmission facilities. Those arrangements involve complex agreements between TVA and a special-purpose entity (SPE) created for each project: TVA leases an existing facility to the SPE for a term of 50 years and then agrees to lease it back over a 20-year period at prices set to cover the SPE’s debts. TVA has also made use of tax-exempt municipal bonds to raise money to construct power facilities. Memphis Light, Gas, and Water (MLGW) agreed to give TVA $1.5 billion from the proceeds of revenue bonds backed by a 15-year contract with TVA. In return, TVA agreed to sell a certain amount of power to MLGW over the 15-year period and to apply a credit to those purchases that would be sufficient to pay the debt service on the revenue bonds.

The Department of Transportation’s Headquarters Building. In 2002, the General Services Administration (GSA) entered into a series of agreements for the design, construction, financing, and operation of a 1.35-million-square-foot headquarters building for the Department of Transportation in Washington, D.C. The government set parameters for the $400 million project (such as its size, location, and cost); selected the development firm; and is covering the costs of the project, including the amount the developer will pay GSA for the conveyance of the government-owned land. GSA will collect and retain proceeds from the conveyance and will receive a sizable share of any residual income from the financing transactions.

The land conveyance and building lease are expressly contingent on each other. The lease agreement obligates the government to rent the building for 15 years, with an option to extend the lease for another 10 years. According to GSA, the rental payments will be backed by the full faith and credit of the U.S. government and will not be subject to appropriations.
Box 1.
Continued

GSA is treating those transactions as an operating lease and is recording its obligations on a year-by-year basis. But those arrangements do not meet the government’s criteria for an operating lease. To classify them as such, GSA has to assume that the initial lease agreement will not be renewed. That is highly unlikely, however, because GSA renews such leases about 90 percent of the time. Furthermore, the Administration’s guidelines specify that agencies should assume that leases will be renewed unless renewal is contingent on additional legislation, which is not the case with this building.

Enhanced-Use Leasing Projects. Various federal agencies are allowed to lease out underutilized land and facilities in exchange for cash or in-kind services. Acting in the dual roles of lessor (of the land) and lessee (of facilities built on the land), agencies have secured private financing for the construction or renovation of buildings, power plants, and other infrastructure. For example, the regional offices of the Department of Veterans Affairs in Chicago and Atlanta were developed, financed, and operated by SPEs that were created for the sole benefit of the government, with financing backed by renewable leases or guarantees of the projects’ debt. Redevelopment of three buildings at Fort Sam Houston in Texas was made possible by DoD’s agreement to lease the properties to developers for 50 years, coupled with its commitment to lease the renovated facilities for the U.S. Army South Command and other federal agencies. In such cases, the government has set parameters for the development, retained an ownership interest in the property, and received ongoing compensation as lessor.

Oak Ridge National Laboratory. Financing for a $70 million facility at the Department of Energy’s (DOE’s) Oak Ridge National Laboratory was arranged by the contractor that manages and operates the lab, backed by various federal commitments. For example, DOE transferred eight acres for the project at no cost but retained the right to repurchase the land and facilities in 2028 for a nominal fee as long as it does not take actions that would result in the termination of the building lease while debt for the project is outstanding. DOE also agreed to reimburse the operator for the cost of leasing the building from the SPE that the operator set up to construct it.

Transmission Lines for the Bonneville Power Administration. In 2004, the Bonneville Power Administration (BPA) used third-party financing to cover much of the construction cost of a transmission-line project in Washington State. For BPA, the perceived advantage of such financing was the expectation that costs funded by third parties would not count against the statutory limit on the agency’s borrowing authority. (That limit is the only statutory control that exists over BPAs spending.) Under the arrangement, the Northwest Infrastructure Financing Corporation (NIFC) will own the transmission towers and lines and will lease them for 30 years to BPA, which will own the rights of way, roads, and substations. NIFC raised $120 million by issuing 30-year bonds backed solely by revenues from BPA’s future electricity sales. After the bonds are repaid, BPA has the right to obtain full ownership of the assets for a nominal cost.

Energy Savings Performance Contracts. Over the past six years, third parties have raised at least $1.8 billion for energy-conservation improvements in federal buildings, the Congressional Budget Office estimates. The notion behind energy savings performance contracts (ESPCs) is that investing in more-
Box 1.
Continued

Efficient equipment should lower the government’s energy use and hence its costs. Under the ESPC program, a contractor both finances and installs the energy-efficient equipment. The financing is backed by fixed-price contracts that obligate the government to repay the vendor’s costs, including a guaranteed rate of return, and to pay off any outstanding debt if it cancels a contract. As a result, the contractor bears little or no financial or performance risk. Nonetheless, the contracts usually allow contractors to charge interest rates that are at least 2 percent to 3 percent above the Treasury’s borrowing costs. Although the payoff from such investments would be higher if they were financed by appropriated funds, agencies rely on third-party financing because ESPCs have been given preferential budgetary treatment to promote energy-conservation goals.5

The law authorizing ESPCs is unusual in that it allows agencies to sign long-term contracts without getting an appropriation to cover the full cost of the government’s contractual obligation—only the amount needed to cover one year of the contract’s cost is required when the agreement is approved. In effect, the law gives agencies indefinite budget authority to cover the full extent of the government’s commitments, which is a form of direct spending. However, potential savings from reduced energy use would be reflected in the amount of future discretionary appropriations.

5. That treatment was specified in “Cutting Greenhouse Gases Through Energy Savings Performance Contracts” (memorandum from President William J. Clinton to the heads of executive branch departments and agencies, July 25, 1998).