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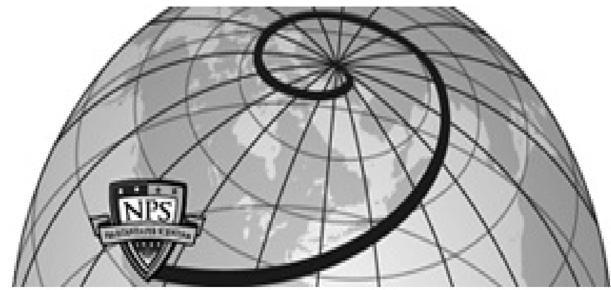

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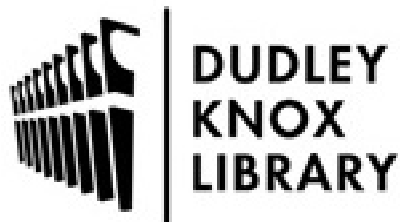

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A STUDY OF THE U.S. NAVY'S FAMILY HOUSING PROGRAM AND PRIVATIZATION: METHODS, PROPOSED BROADENED AUTHORITIES, AND RISK ANALYSIS

by

David John Sasek, P.E.

B.S. Mechanical Engineering, United States Naval Academy
(1987)

Submitted to the Department of Civil and Environmental Engineering
in Partial Fulfillment of the Requirements for the
Degree of

MASTER OF SCIENCE
IN CIVIL AND ENVIRONMENTAL ENGINEERING

at the

MASSACHUSETTS INSTITUTE OF TECHNOLOGY
September 1995

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A STUDY OF THE U.S. NAVY'S FAMILY HOUSING PROGRAM AND PRIVATIZATION: METHODS, PROPOSED BROADENED AUTHORITIES, AND RISK ANALYSIS

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DAVID JOHN SASEK, P.E.

Submitted to the Department of Civil and Environmental Engineering
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Master of Science in Civil and Environmental Engineering

ABSTRACT

One of the vital problems facing today's military is recruitment, and retention of highly motivated career minded personnel. The quality of life provided to them and their families is one of the most important issues weighing on young service members' minds. Adequate housing makes a large contribution to that quality of life. Housing allowances paid to a typical sailor living off-base represent up to one third of his overall compensation package. A sailor living on-base forfeits all housing allowances in exchange for free housing. In many areas, affordable adequate housing is unavailable to sailors in the off-base economy. Conflicting priorities between housing needs and other military programs have created an $11 billion backlog in housing maintenance and construction. This and the lack of suitable off-base housing has produced a crisis in military housing that directly impacts military readiness. Since 1984 the Navy has used public private ventures in attempts to increase the supply of quality housing near bases. These attempts have met with mixed results, and shortages remain in many areas.

It will take a concerted effort to stop the decline of military housing. The military must employ privatization if the decline is to be halted and reversed. This thesis reviews the concept and methods of privatization in general terms. It then analyzes the Navy's previous attempts to use privatization in the housing program. Legislation contained in the 1995 federal budget is introduced and analyzed. This legislation allows the Navy to create limited partnerships with private developers to encourage the housing construction near naval bases. This thesis then discusses limited partnerships in terms of their structure and limitations. Additionally, legislation proposed in the 1996 federal budget titled "The Military Housing Revitalization Act of 1995" is introduced and studied in detail. The proposed legislation grants the Department of Defense broader authority and allows extensive assumption of risk by the military. Finally, this thesis investigates risks in real estate development to provide guidelines for the Navy in structuring future limited partnerships. It also analyzes risks with the objective of determining those best allocated to the Navy, should the proposed legislation become law.

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INTRODUCTION

1.1 General

One of the most vital issues facing today's navy and the military in general is the recruitment and retention of highly motivated, career minded personnel. Today's all volunteer military depends on its ability to attract and satisfy superior performers to ensure the highest possible levels of readiness. One of the most important issues weighing on young service members' minds is the quality of life provided by the military for themselves and their families. "If the family is not satisfied with their [sic] quality of life, it is likely that the service member will not remain in the military," (Office of the Secretary of Defense, Military Family Housing: Goals and Challenges, 1995). There is a crisis developing in the arena of military housing which is having a direct impact on military readiness.

Military housing has been neglected for years. The poor condition of military housing reflects this neglect. If one considers Department of Defense estimates, the current backlog of deferred maintenance for military housing is over $11 billion and growing at a rate of about $350 million per year. About two thirds of the current stock of military housing was constructed between 1950 and 1966 and will be soon reaching a point in its life when it will either require extensive repair or be taken out of service. Also, the allowances for off-base housing, which have never fully compensated military members for the cost of housing, have not been increased at the same rate as inflation, and the gap between allowances and housing costs is growing wider (Congressional Budget Office, 1993).

The crisis is not exclusive to family housing, it encompasses an entire range of issues relating to the quality of life of military personnel and their families. Secretary of Defense William Perry recognized the magnitude of the problem and on 10 November 1994 announced the formation of the Department of Defense Quality of Life Task Force. This blue ribbon panel is chaired by John O. Marsh, Jr., a former member of the United

States Congress and Secretary of the Army for 8 years under President Reagan. The charter of this task force covers a wide range of issues including military family housing. These include are developing off-budget actions capable of improving military quality of life, improving personnel tempo (issues dealing with deployment overseas, family separation, etc.), setting department wide standards for quality of life and developing more self help programs aimed at improving quality of life. One product of the task force is legislation titled "The Military Housing Revitalization Act of 1995." This act, which will be discussed in more detail in Chapter Four, would provide a number of tools with which the military could solve the housing problem (DOD New Release, 10 November 1994).

While this problem is not limited to the Navy, the author's experience and background has been in the Navy. This thesis focuses on the Navy's Family Housing Program and efforts to improve the quality of housing provided to young sailors. The emphasis of this thesis is to provide a tool to help alleviate some of the pressure on the Family Housing Program through the use of privatization. The problems faced by the Navy are similar to those faced by the other services. The conclusions drawn in this work can easily be adapted for use by the other services.

1.2 Background Information on Navy Family Housing

1.2.1 Why is Housing Provided

Before the cold war, on-base housing was the norm for personnel during peacetime, and housing allowances, which were an exception to the rule, played a much smaller role in the compensation system. As late as 1948, the Hook Commission, an advisory group appointed by the Secretary of Defense, assumed that sufficient military housing would eventually be available to house most military families. The Hook commission accepted the prevailing principle that housing allowances should fully cover prevailing rental costs for housing in the private sector. In practice, the military has never achieved the goal of fully compensating military personnel for the housing cost they incur when renting in the private sector (Congressional Budget Office, 1993).

The Navy provides housing to sailors as part of their basic compensation package. Adequate housing for sailors and their family members is viewed as essential for a number

of reasons. First and foremost is the Navy's moral obligation to provide suitable housing for the young men and women serving their country. Although neglected by the military until recently, the quality of life of both service members and their families has been made a top priority of the Secretary of Defense. One of the most important factors contributing to the quality of life is suitable housing. The young service members who have volunteered to serve their country deserve to be housed in suitable quarters.

Additionally, since the Navy is competing with the civilian job market for the most qualified high school graduates, it is essential that the Navy is competitive with the civilian marketplace. The Navy has historically been competitive in the area of technical training and advancement opportunities. Until recently however, the Navy has neglected the impact of quality of life on recruiting. The Navy was able to do this and get away with it primarily due to the high level of technical training provided and the high regard in which the public has held the military in the recent past.

This is no longer the case. The military is down-sizing, and as a result many no longer view the military as the source of a rewarding career. In order to attract and retain quality recruits, the military must ensure that they and their families have a quality of life comparable to that provided by the civilian sector. Additionally, the makeup of the military has changed drastically over the last twenty years. The military has shifted from a predominantly unmarried draft force to one that is a predominantly married all volunteer force. A large number of these married personnel are junior enlisted (Office of the Secretary of Defense, Military Family Housing: Goals and Challenges, 1995).

Finally, the Navy must provide suitable family housing for a very practical reason. Personnel serving in the Navy are unique in the sense that they must serve on ships at sea. In doing so, they regularly leave their families at home for extended periods of time during both peace and war. Manning a ship at sea is a twenty four hour a day job that requires constant vigilance. The sea is unforgiving to those who are inattentive. Even a small lapse could result in a large loss of life. A sailor who is worried about his or her family at home is more likely to make an error than one who is confident that his or her family is safe. Therefore, it is in the both the Navy's and the sailors' best interest that suitable housing be provided. Admiral Jeremy M. Boorda, Chief of Naval Operations states,

"Housing is the major element in the Quality of Life Environment. It directly influences the productivity and career decisions....While our forces and base structure may be smaller in the future and fiscal constraints may limit resources, we cannot compromise the quality of housing for our people." (Office of the Secretary of Defense, Military Family Housing: Goals and Challenges, 1995).

1.2.2 The Navy Family Housing Program

The Department of Defense's stated policy is to rely on its own housing only when the private sector is unable to provide adequate, affordable housing or when personnel must be housed on-base to ensure military readiness. The Navy provides housing to sailors and their families in one of two ways. Sailors are either housed in Navy owned housing on base or provided a housing allowance with which to obtain housing on the private market. Sailors who reside on base receive housing and utilities (except phone) free of charge but do not receive financial compensation.

Those who reside off base receive two types of compensation. The first is Basic Allowance for Quarters (BAQ), and the second is Variable Housing Allowance (VHA). The military accepts that VHA and BAQ together pay for 80% of all housing expenses. The fiscal reality will not allow full compensation and never has. All military personnel who do not live in DOD housing are eligible for BAQ. The amount of the allowance depends on rank and on whether the individual is married or has dependents (Note: The number of dependents is insignificant. The mere fact that a military member has dependents entitles him or her to higher BAQ). It does not depend on geographic location or on the individual's actual expenditures for housing. In 1980, Congress enacted the VHA to compensate families living in the United States for regional differences in the cost of housing. VHA rates vary by geographic location. They are set for each paygrade based on the local median expenditures by military personnel for housing. Higher rank and more time in service entitle a sailor to increases in VHA/BAQ and the improvements in living standards that can be purchased with this additional financial compensation. The remaining twenty percent of the cost of housing is paid by the sailor out of his or her base pay. About one fourth of all Navy families reside in Navy housing, while the others either rent or buy on the local market.

The Navy currently owns and operates about 78,000 family housing units worldwide. The total budget for the housing program (which includes construction, maintenance, management and utilities, but not VHA/BAQ) in fiscal year 1994 was $1.013 billion. Table 1.1 provides historical data for the housing program. The data indicate both the recent emphasis being placed on the quality of life of naval personnel through the housing program and the neglect of Family Housing throughout the 1980's. The amount spent on Family Housing through the early 1980's remained relatively constant since the emphasis in military was placed on weapons systems. As the 1980's came to a close, the emphasis shifted, and more money was diverted from weapons systems towards quality of life programs. This trend continues to date.

Table 1.1: Budget and Inventory History of Navy Family Housing

Fiscal Year	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Number of Units	67.2	67.8	68.6	69.6	70.8	72.2	74	75.3	72.9	73.4	78.5
Budget	$472	$520	$502	$552	$607	$698	$687	$755	$793	$850	$1,032

Note: Number of Units is in thousands and Budget amount is in hundred thousands (then year dollars). The large increase in the number of units in the inventory between 1993 and 1994 is the result of the transfer of housing in Oahu from the Army to the Navy.
Source: Masica Telephone Conversations.

As mentioned above, VHA/BAQ does not cover all of a sailor's off base living expenses. The sailor living off-base is receiving twenty percent less compensation then his counterpart who is living on base (since he or she must reach into base pay to cover housing costs while his or her counterpart residing on base does not). Additionally, the Navy is located in areas known for their high cost of living. In many cases VHA/BAQ is inadequate compensation for off-base housing. Sailors can choose to live in smaller less suitable housing or live a long distance away from the base. In either case, the sailor living off base must give up some level of quality of life to obtain housing. He or she can either live in a small cheap residence or reside a greater distance away from the base. Living far from the base means more than a long commute to work. It means a longer drive for family members who need to come to the base for a variety of other services and entitlements including, medical and dental care, child care services, commissary and

exchange privileges and other activities/services provided on the base. These services, while very convenient to the sailor and his family who resides on base, are often inconvenient and difficult to obtain by those residing off base.

From the point of view of the Navy, the problem looks a bit different. It costs the Navy significantly more to own and operate its stock of housing than it costs the private sector to own and maintain comparable units. The current estimate is that the actual cost to the military exceeds the cost to the private sector by 40% (Congressional Budget Office 1993). Navy families that live in private sector pay a price that covers the full cost of housing. But families living in navy housing forfeit a housing allowance that is equal, on average, to only 60% of the cost that the Navy incurs in providing the housing. As mentioned above, one reason for maintaining on-base housing is to ensure a higher state of readiness. But, in almost every instance (a few positions labeled "Command" or similar are the exception) housing is assigned based on a waiting list with little regard to a service member's position or expected job on the base.

1.2.3 Shortage of Affordable/Suitable Housing

While the Navy does provide housing for sailors and their families at Navy bases, these accommodations do not always meet minimum standards. Additionally, due to the high cost nature of the markets in which sailors must obtain housing, their allowances frequently do not cover the actual expense of obtaining suitable housing. The problem of inadequate housing therefore includes both on-base and off-base housing.

The overall condition of housing provided on base is marginal at best. About twenty five percent of all military housing is over 40 years old. These units are in a state of ill repair. Many suffer from peeling lead-based paint, extensive asbestos content in construction materials which are deteriorating, corroded pipes, and other problems that are the result of both the age of the buildings and years of minimal maintenance. While there is no clear guideline used to define the difference between adequate and inadequate housing, the Department of Defense, using subjective measures which set some minimum standards, reports that as many as sixty percent of all military housing is inadequate (Graham, 9 May 1995). Additionally, the design and construction standards of the 1950's and 1960's are not suitable for today's lifestyle. Many of these units have only

one bathroom for three or four bedrooms, only enough parking space for a single automobile (either garage or carport), small or non-existent closets, insufficient electrical service for today's high use and other shortcomings that make them less then adequate for today's families (Graham, 7 March 1995).

As described above, sailors who reside off base receive allowances which do not compensate them for the entire cost of living off-base. There are many problems with this system. These include are the fact that in many locations the allowances have not increased at the same rate as inflation, putting suitable off-base residences beyond the budget of a significant number of young sailors (Hudson, 1995). Also, the Navy's presence in high cost of living areas greatly increases the average cost of housing within commuting distance from the base. Many personnel choose to reside in either smaller, less comfortable housing or live a very long way from the base. In a survey of twenty nine Navy bases, the Navy discovered that Third Class Petty Officers (E-4) and below could afford to rent one bedroom apartments at or near only five of the bases and efficiencies at or near seventeen of the bases (Graham, 7 March 1995). Finally, since the allowances cover only a portion of the off-base housing cost, sailors living off-base are forced to use other sources of funds (base pay) to cover living expenses. Sailors residing on base forfeit this allowance but receive housing without having to use base pay to cover any expenses. This creates both a higher demand for on-base housing and a perception of inequality. Since there is an insufficient number of on-base housing units to meet demand, many sailors who desire to reside on-base are forced to live off-base at a higher net cost.

Table 1.2 contains typical allowances and housing costs for a married Third Class Petty Officer (E-4) renting an apartment in five markets. The costs shown include rent

Table 1.2: Typical Allowances and Housing costs at Various Locations for a married E-4. Source: Navy PSCHOUSE Base Information Database (Last update: 1 January 1995).

	VHA/BAQ	EFFICIENCY	1 BEDROOM	2 BEDROOM	3 BEDROOM
Washington DC	$687	$650	$705	$850	$1220
Oahu, HI	$925	$750	$862	$1087	$1355
San Diego, CA	$595	$594	$664	$1115	$1417
New London, CT	$563	$550	$625	$825	$1175
Pensacola, FL	$399	$400	$475	$600	$800

and utilities. To help put these costs and allowances in perspective the highest base pay an E-4 could receive in 1995 is $1322.40 a month or about $15,800 per year (Base pay is based on rank and the number of years in service with each rank reaching a maximum base pay after a certain number of years. An E-4 reaches maximum base pay after six years.) . This information demonstrates the burden placed on young sailors as it relates to finding affordable housing. For example, an E-4 living in any of the above listed locations could not afford to rent a two bedroom apartment and in most (the only exception is Oahu) could not even afford to rent an apartment with a single bedroom. This presents an undue burden on the sailor who is very likely to be married and have a child. According to the Military Family Housing Task Force Report, three fourths of all married junior enlisted members live off base "in private-sector housing--much of it located in low income, high crime areas," (Office of the Secretary of Defense, Military Family Housing: Task Force Report, 1995). An efficiency apartment, while adequate for a single person living alone, is certainly insufficient for a young married couple with a child.

Secretary of Defense Perry summarizes this problem well when he states, "The housing allowances paid to service members are inadequate which puts them in a dilemma. They have to choose between living in a slum and basically having housing, and basically eating into their pay because their housing allowance is not sufficient to get a decent house." (Office of the Secretary of Defense, Military Family Housing: Goals and Challenges, 1995).

Tables 1.3 through 1.7, at the end of this chapter contain a summary of allowances and housing costs for enlisted sailors ranked E-2 through E-9, for the five locations included in table 1.2. These are five widespread locations where the Navy has a relatively large number of personnel. The locations were selected to give a sampling of the actual cost of maintaining a residence. The tables indicate that the problem while more pronounced for the lower ranks, is still an issue for more senior enlisted who are more likely to have larger families and thus require more bedrooms for their children. In most cases, they simply can not afford to rent suitable residences.

The data contained in these tables support the finding of the survey cited by Graham above and is indicative of the situation at other Navy bases throughout the United States. The information contained in the tables was obtained from the Navy's "PSCHOUSE Base Information" Database which was most recently updated on 1 January 1995. Also worth noting is the fact that the waiting time to move into Navy owned housing in these locations varies from six months to over two years, depending on rank and location.

1.3 Budget Difficulties Point Toward Privatization

The current mood in the United States is one of expenditure reductions. The Department of Defense is suffering the effects of the reduction more so than other areas of government. The climate is one of reaping the peace dividend now that the cold war has been successfully concluded. The obligation authority, or budget, for the Navy has declined from $102.4 billion in fiscal year 1988 to $78.1 billion in fiscal year 1994, about a twenty four percent reduction. The information in Table 1.1 demonstrates the military's commitment to maintaining the quality of life of the men and women serving in the armed forces. Despite the overall reduction of the defense budget, expenditures on family housing have increased by over seventy percent over the same period of time. Stated another way, in 1988 the Navy Family Housing Program represented only 0.6 percent of the total budget while in 1994 the Family Housing Program represented 1.3 percent. This is over double the relative budget share, a significant increase during a time of reducing budgets (Source: Navy Family Housing Budget Reports).

In spite of this increase in spending, family housing remains inadequate. Based on current levels of spending, the Department of Defense estimates that it would take over thirty years to bring the existing housing stock up to acceptable standards (Graham, 9 May 1995). The current unfunded backlog is $11 billion and growing. The years of neglect have taken their toll and current levels of expenditures for repair, maintenance and new construction, although increasing, are woefully inadequate to solve this problem. The advanced age of a large portion of the units, the fact that the Navy is admittedly not the most efficient provider of housing, and the fact that the military can not expect to increase

the funding for family housing to a level that will quickly solve the housing problem, all point toward privatization as a possible solution. The best opportunity to stem the tide of poor housing and its effects on military readiness, through low retention and difficulty in recruiting, is through innovative financing methods or privatization.

1.4 Thesis Organization

Chapter Two provides an introduction to privatization. It begins with a discussion of the basic concept of privatization. The reasons behind privatization are then discussed. These include increased efficiency and "off-budget" financing. Privatization is then defined in terms of the three most common methods: Sale of State Owned Enterprises; Alternative Delivery Methods; and Public/Private Partnerships. Next the discussion turns to a definition of the four types of goods and services and their impact on Privatization. The four type of goods are: Toll Goods; Private Goods; Common-pool Goods; and Collective Goods. A detailed discussion of the three most common methods of privatization follows the discussion of goods and services. The chapter concludes with discussions of the common attributes of privatization and the government's role in privatization.

Chapter Three is a discussion of previous uses of privatization in Navy Family Housing. The two methods used are the Section 801 and Section 802 Housing Programs. The Section 801 Housing Program is a program which allows the government to enter into long term leasing agreements for newly constructed or recently rehabilitated housing units or construction and subsequent leasing of housing units on private land for up to twenty years. Units are then assigned to service members in the same manner as units owned by the military. The Section 802 Housing Program permits the government to enter into agreements (for up to twenty five years) to assure occupancy of up to 97% of rental housing units constructed by a private developer or local housing authority on or near military bases. The service member receives VHA/BAQ and rents directly from the developer in the Section 802 Program. The successes and failures of these two programs will be discussed as will the impact of Congressional "scoring" (how funds are accounted for from year to year) on the final demise of these two programs. One case of note, the

Section 801 project entered into with the Aspin Knolls Corporation for construction of housing on Staten Island for Naval Station New York, New York, will be discussed in detail.

Chapter Four will introduce recent enabling legislation that was included in the fiscal year 1994 Defense Authorization Act. This legislation grants the Navy permission to enter into limited partnerships with private developers for the sole purpose of encouraging the construction of housing and accessory structures within commuting distance of Navy bases, thus creating adequate and affordable housing for Naval Personnel. While the legislation provides no funds, it does provide a framework for the Navy to assume an at risk position in limited partnerships whose objective is real estate development. The legislation also allows the Navy to enter into "Collateral Incentive Agreements" to further encourage construction. This chapter will also discuss in detail the legal framework and requirements of limited partnerships. The final section of Chapter Four discusses legislation proposed by the Secretary of Defense's Task force on Quality of Life. This legislation is broader and provides more flexibility then current authorities. Provisions contained in the legislation would allow the military to not only enter into limited partnerships, but also to make stock purchases and make use of debt instruments. Another key provision contained in this legislation is authority for the military to sell or lease military land or property in conjunction with military housing deals.

Chapter Five will discuss the risks involved in real estate development. For the purposes of this discussion real estate development is divided into three primary phases: the development phase; the construction phase; and the operation phase. The primary risk in the development phase is the risk of non-realization. The two most important risks in the construction phase are completion risk and cost over-run risk, and the key risks in the operation phase are cost over-run risk, equity resale risk, and market risks. These and other risks involved in each phase will be discussed in detail with an emphasis on those risks associated with the development of rental housing where applicable. The discussion will not only stress an understanding of all risks involved but will also suggest the most appropriate party and possible methods to manage said risks. Finally Chapter Six provides conclusions and recommendations for further research.

1.5 Chapter Summary and Conclusion

This chapter provided a short introduction to the problems facing Navy Family Housing. In a time of shrinking budgets and increasing maintenance expenses, the Navy must make use of any or all available alternative financing methods to maintain and improve the quality of housing available to military members. The focus of this thesis is to explore the use of limited partnerships to encourage the construction of housing and accessory structures which will increase the quality of adequate and affordable housing for sailors and their families. The driving force behind this thesis is best summarized by the following statement by the Secretary of Defense, William J. Perry:

> The readiness of our forces depends on retaining the high quality, experienced personnel we now have in the military. One of the most important factors in retention of senior personnel is our ability to provide decent and affordable housing for their families to live in. This inadequate housing affects our ability to retain a professional force and degrades our readiness. But the quality of housing has declined for more than 30 years because of a lack of priority and because earlier attempts at solution have run into regulatory or legislative roadblocks (DOD News Release, 8 May 1995).

It will take a concerted effort to stop this thirty year decline in the quality of military housing, and privatization is one of the tools that must be employed if the decline in military housing is to be halted and reversed.

Table 1.3: Summary of Allowances and Housing Costs in Washington, DC. Source: Navy PSCHOUSE Base Information Database (Last updated: 1 January 1995).

RANK	VHA/BAQ	EFFICIENCY	1 BEDROOM	2 BEDROOM	3 BEDROOM
E-2	$631	$650	$705	$850	$1220
E-3	$637	$650	$705	$850	$1220
E-4	$687	$650	$705	$850	$1220
E-5	$758	$650	$705	$850	$1220
E-6	$874	$650	$705	$850	$1220
E-7	$967	$650	$705	$850	$1220
E-8	$1027	$650	$705	$850	$1220
E-9	$1032	$650	$705	$850	$1220

Table 1.4: Summary of Allowance and Housing Costs in Oahu, HI. Source: Navy PSCHOUSE Base Information Database (Last updated: 1 January 1995).

RANK	VHA/BAQ	EFFICIENCY	1 BEDROOM	2 BEDROOM	3 BEDROOM
E-2	$837	$750	$862	$1087	$1355
E-3	$856	$750	$862	$1087	$1355
E-4	$925	$750	$862	$1087	$1355
E-5	$1002	$750	$862	$1087	$1355
E-6	$1116	$750	$862	$1087	$1355
E-7	$1188	$750	$862	$1087	$1355
E-8	$1160	$750	$862	$1087	$1355
E-9	$1331	$750	$862	$1087	$1355

Table 1.5: Summary of allowances and Housing Costs in San Diego, CA. Source: Navy PSCHOUSE Base Information Database (Last updated: 1 January 1995).

RANK	VHA/BAQ	EFFICIENCY	1 BEDROOM	2 BEDROOM	3 BEDROOM
E-2	$528	$594	$664	$1115	$1417
E-3	$540	$594	$664	$1115	$1417
E-4	$595	$594	$664	$1115	$1417
E-5	$677	$594	$664	$1115	$1417
E-6	$777	$594	$664	$1115	$1417
E-7	$851	$594	$664	$1115	$1417
E-8	$891	$594	$664	$1115	$1417
E-9	$992	$594	$664	$1115	$1417

Table 1.6: Summary of Allowances and Housing Costs in New London CT. Source: Navy PSCHOUSE Base Information Database (Last updated: 1 January 1995).

RANK	VHA/BAQ	EFFICIENCY	1 BEDROOM	2 BEDROOM	3 BEDROOM
E-2	$512	$550	$625	$825	$1175
E-3	$51[illegible]	$550	$625	$825	$1175
E-4	$5[illegible]	$550	$625	$825	$1175
E-5	$63[illegible]	$550	$625	$825	$1175
E-6	$709	$550	$625	$825	$1175
E-7	$787	$550	$625	$825	$1175
E-8	$852	$550	$625	$825	$1175
E-9	$963	$550	$625	$825	$1175

Table 1.7: Summary of Allowances and Housing Costs in Pensacola, FL. Source: Navy PSCHOUSE Base Information Database (Last updated: 1 January 1995).

RANK	VHA/BAQ	EFFICIENCY	1 BEDROOM	2 BEDROOM	3 BEDROOM
E-2	$362	$400	$475	$600	$800
E-3	$373	$400	$475	$600	$800
E-4	$399	$400	$475	$600	$800
E-5	$463	$400	$475	$600	$800
E-6	$496	$400	$475	$600	$800
E-7	$542	$400	$475	$600	$800
E-8	$605	$400	$475	$600	$800
E-9	$615	$400	$475	$600	$800

-2-

PRIVATIZATION

2.1 General-Introduction

This chapter provides an introduction to privatization. It begins with a discussion of the basic concept of privatization. The reasons behind privatization are then discussed. These include increased efficiency and "off-budget" financing. Privatization is then defined in terms of the three most common methods: Sale of State Owned Enterprises; Alternative Delivery Methods; and Public/Private Partnerships. Next the discussion turns to a definition of the four types of goods and services and their impact on Privatization. The four type of goods and services are: Toll Goods; Private Goods; Common-pool Goods; and Collective Goods. A detailed discussion of the three most common methods of privatization follows the discussion of goods and services. The chapter concludes with discussions of the common attributes of privatization and the government's role in privatization.

2.2 Privatization: an Overview

2.2.1 The Concept of Privatization

Privatization is a method by which market forces are introduced into the supply and production of goods and services that are traditionally provided by the government. It involves incrementally shifting the responsibility for key decisions about resource use and disposition from the government to the private sector. In its strictest form, privatization leads to the conversion of Public Enterprises from traditional government structures to a form resembling the corporate model followed by the transfer of ownership to the private sector (Boustany, 1992). Privatization shifts the burden of production and service delivery to the private sector which arguably has many advantages over the public sector with regards to efficiency, effectiveness and innovation.

The role of the government in service production and delivery does not disappear. It is merely diminished. The most effective process involves the public and private sectors being jointly involved in meeting needs. The public sector identifies the needs and

provides a framework of regulation, and the entrepreneur in the private sector creates a market or a customer so that the needs can be met through private modes of delivery (Brooks, 1984). The three most common forms of privatization are sale of an existing state-owned enterprise; use of private financing and management rather than public for new infrastructure developments; and outsourcing of public services previously provided by government employees (Gomez-Ibañez and Meyer, 1993).

2.2.2 Why Privatize?

2.2.2.1 Trends Leading Towards Privatization

There are a number of driving forces behind the desire to privatize a given product or service. The overarching objective is to reduce government expenditures without lowering the level of service or the amount of a good provided. The current budget deficit is over $200 billion, and there has been a gradual shift in the perception of the relative size of government by the American people. The people are beginning to believe that the government is too large and plays too big a role in the economy. This creates an atmosphere in which new ideas for privatization can take root. Additionally, the pressure from the electorate to reduce the budget deficit is growing. This places even more pressure on government to find more efficient and creative ways to provide goods and services to those in need.

In their recent work, Going Private: The International Experience with Transport Privatization, Gomez-Ibañez and Meyer outline motives for the three most common types of privatization as they apply to the specific method of privatization. Governments could sell an existing enterprise in an effort to raise cash for use in other areas. Use of private financing and management rather than public for new infrastructure developments and outsourcing are driven by the perception that the private sector is more efficient than the public sector (Gomez-Ibañez and Meyer, 1993).

Other forces driving governments to privatize is the ever increasing need for both repair of old and construction of new facilities. Governments are faced with both a decreasing availability of funds and an increasing demand for more repair and construction of facilities (Anonymous, "Time for a Change," Bechtel Briefs). Additionally, the cost of private financing of projects is decreasing relative to the cost of public financing, making

privatized projects more attractive and competitive. Finally, there is an increasing number of successful privatization projects which is increasing the confidence in this type of approach (Boustany, 1992).

2.2.2.2 Summary Benefits of Privatization

There are many benefits to privatization. The most significant is the higher efficiency of the private sector stemming from the profit motive and the cost savings that come from this higher efficiency. Private sector businesses must either prove profitable or they will not be able to remain viable. The reduction of government through privatization provides a benefit through a corresponding reduction in the public's tax burden. Increased innovation provided by the private sector is another important benefit of privatization. Finally, an increase in the amount of capital available for government projects and a potential reduction in delivery time are both important benefits of privatization (Gomez-Ibañez and Meyer, 1993). A more detailed discussion of each of the above benefits will be completed below. Additionally, for less developed countries, privatization offers the benefit of introducing new technology and attracting capital from more highly developed countries (Boustany, 1992).

2.2.2.3 Summary of Objections to Privatization

One objection to privatization is that it does nothing to actually increase the overall amount of capital available for investment. It merely channels a larger portion of the available capital away from other projects or developments. Another objection is centered on the argument that many of the so called savings provided by privatization are not savings at all. They merely transfer the burden from one segment of society to another while not actually reducing the overall cost to society (Gomez-Ibañez and Meyer, 1993).

Some fear that business involvement will replace the current service ethic with a profit-maximizing ethic. People in areas where provision of the service proves to be unprofitable would not necessarily be served in such a case (Brooks, 1984). Finally, there is a fear that private firms are more susceptible to corruption and that the resulting privatization will result in unreasonably high profits for the contractors (Savas, 1982). The discussion of these objections will be expanded below.

2.2.3 Three Most Common Methods of Privatization

As mentioned above, the three most common forms of privatization are the sale of an existing state-owned enterprise; use of private financing and management rather than public for new infrastructure developments; and outsourcing public services previously provided by government employees. Outsourcing or contracting out is currently the most commonly used method and has been commonly used for years. There is a large body of data supporting the argument that outsourcing has proven to be cost effective. Most studies reflect an overall savings to the government of about twenty percent (Gomez-Ibañez and Meyer, 1993).

Sale of state owned enterprises can only be effective if the enterprise to be sold holds the potential to earn sufficient income to cover expenses, finance new investment needs and provide a suitable return on capital investment (Gomez-Ibañez and Meyer, 1993). Finally use of private financing and management can be effective only if two key principals apply. The government must ensure the private sector has a suitable market, and make sure it will be free of bureaucratic interference while executing the construction and operation of the facility.

2.3 Definition of Types of Goods and Services and Impact on Privatization

In order to understand whether or not it is possible to privatize particular goods or services and be able to choose the right method of privatization, it is necessary to understand the basic nature of good and services. It is also necessary to classify them, since their nature determines whether or not they will be produced at all. They can be most effectively classified based on methods of exclusion and consumption. Unless otherwise noted, the section that follows is based on the discussion of the classification goods and services contained in Privatizing the Public Sector, by E.S. Savas.

2.3.1. Exclusion

Exclusion is he first criterion for classifying goods and services. They have the characteristic of exclusion if the user of it can be excluded from its use or can be denied the good unless he meets the demands established by the supplier. They can change hands only if the conditions set by both the buyer and seller are met.

Savas uses the example of a fireworks show to demonstrate a situation in which exclusion is impossible. While it is possible to charge admission (an attempt at exclusion) for a seat in a grandstand to view a display of fireworks, it is impossible to prevent others from viewing the show from outside the stadium. It is just not possible to close a large enough space to prevent anyone else from watching the show. Therefore in this case, complete exclusion is not possible, but partial exclusion (through the use of more comfortable seats in the grandstand) is possible.

2.3.2 Joint Consumption

A good that has the quality of joint consumption can be used or consumed jointly and simultaneously by a large number of customers without being reduced in quality or quantity. A good lacking this quality is available only for individual consumption. A candy bar and a haircut provide examples of a good and service that are subject to individual consumption. Good examples of goods or services with the qualities of joint consumption are national defense, television broadcasts, and parks and streets. Parks and streets are not pure joint consumption goods, since, if they get too crowded, use will be limited.

2.3.3 Classifying Goods and Services

The discussion of the two properties above illustrates the four extremes on the classification scale. Very few goods or services can actually be defined as having the characteristics of pure exclusion or pure joint consumption. Instead, they are classified on a scale of increasing or decreasing levels of similarity to the pure condition. The pure forms of the goods or services are pure individually consumed goods or services for which exclusion is completely feasible (Private Goods); pure jointly consumed goods or services for which exclusion is completely feasible (Toll Goods); pure individually consumed goods or services for which exclusion is completely unfeasible (Common-pool Goods); and pure jointly consumed goods for which exclusion is

completely unfeasible (Collective Goods). Figure 2.1 below demonstrates how this classification is performed. The pure forms of goods and services are represented by the corners of the box.

Figure 2.1: Classification of Goods and Services, (Savas, 1982).

	Individual Consumption ←	→ Joint Consumption
Exclusion Possible ↑	Private Goods -Store Bought Goods -Housing -Taxi Service	Toll Goods -Cable TV -Bridge/Turnpike
↓ Exclusion Not Possible	-Rivers/Lakes -Fish in the Sea -Air Common Pool-Goods	-Streets -Broadcast TV - National Defense Collective Goods

The examples shown in figure 2.1 clearly demonstrate the nature of goods varying by degrees and subtleties of interpretation. Some goods are easily defined by their qualities. Air for example is a good in which exclusion not possible and which is purely individually consumed. Another good example is national defense, in which exclusion is impossible, yet it is collectively consumed. Others for example, bridges, streets and fish in the sea are not as easily defined. While they have some level of the different qualities, they are not pure in any sense, and their classification is subject to the judgment of the individual performing the classification.

The nature of a good or service determines the willingness of producers to supply it and of consumers to pay for it. The qualities help to determine whether or not collective action or intervention is needed to ensure that a good or service is produced in an adequate quantity and quality. The impact of the nature of goods on their production is discussed below.

2.3.3.1 Private Goods

The nature of private goods does not create any problems of supply. They are produced by the market. Consumers create a demand for private goods and capitalists in the market produce them. They are sold to consumers at whatever price the market will

bear. Since they can be individually consumed and exclusively sold, market forces will ensure they are produced in suitable quality and quantity.

2.3.3.2 Common-pool Goods

The nature of common-pool goods does produce a difficulty. Since there is no need to pay for these goods and no possible way to prevent excess consumption, they will be consumed at a level in excess of their actual cost. The consumption of these goods will be excessive to the point of exhaustion as long as the cost of collecting, harvesting or any other means of taking possession of these free goods does not surpass the value of the goods to the consumer. There are innumerable examples of this occurring in modern society. This phenomena has been described in literature as the tragedy of the commons (Hardin, 1968). Common-pool goods would be consumed to exhaustion if they were not collectively controlled. Collective action is required to limit consumption to reasonable levels and to ensure that these goods are not consumed to the point of extinction.

2.3.3.3 Toll Goods

It is possible to exclude non-payers from the use of toll goods. This quality of toll goods makes it feasible for the market to supply them. Suppliers will provide the good in the quantity demanded by consumers and users will pay for the perceived value of the toll good. There is a general shift towards the acceptance of toll goods as replacements for goods that were previously viewed as either common-pool or collective goods.

2.3.3.4 Collective Goods

Collective goods present the most serious problem for society. A capitalistic marketplace can not supply collective goods since they are used simultaneously by many people, and it is impossible to exclude anyone from their use. More importantly, it is in an individual's best interest to fully use collective goods while not paying for them or without contributing their share of the work necessary to supply them.

Collective goods are very difficult to measure and by their nature offer little choice to the consumer. The consumer has little choice but to make use of the good in the quantity and quality available. Also, since there is no method for measuring consumption and charging users for their proportionate share of the good consumed, payment for their use is completely unrelated to consumption or demand. In the case of collective goods, it

is impossible to rely on the market. The only way to ensure fair use and billing is to rely on the government or a political process to determine rates charged users. Table 2.1 below summarizes the major differences between private and collective goods.

Table 2.1: Comparison Of Private And Collective Goods (Savas, 1982).

Characteristic	Private Good	Collective good
Consumption	Individually	Joint and simultaneous by many people
Payment for goods	Related to consumption paid by consumer	Unrelated to consumption; paid by collective contributions
Exclusion of non-payer	Easy	Difficult
Measure of Quality and Quantity of goods	Easy	Difficult
Measurement of performance of goods producer	Easy	Difficult
Individual choice in consuming or not consuming	Yes	No
Individual choice as to quantity and quality of goods consumed	Yes	No
Allocation decision	Made by market mechanism	Made by political process

2.3.3.5 Characteristics of Services

A unique property of services is that they must be defined to the provider in such a manner that there is no misunderstanding between the consumer and the provider. Some services are easily defined with little room for ambiguity and low likelihood of misunderstanding. Other services, however, are not as easily specified, and there is much room for interpretation with regards to what that particular service entails. Savas uses the examples of street paving and education to illustrate the possibility of misunderstanding and the impact of interpretation on service delivery. It is very easy to define the standards for street paving. One must simply define the required design and communicate that requirement to the contractor providing the paving service. The qualitative nature of education makes it very difficult to define the service required.

Services like street paving permit the development of relatively simple delivery methods. The party requiring the service simply develops a clear, concise request for proposals for service. In return, the service providers respond with a proposal in conformance with the request and are awarded the work based on their response. The performance is then measured against the standards set in the contract. Services like

education, are much more difficult to define and as such require more care and judgment in the contract development phase. These types of services are most appropriately procured through negotiation or performance based specifications.

2.3.3.6 Classification of Family Housing

Family housing is best classified as a private good. Exclusion from use is certainly possible. The owner of a home or rental will not allow a family to move into it without prior agreement (usually in the form of a mortgage or lease). While homeowners and renters are provided certain rights under the law, failure to make the required mortgage or rent payments would most certainly result in eviction. Family housing is individually consumed. If one family is living in a particular unit of housing, another family is unable to live there.

2.3.4 Delivery of Good and Services

As their characteristics and properties allow, private and toll goods are supplied by the market. The collective action of society or government should have a minor impact on the process of delivery of these goods. The role of government in this case is to establish basic rules for market transactions, to ensure the safety of private goods and to regulate toll goods that are monopolistic in nature. In the case of common-pool and collective goods, the roll of collective action is imperative in order to ensure a continued supply of such goods. Collective action is also necessary to provide certain private and toll goods which society determines are to be subsidized and thus supplied as if they were collective goods. In the process of delivering goods or services, there are three elements to the system: the consumer, the producer and the arranger. While the three elements represent three distinct activities that must be performed (as will be discussed below), they do not necessarily have to be performed by three different parties.

2.3.4.1 The Consumer

The consumer is the party who directly obtains the good or gains benefit from the service. Consumers can be individuals, households, geographic areas or any other of a number of different groups or segments.

2.3.4.2 The Producer

The producer is the party who actually manufacturers the product or directly performs or delivers the service to the consumer. The producer can be either a private firm, a government agency or some combination thereof working together to deliver the product.

2.3.4.3 The Arranger

The arranger is the party who brings the producer and the consumer together. This can be achieved through voluntary association (typical of private goods) or through assignment of producer to consumer or vice versa. In the case of collective goods, the arranger is viewed as a collective decision unit. The arranger communicates the demand for collective goods. The arranger must be able to collect taxes or user charges to pay for the collective good (sometimes in the face of conflicting opinion in regard to the need and value of the good). The arranger must also establish a method to decide which goods and services are to be provided at what level of quality and to set a price for their delivery.

2.3.4.4 Arrangements for Providing Public Services

Table 2.2 below lists the seven possible arrangements for the delivery of public services. The service arrangements listed below range from pure government provision (government service and inter-governmental agreement) to pure market based provision (market).

Table 2.2 Institutional Arrangements For Providing Public Services (Savas, 1982).

SERVICE ARRANGEMENT	ARRANGES SERVICE	PRODUCES SERVICE	PAYS PRODUCER
Government service	Government	Government	NA
Inter Government agreement	Government	Government	Government
Contract	Government	Private firm	Government
Franchise	Government	Private firm	Consumer
Grant	Government and consumer	Government and private firm	Consumer
Voucher	Consumer	Private firm	Government and consumer
Market	Consumer	Private firm	Consumer

The most appropriate method for arranging the delivery of a good or service depends on the nature of that particular good or service. Each must be evaluated individually and the decision made on a case by case basis. There are, however, some delivery methods which can be ruled out as being obviously inappropriate or impractical based on the general nature of the type of good or service in question. For example, private goods should not and cannot be efficiently provided by government service. Table 2.3 summarizes the results of a systematic elimination of inappropriate or impractical delivery arrangements. The arrangements marked with an "X" are those remaining as possible delivery methods. As demonstrated in the table below, it is feasible to privatize to one degree or another every good or service now provided by the government. Brooks argues that every good or service provided by the government is "a fair candidate for private suppliers. Why? If we believe that a monopoly will always operate less efficiently than competitive firms...we must recognize that any service provided by a government monopoly can be more efficiently provided by private competitive firms," (Brooks, 1984).

Table 2.3 Types of goods and Institutional Arrangements Most Efficiently Used for Their Delivery (Savas, 1982).

Arrangement	Private Goods	Toll Goods	Collective Goods	Common-Poll Goods
Government service		X	X	X
Inter Government Agreement		X	X	X
Contract		X	X	X
Franchise		X		
Grant	X	X		X
Voucher	X	X		X
Market	X	X		

2.4 Sale of State Owned Enterprises

Sale of State owned Enterprises or denationalization returns the product or service delivery method to the market. In most cases, the government releases all or most control

over the product delivery system. This method is motivated by the belief that the private sector which is subject to competitive forces will be more efficient in product and service delivery and by the prospect of immediate financial gain to government or immediate deficit reduction (Gomez-Ibañez and Meyer. 1993). In many cases, public ownership is used to foster goals other than profit maximization. Those include increased employment and making goods and services available at affordable prices throughout the market. When denationalization occurs, these goals may not be met (Liddle, 1993).

As mentioned above arguments in favor of denationalization rely very strongly on the proposition that private ownership is more efficient than public ownership. While private ownership contributes to increased efficiency, the most important factor is not ownership, it is competition. Private firms who are not subject to competition will either grow fat and become inefficient or take advantage of their unique position to reap excessive profits. Liddle argues that a more effective way to achieve the efficiencies resulting from privatization and competition in the market place is not by selling public assets, but by contracting out services to the best bidder (Liddle, 1993). This is true, but contracting out constrains the private sector to provide the service or good as specified, thereby reducing the advantage of private sector innovation. The two examples discussed below help illustrate some of the issues created by denationalization.

2.4.1 Excessive Profits in Great Britain

The utility privatization efforts in Great Britain show the effects of privatization with improper regulation. This example shows newly privatized firms taking excessive profits and excessive remuneration of executives. Profits for regional electricity companies have more than doubled between 1990 and 1994 and profits of the water companies nearly quadrupled over the same period. The system was structured to reward cost cutting and productivity improvements while maintaining price stability. The private firms proved to be highly effective in their efforts, but the savings were not passed on to the users. This has created a public outcry and negative perception of this privatization effort in Great Britain. Regulators are currently searching for a way to restructure the regulation to reduce the private utility's profits to a reasonable level. (Pope, 1995).

2.4.2 Sale of Assets in Hungary

The second example is the move to sell a significant number of state assets in Hungary. Hungary is attempting to sell three huge publicly owned enterprises. They are the state oil and gas company, the national electric company and the state telephone company. The objective in this case is to raise revenues for the government. Hungary's Finance Minister Lajos Bokros has planned his budget around receiving $1.3 billion in revenues from these and other sales. Hungary's 1995 budget has a huge deficit. The country is relying on selling the state owned enterprises to balance the budget. While the current government is strongly supporting this move, there have been numerous dissenters who believe that this move will not generate the needed cash and result in increased rates to the users. Unions and the current utility management are strongly opposed and may be able to forestall the sale (Condon, 1995). This issue is far from being resolved and will serve as an example for others who hope to make similar sales in the future.

2.5 Alternatives for Good and Service Delivery

The provision of goods and services and their delivery or production are independent. As indicated above, the government does not have to both provide and deliver the good or service. The government may more effectively act as arranger or overseer of the process. There is a growing belief that government should not act as a service provider; it should instead be concerned with the provision of goods and services regardless of how they are delivered (Hatry, 1983). The four most common alternative delivery methods are contracting out, grants and subsidies, franchising, and vouchers.. The two methods of delivery that will be used as a comparison base are complete government provision of good and services and the other end of the spectrum, complete market provision.

2.5.1 Contracting Out

Contracting out is currently the most common and the most accepted alternative method of good or service delivery. The government pays a private company to provide a service or produce a good as defined by clear and concise specification. The government determines the service level and quality of the product. Contracting out has proven to be

effective in producing savings in cases where the good or service is easily defined (Liddle, 1993). Contracting out provides an opportunity to take advantage of competitive forces and the more efficient management provided by private firms. It allows the government to take advantage of specialized skills available on the private market and avoids large capital outlays while spreading costs out over a long period of time at a relatively constant rate. Finally, it reduces the size of the government in terms of the number of employees on the government payroll (Savas, 1982).

Contracting out involves increased administrative costs which are necessary to implement the contracting process and monitor the contracts. These increased costs will reduce the net savings from contracting out. Contracts must be competitively awarded to ensure market pricing. One major disadvantage of relying on contracting out is that the goods or services provided are designed by the public sector which greatly limits the possibility of innovation. Public officials operate in an environment which is not conducive to innovative free thinkers who have a tendency to rely on proven designs or methods. Also, contracting out greatly reduces the government's ability to respond to emergencies and fosters an undesirable dependence on contractors which leaves the public vulnerable to strikes and the financial stability of the contractors.

While there are a number of positive and negative aspects to contracting out, as mentioned above, it has proven to be very effective in cases in which the product is easily defined and suitable competition exists.

2.5.2 Franchising

Franchising is growing in popularity. The government decides to award either an exclusive or non-exclusive franchise to private firms for good or service provision in a certain geographic area. Advantages of franchising include the fact that off-budget financing can be arranged in deals involving franchising, thus lowering the budgetary requirements of government (Liddle, 1993). This type of arrangement is commonly referred to as Build-Operate-Transfer or Build-Operate-Lease in the construction industry. Frequently, the government provides second level guarantees in a franchising agreement. Additionally, franchising allows the government to take greater advantage of the innovations available in the private sector. Franchising provides the private firm with a

guaranteed market or market segment. Franchising permits providers to take advantage of economies of scale and scope if the geographic area of the franchise is large enough. Franchising directly ties the consumer to the provider, thus making the government's role one of regulation and supervision (Hatry, 1983).

Disadvantages of franchising include limitation of competition for private firms that receive franchises. One of the keys to a successful franchise is clearly defined geographic arena in which to conduct business which limits the potential for competition. Even in cases where non-exclusive franchises are granted, the likelihood of collusion or price fixing is increased due to the reduced number of market players (Savas, 1982). Franchising also reduces government control and ability to pursue other goals (employment and distribution). Franchising could result in lower overall employment and loss of service in areas where market conditions will not allow profitable operation.

2.5.3 Vouchers

Vouchers are used in place of cash for consumers to purchase good or services. The government provides vouchers to citizens in need of the good or service. The citizen then gives the voucher to the service or good provider who then receives reimbursement from the government (Hatry, 1983). Vouchers give the consumer a choice of producers of a given service but no choice of services purchased. The most important advantage of vouchers is that they always increase competition by allowing the consumer the freedom to choose the provider, and they create an opportunity for the provider to innovate to stay competitive. Vouchers also allow the government to ensure service is provided to consumers in unprofitable markets. It is important that the value of vouchers is set at or near the level of the most efficient producer. This will force the other competitors to improve their level of service or the cost of a good or run the risk of losing market share (Liddle, 1993).

A major disadvantage of vouchers is the continued requirement for monitoring and involvement by the government. Also, the net effect of instituting vouchers may not necessarily reduce the overall cost to the government.

2.5.4 Grants and Subsidies

The government provides a financial or in kind contribution to a private organization to encourage them to provide a good or service. In this case, the government decides how much compensation and to whom the compensation is given. The desired effect is to provoke increases in supply and consumption by lowering firms' costs and the prices they must charge consumers to remain profitable. Grants and subsidies are used to increase the number of suppliers if there are a limited number of suppliers and the cost of entering the market is prohibitive. Additionally, grants and subsidies are used to establish new programs requiring extensive development costs (Hatry, 1983). Grants and subsidies are usually less expensive than franchises or vouchers and more easily managed (Liddle, 1993).

Disadvantages of grants and subsidies include the facts that the government is heavily involved in the market process and that politics can greatly impact which firms receive funding. Additionally, the effect of introducing grants or subsidies may not necessarily reduce the cost to government (Liddle, 1993).

2.5.5 Summary

Table 2.4 below summarizes the comparison of the different alternative methods of goods and service delivery. The various options discussed provide a number of different approaches available to the government when it attempts to privatize through alternative delivery methods. No single method is best for all cases, and each case of privatization must be evaluated in light of the government's objectives. Several factors should be considered when trying to determine which method of delivery is most appropriate for any given case. Among the factors that must be evaluated are the cost of having the service provided by the government compared to the financial costs to the citizens of the alternative approaches. The financial health of the private sector and its staying power must be evaluated. It is also important to evaluate the number of choices available to service the clients and the quality and effectiveness of each available choice. It is also important to view the change in terms of overall feasibility and the general impact on the public. Finally, potential distribution effects resulting from the move to privatization must

be considered (Hatry, 1983). Only after these factors are weighed and all the different options are considered should a government proceed with alternative delivery methods.

Table 2.4 Privatization Goals and Services Delivery Methods (Liddle, 1993)

Goals of Privatization	Government Supply	Contract	Franchise	Grant/ Subsidy	Voucher	Market
Reduce Government cost	No	Yes	Yes	Maybe	Maybe	Greatly
Reduce Consumer cost	No	Maybe	Maybe	Yes	Yes	Yes
Increase consumer choice	No	No	No	Maybe	Yes	Yes
Increase competition	No	Maybe	No	Maybe	Yes	Yes
Improve Quality/Innovation	No	Maybe	Somewhat	Maybe	Yes	Yes
Limit Size of Government	No	Somewhat	Somewhat	Somewhat	Somewhat	Greatly
Distribution goals other policy goals	Yes	No	No	Somewhat	Yes	No
Direct contact between consumers and suppliers	No	No	Yes	Yes	Yes	Yes
Decrease Potential for Service Disruption	No	Yes	Yes	Maybe	Maybe	Maybe

2.6 Public/Private Partnerships

With the exception that the government assumes both some of the risks and some responsibility for managing the project, public/private partnerships are very similar to franchising agreements. The government's role in the partnership is defined by the structure of the partnership, but, generally, the government has identical rights and responsibilities as other partners in the venture. Chapter Four will discuss in great detail the formation and structure of limited partnerships. In public/private partnerships, the government is able to transfer varying degrees of risk and responsibility to the private sector. The public sector can transfer responsibility for all or any of the following to the private sector: ownership, financing, operation and construction of the project. Differing circumstances in the market or in the details of the specific project would dictate what level of transfer to the private sector occurs (Liddle, 1993).

The most important aspect of public/private partnership is the sharing of goals and risks. The two entities will form a partnership only if mutual goals exist or if each can not reach individual goals without the assistance of the other. However, in many cases their goals and methods diverge. The private sector is motivated by the possibility of profit and

has strong incentives to be more cost conscious, efficient and customer oriented than a public enterprise. The public sector has an obligation to protect the public, and often this obligation is in conflict with private sector objectives of profit maximization. A key aspect of successful public/private partnerships is balancing these sometimes diverging goals.

Another obstacle to successful public/private partnerships is the government's reluctance to shoulder its fair share of the risk. Proper and efficient allocation of risk is one of the keys to a successful project. The party who has the most power to control the risk, who has the most to gain by controlling the risk and/or who is in the best financial position to handle the risk will manage the risk more efficiently. It is this party to whom the risk should be allocated (Gordon, 1991). In many cases this is the government, but the government's aversion to risk leads to risk being placed entirely on the private sector. This inefficient allocation of risks leads to higher final costs of the project and could in an extreme case result in the project never being undertaken. Many of these projects require long term financing and without government's assuming the appropriate risks private financing institutions will not back them (Michel, 1993).

The government's inexperience with the nuances of structuring complex projects involving risk allocation, risk sharing and private financial institutions is also a major obstacle to successful public/private partnerships. The government has a very limited understanding of and sensitivity to the time value of money, the concept of return on investment or return on equity, and the need for profitability. This lack of appreciation for the financial aspect of private business processes combined with the diverging goals discussed above makes private financial institutions reluctant to support public/private partnerships (Michel, 1993).

In a successful public/private partnership, the public sector creates an opportunity for the private sector to make profits and the private sector delivers a project with positive social benefits that would not have been feasible without joint public and private participation. Risks and responsibilities are efficiently allocated between the two parties. The private sector is responsible for those activities at which it is most effective: management, operation, maintenance, finance and/or construction. And the public sector is responsible for cost and quality control, regulation, and planning (Liddle, 1993). Risks

which are allocated to the party most able to efficiently control them, must be evaluated on a case by case basis.

2.7 Common Attributes and Qualities of Privatization

Privatization has many forms and structures, but independent of the type of privatization utilized, there are a certain number of attributes and qualities of privatization that are common throughout the various structures. These attributes can be divided into three major categories. They are the benefits of privatization, the objections to privatization and the keys to success in any privatization effort. These three categories will be discussed in detail below.

2.7.1 Benefits of Privatization

There are five major benefits of privatization: increased innovation, reduction of government, increase in capital spending on public projects, increased efficiency (lower cost) and shortened delivery time. While the degree and magnitude of the benefits vary depending on the selection of privatization method, each is present in every case.

2.7.1.1 Increased Innovation

Increased innovation and the corresponding improvements in service and quality of the good provided is a key benefit of privatization. Private firms' freedom from bureaucratic red tape and other procedural constraints and their dependence on profits to remain viable lead to more flexible managers who are more apt to try new ideas then their counterparts in government (Gomez-Ibañez and Meyer, 1993). The level of innovation resulting from privatization is directly dependent on the privatization method being utilized and the amount of government participation and restrictions placed on the private firms. Fewer restrictions provide the opportunity for substantial innovation. While contracting out may reduce costs, it provides reduced opportunity for innovation. Franchising or public/private ventures provide larger opportunities for innovation.

2.7.1.2 Reduction of Government

The reduction of government is one of the top sources of motivation for those desiring to implement privatization. This is indeed one of the benefits of privatization. By instituting privatization, governments can both reduce their payroll (by shifting employees

from public payrolls to those of private firms) and reduce the government's overall budget (by tying the consumer directly to the supplier, for example toll roads). While the government's role is greatly reduced, it is never completely eliminated. The government, depending on the method of privatization used, could still be responsible for setting standards, licensing, monitoring, designing, market analysis or any myriad of efforts involved in providing the product (Brooks, 1984).

2.7.1.3 Increase in Capital Spending on Public Projects

By taking advantage of either franchising or public/private partnerships, the government is able to tap private capital markets for public projects. Private markets are more selective in their choice of projects to finance and would be eager to finance those that show potential for profitability (Liddle, 1993). Those projects that are not able to attract private capital could still be financed through traditional government methods. This potentially could increase the number of public projects being undertaken during a time of reduced budgets. The private firms would finance the most profitable while those that are not profitable but still deemed necessary could be financed through public coffers. It is important to note that privatization does nothing to increase the amount of capital available in the entire economy. It merely channels private funds that would have been used for private projects to public projects (Gomez-Ibañez and Meyer, 1993).

2.7.1.4 Increased Efficiency and Lower Costs

The private sector is more efficient when subjected to competition. It is this competition and the public sector's lack of competition that contributes to the increases in efficiency resulting from privatization. In every instance when the government is operating under a monopoly or pseudo-monopoly, there are efficiency gains and cost reductions to be captured (Brooks, 1984). According to Gomez-Ibañez and Meyer, studies have demonstrated that in most cases, when privatization is implemented properly and carefully controlled, it reduces costs by at least twenty percent. They state that the bulk of savings are generated by higher labor productivity, leaner management, and reduced maintenance expenses. Additionally, these savings are consistent over time. The private sector, not being subject to government regulations, can quickly adapt to changing markets and is capable of hiring the most qualified personnel (Brooks, 1984).

2.7.1.5 Shortened Delivery Times

The private sector has developed quicker delivery processes as a result of their higher sensitivity to the cost of delays (high interest rates) and their increased flexibility in finding compromise solutions (Gomez-Ibañez and Meyer, 1993). This advantage is exploited most effectively through the use of franchising and public/private partnerships. These two methods most able to free the private sector from government control and regulation.

2.7.2 Objections to Privatization

The major objections to privatization are that it actually does nothing to increase the amount of capital in the economy, that the savings from privatization are merely transfers from one segment of society to another, that the profit motive will replace the service motive in provision of traditional government services, and that private firms are more susceptible to corruption and more likely to reap unreasonably high profits. None of these objections are unfounded but not all of them are necessarily worthy of concern and those that are can be controlled through appropriate government participation.

2.7.2.1 Failure to Increase Capital

The fact that privatization does not increase the overall savings and the amount of capital in the economy is not disputed. It is not necessarily significant either. Increasing the amount of capital in the economy is not an objective of privatization. The fact that privatization channels funds away from private projects to those benefiting the public is occasionally viewed as a negative aspect of privatization. In reality, private investors will be willing to invest only in public ventures showing a potential for greater profit then those available in private markets (Gomez-Ibañez and Meyer, 1993). The net effect is a more efficient use of capital funds.

2.7.2.2 Savings are Merely Transfers

It is true that in many debates over cost savings and efficiency gains there is a failure to distinguish between true efficiency gains and those that are merely transfers from one segment of society to another. This problem can be solved by a very close analysis of the potential savings in the context of the society as a whole. True savings are achieved only when the resources required to complete the project are reduced. These resources

include not only natural resources (materials and labor) but time as well (Gomez-Ibañez and Meyer, 1993). Finally, transfers are not necessarily bad, if they result in transferring the cost of a good or service to the actual end user.

2.7.2.3 Replacement of Service Motive with Profit Motive

The replacement of the service motive of the public sector with the profit motive of the private sector is a very important concern. The effect of this change is most strongly felt in markets or market segments that prove to be unprofitable. Government seeks an even or fair distribution of services which will not necessarily result from privatization. The government must carefully structure shifts to private firms to avoid this effect. It can be accomplished through the use of either subsidies and grants or vouchers. Additionally, government is placed in the difficult position of having to ensure the quality and quantity of service without necessarily having direct control over the people who perform the service (Brooks, 1984). This difficulty can be assuaged through the proper structuring of privatization legislation.

2.7.2.4 Increased Corruption

The effects of increased corruption and the taking of undue profits would result in higher priced goods and services. The example of the utility companies in Great Britain exposes this as a real problem facing governments as they move towards privatization. In response to this problem, the British Government is examining the regulation and will be restructuring it to prevent this from occurring in the future. There is a precarious balance between freedom of the market and the restrictions provided by the government regulation. In order to limit corruption and excessive profiteering, the government must both closely observe and regulate private firms and ensure adequate competition exists in the market.

2.7.3 Keys to Successful Privatization

There are five factors that are necessary for successful privatization. The first is the presence of an adequate number of competitors. There must be relatively large efficiency gains and a minimization of transfers. There must be few environmental and other administrative problems related to the project. And finally, contractors must be allowed to obtain a reasonable profit.

2.7.3.1 Competition

"A competitive market is cited as important or even essential to successful privatization in almost every serious study of the subject," (Gomez-Ibañez and Meyer, 1993). Privatization provides great opportunities for cost reductions and efficiency gains; but without suitable and stable competition, these cost reductions will either be short lived or will not be passed on to the consumers.

2.7.3.2 Large Efficiency Gains

While privatization is likely to result in efficiency gains in nearly every case, the larger the efficiency gain, the greater the prospect that most parties will gain and few will lose. Most parties or participants base their opinions on how privatization will effect them. Therefore fewer losers mean less political resistance to the change and a higher likelihood that it will be successfully implemented (Gomez-Ibañez and Meyer, 1993).

2.7.3.3 Minimize Transfers

The transfer or redistribution of resources creates winners and losers. The winners will naturally support the new privatization while the losers will not. The greater the transfer or redistribution, the greater the resistance to privatization (Gomez-Ibañez and Meyer, 1993). Additionally, transfers are not true efficiency gains and if they are great, the political capital and the effort to make the change may prove too costly when viewed in terms of making changes where the effect will be more strongly felt and more widely supported.

2.7.3.4 Few Environmental and Administrative Problems

Delays resulting from environmental and other administrative problems have the potential to offset any potential savings created by the privatization efforts. Additionally, the prospect of environmental problems could make securing private financing difficult, if not impossible (Gomez-Ibañez and Meyer, 1993).

2.7.3.5 Reasonable Profit

Private firms are in business to make profit. They will not be interested in any privatization projects that do not provide the opportunity for a reasonable return on their investment. The term reasonable is subject to interpretation and varies from one project to the next depending on the level of risk involved. However, without the perception that

there is profit to be made, private firms will shy away from privatization (Gomez-Ibañez and Meyer, 1993).

2.8 The Government's Role in Privatization

Strong government is needed for successful privatization. The role of government is shifted from supplier to overseer of the supply system. Government personnel are placed in the difficult position of having to exercise authority that is not commensurate with their responsibility. They must ensure the quality of service provided without exercising direct control over the people who actually perform the service (Brooks, 1984). The government's role in privatization can be broken into five major categories: monitoring supply, regulation of the system, providing some guarantees, ensuring the public good and selection of contractors.

2.8.1 Monitoring Supply

It is important for the government to ensure that the goods and services that have been privatized are supplied in acceptable quality and quantity. While the government's responsibility for the actual product may no longer exist under privatization, its responsibility to ensure that the goods and services are supplied in acceptable condition does not disappear.

2.8.2 Regulation of the System

Regulation of the system of goods and service provision is closely related to monitoring the supply of good and services. As is evident from the British example, continuous review and revision of regulation is necessary to ensure acceptable performance of the privatization efforts. This includes ensuring that adequate competition exists in the market.

2.8.3 Providing Some Guarantees

The private sector is reluctant in some cases to invest capital without guarantees from the public sector. This especially true in projects requiring large investments or investments over a long period of time. There is more risk in these situations, and government guarantees in the form of franchises or other guarantees will help entice private sector investment.

2.8.4 Ensuring the Public Good

One of the most important concerns of government is how to ensure the public good when instituting privatization. The private sector is motivated by profit and cost reduction while the aim of the government is ensuring the welfare of the people. These two objectives will not always be in agreement. In cases where they diverge, government intervention is needed to ensure the public good.

2.8.5. Selection of Contractors

The importance of contractor selection can not be understated. In many cases, the contractor selected will gain a long term agreement. Poor selection could result in long periods of poor performance or costly efforts to nullify the deal. In any case, care must be taken in the selection of contractors for privatization efforts. While price is important and should be a factor in the selection process, the criteria for selection should not be based solely on price. Contractor's past performance on similar work and track record in the industry must be considered as well.

2.9 Conclusion

This chapter provided a general introduction into privatization and the classification of goods and service. It laid the foundation for discussion in later chapters relating to the Navy's attempts to privatize family housing. The three most common types of privatization are the sale of state owned enterprises, alternative delivery methods and public/private partnerships.

Family housing is best classified as a private good. The Department of Defense's stated policy of relying on its own housing only when the private sector is unable to provide sufficient housing or when personnel must be housed on-base to ensure military readiness is a sound one based on the above discussion. Additionally, attempts to move an even greater percentage of military families off-base or to use private financing to build, operate and/or renovate on-base housing are justified by both the potential savings to the government and the possibility of a quicker solution to the housing problem. The Navy's past attempts at privatization, which will be discussed in Chapter Three, have centered around alternative delivery methods. Recent legislation has created an opportunity for the

Navy to pursue public/private partnerships. Additionally, there is proposed legislation which would grant the military even more options and flexibility to take advantage of the private sector in solving the family housing shortage. These will be discussed in Chapter Four.

-3-

THE NAVY'S PREVIOUS PRIVATIZATION ATTEMPTS:

SECTION 801 AND 802 HOUSING

3.1 General-Introduction

This Chapter is a discussion of previous uses of privatization by the Naval Facilities Engineering Command for Navy Family Housing. It focuses on the two most commonly used methods, the Section 801 and Section 802 Housing Programs. The Section 801 Housing Program allows the government to enter into long term leasing agreements for newly constructed or recently rehabilitated housing units or construction and subsequent leasing of housing units on private or public land, for up to twenty years. Units are then assigned to service members in the same manner as units owned by the military. The Section 802 Housing Program permits the government to enter into agreements (for up to twenty five years) to assure occupancy of up to 97% of rental housing units constructed by a private developer or local housing authority on or near military bases. The service member receives VHA/BAQ and rents directly from the developer in the Section 802 Program. The successes and failures of these two programs will be discussed as well as the impact of Congressional "scoring" (how funds are accounted for from year to year) on the final demise of these two programs. One case of note is a Section 801 project entered into with the Aspin Knolls Corporation for construction of housing on Staten Island for Naval Station New York, New York which will be discussed in detail.

3.2 Section 801 Housing: Long Term Leasing

3.2.1 General

The Section 801 Housing Program was first authorized by Congress in 1984 and was permanently authorized in 1992 (10 USC 2835). Its objective is to lessen the housing shortages at or near military installations within the United States. It permits the government to lease recently rehabilitated or newly constructed housing units on private

or public land for up to twenty years. not including the period of construction. Units, which must be built to government standards for number and size of rooms, and for the total unit area, are assigned to the service members in the same manner as units constructed with Military Construction funds and owned and operated by the Navy. Other supporting facilities, such as child care or community centers may be included in the lease. Projects must be specifically authorized by law, must be competitively awarded, and can include operations and maintenance. Authorized projects require Office of the Secretary of Defense approval and Congressional notification prior to contract solicitation. An economic analysis must be used to demonstrate that it is more cost effective to use the Section 801 Housing Program than to use other means. Additionally, the project must prove to be at least five percent cheaper than military construction (Fuligni, 10 March 1994). The Section 801 Housing Program is essentially contracting out (through the format of a lease) for family housing.

One of the most notable advantages of using the Section 801 Housing Program is that the units are provided more quickly to the Navy for use than by using the more traditional Military Construction Method. Section 801 has been able to deliver units ready to be occupied up to two years faster than the traditional method. It can take over seven years between the time a housing shortage is documented to the day when Military Construction units are ready for occupancy (Cosgrove, 1987). Other advantages of the Section 801 program is the absence of upfront construction costs and, by the required guidelines set in the legislation, lower lifecycle costs to the Navy (Fuligni, 10 March 1994). The Navy avoids all construction risk and does not begin paying any lease costs until after the first units are occupied. While the Navy does incur a long term commitment, the lease payment-the majority of the risk, is carried by the developer during the construction period.

3.2.2 Navy's Use of The Section 801 Program

The Navy has had success in using the Section 801 program to help reduce housing shortages. The first Section 801 housing project was awarded in Norfolk Virginia and resulted in the completion of 300 units of family housing. The Navy has subsequently used the Section 801 program for 8 other contracts with mixed results. One point of note

is that in order to gain the confidence of lenders and ensure an adequate number of participants, the Navy did not include the standard "Termination for Convenience" clause in all Section 801 contracts. Among other things, this clause allows the government to terminate a contract for any reason they perceive to be in the best interest of the United States without causing a breach of contract. The significance of this will be discussed in more detail below in Section 3.5. Table 3.1 below is a summary of the Navy's use of Section 801 Housing. The project at Staten Island is called Aspin Knolls and will be discussed in greater detail in Section 3.5.

Table 3.1 Navy's 801 Housing Program (Fuligni, 10 March 1994 and Bergo, 1995).

Location	Number of Units	Date	Status	On/Off Base	Maint. in/out
Norfolk, VA	300	FEB 1986	Complete	Off	In
Mayport, FL	200	AUG 1986	Complete	Off	In
Earle, NJ	300	OCT 1986	Complete	On	In
29 Palms, CA	200	OCT 1986	Complete	Off	In
Woodbridge, VA	600	SEP 1898	Complete	Off	Out
Staten Island, NY	1000	JUN 1989	Terminated	Off	In
Summerfield, MD	414	AUG 1991	Complete	Off	Out
Port Hueneme, CA	300	SEP 1991	Complete	On	Out
Pensacola, FL	300	SEP 1991	Complete	Off	In

This program has been able to provide over 2600 units of family housing to the Navy for use over a twenty year period. No projects have been awarded or pursued since fiscal year 1991. The new "scoring" rules set by the Office of Management and Budget, which will be discussed below, have made the Section 801 Program very unattractive because of the requirement to include budget authority for the entire lease in the first year. Any Section 801 project awarded after 30 September 1991 requires more budget authority than Military Construction. This has essentially killed the Section 801 Program (Fuligni, 10 March 1994). The Navy had originally programmed for an additional 1150 units of

Family Housing using the Section 801 Program for Fiscal Year 1992. These were subsequently canceled due to the issues related to scoring (Fuligni, 10 March 1994).

3.2.3 Lessons From Section 801 Housing

There are three valuable lessons that the Navy has learned from the Section 801 experience. They are the importance of gaining the confidence of private financial institutions, the vital characteristic of minimizing siting risks and the issue of whether or not to include maintenance in the lease.

3.2.3.1 Confidence of Lenders

The Navy has learned the importance of gaining approval and confidence of private lenders in order to ensure successful projects. In an attempt to solve the scoring problem, the Navy changed the lease contract to include a provision that the obligation to make payments is subject to annual appropriation. While the contract did include a commitment to obligate funds each year in the amount of the lease, it also included a statement that this commitment does not constitute an obligation of the United States (Fuligni, 10 March 1994). This put a huge risk on the financial institution making the loan. There was an understanding that the government was not providing a true long term obligation. This approach made it impossible or impractical (high interest rates) for private contractors and developers to gain private financing for the proposed projects.

3.2.3.2 Project Siting

The second valuable lesson learned related to siting of the projects. The number of proposals received for off-base projects where no specific land rights or options had been obtained averaged between 2 and 4. The reason for this is the difficulty and expense involved in procuring suitable land in the areas in question and the difficulty faced by private developers in obtaining zoning rights and clearing environmental hurdles. In the 1986 project in 29 Palms for the Marine Corps, the Navy obtained a land option (zoning and preliminary environmental approval included) and allowed all bidders to make use of this land for the project. It was not required that the bidders use this land for their projects, but there were thirteen prospective bidders on this project. Additionally, a number of projects for which the land was not obtained prior to bidding were delayed due to zoning and environmental proceedings with the local community (Stone, 1987). While

private contractors are more sensitive to such delays due to the profit motive, in many cases the local communities are more trusting of government officials than private developers. This allows the government to more successfully gain approval for the desired project (Gomez-Ibañez and Meyer, 1993).

In 1987, the Deputy Assistant Secretary of Defense for Installations, Mr. Robert A. Stone, recommended that future projects be "be structured with the government obtaining a land option to both increase competition and increase the probability a project will result from a proposal." (Stone, 1987). This is a good example of a case in which the government recognized its superior ability to more efficiently control, minimize and economically absorb a given risk. The decision by Mr. Stone to structure these projects as stated above was a sound one.

3.2.3.3 Maintenance Inclusion

The question of maintenance inclusion is a complex one, and it is difficult to make a general statement to adequately address the issue. However, it is important to be aware of the issue. One can not simply state that maintenance should or should not be included in the contract. At issue is the question of risk as it relates to planning the maintenance cost for a housing project over a twenty year period and the initial quality of the constructed product. When the military requires the developer to be responsible for maintenance, he or she is forced to assume a relatively large risk for future year maintenance costs. This could result in a higher overall cost to the government since the developer must include a premium or contingency to cover the risk. However, if the burden of maintenance is placed on the developer a higher quality project with a lower overall lifecycle cost will be the likely result. In this case, it is in the developer's financial interest to ensure that the maintenance costs over the life of the project are as low as possible which could in fact lower the cost of the project. The release of the developer from maintenance responsibility may lower the initial lease cost, but could also result in a reduction of the overall quality of the project and higher maintenance costs in the out years. The diversity in the Navy's approach to maintenance inclusion reflects differing market conditions and variations in the judgment of the responsible Contracting Officers. The answer to the question of whether or not to include maintenance will become more

clear when these projects move towards the later years of their expected lives and the actual total lifecycle costs can be compared.

3.3 Section 802 Housing: Rental Guarantee Program

3.3.1 General

The Section 802 Military Rental Guarantee Program was first authorized by Congress in 1984 and was permanently authorized in 1992 (10 USC 2821). Its primary purpose is to alleviate the shortage of military housing near bases through private developers by providing minimum occupancy rates for housing units constructed or renovated under the program. The basis concept of the Section 802 Program is an agreement between a military service and a developer whereby the military service guarantees occupancy of rental housing to be constructed or rehabilitated for residential use. The projects must be specifically authorized by Congress, require Office of the Secretary of Defense approval, and Congressional notification prior to contract solicitation. An economic analysis must be used to demonstrate that it is more cost effective to use Section 802 Housing Program than to use other means. The project must be competitively awarded. The site of the project may be on government or private land at or near a military installation. The project must be built to Department of Defense standards for the number and size of rooms, and unit total area in square feet. The term of the agreement can be up to twenty five years not including the construction period. For projects on government property, the military has the option to renew the agreement for as many as twenty five years (10 USC 2821).

The management and maintenance of the project could be performed by either the government or the developer. The government may provide utilities, trash collection and other services at no cost to military occupants. Non-military occupants may be charged for utility service. Service members have priority of occupancy, but the developer may rent to non-military families if there are not enough military members to fill apartments. The rental rate for service members is set at the VHA/BAQ rate for the project location, and the occupants enter into leases directly with the developer and pay rent directly to the developer. The developer is obligated to make reasonable effort to rent excess units to

private sector in order to be entitled to the rental guarantee. The amount of the government guarantee is equal to the shelter rent, the monthly amount required to amortize the construction costs (debt service), for any unoccupied units when the occupancy rate falls below 97 percent (10 USC 2821).

The Section 802 Housing Program offers the potential for essentially the same advantages as the Section 801 Program: units provided more quickly to the Navy for use than by the more traditional Military Construction Method, the absence of upfront construction costs, lower lifecycle costs to the Navy and Naval avoidance of all construction risk. One unique aspect of the Section 802 is that, unless the occupancy rate dips below the minimum level, the Navy receives an increase in the number of adequate family housing units without expending any additional funds (beyond the expense of BAQ/VHA which is already budgeted).

3.3.2 Navy Use of Section 802 Housing Program

The Navy has not pursued nor has it had the same amount of success with Section 802 Housing as it has with Section 801 Housing. To date only one project, for the Marine Corps at Kaneohe Bay Hawaii, has been completed. This project has provided 276 family housing units. Since the original legislation allowed only a fifteen year amortization period, the first projects that attempted to use Section 802 Housing failed because the bidders were not able to obtain permanent private financing (Pylant, 1989). After the legislation was adapted to allow for a longer, twenty five year, amortization period, the Navy intended to use Section 802 for projects in areas with a high land costs. The government would provide the necessary land and the high housing allowances provided military members would provide a high enough rent payment to allow the developer to amortize the development costs. The Navy recognized that this program would not be feasible in low cost areas (Pylant, 1989).

In fiscal year 1992, the Navy received authorization to pursue a Section 802 project for Oahu, Hawaii as a test project to determine the feasibility of the new Section 802 program. This project was intended to provide 368 units of Family Housing which were to be constructed at the West Loch branch of the Naval Magazine. The project would last for twenty five years; maintenance would be performed by the developer; and

the project would take place on government land. The Navy included a "Conditions of Obligations of Funds" clause in this proposal. The clause made the payment of the guarantee amount subject to annual appropriations. The contract would include a commitment to obligate the appropriated funds each year and a statement that this commitment does not constitute an obligation of the United States (Fuligni, 29 March 1994). This statement was inserted as an attempt to circumvent the new scoring rules to be discussed below without which the project would have been canceled outright.

The Navy attempted to work with the private sector to develop a workable program for the successful completion of this project. Two public/private partnership housing forums were conducted which brought together key military housing representatives and private developers, financiers, contractors and other interested parties. The primary objective of these meetings was to allow the Navy to understand how private developers and financial institutions view the program as it is designed and to examine the feasibility of this project being successfully pursued (Rose and Drew, 1992). Response from the private sector was mixed, but it became clear at the conclusion of the forums that the project would not be able to obtain the necessary private financing (Fuligni, 29 March 1994). The project has not proceeded past the planning stage to date (Bergo, 11 June 1995).

3.3.3 Lessons from Section 802 Housing Program

There are only a limited number of dollars available in the private sector for capital investment. Any project that proposes to gain access to those dollars whether public or private must prove both that any risk involved is properly rewarded by suitable opportunity for profit, and that the project is competitive with other projects whether public or private, currently in search for financing. The private sector will only invest in those projects that meet the above criteria.

While it is not obvious what factors lead to the West Loch project's inability to obtain private financing, it appears that there was a perception that there was some risk that the government would fail to appropriate the funds to cover the guarantee. In essence, this perception might lead the lenders to believe the rental guarantee is virtually

non-existent. Developers and their financial backers were being asked to cover a political risk. The chance exists that at some point in the future, the military could be forced to reduce the number of personnel in Hawaii as a result of a funding reduction (politically oriented). This downsizing could result in the failure to meet occupancy rates. Also in a time of funding reduction, Congress may chose not to appropriate the necessary funds to make good on the guarantee. The contractor's only recourse at this point would be costly litigation. In order for the government to obtain long term project commitments with developers, it must reciprocate with suitable long term commitments to any guarantees it provides.

3.4 Effects of Budget Scorekeeping on Section 801 and 802 Programs

3.4.1 Definitions

3.4.1.1 Scorekeeping

Scorekeeping or scoring is the basis for presenting budget authorization, appropriations and outlays for financial obligations entered into by the United States. The scorekeeping guidelines are used by the House and Senate Budget Committees and the Office of Management and Budget for the purpose of measuring compliance with Congressional budget targets (Office of Management and Budget [OMB], 1990).

3.4.1.2 Budget Authority

Budget authority is the authorization from Congress for a federal agency to enter into a contract for goods, services, leasing, etc. It is permission from Congress to obligate the government of the United States to spend funds from the treasury via a contractual arrangement. Budget authority can also be viewed as authority to borrow in the name of the United States. Budget authority is in most cases provided in the form of an appropriation (OMB, 1990).

3.4.1.3 Appropriations

An appropriation is a statute which provides budget authority for federal agencies to incur obligations and make payments (outlays) out of the treasury for *specified purposes*. The use of budget authority to make appropriations for both military construction and Sections 801 and 802 housing are appropriated on a project specific

basis. This means that funds are designated for a specific project and can not be moved to another project without congressional approval. Authority to make appropriations can be annual (military personnel, and operations and maintenance) or multi-year (procurement, research and development, and military construction). Annual appropriations must be obligated prior to the end of the fiscal year while multi-year appropriations may be obligated over a period of a number of years (Department of the Navy Program Information Center, 1993).

3.4.1.4 Outlays

Once funds have been obligated through the various contracting methods, they must be drawn from the treasury through outlays. Outlays are expenditures or checks issued to pay for contractual obligations of the United States. Outlays can take place over a period of years or for the duration of a contract depending on the contract and the rules governing the specific type of money used (Department of the Navy Program Information Center, 1993).

3.4.1.5 Lease-Purchase

A lease-purchase is a type of lease in which ownership of the asset is transferred to the Government at or shortly after the end of the lease period. Such a lease may or may not contain a bargain-price purchase option (OMB, 1990).

3.4.1.6 Capital Lease

A capital lease is any lease other than lease-purchase that does not meet the criteria of an operating lease (OMB, 1990).

3.4.1.7 Operating Lease

An operating lease must meet all of the following criteria.

-Ownership of the asset remains with the lessor during the term of the lease and is not transferred to the Government at or shortly after the end of the lease.
-The lease does not contain a bargain-price purchase.
-All risks of ownership of the asset (for example, financial responsibility for destruction or loss of the asset) remain with the lessor, unless the Government is at fault for such losses.
-The lease term does not exceed 75 percent of the estimated economic life of the asset.

-The present value of the minimum lease payments over the life of the lease does not exceed ninety percent of the fair market value of the asset at the inception of the lease.
-The asset is a general purpose asset rather than one for a special purpose of the Government and is not built to a unique specification of the Government lessee.
-There is a private sector market for the asset.
-The asset (structure) is not constructed on Government land.
-Multi-year service contracts and multi-year purchase contracts for expendable commodities will be considered to be operating leases. (OMB, 1990).

If the above criteria are not met, the lease will be considered to be a capital lease or lease purchase, as appropriate.

3.4.2 OMB Instructions for Purchase, Lease-Purchases and Leases

On October 18, 1990 the Office of Management and Budget issued a new scoring rule that focused on purchase, leases and lease-purchases specifically identified in authorizing legislation or appropriation acts. These scoring rules also apply to capital leases and lease-purchases that agencies may enter into under existing general legal authorities (OMB, 1990). These rules were applied to the fiscal year 1992 budget and all subsequent budgets. This new scoring rule does not apply to operating leases. The new scoring keeping rule reads in part:

> When an agency is authorized to enter into a contract for the purchase, lease-purchase or lease of a capital asset, budget authority will be scored in the year in which the authority is first made available in the amount of the Government's total estimated legal obligations, as described in section five of this part (OMB, 1990).

Section 5 outlined the Government's total estimated legal obligations (costs to be incurred) as follows. There are two components to the cost: asset cost and imputed interest cost. The asset cost is the net present value (NPV) of the agency's lease payments discounted from the date of the first payment using the Treasury interest rate. This is the same as the total construction or acquisition costs plus any interest above the Treasury's cost of financing. Imputed interest costs are the financing costs that the Treasury would have incurred if it had issued debt equal to the total project cost (OMB, 1990). Outlays

for a lease will be spread across the lease period and in all cases, the total amount of outlays will equal the amount of budget authority scored.

3.4.3 Direct Impact on Section 801 and 802 Programs

3.4.3.1 Section 801

The Office of Management and Budget determined that the Section 801 Housing Program constituted a capital lease and as such was subject to the new scorekeeping rule. The Navy contended that Section 801 was an operating lease and not subject to the scorekeeping rule. This attempt at avoiding the new scorekeeping rule was unsuccessful, and the resulting requirement to score the NPV of the lease payments in the first year of the project's life resulted in the demise of the program (Fuligni, 19 March 1994).

In order to understand why this occurred, it is important to note that while each project is approved on an individual basis by Congress, the Navy is given an overall budget amount which must then be divided into the various projects and programs. The choice facing the Navy was between tying up a huge portion of a given year's budget authority (enough to cover the entire cost of a twenty year lease) or using the budget authority for Military Construction. Using the budget authority for Section 801 Housing would necessitate not being able to spend large sums of budgeted money on other projects. The money would need to be "set aside" for future outlays in the form of lease payments. While the use of Military Construction for selected projects had a higher lifecycle NPV, the Navy is not required to score the operations and maintenance costs for these projects in the year the project is approved. These costs are annually renewed. This makes Military Construction more attractive in the sense that for a given year more family housing units can be purchased using Military Construction than through the Section 801 Program.

3.4.3.2 Section 802

While the Navy does not actually have a lease with the developer in Section 802 Housing (the only lease signed is between the developer and the occupant of the family housing unit), the Office of Management and Budget and the Office of the Secretary of Defense determined that Section 802 projects are both a form lease (or lease-purchase) and an acquisition of facilities. This makes Section 802 subject to scorekeeping rules. The

decision arrived at by the Office of Management and Budget was that the Government would have to program or score budget authority equal to the NPV of all consideration guaranteed to the developer in the year of contract award. This amount is equal to 97 percent of the shelter rent for all units for twenty five years (Memorandum FAC 242, 15 January 1991). This created the same dilemma for the Section 802 Program as the scorekeeping rule created for the Section 801 Program.

In an attempt to circumvent this problem, the Navy included a "Conditions of Obligations of Funds" clause in its most recent Section 802 proposal for West Loch in Hawaii. The clause made the payment of the guarantee amount subject to appropriations annually. The contract would include a commitment to obligate the appropriated funds each year and a statement that this commitment does not constitute an obligation of the United States (Fuligni, 29 March 1994). This made the contract a twenty year contract renewed annually with no obligation on the part of the government. As discussed above private investors were reluctant to participate in the West Loch project, and to date the project has not proceeded.

3.5 Discussion of the Aspin Knolls Project

The information in the discussion of the Aspin Knolls project below was obtained from a Naval Facilities Engineering Command memorandum titled "Background Information and Recommendations: Aspin Knolls 801 Housing Project" dated 16 December 1994.

3.5.1 Background

In the 1980's Naval Station New York, Staten Island, New York was established as a part of the Navy's expansion resulting from the strategic homeport initiative. There was a shortage of affordable housing in the area for military families. In order to help alleviate this shortage the Navy awarded a Section 801 contract to MWWW Reality Corporation (which subsequently sold its interest in the contract to the Aspin Knolls Corporation) for 1,000 units of family housing.

There were three solicitations for proposals; the first two did not result in acceptable proposals from the development community. The Navy determined that one

factor causing the lack of acceptable proposals was the inclusion of the "Termination for Convenience" clause. In an effort to reduce the risk to private sector investors, this clause was not included in the third solicitation. The third solicitation resulted in acceptable offers, and the contract, awarded on 9 June 1989, had a twenty year life over which the Navy would pay a total of $348 million to the contractor for rent of the units. The contract included operation and maintenance, and the units were to be constructed on private property. The contract required that the project deliver 1,000 units of family housing to the Navy for occupancy no later than 9 June 1991.

3.5.2 Delays Lead to Contract Extension

There followed a series of delays and requests for extension of the completion date of the project. The first came in February 1990 in which the contractor cited difficulties in obtaining financing and changes in the New York City zoning requirements. The contracting officer found these delays excusable under the circumstances that existed at the time and granted the contractor an extension until 30 April 1992. Again in March, October, and November the contractor requested additional time extensions for delays resulting from changing zoning laws, changes in the New York City Mayor's Office, early base closure discussions, and other causes. The time extensions were found to be beyond the control of the contractor, and the contracting officer granted the contractor an extension in the project until 30 November 1993. The revised schedule included a phased delivery of the units, with the first delivered in February 1992 and the final units delivered in November 1993. The contractor continued to experience delays and requested more time extensions through 1993. The first units were not actually delivered until 22 October 1992 and only 300 units were ultimately occupied by the Navy.

3.5.3 Closure of Naval Station New York

On 1 July 1993, the Base Closure and Realignment Commission (BCRC) forwarded a recommendation to the President that included, among other things, the decision to close Naval Station New York. This recommendation became law on 27 September 1993. With the impending closure of the naval station, the Navy determined that there was no long term need for the housing being constructed under the Aspin Knolls Section 801 contract. The Navy was placed in a very difficult position. It was just

beginning a long term contract with a private developer and had no effective means of escaping the contract.

3.5.4 Navy's Options and Actions Taken

Since the Navy did not have a "Termination for Convenience" clause in the contract, it requested Aspin Knolls to submit a buy-out proposal as a means of terminating the contract. Aspin Knolls submitted a proposal in the amount of $162 million in August 1993. The Navy determined that it needed to end its contractual relationship with the Aspin Knolls Corporation but did not have an acceptable contractual means to do so. On 8 December 1993, the Navy unilaterally terminated the contract with Aspin Knolls. In February 1994 Apsin Knolls submitted a revised settlement proposal in the amount of $222 million. Aspin Knolls took the position that the Navy's unilateral termination of the contract represented a breach of contract. Aspin Knolls' second proposal included anticipatory profits (payable under a breach of contract, but not under a termination for convenience), costs incurred to date and settlement costs.

3.5.5 Negotiated Settlement

The Navy accepted its obligation to make equitable remuneration to the Aspin Knolls Corporation, and in April 1994 the two parties began the negotiation process with the objective of settling their differences. On 30 November 1994 the two parties reached a final agreement which settled all outstanding issues relating to the termination of the contract. The final settlement called for a total payment of $126 million to the contractor. While the exact details of the settlement are not available, the settlement does allow Aspin Knolls to pay all creditors and lenders who contributed to the financing of the project. There is also sufficient funding to allow Aspin Knolls to pay all contractors who contributed goods and services to the project. The settlement includes "settlement costs" and a differential of an unknown amount compensating the contractor for his efforts.

3.5.6 Significance of Aspin Knolls

The most important aspect of the entire Aspin Knolls case is that the lender and creditors were all made whole by the settlement which was arrived at fairly quickly without any need for costly litigation. This proves the Navy's willingness to negotiate honestly and make good on its obligations in dealings with the private sector. Had the

Navy taken a different approach and either forced the negotiations to drag out for a long period or fail completely, making litigation necessary, the private sector would be more reluctant to enter into public/private ventures with the Navy in the future. While this project is not a shining example of the success of public/private ventures, it is one example of the public sector recognizing its obligation to deal honestly with the private sector and taking a strategic approach to settling a dispute. This should aid the Navy in future public/private ventures by being held up as an example of the Navy exercising good judgment and honest negotiation tactics in making the best of a bad situation.

3.6 Conclusion

This chapter provided a review of previous uses of privatization by the Navy in its attempts to reduce the family housing shortage. The Section 801 Program had proved very successful by providing over 2600 units of family housing for use at or near military bases at a lower cost to the Navy than comparable Military Construction. The Section 802 Program did not prove to be as successful but did show promise for use in very high cost areas. Both programs were, for practical purposes, terminated in fiscal year 1992 by new Office of Management and Budget scorekeeping rules which forced the Navy to budget for the entire lifetime cost of the long term (Section 801-twenty years, Section 802-twenty five years) contracts in the year of the contracts' inception.

The Navy has learned some valuable lessons from both the success and failure of these programs. The first and most important lesson the Navy learned is the importance of gaining the confidence and trust of private lenders and developers. The Navy's handling of the Aspin Knolls project reflects a genuine desire to deal honestly and fairly with private firms who enter into projects with the Navy. Also, the Navy's willingness to discuss the Section 802 project in Hawaii with the private sector prior to issuing solicitations for offers reflects a desire to understand and gain the confidence of the private sector.

Another important lesson is the importance of properly distributing the risk to those most capable of handling it. The Navy found that by keeping the risk of siting and gaining environmental approvals, it was able to spur more interest and obtain a larger

number of proposals for Section 801 projects. Also, the Navy learned that the private sector is not willing to bear a long term political risk in the form of a "Conditions of Obligations of Funds" clause included in a contract. While this was a commendable attempt at keeping the program alive in the face of new scorekeeping rules, it proved to be too large a risk for the private sector.

The Section 801 Program was successful because the risk was relatively low due to long term commitment by the Navy. However, the Section 802 Program was not as successful because it placed too great a risk on the private sector. In order for the government to obtain long term project commitments with developers, it must reciprocate with suitable long term commitments to any guarantees it provides.

It is important that the Navy keep these lessons in mind as it moves forward in its efforts to reduce the family housing shortage through privatization. Chapter Four introduces new legislation which will allow the Navy to enter into limited partnerships with private developers in order to spur new housing starts in areas where there is a shortage of adequate military family housing. The Navy, when entering into limited partnerships, will be taking a vested interest in private real estate development, and will be in a position of direct financial risk in these developments. Additionally, Chapter Four introduces legislation pending Congressional approval which grants extensive authority to the Department of Defense in the area of public/private ventures for family housing construction. In order to ensure the success of these new ventures, the Navy must keep an open mind, must be prepared to use creative methods and must be willing to bear the financial risk.

-4-

ENABLING LEGISLATION, LIMITED PARTNERSHIPS AND PROPOSED LEGISLATION

4.1 General-Introduction

The discussion in Chapter Three illustrated the Navy's previous privatization attempts, briefly described the limitations of these attempts, and outlined reasons why the Navy is no longer pursuing them as solutions to the family housing shortage. This chapter introduces recent enabling legislation which was included in the fiscal year 1995 Defense Authorization Act in an effort to provide the Navy another option. The legislation grants the Navy permission to enter into limited partnerships with private developers for the sole purpose of encouraging the construction of housing and accessory structures within commuting distance of Navy bases, this creates adequate and affordable housing for Naval Personnel. While the legislation provides no funds, it does provide a framework for the Navy to assume an at risk position in limited partnerships whose objective is real estate development. The legislation also allows the Navy to enter into "Collateral Incentive Agreements" to further encourage construction and give the Navy an additional tool to help facilitate the formation of the limited partnership. The second part of the chapter discusses in detail the legal framework and requirements of limited partnerships. The final section of this chapter discusses the legislation proposed for fiscal year 1996 by the Secretary of Defense's Task Force on Quality of Life. This legislation, titled "The Military Housing Revitalization Act of 1995" is much broader and provides many more options and flexibility then any previous legislation and permissive authorities. It provides the Secretary of Defense (or other duly appointed officials) the authority to individually structure each project or contract according to the market conditions and/or other factors which impact the structure of the deal. The authority which this legislation would grant is extremely broad.

4.2 Fiscal Year 1995 Defense Authorization Bill Enabling Legislation

The legislation contains eight major provisions. The five most important are the following: it allows the Navy to enter into limited partnerships; it allows the Navy to enter into collateral incentive agreements; it requires the Navy to use competitive contracting procedures for contractor selection; it establishes the Navy Housing Investment Account; and it requires the Navy to establish the Navy Housing Investment Board. These five will be discussed in detail below. Additionally, the legislation requires the Secretary of the Navy to report to Congress the amount and nature of all expenditures made through the account within 60 days after the end of each fiscal year. The legislation prohibits the Navy from transferring the right, title or interest of the United States in any real property. It also specifies the Navy may no longer enter into limited partnerships after the expiration date of September 30, 1999. The complete text of the enabling legislation is included in Appendix A.

4.2.1 Limited Partnerships

The heart of the legislation is the authority granted to the Secretary of Navy to enter into limited partnerships with private developers to spur the construction of housing and accessory structures within commuting distance from any Navy base at which there is a shortage of suitable housing for military members and their families. The Navy is authorized to contribute between five and thirty five percent of the development costs as a limited partner. As this author discusses in section 4.3 below, the Navy will be assuming a limited financial risk without having any direct control over how the investment is managed. The relative amount of risk taken is directly proportional to the amount of equity the Navy invests. Additionally, the structure of the limited partnership agreement is vital as it directly specifies the Navy's rights and privileges under the partnership.

4.2.2 Collateral Incentive Agreements

The other very important provision of the legislation is the authority granted the Navy to enter into collateral incentive agreements with the private developers who enter into the limited partnerships. The authorization allows the Navy to make agreements with the developers to ensure that an appropriate number of units included in the development will be designated such that military members have priority in either leasing or buying the

units. It also allows the Navy to enter into agreements to ensure that the rental rates or sale prices of the designated units discussed above are affordable to military members.

This authority gives the Navy an effective tool for negotiating with prospective developers. One possible way to use this to the Navy's advantage is to structure the limited partnership in such a manner that the Navy would provide capital in the form of the initial investment. In return the developer would provide a certain percentage of the units at an affordable to rate to military families. The Navy would not be entitled to any profits from the limited partnership; instead the Navy's participation would be contingent on the number of units provided and the price of the units. The Navy could also include a provision whereby it could sell its interest in the partnership after a given period of time. Additionally, the Navy could guarantee a minimum occupancy rate for any units designated for military use.

4.2.3 Competitive Contracting Procedures

As this author mentioned in Chapter Two above, competition is one of the most important factors of successful privatization. The legislation requires the Navy to use publicly advertised, competitively bid or competitively negotiated contracting procedures. These procedures are clearly specified under Chapter 137 of Title 10 of the United States Code. They will not be discussed in detail in this work. Due to the nature of the procurement, it is the author's opinion that using a competitively bid procedure would be inappropriate. In this procurement action, the Navy is doing more than buying a commodity that any number of contractors are able to provide. It is buying a service and will be entering into a long term agreement in which it has taken an at risk position with the contract winner. Negotiation is the most appropriate award method when the item being procured a service (Gordon, 1991). Therefore, the choice of partner in a limited partnership would be decided through competitive negotiation.

The Navy is required to report in writing to Congress anytime a decision is made to enter into a limited partnership. The report is required to contain the justification for the limited partnership, the terms and conditions of the deal, a description of the development costs for the projects included in the deal, and a detailed description of the

costs to be incurred by the Navy in the deal. There is a twenty one day waiting period after which the Navy may consummate the limited partnership.

4.2.4 Navy Housing Investment Account

The Navy Housing Investment Account is an account that has been established on the books of the United States Treasury. This account will receive deposits from any funds authorized and appropriated by Congress for the account and any proceeds from investments or profits from the limited partnerships entered into by the Navy. The Navy will, subject to approval of Congress in advance through appropriation acts, withdraw funds from the account in order to enter into limited partnerships. The legislation specifically prohibits the Navy from entering into any agreements or limited partnerships unless the account contains enough capital, as of the date the contract is entered into, to cover the total obligations to be incurred by the United States under the contract. This could create a problem similar to scoring if the Navy finds it necessary to provide any long term guarantees to gain closure of a deal. The Navy would be required, in such a case, to have on hand in the account sufficient funds to cover the total amount guaranteed for the life of the agreement. This could potentially be a large sum of money and makes the use of occupancy rate guarantees unlikely.

4.2.5 Navy Housing Investment Board

Finally, the legislation requires the Secretary of the Navy to establish a Navy Housing Investment Board. The primary purpose of this board is to advise the Secretary on the potential of limited partnership opportunities. The members will examine the limited partnerships to determine their financial soundness and whether they meet the objects set forth by the Secretary. The Investment Board will also be responsible for administering the Investment Account. There are seven board members who are appointed for two year terms. Two of the board members may be private sector businesspersons with experience in housing construction and finance. The importance of having private sector representation on the Board can not be understated since they will be able to provide a "reality check" on prospective limited partnerships based on their prior experience in the industry that the government members of the board will not be able to

provide. They will also prove invaluable in setting the tone for the board by bringing private sector ingenuity and open-mindedness to the government bureaucracy.

4.2.6 Summary

This legislation has provided the Navy with an additional method for easing the housing shortage at or near its bases. When the Navy enacts the limited partnerships as authorized, it will be entering into a new arena in which it has little or no prior experience. While limited partnerships provide the Navy with a tremendous and unique opportunity to take advantage of private markets, the Navy's lack of experience in this area is a major concern, and the provision prohibiting the transfer of real property somewhat limits the Navy's flexibility. The proposed legislation discussed in Section 4.4, in addition to providing many new tools, would lift this limitation if it becomes law. Section 4.3 and Chapter Five will delve into two important areas in which the Navy must gain expertise in order to successfully pursue limited partnerships. Section 4.3 focuses on the legal structure of limited partnerships, and Chapter Five focuses on risk in the project development process.

4.3 Legal Structure of Limited Partnerships

4.3.1 General

The discussion of limited partnerships is based on two works, and unless otherwise noted all information is from West's Business Law, Text and Cases, by Kenneth Clarkson et al., 1980 and West's Business Law, Text, Cases, Legal and Regulatory Environment, by Kenneth Clarkson, et al., 1992. The laws under which business is conducted vary from state to state; however in 1916 the Uniform Limited Partnership Act (ULPA) was promulgated and was adopted by 48 states and the District of Columbia. In 1976 the National Conference of Commissioners approved the Revised Uniform Limited Partnership Act (RULPA), and it has been adopted by most states as a replacement for the ULPA. The discussion below is a general discussion. Prior to the formation of any limited partnership, interested parties should review the statutory requirements of the state in which the limited partnership is formed since there are likely to be some variations from

state to state. A complete general text of the RULPA is included in Appendix B. It includes a complete list of the states in which RULPA has been adopted.

4.3.1.1 Definition: Limited Partnership

A limited partnership is formed by compliance with statutory requirements set out by the state in which it will be doing business. It must consist of at least one general partner and one or more limited partners. (Note: Throughout the remainder of this thesis, the term partner or partners refers to both limited and general partners unless they are specifically referred to as limited or general partners.) The general partner (or partners) assumes responsibility for management of the partnership but the limited partner (or partners) contributes cash or other property and owns an interest in the firm but does not take part in any management responsibilities. The limited partner has no personal liability for debts of the partnership beyond the amount of his or her investment while the general partner has full personal liability for all debts of the partnership. Under the RULPA, a limited partnership can conduct any business that can be conducted by a general partnership unless there is a specific exception in the statutes of the state. The most common exceptions are in banking and insurance.

4.3.1.2 Formation of a Limited Partnership

In compliance with RULPA, the formation of a limited partnership is a public and formal process which is consummated by the filing of a certificate of limited partnership with the appropriate state official, usually the Secretary of State. All partners, both general and limited, must sign the certificate. At a minimum, the certificate must contain the following:

-firm name
-character of the business
-location of the principle place of business
-name and place of residence of each member and whether each is a limited or general partner
-duration of the partnership; or act which signifies completion of business objective of the partnership
-amount of cash and a description and agree-upon valuation of any other property contributed by each limited partner
-additional contributions (if any) to be made by each limited partner and the dates on which they are to be made

-methods for changes of personnel (if any) and subsequent continuance of the business
-the share of profits or other compensation that each limited partner is entitled to receive.

Additional conditions or agreements which partners determine appropriate may be included in the certificate as well.

4.3.2 General Partners

General partners are responsible for the day to day operations of the business and for running the business as if it were a general partnership. Corporations or individuals may act as general partners. General partners may be equity holders of the limited partnership if they contribute cash or property to the limited partnership; could have an interest based solely on being eligible to receive a certain percentage of any profits obtained; or could be hired and work for a set fee. In any case, as mentioned above, the general partners are held personally liable for any debts accrued by the limited partnership and will expect to be compensated for this liability. General partners may dissolve the partnership either in accordance with the partnership agreement (upon completion of the specified objective or after the expiration of the defined period of time) or merely by expressing his or her will to dissolve the partnership. General partners also have the right to operate the partnership while winding up the firm's business.

4.3.3 Limited Partners

The limited partner contributes cash or other assets to the limited partnership and owns an interest in the firm but is not personally liable for its debts. A limited partner's liability is limited to the amount of cash or property invested or the amount of investments promised to be made at a future date as specified in the partnership agreement. A limited partner may not contribute services to the firm but can be hired to perform services at the market rate for such services. The name of a limited partnership can not contain the name of a limited partner and a limited partner can not participate in the management of the limited partnership. Additionally, a limited partner has no authority to bind the firm contractually.

The exemption from personal liability of the limited partner is contingent upon the compliance with the above provisions. A violation of them removes the limitation and in effect makes the limited partner a general partner as it relates to liability. The limited partner would then have complete personal liability for the firm's debts. The limited partner may not withdraw from the limited partnership unless that right is included in the partnership agreement.

In addition to the above limitations on participation by the limited partners, they have certain rights guaranteed under the law. They have the right to inspect the accounting and other records of the firm at any time. Limited partners have the right to sue, either individually or for the firm, for financial injury to the firm by either general partners or outsiders. They are entitled to receive from the general partners upon request an accounting and summary of the firm's business. They may assign their interests in the firm without terminating the limited partnership. They are allowed to participate in the dissolution, winding up and distribution of partnership assets. They are entitled to a return of their distributions in accordance with the partnership certificate. And finally, they are entitled to other rights or privileges as specified in the partnership agreement.

4.3.4 Dissolution

Dissolution begins the process of termination of the partnership. It can come about through the action of general partners, by operation of law or through judicial decree. In most cases, the firm continues to operate when dissolution occurs until winding up is complete.

4.3.4.1 Actions of Partners

Actions of the partners that result in dissolution include express will of a general partner, withdrawal or addition of a partner, and the transfer of a partner's interest to a third party. Any change in the composition of the partnership results in a dissolution of the partnership unless the consent of all partners is received prior to the change, or unless the change is allowed by the partnership agreement. If a general partner dissolves the partnership through his or her express will without the consent of all partners before the end of the term fixed by the certificate, the dissolution is considered a breach. Also, the retirement of a general partner creates a dissolution of the partnership unless specifically

provided for in the partnership agreement unless the remaining partners agree to continue the partnership. In all cases if the partnership intends continue to conduct business as a limited partnership, it must file a revised certificate of limited partnership.

4.3.4.2 Operation of Law

A partnership is dissolved by operation of law in the case of death, bankruptcy or illegality. In the event of the death of a partner, the partnership is dissolved even if the agreement contains a provision for carrying on the business with the executor of the descendant's estate. A new certificate must be filed. Bankruptcy of a general partner dissolves the partnership. Bankruptcy of a limited partner results in dissolution only if it also results in the bankruptcy of the firm. Any act or event that makes it unlawful for the partnership to conduct business or that makes any partner's participation in the partnership unlawful results in dissolution of the partnership.

4.3.4.3 Judicial Decree

Finally, a partnership may be dissolved as the result of a judicial decree. In order for a dissolution to occur by judicial decree a petition must be filed in the appropriate court. There are four general categories of petition that may be filed: insanity, incapacity, business impracticality, and improper conduct. A partnership is dissolved by judicial decree on the grounds of insanity when a general partner has been adjudicated insane or shown to be of unsound mind by court decree. In the event that a general partner is judged incapable of performing his or her duties as required by the agreement, a judicial decree is necessary to dissolve the partnership. If the firm's business is found to be only capable of operating at a loss, a decree may be issued to dissolve the partnership. Finally, improper conduct by a partner in completing partnership business or conduct reflecting poorly on the firm may result in a judicial decree dissolving the partnership.

4.3.5 Winding up

Winding up of a limited partnership includes closing out the business, paying all debts, collecting and maintaining all assets, and providing each partner with his or her respective portion of the remaining value of the firm. In the event that the dissolution is caused by a partner's act in violation of the partnership agreement, the innocent partners have the right to damages resulting from the dissolution. Additionally, remaining innocent

partners have the right to buy out the guilty partner and continue the partnership rather than wind up the firm. In other cases where there is no guilty party, as mentioned above, the remaining partners may vote to continue the partnership and in such a case must file a revised certificate of partnership. When funds are distributed upon winding up, creditors are paid first, and limited partners are paid before general partners. Distributions (profits) from business conducted prior to dissolution are paid before partners are repaid for their capital contributions. Capital contributions are repaid before profits generated from business conducted after dissolution.

4.3.6 Summary-Importance to the Navy

Table 4.1 below contains a summary of the discussion above in the form of a comparison of limited and general partnerships. There are several important qualities of limited partnerships that should be emphasized. The most important of which is the inability of the limited partner to take part in the management and day to day operation of the firm. This places the Navy in a vulnerable position once the limited partnership is formed. Therefore, the Navy must exercise extreme care in the selection of general partners. Price can not be the sole or even the major criterion for selection. Past experience, success in similar projects or partnerships, and the financial well being of the prospective general partners are more important than price alone. The prospective general partners must be evaluated as service providers, placing a heavy weight on the above two factors.

Other important considerations for the Navy are the financial health of the project and how financial shortfalls or cash flow problems during the life of the project will be solved. This can be partly controlled by selecting a successful developer as the general partner, but this alone is not enough. The Navy should also include a provision in the partnership agreement discussing how this eventuality will be handled. There are a number of ways this can be accomplished. The agreement could call for future assessments from the Navy. It could require the developer to guarantee to cover negative cash flow which would likely result in a higher fee from the general partner. The agreement could specify procedures for future borrowings or allow the general partner to have the right to raise new capital by admitting additional partners (Fisher, 1993). The

Navy's position on this issue will vary from project to project, but it must be carefully considered since it greatly effects how the partnership will conduct business.

Table 4.1 A Basic Comparison of Limited and General Partnerships (Clarkson, 1992).

Characteristic	General Partnership (UPA)	Limited Partnership (RULPA)
Creation	By agreement of two or more persons to carry on a business as co-owners for profit.	By agreement of two or more persons to carry on a busine as co-owners for profit. Must include one or more Gener Partners and one or more Limited Partners. Filing of certificate with secretary of state required.
Sharing of profits and losses	By agreement, or in the absence thereof, profits are shared equally by partners, and losses are shared in the same ratio as profits.	Profits are shared as required in certificate agreement, an losses are shared likewise, up to their capital contribution In the absence of provision in certificate agreement, profi and losses are shared on the basis of percentages of capit contributions.
Liability	Unlimited personal liability of partners.	Unlimited personal liability of all general partners; limite partners only to extent of capital contributions.
Capital Contribution	No minimal or mandatory amount; set by agreement.	Set by agreement; may be cash, property, or any obligatic
Management	By agreement, or in the absence thereof, all partners have equal voice.	General Partners by agreement, or else each has an equa voice. Limited Partners have no voice, or else are subject liability as a general partner, but only if a third party has knowledge of such involvement. Limited partner may ac agent or employee of the partnership, and vote on amendi certificate or sale or dissolution of the partnership.
Duration	By agreement, or can be dissolved by action of partner (withdrawal), operation of law (death or bankruptcy) or court decree.	By agreement in certification, or by withdrawal, death o mental incompetence of general partner in absence of rigi of other general partners to continue the partnership. De of a limited partner, unless he or she is the only remainin limited partner, does not terminate the partnership.
Assignment	Interest can be assigned, although assignee does not have rights of substituted partner without consent of other partners.	Same as general partnership; if partners consent to assignee's becoming a partner, certificate must be amend Upon assignment of all interest, the partner ceases to be a partner.
Priorities (order) upon Liquidation	1. Outside creditors 2. Partner creditors 3. Partners, according to capital contribution 4. Partners, according to profits.	1. Outside creditors and partner creditors. 2. Partners and former partners entitled to distributions before withdrawal under the agreement or RULPA. 3. Partners according to capital contributions. 4. Partners according to profits.

The Navy should also carefully examine the structure of the limited partnership in terms of the equity position of the general partner. It is advantageous to the Navy if the general partner has a significant equity stake in the project. If the general partner has no or a very small equity stake in the project, he or she will be essentially earning all or most of his or her compensation through fees and would have very little stake in the long term performance of the project. Long term commitment and stable partnerships are required to solve the Navy's housing problem; this means forming a partnership with developers with

the same intentions. One way the Navy can ensure this is to require the developer take an equity position in the partnership.

4.4 Proposed Fiscal Year 1996 Legislation: The Military Housing Revitalization Act of 1995

4.4.1 General

Because the Secretary of Defense's Task Force on Quality of Life recognizes the important role adequate housing plays in the quality of life of service members, it has drafted and proposed legislation that would greatly enhance the military's ability to take advantage of private markets to solve the housing problem. The proposed legislation would be included in the Defense Authorization Bill for Fiscal Year 1996 and is titled "The Military Family Housing Revitalization Act of 1995." This would amend Title 10 of The United States Code by adding a new chapter, Chapter 170, "Alternative Provision of Family Housing and Facilities, Sections 2871-2876". The discussion that follows is based on an undated draft version of the Act. While the final version may be different or may not even be passed into law, an analysis of this act brings to light the military's attempt to learn from past failures and incorporate past successes into the new law. The act would combine updated existing authorities (Section 801-Build/Lease, Section 802-Rental Guarantee, And Limited Partnerships) with new authorities like debt instruments and mortgage guarantees. The program could be used to build or renovate housing using the most effective method suitable for each individual location by mixing and matching various authorities under the act. Appendix C is a complete copy of the draft legislation. This proposed legislation provides the military with an infinite number of degrees of freedom relating to the structure of any contracts entered into under this act. The ultimate result of its passage would be to provide the military with the authority to individually structure each contract according to the market conditions. Allocation and management of risk would be subject to the judgment of the Service Secretary or his/her appointed representative.

4.4.2 Review and Analysis of the Act

One of the most important features of this Act is the deliberate attempt to give the military as much flexibility as possible to create innovative contract structures. This Act attempts to give authority to tailor each project to meet not only the distinct characteristics of the market, but to both meet the military's needs and utilize the developer's skills and strengths as well. The act is divided into six different sections: definitions, general limitations and authorities, family housing improvement fund, guarantees and direct loans, commitments, and investments. The following discussion will address key points in these six sections and analyze them as they relate to lessons learned from previous privatization attempts.

4.4.2.1 Section 2871 "Definitions"

The two definitions of note in this section involve the terms "construction" and "supporting facilities". These are defined in the broadest terms. Construction is defined as "the construction of additional family housing units, or the replacement or renovation of existing family housing units, including supporting facilities and infrastructure". And supporting facilities are defined as any "related facilities such as day care centers, community centers, housing offices...primarily used by the occupants of the family housing." Commercial facilities that "could not otherwise be constructed using funds appropriated to the Department" are specifically excluded. The use of broad definitions in this act help create an extensive amount of flexibility for the military in developing solutions to the family housing shortage.

4.4.2.2 Section 2872 "General Limitations and Authorities"

There are four noteworthy provisions in this section which will be discussed in detail below. First, this section provides authorization for the use of any or all of the various authorities and provisions contained in the Act in any combination deemed appropriate. This adds to the flexibility the military would acquire for shaping contracts formed under the authority of the Act. Past authorizations were limited in their success due in part to their inflexibility in meeting the distinct characteristics of the individual deal being made.

Another provision of this section that helps add to the flexibility of the act is the provision that sets the term of any contracts entered into by the military. This act allows the military to set the term of the contract at any length deemed to be appropriate to ensure the success of a given project. Previous legislation on privatization arbitrarily set the term of the contract. Section 801 limited the term to twenty years and Section 802 originally limited the term to fifteen years but was amended to allow twenty five years with an option to renew for another twenty five years (if the project was on military property). In either case, the term frequently was not consistent with commercial real estate and banking practice which made it difficult for many projects to obtain financing or increased the cost of the projects. The new legislation, if passed, would eliminate this problem and allow the military to create deals with terms in conformance with private practice.

The third key provision of this section also increases the military's flexibility. This provision lifts requirements set in previous programs to build projects to government specifications for room size and total floor area. Units built to government size and space specification are often not equivalent to those constructed in the private markets. Because the act eliminates the need to build to government requirements, the units acquired or built under this act are required only to be comparable to private sector housing available in the local economy. This will make it easier for the military to appeal to private developers since the units could then be easily converted to private use in the future should the military no longer need them.

The final, and perhaps most important, key provision of this section grants the military authority to outlease or sell government land or improvements for the sole purpose of acquiring additional family housing or improving existing family housing under this act. The provision allows the military to sell or lease such land at a nominal rate if the sale or lease is consistent with the goals of reducing the family housing shortage and is in the public's interest. The only limitation of this authority is that the military may not sell or lease land on any base approved for closure. The reasons for this limitation are obvious. Beyond this limitation, the military may determine the size of such land parcels and the amount of consideration to be received for the land's use or ownership on a case

by case basis. Since the cost of land in a project is often over twenty five percent of the total project cost, the ability to sell or lease property to developers for virtually nothing will significantly lower the project's overall cost. Lower project costs will lead to the possibility of more projects being completed, which will create more affordable housing for military members.

4.4.2.3 Section 2873 "Family Housing Improvement Fund"

This section creates, on the books of the Treasury, an account called the Family Housing Improvement Fund. This fund functions like the Navy Housing Investment Account. The primary differences are that it is administered by the Secretary of Defense for all services; it is limited in total expenditures to one billion dollars; and the account may receive deposits from proceeds received by the sale and lease of any property under the act. The funds in the account may be used to pursue the authorities of the act in any combination, but like the Navy Account, contracts may only be entered into only if there are sufficient funds in the account to cover their costs. This still presents a problem as it relates to the scoring issue, and costs are total costs over the life of the contract.

4.4.2.4 Section 2874 "Guarantees and Direct Loans"

This section authorizes the military to enter into contracts that include provisions for direct loans, guarantees, insurance or any other contingent payments to developers, mortgagors or assignees of projects under this act. The contracts entered into must be considered "necessary or desirable to induce the provision of family housing...for use by military personnel, and to protect the financial interests of the United States". This is another example of the flexibility of the act that was not present in past authorizations. By creating this flexibility, the act allows the military to provide guarantees against, among other things, the political risks of base closure, large reductions in force, or extended deployments away from the base. These are not typical market risks and would be costly for developers to handle. The military, by providing guarantees, could potentially lower the cost of development and create more options for housing development, but may never expend any funds if the projects are properly planned in the context of future military needs.

4.4.2.5 Section 2875 "Commitments"

This section authorizes the military to enter into leases and/or contracts to provide differential payments to developers in addition to rental payments made by individual service members. The lease authority is not significantly different from the leasing authorized in the Section 801 Program. The differential payment authority allows the military to enter into contracts to pay developers or owners of housing a differential amount in addition to the rent paid by service members. This authority will prove useful in areas where military housing allowances are not sufficient to pay for private housing by providing an incentive to developers to build or renovate housing that might otherwise be left vacant. Additionally, this provision could be used in combination with guarantees authorized in Section 2873 to protect both the developer from market risks and the financial backer from political risks which would facilitate a successful project.

4.4.2.6 Section 2876 "Investments"

This section greatly expands the authorization of the Navy's limited partnership legislation. It allows the military to make investments in private entities involved in the purchase or construction of family housing and supporting facilities on or near military bases. These investments may be in the form of limited partnerships, stock purchases, debt instruments and/or any combination of the three. It does limit the military's contribution in cash to thirty five percent of the capital costs of the project but allows the military to contribute up to forty five percent of the capital costs if the military is contributing land or buildings in addition to cash to the project.

4.4.3 Comments

This legislation, if passed, would provide the military with a number of new tools and an incredible amount of flexibility to solve the military housing problem. The most significant aspects of the act are that it opens many avenues previously closed to the military in pursuing private capital and allows the military to tailor each contract to the specific market conditions and individual contractor's disposition thus greatly enhancing the likelihood of successful projects being completed. Also important is the provision allowing the lease and/or sale of military property in-conjunction with contracts entered

into under the act. In many areas, the cost of acquiring land is prohibitive, and without the contribution of land from the military, projects would not be feasible.

Notably missing from this draft of the act are two requirements present in the Navy's enabling legislation: the formation of an investment review board and the requirement for competitive contracting procedures specified in Chapter 137 of Title 10 of The United States Code. Both requirements are important and should be considered as additions to future drafts of the act or, if not included as mandatory, should be voluntarily executed by the Department of Defense. The importance of competition to the success of privatization, as discussed above, can not be understated. While the competition should not be based only on price, price is certainly a consideration along with qualifications of the team preparing the proposal. The military's lack of experience in the private market makes it prudent to establish a board of review for potential investments. It is wise to include on such a board individuals who have been successful in the private sector.

4.5 Conclusion

This chapter introduced legislation passed in 1994 authorizing the Navy to enter limited partnerships with private developers in order to spur construction of family housing on or near Navy bases. Additionally, it discussed the legal structure of limited partnerships. Finally, it introduced the proposed "Military Housing Revitalization Act of 1995." The military has recognized its inability to solve its housing problem using conventional means, and also recognized the potential for the use of privatization as a supplement to conventional methods. The 1994 legislation is a good start; however, it is limited. "The Military Housing Revitalization Act of 1995" is a comprehensive approach to the problem and provides the most flexibility seen to date. The Act is currently being discussed in Congress and will be considered for passage with the President's Budget in September of this year. Additionally, the Secretary of Defense's Task Force on Quality of Life will be completing its final report for submission to the Secretary on 22 September 1995 (Page, 1995). It appears that "The Military Housing Revitalization Act of 1995" has bipartisan support in both houses of Congress and is likely to gain passage (Page, 1995). If passed, it will provide a tremendous opportunity to pursue

public-private ventures. In order to successfully apply either of the programs discussed above, the Navy must have a thorough understanding of the risks involved in project development, construction and operation. These will be discussed in Chapter Five.

-5-

ANALYSIS OF RISKS IN REAL-ESTATE DEVELOPMENT

5.1 General-Introduction

This chapter discusses the risks involved in real estate development. This author, while researching risk in the development process, found a general lack of understanding of the risks in developing rental housing, and most investors view such development as risky without a true understanding of the risks involved (DiPasquale and Cummings, 1992). The literature surveyed approached the question of risk primarily from two perspectives. A large portion of the literature viewed risk from the perspective of a financial institution interested in participation in the investment through project finance or non-recourse lending. The other principal viewpoint was that of a financial institution considering whether or not to underwrite a loan for a given development. While these approaches vary slightly from the perspective of one interested in becoming a limited partner or investing in a rental housing real-estate development, the discussions of the risks and the general conclusions in these works are very thorough and can be applied to the rental housing development market.

For the purposes of this discussion, real estate development is divided into three primary phases: the development phase; the construction phase; and the operation phase. These phases are not always differentiated from each other by distinct breaking points; however, the risks associated with each phase are those which may directly impact the project during that phase. The primary risk in the development phase is the risk of non-realization. The two most important risks in the construction phase are completion risk and cost over-run risk. The key risks in the operation phase are cost over-run risk, equity resale risk and market risks. Additionally, there are certain risks which occur throughout the total life of the project. Among those are interest rate risk and promoter risk. These and other risks involved in each phase are discussed in the following sections with more details devoted to those risks associated with the development of rental housing where applicable.

The discussion not only stresses an understanding of all risks involved but also suggests the most appropriate party and possible methods to manage them. Throughout this chapter, the issue of risk is addressed from the perspective of a potential investor or limited partner who during any given phase is interested in the anticipated risk and how to best manage it. Additionally, at the conclusion of the discussion of each risk, is an analysis of how that risk specifically relates to the Navy Family Housing Program and the lessons learned through previous privatization attempts. The Navy is in a unique position since it is not simply a potential investor, but a part of government with huge financial reserves, many assets, extensive experience in construction and engineering, and a certain degree of stability not found in the average investor. As such, the Navy often is better suited to manage certain risks than a less substantial investor, which is likely to be incapable of handling them. The discussion is based on the assumption that "The Military Housing Revitalization Act of 1995" is passed, which will allow the Navy to do more than merely become limited partners in real-estate developments. As discussed in Chapter Four, limited partners may not take part in the management of a project, and therefore are constrained to assuming financial risk in the form of the capital invested.

The term investor is used to refer to either an investor in the traditional sense or a limited partner throughout this chapter. The term promoter is used in its traditional sense and interchangeably with the term general partner or sponsor to refer to the party who initiates the project and takes the active role in managing it throughout its life.

5.2 Development Phase Risks

5.2.1 General

The development phase is the initial phase of the project. In this phase, the project evolves from an idea to a completely designed, approved and financed project ready for the commencement of construction. Activities occurring during this phase include feasibility studies (environmental, technical, and market); creation of the consortium or partnership which will build and operate the project (including financing); engineering and design of the project; development of cost and cash flow estimates; and submission and receipt of necessary approvals (zoning, environmental, construction permits, etc.). During

this early stage of the project, funding is venture capital, and many investors are reluctant to provide seed money due to the risks involved (Beidleman, 1990). In many cases, the promoter or originator shoulders most of the financial risks of startup, but as the project moves closer to the construction phase, those risks are shifted to investors, creditors and partners (Selwan, 1990).

There are fewer risks involved in this stage, but the effect of those risks can potentially be greater than those occurring later. The largest risk involves non-realization of the project, often referred to as bid risk, and could result in total loss of all funds invested up to that point. Other risks include, credit risk, in which the promoter or other sponsors of the project are sound financially, and technology risk, the risk that a new technology may not prove functional or practical (Beidleman, 1990). Each of these risks will be discussed in detail below.

5.2.2 Non-realization Risk

All projects have a certain degree of risk of not being successfully realized. There are many reasons for unsuccessful project initiation. Many of them are related to the other predominant risks in the development phase. For example, failure of a major creditor or financial partner could result in failure of the project. While such risks do indeed have an impact on non-realization, they will not be addressed here but will be discussed individually below. Among the other reasons for unsuccessful initiations of the project are the failure to obtain zoning, subdivision or building permits (Pisani, 1989). Additionally, there may be legal issues which tie up the project including difficulty in obtaining clear or lien free title to the property and failure to obtain the requisite environmental approvals.

In the development phase, non-realization risks are most efficiently and in practice most often managed by and allocated to the project promoter or sponsor. This party is involved in the project from the outset and not only has the most to gain, but also the most effective means of controlling these risks. Rental housing development is a local business, and knowledge of local practices and the local political climate can greatly increase a project's likelihood of success (Knapp, 1989). This knowledge is one key criterion in evaluating a project's promoter. While an absence of a local partner does not in and of itself increase the chances of failure, the presence of such greatly reduces the risk of non-

realization due to the local nature of the requirement to submit permits and other regulatory submissions. The investor should look for a promoter for a project whose local knowledge includes an understanding of the local political climate, knowledge of zoning and subdivision regulations, knowledge of key players in the community and the presence of a local lawyer (Pisani, 1989).

Title problems are best borne by the promoter as well. Before he invests in a real-estate development, it is prudent for the investor to ensure that there are no problems in the form of liens, outstanding taxes, or easements. These may complicate the acquisition of clear title to the property upon which the project will be built (Pisani, 1989). However, once the investor buys into the project, unless specifically stated otherwise in the contract, this risk will be shared with the promoter. With the ever increasing number of environmental regulations, the threat that an environmental snag could potentially derail an otherwise perfectly planned project is very real. Again this risk is best managed and borne by the promoter, who is involved in the project from its earliest stages, and is in the best position to both understand and manage the risk. It is essential that the promoter bring professional environmental advice to the project as early as possible. The investor, when evaluating a potential investment, should take great care in reviewing both the credentials of the environmental advisor and any reports or studies prepared for the project. As in the case of title problems, when the investor enters into the project he or she assumes a proportional share of the non-realization risks emanating from environmental problems.

There are a number of methods in which the Navy is in a better position than a typical investor to reduce the risk of non-realization. One key lesson learned from the Section 801 Program is that in many cases developers are reluctant to or have difficulty in obtaining the necessary land and zoning approvals for a development. The Navy, as a member of the team, can not only provide the needed land, but can also assist with its permitting. Projects sited on government land appear to be less subject to the pressure of local government and are surely not subject to title disputes. Additionally since the Navy has a professional environmental staff, the Navy could provide assistance in preparing and gaining approval for any required environmental permits. In order to ensure adequate competition, one approach may be for the Navy to select the site, gain approval for the

development in the broadest terms possible, and then issue a solicitation for proposals for the development. The Navy could then evaluate the proposals received based on a predetermined set of criteria.

5.2.3 Credit Risk

The second most important risk during the development phase involves credit. This is related to the creditworthiness of a major individual sponsor or the project as a whole (Beidleman, 1991). Even though the typical construction project obtains financing in two forms, construction financing and permanent financing, this thesis will not differentiate between the two. Financial failure of the primary promoter of the project puts the entire project in jeopardy. Additionally, if the project is unattractive and unable to obtain the required financing, it will most likely never proceed. Balloon financing, especially in rental housing development, brings additional risk to the project, since the balloon must be paid off or refinanced at the end of the term. Usually, this coincides with the time at which the project requires an infusion of cash for capital improvements. These simultaneous requirements for financial resources could put a large strain on the cash flow of the project (DiPasquale and Cummings, 1992).

There are a number of ways to manage credit risk. The issuance of letters of credit on behalf of the promoter by small or medium sized banks enhances the credit position of both the project's promoter and the project itself. This takes some of the credit risk away from the promoter and ensures that any other lenders or investors are not relying solely on the creditworthiness of a single sponsor (Beidleman, 1990). Another way to ensure creditworthiness for larger projects is to have rating agencies (Standard and Poors, Moody's, etc.) rate the project. This method is not commonly used for rental real estate projects due to the high relative cost of obtaining the rating and the difficulty in meeting underwriting requirements (DiPasquale and Cummings, 1992). Finally, a requirement for a large equity participation by the project's promoter can lower the credit risk of the project. In fact, many lenders desire or require the project's promoter to have between ten and twenty percent equity in the project (Krizan, 1992).

An investor, looking to determine the extent of credit risk in a given project, should determine if any of the above steps have been taken to minimize the exposure of

the project. The investor can look beyond those measures as well. Given the local nature of rental real estate development, knowledge of the business practice of the local lenders who are originating the loans or letters of credit can provide clues to the level of risk on the project (DiPasquale and Cummings, 1992). The local lender is in the best position to make accurate evaluations of the promoter's qualifications and the overall adequacy of the properties. Familiarity with the local lender can prove to be one of the most vital ingredients in the credit risk evaluation process. The knowledge of a lender's past history in similar projects, its basic business philosophy, the experience of the staff members working the loan, and the degree of active participation in the project by the lender, provides invaluable clues to the credit worthiness of the project (Steinbach, 1992).

The Navy lowers the credit risk of any project simply through its participation in it. The Navy is certainly not going to become bankrupt and unable to fulfill its financial obligations to the project. The Navy learned, through both the Section 801 and Section 802 projects, the importance of gaining the confidence of lenders. One way to do this would be if the Navy provided a guarantee or an option to provide assistance in funding future capital needs of the project. The Navy can help to bolster the financial position of the project by ensuring that the its investment obligations are not subject to annual appropriation (and by extension, effects of the political tides). Should the Navy choose to provide land to the project, the effect would be to further increase the financial strength of the project. In such a situation, the promoter would not have to borrow funds to purchase the land which typically represents twenty five percent of the cost of development.

5.2.4 Technology Risk

Technology risk involves the concern that a new technology will not function as designed or that it will prove uneconomical in the existing marketplace. Additionally, there is a risk that a given technology will be subject to changes in government regulation which affect its use on the project (Beidleman, 1991). This risk is most commonly borne by the project promoter. It is not uncommon for the sponsoring parties to require the technology provider to take an equity position in the project to help mitigate the risk of failure.

The use of new technology in rental real estate development is uncommon. However, it is important for the investor to be aware of any potential technology risk that may exist. Once again, as soon as the investor enters the project, he or she joins the team and begins to bear the technology risk as well. Prior to joining the partnership, the potential investor must thoroughly investigate the project with the specific intention of uncovering any new technology upon which the success or failure of the project relies. The Navy is not in a unique position to manage technology risk. It does, however, bring with its membership to a project team a great deal of experience and knowledge in both the field of construction and maintenance of housing, and in the general field of engineering. This experience, if properly utilized to evaluate any proposed innovations, could reduce any technology risks in the project. Finally, the Navy has an official means of communicating with Congress. It could use this conduit to inform Congress of the harmful effects of any upcoming legislation on new technology, thus reducing the likelihood of passage.

5.2.5 Development Phase-Conclusions

This section focused on the risks occurring in the project development phase. It is during this phase that most investors will join the development team. An investor who considers joining a project during this phase should be concerned with the likelihood of non-realization and the financial health of both the project sponsors and the project in general. There are a number of ways these risks can be managed and allocated, but the promoter is one of the most important aspects at this point in the project. What is the promoter's track record on similar projects? Is the promoter financially sound? Is the promoter familiar with the community politics and local regulatory requirements?

The Navy's special position as a government entity with both vast financial assets and broad experience in the construction and engineering fields makes it uniquely capable of reducing some of the risks during the development phase. The Navy greatly increases the likelihood that a given project will indeed be successfully completed by providing land and/or obtaining the required permits for a given project and by providing sound financial backing for the project. The Navy's presence as a member of the project team will help considerably in gaining additional financial backing, since the mere presence of the Navy

on the development team adds stability to the project. Additionally, the Navy's experienced environmental and engineering staff will foresee and prevent many potential problems and quickly solve others that arise.

In addition to the concern with the risks incurred during this phase, the potential investor must also be aware of the risks that can be incurred during the subsequent phases. The investor must know how the project development team is planning to allocate and manage these risks. During the development stage, the project begins to be committed to greater and greater sums of future financing, and as time progresses the ease with which changes can be made decreases. The promoter will attempt to gain as large a financial cushion as possible, while the investor's main concern at this point is a clear understanding of his or her maximum financial exposure at any time throughout the life of the project (Grabel, 1985). The sum total of risks and unknowns faced by an investor at this point in the project are greater than at any other, but the potential rewards are higher as well.

5.3 Construction Phase Risks

5.3.1 General

The construction phase is the phase in which the project actually comes to fruition. It is the period between the time the first actual expenditures are made for hard costs of construction and the actual beneficial occupancy of the project when the project begins to generate income. Large sums of money are expended during the construction phase which can not begin to be recovered until the project begins operation. Therefore any interruptions or slowdowns in the construction of project which delay the revenue flow not only jeopardize the completion of the project, but also the timely repayment of its debt (Beidleman, 1990). A number of the risks in this phase are more readily quantified and managed, and investments are viewed less as venture capital and more in the light of rate of return and net present value. Risks occurring during the construction phase of a project are common to all projects. There are no unique aspects of the construction phase of rental housing development, and the general discussion below is applicable to virtually any development project.

The two most important risks in the construction phase are completion risk and cost over-run risk. These two could easily render the entire project a failure and render any money invested as completely lost. Additional risks during this period include political risks arising from changes in legislation or regulations and force majeure risks arising from acts of nature (Beidleman, 1990). In some cases, force majeure risks are included as a sub-category of completion risk, but they will be treated separately in this thesis.

5.3.2 Completion Risk

Completion risk is the risk that the project will not be completed in a timely manner and/or fail to reach the operations phase. Completion includes risk arising from a completed project that does not quite meet the required specifications (Beidleman, 1990). Projects can be delayed due to material shortages, inadequate construction contractor performance (this includes both prime and subcontractors), labor difficulties, and failure of project sponsors to provide financing in a timely manner which could create difficulties for the construction contractor.

In most cases, completion risk is allocated to the construction contractor through the use of standard construction contracts, turnkey contracts, performance incentives and/or the requirement for construction performance bonds (Beidleman, 1990). Contractors are responsible to construct the project in conformance with the plans and specifications. Failure to do so enables the promoter to withhold progress payments until the deficiency is corrected. The construction contractors are able to manage this risk through control of their personnel and the use of the appropriate contractual arrangements with equipment and material suppliers, and subcontractors.

The possibility that the sponsors will delay the project by failure to make timely payments can be handled through the use of an escrow account from which such funds may be drawn (Selwan, 1990). Additionally, completion risks stemming from the construction contractor can be mitigated through the selection of an accomplished contractor and by the requirement that the contractors to take an equity position in the project. This will align their financial interests with those of the project. A contractor who has successfully completed similar work recently in the locality or who has a solid track record for completing projects on time and within budget should be sought for selection

for the work. While price is important, it should not be the overriding consideration when selecting the construction contractor.

The Navy's most important contribution to reducing the completion risk is experience. The Navy has a great deal of experience managing construction contracts and is able to contribute this experience to any privatization project it joins. While the majority of completion risk is allocated to the contractor through the various contracting methods, unless these contracts are appropriately worded and administered, they are ineffective in reducing the risk of untimely completion. The Navy would not assume or manage these risks, merely help ensure they were appropriately allocated to and managed by the construction contractor.

5.3.3 Cost Over-run Risk

Cost over-runs are very common in the construction phase, and there are a number of sources of them. Among the numerous sources of cost overruns are inaccurate estimates of the labor and materials necessary to complete the project; inefficient or ineffective management by the construction contractor; force majeure (which will be discussed below); changes to design during the middle of the project; and high rates of inflation which effect key materials and equipment required for completion of the project. The control of construction costs is vital to the success of any project. Not only do most projects have a limited pool of capital, but they must also obtain financing for the operation phase separately from that required for the construction phase. Project financing is evaluated based on projected operating income. Lenders and investors are reluctant to loan to projects with low projected operating income or those which appear unable to control spiraling construction costs (Jubelt, 1992).

There are a number of ways to control cost over-run risk. In most cases, this risk is allocated to the construction contractor or equipment suppliers through the use of fixed price lump sum contracts (Beidleman, 1990). Fixed price contracts place the burden of controlling prices squarely on the construction contractor, which in the case of a clearly defined, completely designed project is the most effective method of controlling cost over-runs.

There are situations in which fixed priced contracts are inappropriate or not feasible at the beginning of a contract. This occurs in instances of fast track construction when timely completion of the project is essential and the design is not complete at the time construction begins. In these cases, cost over-run risk can be controlled through the use of guaranteed maximum price contracts, or when possible, through the use of unit price contracts. These two methods do not completely control risk, but merely help limit exposure to escalating prices. Cover over-run risk, much like completion risk, can also be minimized through the use of an experienced contractor who has successfully completed similar work in the recent past.

The impact of inflation on pricing can be minimized through the early purchase of any high priced materials or equipment. Finally, the risk of changes to the design during the construction phase must be allocated to either promoter or the designer who are the only parties in a position to control such changes. Changes stemming from design errors or omissions are the responsibility of the design professional while the other changes originating from the promoters must be the responsibility of the promoters. Design changes are very expensive when implemented in the construction phase. The promoters must clearly define their objectives and design criteria prior to the commencement of construction. Failure to do so will increase the final cost of the project which will ultimately be borne by the promoters.

As in the case of completion risk, the Navy's most important contribution to reducing the cost over-run risk is experience. The Navy's extensive experience in managing construction contracts could easily be applied to any privatization project it joins. Like completion risk, the majority of cost over-run risk is allocated to the contractor through the various contracting methods. Unless these contracts are appropriately worded and managed, they are ineffective in reducing the risk of untimely completion. Again, the Navy would not assume or manage these risks, merely help ensure they were appropriately allocated to and managed by the construction contractor.

5.3.4 Political Risk

Political risk is the risk that there will be legislative or regulatory changes during the construction phase and, for international projects, the likelihood that the host

country's government will not allow the repatriation of funds and/or other acts by the host country, including nationalization (Beidleman, 1990). For domestic construction projects, political risks during construction are less significant then other risks. While there is a possibility that zoning requirements or environmental changes will occur, it is unlikely that these changes will occur rapidly or without sufficient public notice. The effects of changes in tax laws will be discussed in Section 5.4.6.

Political risks are best borne by the promoter and best managed through the use of a knowledgeable local agent who is familiar with local politics and aware of any pending legislative changes, through strong public commitment of local government, or through the participation of local government as a member of the sponsoring team (Beidleman, 1991). The Aspin Knolls case, discussed in Chapter Three clearly illustrates the effect of political risks on the contract. It is impossible to determine whether the causes which resulted in the delay in the project were predictable. However, they were ultimately borne by the Navy, who in this case was essentially the promoter. The Navy granted time extensions to the contractor without assessing any penalties.

The mere presence of the Navy as an investor and a member of the team helps to reduce the political risk in the project. The Navy's willingness to contribute financial assets to the project demonstrates its commitment to the development. This reduces the doubts of other potential investors. Additionally, the Navy brings to the team a well developed, experienced staff capable of looking into the future and predicting any upcoming legislative changes. Finally as mentioned above, the Navy has official channels through which it may communicate to Congress the potential harmful effects of pending legislation, which would reduce the likelihood that such changes become law.

5.3.5 Force Majeure Risk

Force majeure represents happenings beyond the control of the promoters or events beyond participating parties' ability to foresee or predict. It is a very real risk facing any construction project. Many times these events will either delay the project or damage a portion of the completed work. In either case, majeure threatens the viability of the project. The causes of delay or damage generally categorized as force majeure include: unseasonably severe weather, earthquakes, floods, labor strikes, war or other

civil unrest, and any other delaying factor which could be described as an act of nature. Force majeure risk is almost always assumed by the project promoters and equity investors but can be effectively managed through the use of standard insurance policies (Beidleman, 1991). Beyond its extensive experience in contracting, the Navy does not bring any unique qualities or skills which could be used to help reduce or manage force majeure risks.

5.3.6 Construction Phase-Conclusions

This section focuses on the risks incurred during the construction phase. During this phase, the development team expends large sums of money to build the project while the project has yet to begin to receive any income with which to begin paying off creditors. The promoters are at a great risk in the sense that any delays to the completion of the project or any unplanned increases in the cost of the project could have potential disastrous effects on the financial well being of the project. Delays in the project construction postpone the receipt of operating income and consequently increase the overall project cost through the increased cost of financing. And, any increases in construction costs directly weaken the project's financial strength. These risks are more volatile and potentially hazardous at the inception of construction and decrease gradually as more of the project is completed.

The Navy brings a vast amount of experience and skill to the project which can be used to ensure that risks during the construction phase are appropriately allocated and managed. While the Navy will not assume any of these risks directly, its comprehensive knowledge of both construction and contracting will serve to provide sound guidance to the project team. Additionally the Navy can make sure that these risks are suitably managed. The presence of the Navy as an investor in the project and a member of the development team will help reduce the perception of political risk by other investors and provide assurance that the government is indeed behind the project.

An investor who contemplate joining the project team during this phase should be very concerned with the methods with which the promoters have allocated and managed the above risks and with planned methods for handling the risks during the operations phase of project. Many of the risks incurred during the construction phase can be

allocated to other parties through contractual agreements or insurance policies. The investor should examine the methods used with particular attention paid to the methods used to allocate completion and cost over-run risk. Also, special attention should be paid to the credentials of the construction contractor selected for the project, since he or she will be responsible for managing many of the risks incurred during this phase.

5.4 Operations Phase Risks

5.4.1 General

The final phase of the project is the operations phase. This phase commences with the completion of construction. It does not conclude until either the end of the functional or economical life of the asset, or until the investors divest themselves of their interest in the project. At this point, the project has become a capital asset. It has, in and of itself, a financial value, and many of the risks have been resolved. They no longer constitute an issue since the project is operational and earning income (Beidleman, 1990). Usually the promoter will prepare a separate, more favorable financing arrangement to reflect the reduction in the risks in the project (Boustany, 1992).

While the risks involved with the project are indeed reduced, they are by no means eliminated. In the case of the rental real estate development, the risks and management issues involved in this phase are actually more complex and less understood than those in the earlier two phases (DiPasquale and Cummings, 1992). The most important risks in the operations phase are market, cost over-run, and equity resale. Additional risks include liability risk, political risk and operations contractor performance risk (This is closely related to cost over-run risk but will be discussed separately). Market risk is certainly the most complicated and the most difficult to manage, and together with equity resale risk and political risk are the risks that deserve the most attention from real estate investors. The profound negative effect of changes in tax laws on the rental real estate market has brought political risk during the operations phase of a project to the front of the minds of potential investors. Each of these risks is discussed in detail below.

5.4.2 Market Risk

Market risk is perhaps the most vital risk to manage during the operations phase, and yet, it is the most difficult to grasp. The risk that a project will not meet expected revenue levels due to changes in the market affects all types of projects, including the rental real estate market. An increase in supply by competitors, a general decline in the area's economy and/or a deteriorating competitive position relative to alternate suppliers could all lead to a situation in which a project is unable to provide the expected revenues. The markets for rental housing are both local and cyclical in nature (Steinbach, 1990). Regional economic differences and the possibility that two areas may be moving in different directions make it necessary to evaluate each project in a close, comprehensive, manner.

According to Gordon Steinbach, Executive Vice President (Risk Management) of the Mortgage Guaranty Insurance Company of Milwaukee, Wisconsin, "The current level of local market risk is unprecedented in its potential to fluctuate over the life of a mortgage," (Steinbach, 1990). In order to effectively evaluate this risk, each individual project must be studied in the context of the local market. It is important to study the relative supply and demand to prevent excessive new construction which would serve to reduce the revenue stream from a project. The market analysis should also examine employment trends, median sale/rental prices and other statistics that can shed light on the balance of supply and demand. Geographic areas that appear to be in the middle of a continuous building boom or those that are supported by a single major industry justify close scrutiny, since market risk in these areas is higher (Steinbach, 1990).

Methods to mitigate market risk include a thorough market analysis and the arrangement of long term contracts for the purchase the good (Krizan, 1992). Guarantees can be provided which ensure certain occupancy levels for rental housing. While these guarantees may be necessary to attract lenders or investors, if a careful market analysis is conducted, the guarantor may never need to expend any funds. There are two reasons for this reduced likelihood of the requirement to exercise guarantees. First, according to Denise DiPasquale, the Associate Director of the Joint Research Center for Housing Studies at Harvard University, "In many markets, there is a strong demand for but an

insufficient supply of good-quality low-cost units for low- and moderate-income households" (DiPasquale and Cummings, 1992). This short supply creates a lower vacancy rate among such units (DiPasquale and Cummings, 1992). And second, since rental units are subject to short term leases, the rent can be adjusted more often. This prevents the deterioration of the value of the rental dollars by inflation.

The Navy's unique position as a major employer in the markets in which it will be entering real estate development projects makes it a prime candidate to assume some of the market risk. This can be accomplished through occupancy guarantees similar to those which were used in the Section 802 Program. One drawback of using these guarantees is that they will tie up a large portion of the capital available for the effective life of the guarantee. Additionally to lower market risk, these developments can be limited to areas in which the Navy intends to have a stable long term presence. This will reduce the risk that a major employer (the Navy) will leave and help prevent the resulting market decline. The Base Closure and Realignment Committee has submitted the list of recommended closures for the final round of cuts. This should allow the Navy to more confidently develop long range plans and family housing requirements. Some geographic areas in which it appears as though there will be a long term naval presence include, but are not limited to: San Diego, California; Honolulu, Hawaii; Norfolk, Virginia; Kings Bay, Georgia; Jacksonville/Mayport, Florida; Bremerton/Everett, Washington; and Washington, DC.

Another method, specifically permitted in "The Military Housing Revitalization Act of 1995," is the payment of differential payments to make up for low rental rates. This would provide an assurance to developers that they will obtain an adequate rental fee for those units rented to military members. Finally, the Navy can use its staff to independently study the market trends. In preparing an independent analysis, the Navy will confirm the promoter's analysis or find errors and omissions in the promoters analysis. This will strengthen the overall analysis.

5.4.3 Cost Over-run Risk

The cost of operation and maintenance of the completed project may end up being more than planned or expected. This risk is more critical to infrastructure projects and

industrial or energy generation plants which may depend on large amounts of labor, raw materials or energy to operate (Beidleman, 1990). Increases in these costs or poor management of resources could adversely affect any project. Rental housing, which has large costs associated with frequent turn over of units, is not completely free of this risk. The tenants of low- to mid-income rental housing, if not carefully controlled, generally put more wear and tear on the units which increase the maintenance cost (DiPasquale and Cummings, 1992).

Long term contracts for the procurement of essential goods or services reduce the risk of price escalation. The utilization of fixed price contracts, incentive clauses, and/or requiring the operations and maintenance contractor to take an equity position in the project shifts either all or part cost over-run risk away from investors toward the operations and maintenance contractor. Additionally, as mentioned above, the short term nature of most rental leases provides some price protection from true cost escalation (Escalation that is the result of inflation, not mismanagement). Finally, adequate security deposits help to mitigate the risk of increased wear and tear on units. However, there is still some likelihood that the units will require major repairs or renovations sooner than expected (DiPasquale and Cummings, 1992).

The Navy can help reduce the risk of cost over-run in a number of ways. The Navy has a depth of knowledge and a great deal of experience in maintaining family housing units on a meager budget. And, as mentioned above, the Navy also has a great deal of experience in contract management. It can bring this experience to the project and help minimize cost over-run risk in two ways. As in construction cost over-run risk, it can use its knowledge to ensure that the contract with the maintenance contractor is properly worded to ensure risk is allocated to the contractor. The Navy could share its practical experience in maintaining family housing with the contractor selected in the hopes of increasing his or her level of competence. This will reduce the risk of cost over-run.

There is one other unique way in which the Navy could help manage and reduce the risk of cost over-run. The Navy is a military organization which allows it to exercise increased control over military members residing in rental units. This increased control can be used to motivate them to take better care of the rental units. The fear of fines or

the military's ability to track parties responsible for excessive damage should serve as a deterrent to reckless abuse of the rental property. This in itself should serve to reduce the risk of cost over-run. But, the Navy could go further in assuming some of the risk involved in capital improvement cost. This could be achieved through guarantees or options for capital infusion in the out years. Once again the negative side of this is the fact that the Navy would then, due to scoring rules, have to set aside a sufficient amount of money to cover the guarantee.

5.4.4 Equity Resale Risk

Investors may not be capable of selling their share of the project because the possibility exists that the secondary market for their equity positions is very limited (Beidleman, 1990). This is a key risk to understand and account for, since it could prevent prospective investors from contributing to the project and ultimately prevent the project from commencing. This issue is especially important to the rental housing market. While the secondary market for rental property mortgages has been growing since the 1980's, it is still very small. In 1990 only 28% of all rental family loan originations were sold on the secondary market (DiPasquale and Cummings, 1992).

The most common method for mitigating this risk is the use of subordinated loans in place of actual project capital. The investor provides the necessary funding in the form of a loan. Since the cash provided is a loan, the amount borrowed will eventually be repaid by the project, after the repayment of the loans to which it is subordinated. In most cases, these loans are only subordinated below a limited number of senior third party loans. Additionally, the investor desiring to preserve the advantage of an equity stock position can do so through the use of stock warrants or the inclusion of the right to convert debt to stock in the subordinated loan agreement (Beidleman, 1990).

The Navy does not possess any unique characteristic or quality that could be used to help mitigate or manage equity resale risk. It could, however, be in the Navy's best interest to provide the capital for the project as subordinated loans. The Navy's "Equity" would be in the form of loans to be repaid after other loans. The interest rate at which the Navy's loans are provided could be used as an inducement for potential developers for projects in areas lacking interest. This would have two important consequences. It would

enhance the profitability of the project by lowering the financing costs, which ultimately makes the project less susceptible to market risk. It would also provide a means by which the Navy could, in good conscience, require the developer to rent a certain percentage of the units to military members at below market rates. One final result of subordinated loans would be the reimbursement of the Housing Fund with the proceeds of the loan. This return of funds would create an opportunity for the pursuit of additional projects.

5.4.5 Liability Risk

Liability risk is the risk of death or injury to personnel performing duties while in the employment of the project. While this risk is a major concern for investors in an industrial or energy production plant, it is of minor importance in rental real estate investment. In either case, liability risk is easily managed through commercial insurance policies. There is no unique quality of the Navy that could assist in more efficiently managing liability risk. It remains most efficient and effective to manage such risk through insurance policies.

5.4.6 Political Risk

As discussed above, political risk is the risk that there will be legislative or regulatory changes during the operations phase which will have an impact on the project's profitability. For international projects, it includes the likelihood that the host country's government will not allow the repatriation of funds and/or other acts by the host country, including nationalization. Legislative changes in the form of tax laws can have a profound impact on the rental real estate market. According to Ms. DiPasquale, "Federal tax policy has so dominated the underlying economics of rental housing deals that many analysts have concluded that rental housing investments have been tax driven." (DiPasquale and Cummings, 1992). For example, the 1986 Tax Reform Act lowered the maximum marginal tax rates on investments from fifty percent to twenty eight percent, prohibited passive investors from offsetting ordinary income with losses from real estate investments, and revised the depreciation regulations, greatly reducing the amount of depreciation available in the early years of a project. These and other changes in the tax laws have greatly decreased the benefits to investors of rental real estate, and have reduced the investment volume (DiPasquale and Cummings, 1992).

Political risks during operation are borne by the investors. As in the case of political risk during construction, they are best managed through the use of a knowledgeable local agent who is familiar with local politics, and is aware of any pending legislative changes. Another method to manage political risk is through local government's strong commitment to the project or participation by local government as a member of the sponsoring team (Beidleman, 1991).

Also as in the construction phase, the mere presence of the Navy as a member of the team helps to reduce the political risk in the project. The doubts of other potential investors can be reduced by the Navy's willingness to contribute financial assets to the project and commitment to the development. Additionally, the Navy's experienced staff is capable of looking into the future and foretelling any upcoming legislative changes. Finally, the Navy has official channels through which it may communicate to Congress the potential harmful effects of pending legislation, and therefore reduce the likelihood that such changes become law. The Navy will not assume or eliminate the risk, but merely reduce it.

5.4.7 Operations Contractor Performance Risk

The operations and maintenance contractor may not perform to required performance standards. In the rental real estate market, this could result in reduced occupancy levels, lower market value of the rental units, and lower market value of the equity in the project. This risk is borne by the contractor through the use of either performance requirements set in the contract and/or the requirement that the contractor maintain an equity position in the project (Beidleman, 1990). Additionally, careful selection of the contractor can reduce this risk. The Navy's contribution toward managing this risk is similar to that of cost over-run risk. It is through advice or the sharing of previous experience that the Navy will make the greatest contribution towards mitigating this risk.

5.4.8 Operations Phase-Conclusions

The operations phase is the phase during which the project begins generating income. The project has essentially incurred all the debt that is required to create it, and the risks associated with this phase are those relating to the generation of income and

profit. To some degree the overall level of risk in the project at this point is reduced by the existence of a capital asset which is generating income. This, however, does not by any means imply that the project is risk free. On the contrary, the discussion above made clear the fact that there are many risks involved in the operation of a project. These risks are complex and very difficult to manage.

As a government entity, the Navy occupies a special position having both broad experience in the contracting, facilities maintenance, and engineering fields and vast financial assets. The Navy is also unique in being both a major employer in the target market, and the employer of many of the future residents of the development. These facts make the Navy uniquely capable of assuming responsibility for and the reduction of some of the risks during the operations phase. The Navy's vast experience and skills can be used to ensure proper allocation to the appropriate party of those risks occurring during the operations phase. The presence of the Navy as a member of the project serves to reduce the political risk because of the confidence provided when the government is a party to the project.

The Navy can effectively assume certain risks. It assumes a portion of the market risk, by providing occupancy guarantees or differential payments to promoters. This has the effect of reducing the market risk for other investors and the promoter. Additionally, market risk is somewhat reduced through selection of markets in which the Navy intends to maintain a long term presence. Assistance in reducing cost over-run risk comes in the form of the Navy's control over naval personnel which results in lower long term maintenance costs. It could be in the Navy's best interest to assume subordinated loans for the project financing. This would effectively lower both the equity resale risk and the financing cost of the project. And, it would have the added effect of providing the Navy with a negotiation tool in the form of the interest rate of the loan.

The risks with which the potential investor should be most concerned are market risk, cost over-run risk, and equity resale risk. Market risks, while possible to study, are impossible to adequately manage or allocate to other parties. There is always some chance that the market will shift or some other change will occur which could ultimately result in the financial failure of the project. There are effective methods for allocating and

managing both cost over-run risk and equity resale risk. Cost over-run risk is usually allocated to the operations and maintenance contractor, and prices can be controlled through the use of long term purchasing agreements. Equity resale risk is more difficult to manage, but can be avoided through the use of subordinated loans.

5.5 Ongoing Risks

5.5.1 General

There are certain risks that are prevalent throughout the life of the project. Two of these risks arise from risk of financial exposure. The first, interest rate risk, is the risk that changes in the interest rates will effect cash flows and market values of borrowers and lenders who depend on fixed-income securities. The second, currency risk, is the risk that changes in the foreign exchange rates will effect international projects in which revenues or expenses are paid out in a foreign currency (Beidleman, 1990). Since this thesis focuses on domestic markets, currency risk will not be addressed in detail. However, there are many hedging techniques available for mitigation of currency risk. The final ongoing risk is promoter risk. This is the risk the investor faces by placing trust in a certain promoter to not only effectively manage the project, but also to have the investor's best interest in mind throughout the life of the project.

5.5.2 Interest Rate Risk

Interest rate risk is the risk that interest rates will increase. This would place a burden of increasing financing costs on the project. Many projects are marginally financially feasible, and any increase in the cost of financing could potentially ruin the project. The most common method for managing this risk is through the use of coupon swaps. The mechanics of coupon swaps revolve around the exchange of one coupon (or interest payment) for another with the same principal amount but a different configuration. For example, borrowers can make use of certain fixed rate and floating rate financing markets to ensure the lowest possible cost of financing (Beidleman, 1990). Another method of mitigating exposure to interest rate risk is through close monitoring of the housing market and limiting construction to amount that can be absorbed in a short period of time. This limits the period of exposure (Pisani, 1989).

The Navy possesses no unique qualities enabling it to mitigate interest rates beyond its ability to participate in coupon swaps for debt it issues. Through the use of the Family Housing Improvement Fund and the authority to issue debt instruments provided for in the Military Housing Revitalization. the Navy can provide debt in the form necessary to give the project the flexibility needed to make coupon swaps possible.

5.5.3 Promoter Risk

Of major concern, perhaps the over-riding concern, to an investor considering entering into a real estate development team is the promoter. Investors, especially those entering limited partnerships, are placing an extensive amount of trust in the promoter and are relying on his or her judgment not only in correctly analyzing market conditions but also in managing the investment. The local nature of housing markets, the importance of understanding community politics, and the varying requirements for zoning/building permits, make selection of a project with a competent promoter who is well versed in these areas essential to the success of the investment. Additionally, the promoter must thoroughly understand the technical nature of the project. He or she must be capable of managing a large complex organization. The promoter must have a certain financial commitment to the success of the project. Many lenders require that the promoter have between ten and twenty percent equity interest in the project. The financial health of the promoter is also a point of concern.

There are a number of ways an investor can minimize his or her exposure to promoter risk. The first and perhaps most effective is to select a project being proposed by a promoter with a sound track record in similar projects (Friedman, 1992). Although successful past performance is never a guarantee of similar success in the future, it is certainly an indication that the promoter has the experience and skills required to manage a project of that scope. The investor can further reduce his or her exposure, by requiring the promoter take an equity position in the project or by searching out projects in which the promoter has an equity position. This risk can be even further reduced by knowing the promoter's financial goals and objects for the project. Investments could be limited to those projects whose promoter has the same financial objectives as investor (Knapp, 1989). The investor must thoroughly investigate and evaluate the prospective

promoters in order to gain in-depth knowledge of his or her past experience, financial health and financial goals for the project.

The prospective investor can also minimize promoter risk by having an internal staff to independently obtain and verify the information used to analyze the feasibility of a given project (Jubelt, 1992). While this does not reduce the risk of poor management by the promoter, it does somewhat reduce the investor's reliance on the promoter's judgment of market conditions. Finally, the investor may consider controlling the flow of investment funds into the project. One method of such control entails tying capital infusion to certain milestones or completed activities throughout the life of the project. This could require the use of an independent third party or trustee whose sole purpose is to manage the disbursement of funds during project (Forsyth, 1994). In this case, financial exposure is limited since failure to meet or reach an objective or milestone would result in termination of the obligation of the investor to further funding of the project.

There is no unique quality possessed by the Navy which makes it a candidate for assuming a portion of the promoter risk. Participation of the Navy in the project would certainly lead to a general perception of reduced promoter risk by other investors. Given the Navy's high level of sophistication and experience in construction and engineering, one would believe that the Navy's review and investigation of prospective promoters would be very extensive and quite accurate.

5.5.4 Ongoing Risks-Conclusions

Ongoing risks are important to understand and mitigate. The most important ongoing risk in rental real estate development is promoter risk. The potential investor will rely on the promoter for the success of the project. He or she must evaluate the promoter as carefully as he or she investigates the project itself. Selection of a project with an inexperienced or previously ineffective promoter greatly increases the risk that the project will not succeed. Additionally, investors should select a promoter with whom they have common financial objectives. Finally, the investor should examine exposure to increasing interest rates and the project's plans for mitigation of such exposure. The Navy's ability to mitigate and manage the ongoing risks is not unique. However, the Navy is capable of

participating in equity swaps and performing thorough background investigations of prospective promoters.

5.6 Conclusion

This chapter explored the risks involved in real estate development, with a special emphasis on those risks associated with rental real estate development. The discussion separated the development process into three phases: the development phase; the construction phase; and the operations phase. Additionally, the chapter included a discussion of the risks normally considered to be ongoing throughout the life of the project. Each phase was discussed in detail. A number of risks were expanded upon for each phase. The discussion included the most appropriate allocation of the risk and the most effective methods for mitigating them as well. The discussion of each risk included a brief synopsis of any unique qualities, which make the Navy more efficient or effective at managing or mitigating the individual risk.

The most critical risk occurring in the development phase is that of non-realization of the project. This risk is most often borne by the promoter, but be will equally shared by early equity investors and lenders. It is most effectively mitigated by the presence of an experienced, politically savvy promoter. The most critical risks faced in the construction phase are cost over-run risk and completion risk. These risks are most effectively mitigated through allocation to the construction contractor. This is accomplished through contracting methods or by the requirement that the construction contractor take an equity position in the project. The key risks in the operations phase are cost over-run risk, equity resale risk, and market risk. Cost over-run risks are, like those in the construction phase, best borne by the operations and maintenance contractor. Equity resale risk is best handled through the use of subordinated loans. Market risk is the most difficult to understand and mitigate, and with promoter risk, is one of the most important risks of the entire project. The most effective method to reduce market risk is a thorough independent market study by potential investors.

Ongoing risks include interest rate risk and promoter risk. If there is a single overarching risk with which a potential investor should be most concerned, it is promoter

risk. The investor is dependent on the promoter to not only correctly analyze the market, but also to manage the day to day workings of the investment. Therefore, careful examination of the project's promoter is the most important pre-investment activity by the investor. The promoter should not only have a successful track record in similar projects, but should also have financial objects in line with the investor and an equity position in the project. Also, the investor could perform an independent market study and control the flow of funds to the promoter by tying funds release to successful attainment of certain project milestones.

In the discussion for each individual risk, unique qualities of the Navy were noted. In some cases, including market risk, non-realization risk, equity resale risk and interest rate risk, the Navy is capable and better suited to assume a portion of the risk. In other cases, including credit risk, technology risk, cost over-run risk, political risk, completion risk and promoter risk, the Navy either contributes expertise which lowers the risk, or the mere presence of the Navy on the project team lowers the risks as they are perceived by the investment community. In each case the risk, benefits and costs of assumption must be evaluated separately. The mere fact that the Navy is capable of managing the risk is by no means sufficient cause for such a decision to be made. For each risk assumed, there must be a suitable reward or potential for reward which will make taking the risk worthwhile. Additionally, any course of action which obligates the Navy to future expenditures of funds must be evaluated keeping in mind opportunities lost, as those funds will most likely need to be set aside at the time the commitment is made to cover possible future obligations. Under current legislation, the Navy is unable to assume or manage any of the project risk. It is merely authorized to become a limited partner in a project. This analysis contained in this chapter is conducted assuming "The Military Housing Revitalization Act of 1995" is passed. Passage of this legislation will authorize the Navy to assume and manage project risks as discussed above.

While this chapter discussed many methods to mitigate and manage the risks associated with real estate development, it is by no means a formula for a risk free development. It merely proposes methods to reduce unnecessary exposure to financial risk. There will continue to be some risk in any project, most notably market risk and

promoter risk. There can be no development without risk and any development worthy of investment will have a certain degree of risk which will correspond to expected return on the investment. The prudent investor will, however, make every effort to minimize exposure to financial risk.

-6-

CONCLUSION

6.1 General

A major issue facing today's Navy is the quality of life of sailors and their families. Quality of life plays an immense role in both the recruitment and retention of members of today's all volunteer military. Since the Navy is competing with the civilian job market for the most highly qualified high school graduates, it is very important that the Navy provide a quality of life commensurate to that being provided in the private sector in order to maintain military readiness. Also, the Navy spends huge sums of money training and educating sailors. This investment is lost if these sailors are unhappy with life in the Navy, and leave the service at the completion of their initial enlistment. Recognizing the importance of quality of life, the Secretary of Defense has established the Department of Defense Quality of Life Task Force. Among the duties of the Task Force, is the study of and preparation of recommendations on the subject of military family housing.

The problem facing military family housing has been developing for years. There is currently a $11 billion backlog of deferred maintenance for military housing. This backlog is growing at a rate of about $350 million per year, despite increases in funding. The majority of the military housing stock was built prior to 1966. It will very soon be reaching the point at which it will require extensive repair. Additionally, there has been a gradual degradation of the purchasing power of housing entitlements provided to service members over the years. This has resulted in a situation in which military members are forced to decide whether to live in inadequate housing, or use a portion of their already meager base pay in order to secure suitable housing. The provision of adequate housing not only affects recruitment and retention, but also affects sailor's ability to perform their duties while deployed. A service member who is worried about his or her spouse back home is not giving his or her undivided attention to performing military duties, and is more likely to make mistakes.

The Department of Defense is faced with a three faceted problem. Entitlements provided to sailors are insufficient for them to procure suitable housing in many high cost areas which indicates a need to either lower the cost of housing in the area or increase the amount of the housing entitlements. The current stock of military housing is in a general state of ill repair and is aging rapidly, which indicates a need for increased funding to ensure adequate maintenance levels. In the face of these growing needs for increased budget authority is the desire for reduction of the size of government, and the reaping of the peace dividend. This has resulted in an overall reduction in the military budget by roughly twenty four percent since 1988. In spite of this, the housing budget has increased over the same period indicating the military's recognition of the importance of quality of life.

This is a definite sign of commitment. However, it is certainly not going to solve the problem, as the backlog continues to grow. At current spending levels, the most recent Department of Defense estimates predict that it would take over thirty years to bring the housing stock up to standards. This is too long. In order to speed up the repairs of on-base units and spur growth in housing markets near military bases, the military must pursue an alternative instrument for financing the work. It must also begin to alleviate the strong need to develop suitable affordable housing for sailors. Privatization is that instrument. This thesis explores privatization; current authorities relating to privatization; and proposed legislation to expand current authorities. It also provides some insight into the issues involved in entering the real estate development arena.

6.2 Summary

Privatization is a method by which market forces are introduced into the supply and production of goods that have previously been provided by the government. It shifts the burden of production and service delivery to the private sector. The private sector has many advantages over the public sector with regards to efficiency, effectiveness and innovation. The three most common methods of privatization are sale of an existing state-owned enterprise; use of private, rather than public, financing and management for new infrastructure developments; and outsourcing public services previously provided by

government employees. In order to be successful in any privatization effort, it is vital to understand what type good or service is being privatized. It is also important to understand the most effective delivery method for each good. Family housing is most appropriately classified as a private good, meaning that it is best provided by the marketplace.

There are many benefits to privatization. Among the most notable are the higher efficiency of the private sector (and the cost savings resulting from this increased efficiency); the resultant reduction of government after privatization; availability of new sources of capital funds; and the decrease in delivery time resulting from privatization. The most important key to successful privatization is competition in the privatized market. Additionally, the larger the efficiency gain or prospective cost savings, the higher the likelihood of success.

Through the Section 801 and 802 Housing Programs, the Navy has attempted to take advantage of privatization. These programs have met with mixed success. Between the two programs, nearly 3000 units of housing were obtained. However, both programs were effectively killed by the issue of Congressional scoring. Congressional scoring is the method by which the House and Senate Budget Committees measure compliance with Congressional budget targets. In the case of Section 801 and 802 Housing, scorekeeping rules require all obligations resulting from a contract action (including out-year obligations) be included in the budget for the year in which the contract was signed. However, there were some valuable lessons learned by the Navy in the process. The Navy has gained some valuable experience in working with private parties. The first, and most important, is gaining the confidence and trust of private developers. Additionally, the Navy has gained some insight into risk allocation and management, which is a key ingredient in any successful development project.

The fiscal year 1995 Defense Authorization Act contained a provision granting the Navy authority to enter into limited partnerships with private developers, for the sole purpose of encouraging the construction of housing within commuting distance of Navy bases. This legislation created a restricted framework through which the Navy could assume an at risk position in limited partnerships. Key aspects of this act include the basic

authority to join limited partnerships; authority to enter collateral incentive agreements; the requirement of competitive contracting procedures; and establishment of the Navy Housing Investment Board. A clear understanding, of the mechanics of limited partnerships, is necessary to both guarantee proper utilization of this authority, and to prevent unnecessary loss of any investments. As a limited partner, the Navy would be unable to take an active roll in the management of the development and as such would be dependent upon the general partner to act in the Navy's best interest and protect the Navy's investment in the project.

The Secretary of Defense's Task Force on Quality of Life has submitted "The Military Housing Revitalization Act of 1995" to Congress for inclusion in the fiscal year 1996 Defense Authorization Bill. One of the most important features of the Act is the deliberate attempt to give the military as much flexibility as possible to create innovative contract structures for solving the housing problem. If passed, this act would provide the military a number of new tools to employ in the struggle to improve military housing. It would grant broad sweeping authorities to the military in the area of risk assumption, allocation, and management. Among the new tools are the debt instruments, stock purchases, differential payment guarantees, variable contract terms, and the ability to mix and match any and all authorities contained in the Act to best take advantage of market conditions. Additionally, the Act applies to all services, expanding the Navy's limited partnership authority to the other services. Finally, the Act contains a provision allowing the lease and/or sale of military property in conjunction with contracts entered into under the Act.

In order to fully take advantage of the authorities discussed above, the military must have a thorough understanding of the risks involved in real estate development. This understanding must include not only understanding the risks involved, but also the most efficient and effective manner to allocate and manage those risks. In many instances, the most appropriate allocation of risk may include the military assuming some risks which have traditionally been allocated to the contractors. Real estate development can be divided into three phases: development, construction, and operation. While each phase

has distinct and separate risks, there are in addition other risks present throughout the life of the project. These are referred to as ongoing risks.

During the development phase, the primary considerations should be the risk of non-realization and the financial health of both the project and the project's promoter. These risks are allocated and managed by the promoter. The investor must thoroughly investigate the promoter's credentials, past experience, and financial objectives. Additionally, the investor must be concerned with plans to allocate and manage the risks of future phases. The sum total of risks and unknowns faced by an investor at this point are greater than at any other time in the project, but the potential rewards are greater as well. During this phase, the Navy could efficiently assume non-realization risk to a certain degree. The Navy could donate a parcel of land or assume some responsibility for permitting. Additionally, the Navy could assume some of the credit risk as this point in the project by providing guarantees or options. Finally, the Navy could lower credit risk by providing future funding which is not subject to annual appropriation.

During the construction phase, the risks are more easily quantified and managed. The two key risks during this phase are completion risk and cost over-run risk. Either of these could potentially cause the project to fail resulting in the loss of any money invested to date. These are usually allocated to the construction contractor and managed through the use of various contracting methods, performance bonds and/or careful selection of the construction contractor. In the construction phase, the Navy would not actually assume responsibility for management of any of the risks. It could, however, provide an extensive amount of advice and experience to the development team. This advice would help protect the development team by making sure the risks are properly allocated to, and managed by the construction contractor.

Key risks occurring in the operations phase are market risk, cost over-run risk and equity resale risk. During this phase the project has finally begun to reap the financial rewards which originally attracted the investors to the investment. Risks involved in this phase are those items likely to decrease the profit of the project, or make it impossible for the investors to convert their equity holdings to more liquid assets. Risks relating to cost over-run can be acceptably managed through the use of various contracting methods

and/or the requirement of contractor's equity. Equity resale risk is most often managed through subordinated loans. Market risk is the most difficult to manage. It is usually mitigated through thorough market studies and long term contracts. As in the construction phase, the Navy could provide a tremendous amount of advice and experience to guarantee that these risks are properly managed. The Navy could assume some of the market risk by providing occupancy guarantees and/or differential payment guarantees. Finally, the Navy could assume a limited amount of cost over-run risk. The Navy would be manage this risk by exercising control over military residents of the development to keep them from causing extensive damage to the units.

The most important ongoing risk is promoter risk. The promoter or general partner of a project is the most important party in the determination of the success or failure of the investment. The promoter is responsible for such a wide array of activities and decisions throughout the life of the project that a poor promoter could ruin an otherwise profitable investment. The investor can mitigate this risk by obtaining extensive knowledge of the promoter's past experience in similar work, the condition of his or her financial position, and his or her financial objectives for the project in question. Additionally, this risk can be mitigated by tying the flow of capital into the project to the successful completion of various project milestones. There is no unique quality of the Navy which would allow it to assume or manage ongoing risks.

6.3 Discussion

The Navy has recognized the important role played by quality of life in the recruitment and retention of qualified personnel. It has also recognized the general shift in government towards expanding the use of public/private ventures and the promise of utilizing them to help solve the family housing problem. The Navy's decision to take advantage of the private housing market is a sound one. Housing is a private good which is best provided by the private market. While privatization provides some answers to the housing problem, an indiscriminate rush to completely privatize all housing may not be the best way to maintain military readiness. In moving in the direction of privatization, the

Navy must keep in mind true military requirements for military residences on base, and the increased quality of life resulting from housing on or very near base.

The Navy has already begun the process of using limited partnerships to alleviate the housing shortage. According to the June 5, 1995 issue of Engineering News Record, the Navy planned to issue two requests for proposals for limited partnerships this summer. The requests were for 200 units each at Corpus Cristi, Texas and Everett, Washington. John Dalton, the Secretary of the Navy, intends to have the first partnership agreement signed by end of the year. If these pilot partnerships prove successful, the Navy has plans to expand the program to include San Diego, California; Mayport, Florida; and Norfolk, Virginia.

According to an undated point paper received from Mr. R. Page, Special Counselor for The Secretary of Defense's Quality of Life Task Force, there is also a movement in the Department of Defense towards the establishment of a "Military Housing Authority" (MHA). The proposed MHA would be a government owned corporation responsible to a board of directors (consisting of the Secretary of Defense, the Service Chiefs, and others as appointed) for the operation and maintenance of all military housing. It would be capitalized by a contribution of all existing military housing facilities now owned by the various services. The MHA would raise capital by issuing mortgage-backed bonds secured by the housing assets owned by the MHA. This capital could then be used to improve existing housing, or to construct new housing where needed. The objective is to achieve the desired improvements and increases in the number of units of military family housing in the most expeditious manner.

Regardless of the method picked, the Navy must be willing to shoulder a certain amount of the risks in these development programs. The current legislation allows the Navy to enter limited partnerships. As a limited partner, the Navy will be vulnerable to financial risk without having any input into the management of the risk. If the legislation discussed in Section 4.4 is passed, the Navy must be prepared to take on even more risk. The analysis in this thesis provides guidelines for the Navy relating to risk assumption and management. It assumes that "The Military Housing Revitalization Act of 1995" will be passed into law allowing the Navy to assume risks and enter business relationships other

than limited partnerships. The private sector will be unwilling to accept responsibility for those risks which are most efficiently managed by the Navy unless it is adequately rewarded for its efforts. This would reduce the effectiveness of any privatization attempt.

It is vitally important that the Navy increase its experience in structuring complex projects involving risk allocation, sharing, and management. It must also increase its appreciation for the time value of money. If this occurs, the Navy's goals and objectives for efficiency will, over time, more closely align themselves with the private sector which makes public/private ventures easier to complete. By using the Navy Housing Investment Board, the Navy will select only the most appealing potential investments. The Board will prove invaluable in evaluating not only the potential of the investment, but potential of the general partner as well. This author recommends that both competitive contracting procedures and the Housing Investment Board (or a similar group performing the same function) be implemented in any privatization attempt.

One of the most important capital contributions the Navy can make to future privatization deals (assuming "The Military Housing Revitalization Act of 1995" is passed into law) is properly zoned, lien free, and environmentally permitted land. Not only will this reduce the likelihood of non-realization, but it will greatly reduce the overall cost of the project. This could help the Navy attract a large number of potential developers resulting in increased competition and a higher quality final product.

No matter what path the Navy finds itself on in the future, it must always bear in mind the ultimate driving force behind its privatization efforts. The words of the Secretary Perry provide a superior summary of that driving force and bear repeating:

> The readiness of our forces depends on retaining the high quality, experienced personnel we now have in the military. One of the most important factors in retention of senior personnel is our ability to provide decent and affordable housing for their families to live in. This inadequate housing affects our ability to retain a professional force and degrades our readiness. But the quality of housing has declined for more than 30 years because of a lack of priority and because earlier attempts at solution have run into regulatory or legislative roadblocks (DOD News Release, 8 May 1995).

The legislation discussed in this thesis will provide the Navy with an excellent opportunity to reverse the degradation of the sailors' quality of life. This will only occur if the personnel who are involved in the programs study the private sector with an open mind. The public sector must make every effort to accept and learn from the private sector, applying those lessons which can only be learned in a capitalistic free market economy.

6.4 Areas For Further Research

This thesis has explored the issue of using privatization to solve the Navy Family Housing problem. The research has taken a snapshot of rapidly evolving programs and legislative agendas. In completing this work a number of interesting questions were raised. Suggested areas for future research in the family housing and privatization arena include:

1. An analysis to determine whether or not to include maintenance in the Section 801 type leasing programs should be performed. As the existing group of properties procured under the old Section 801 Program mature, a lifecycle cost analysis to determine the most economical approach will allow future contracting officers to most efficiently procure leased housing.

2. A deeper analysis of the "Scoring" issue and its potential effects on future privatization attempts should be conducted. This would yield vital information relating to the limits of future privatization efforts.

3. An analysis of the requests for proposals recently released by the Navy for limited partnerships can be performed. A comprehensive study of the solicitation and any proposals received would provide insight into the Navy's approach and potential success of the program. This study should examine the Navy's evaluation process and its method for the selection of the successful developer.

4. An analysis of the proposed Military Housing Authority can be conducted. This analysis should explore the potential benefits, political and economic roadblocks, and the proposed structure of the Authority.

5. An analysis of the most economic method for improving the military family housing stock should be performed. Since so many of these units are old and of antiquated design, the most economic solution may not be to repair and upgrade them. It may prove more economical to simply demolish and replace them with new units.

6. Finally, should "The Military Housing Revitalization Act of 1995" pass into law, a comprehensive review and analysis of the Act should be conducted. This should include choosing a number of potential markets and creating a model of the most efficient contract structure for each market.

Appendix A: Fiscal Year 1995 Defense Authorization Bill
Title XXVIII: Military Construction Program and Military Housing Changes, United States Code Title 10, Chapter 169, Subtitle A Section 2837

Fiscal Year 1995 Defense Appropriations Bill
Title XXVIII-General Provisions
Subtitle A-Military Construction Program and Military Family Housing Changes

Section 2803. Limited Partnerships for Navy Housing.

(a) AUTHORITY FOR HOUSING PARTNERSHIPS.-Subchapter II of chapter 169 of title 10, United States Code, is amended by adding at the end the following new section:

"(a) LIMITED PARTNERSHIPS

(1) In order to meet the housing requirements of members of the naval service, and the dependents of such members, at a military installation described in paragraph (2), the Secretary of the Navy may enter into a limited partnership with one or more private developers to encourage the construction of housing and accessory structures within commuting distance of the installation. The Secretary may contribute not less than five percent, but not more than 35 percent, of the development costs under a limited partnerships.

"(2) Paragraph (1) applies to a military installation under the jurisdiction of the Secretary at which there is a shortage of suitable housing to meet the requirements of members and dependents referred to in said paragraph.

"(b) COLLATERAL INCENTIVE AGREEMENTS

The Secretary may also enter into collateral incentive agreements with private developers who enter into a limited partnership under subsection (a) to ensure that where appropriate-

"(1) a suitable preference will be afforded member of the naval service in the lease or purchase, as the case may be, of a reasonable number of the housing units covered by the limited partnership.

"(2) the rental rates or sale prices, as the case may be, for some or all of such units will be affordable for such members.

"(c) SELECTION OF INVESTMENT OPPORTUNITIES

(1) The Secretary shall use publicly advertised, competitively bid or competitively negotiated, contracting procedures, as provided in chapter 137 of this title, to enter into limited partnerships under subsection (a).

"(2) When a decision is made to enter into a limited partnership under subsection (a), the Secretary shall submit a report in writing to the appropriate committees of Congress on that decision. Each such report shall include the justification for the limited partnership, the terms and conditions of the limited partnership, a description of the development costs for projects under the limited partnership, and a description of the share of such costs to be incurred by the Secretary. The Secretary may then enter into the limited partnership only after the end of the 21 day period beginning on the date the report is received by such committees.

"(d) ACCOUNT

(1) There is hereby established on the books of the Treasury an account to be known as the 'Navy Housing Investment Account'.

"(2) There shall be deposited into the Account--

"(A) such funds as may be authorized for and appropriated to the Account; and

"(B) any proceeds received by the Secretary from the repayment of investments or profits on investments of the Secretary under subsection (a).

"(3) In such amounts as is provided in advance in appropriation Acts, the Account shall be available for contract, investments, and expenses necessary for the implementation of this section.

"(4) The Secretary may not enter into a contract in connections with a limited partnership under subsection (a) or a collateral incentive agreement under subsection (b) unless the Account contains sufficient funds, as of the time the contract is entered into, to satisfy the total obligations to be incurred by the United States under the contract.

"(e) NAVY HOUSING INVESTMENT BOARD

(1) The Secretary of the Navy shall establish a board to be known as the 'Navy Housing Investment Board', which shall have the duties--

"(A) of advising the Secretary regarding those proposed limited partnerships under subsection (a), if any that are financially and otherwise sound investments for meeting the objectives of this section;

"(B) of administering the Account established under subsection (d); and

"(C) of assisting the Secretary in such other ways as the Secretary determines to be necessary and appropriate to carry out this mission.

"(2) The Navy Housing Investment Board shall be composed of seven members appointed for two-year term by the Secretary. Among such members, the Secretary may appoint two persons from the private sector who have knowledge and experience in the financing and the construction of housing. The Secretary shall designate one of the members as chairperson of the Board.

"(3) Members of the Navy Housing Investment Board, other than those members regularly employed by the Federal Government, may be paid while attending meetings of the Board or otherwise serving at the request of the Secretary, compensation at a rate equal to the daily equivalent of the minimum annual rate of basic pay payable for level IV of the Executive Schedule under section 5315 of title 5 for each day (including travel time) during which the member is engaged in the actual performance of duties vested in the board. Members shall receive travel expenses, including per diem in lieu of subsistence, in accordance with section 5702 and 5703 of title 5.

"(4) The Federal Advisory Committee Act (5 U.S.C. App) shall not apply to the Navy Housing Investment Board.

"(f) REPORT

Not later than 60 days after the end of each fiscal year in which the Secretary carries out activities under this section, the Secretary shall transmit to Congress a report specifying the amount and nature of the deposits into, and the expenditures from, the Account during such fiscal year and of the amount and nature of all other expenditures made pursuant to such section during such fiscal year.

"(g) TRANSFER OF NAVY LAND PROHIBITED

Nothing in this section shall be construed to permit the Secretary, as part of a limited partnership entered into under this section, to transfer the right, title, or interest of the United States in any real property under the jurisdiction of the Secretary.

"(h) EXPIRATION AND TERMINATION OF AUTHORITIES

(1) The authority of the Secretary to enter into a limited partnership under this section shall expire on September 30, 1999.

"(2) The Navy Housing Investment Board shall terminate on November 30, 1999.".

Appendix B: Revised Uniform Limited Partnership Act

This act has been adopted in the following 36 States: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Idaho, Illinois, Iowa, Kansas, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, ' 'klahoma, Oregon, Rhode Island, South Carolina, South Dakota, Texas, Virginia, Washington, V :st Virginia, Wisconsin, and Wyoming.

The following states have not adopted the RULPA: Alaska, Georgia, Hawaii, Indiana, Kentucky, Louisiana, Maine, New Hampshire, New Mexico, New York, Pennsylvania, Tennessee, Utah and Vermont.

Article 1: General Provisions

Section 101. **Definitions**

As used in this Act, unless the context otherwise requires:

(1) "Certificate of limited partnership" means the certificate referred to in Section 201, and the certificate as amended or restated

(2) "Contribution" means any cash, property, services rendered, or a promissory note or other binding obligation to contribute cash or property or to perform services, which a partner contributes to a limited partnership in his capacity as a partner.

(3) "Event of withdrawal of a general partner" means an event that causes a person to cease to be a general partner as provided in Section 402.

(4) "Foreign limited partnership" means a partnership formed under the laws of any state other than this State and having as partners one or more general partners and one or more limited partners.

(5) "General partner" means a person who has been admitted to a limited partnership as a general partner in accordance with the partnership agreement and named in the certificate of limited partnership as a general partner.

(6) "Limited partner" means a person who has been admitted to a limited partnership as a limited partner in accordance with the partnership agreement.

(7) "Limited partnership" and "domestic limited partnership" mean a partnership formed by two or more persons under the laws of this State and having one or more general partners and one or more limited partners.

(8) "Partner" means a limited or general partner.

(9) "Partnership agreement" means any valid agreement, written or oral, of the partners as to the affairs of a limited partnership and the conduct of its business.

(10) "Partnership interest" means a partner's share of the profits and losses of a limited partnership and the right to received distributions of partnership assets.

(11) "Person" means a natural person, partnership, limited partnership (domestic or foreign), trust, estate, associate, or corporation.

(12) "State" means a state or territory, or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico.

Section 102. **Name**

The name of each limited partnership as set forth in its certificate of limited partnership:

(1) shall contain without abbreviation the words "limited partnership";

(2) may not contain the name of a limited partner unless (i) it is also the name of a general partner or the corporate name of a corporate general partner, or (ii) the business of the limited partnership had been carried on under that name before the admission of that limited partner;

(3) may not be the same as, or deceptively similar to the name of any corporation or limited partnership organized under the laws of this State or licensed or registered as a foreign corporation or limited partnership in this State; and

(4) may not contain the following words (here insert prohibited words).

Section 103. **Reservation of Name**

(a) The exclusive right to the use of a name may be reserved by:

(1) any person intending to organize a limited partnership under this Act and to adopt that name;

(2) any domestic limited partnership or any foreign limited partnership registered in this State which in either case, intends to adopt that name;

(3) any foreign limited partnership intending to register in this State and adopt that name; and

(4) any person intending to organize a foreign limited partnership and intending to have it register in this State and adopt that name.

(b) The reservation shall be made by filing with the Secretary of State an application, executed by the applicant, to reserve a specified name. If the Secretary of State finds that the name is available for use by a domestic or foreign limited partnership, he [or she] shall reserve the name for the exclusive use of the applicant for a period of 120 days. Once having so reserved a name, the same applicant may again reserve the same name until more than 60 days after the expiration of the last 120 day period for which that applicant reserved that name. The right to the exclusive use of a reserved name may be transferred to any other person by filing in the office of the Secretary of State a notice of the transfer, executed by the applicant for whom the name was reserved and specifying the name and address of the transferee.

Section 104. **Specified Office and Agent**

Each limited partnership shall continuously maintain in this State:

(1) an office, which may but need not be a place of its business in this State, at which shall be kept the records required by section 105 to be maintained; and

(2) an agent for service of process on the limited partnership, which agent must be an individual resident of this State, a domestic corporation, or a foreign corporation authorized to do business in this State.

Section 105. **Records to be Kept**

(a) Each limited partnership shall keep at the office referred to in Section 104(1) the following:

(1) a current list of the full name and last known business address of each partner separately identifying the general partners (in alphabetical order) and the limited partners (in alphabetical order);

(2) a copy of the certificate of limited partnership and all certificates of amendment thereto, together with executed copies of any powers of attorney pursuant to which any certificate has been executed;

(3) copies of the limited partnership's federal, state and local income tax returns and reports, if any, for the three most recent years;

(4) copies of any then effective written partnership agreements and of any financial statements of the limited partnership for the three most recent years; and

(5) unless contained in a written partnership agreement, a writing setting out:

(i) the amount of cash and description and statement of the agreed value of the other property or services contributed by each partner and which each partner has agreed to contribute;

(ii) the times at which or events on the happening of which any additional contributions agreed to be made by each partner are to be made;

(iii) any right of a partner to receive, or of a general partner to make, distributions to a partner which include a return of all or any part of the partner's contribution; and

(iv) any events upon the happening of which the limited partnership is to be dissolved and its affairs wound up.

(b) Records kept under this section are subject to inspection and copying at the reasonable request at the expense of any partner during ordinary business hours.

Section 106. **Nature of Business**

A limited partnership may carry on any business that a partnership without limited partners may carry on except [here designate prohibited activities].

Section 107. **Business Transactions of Partner with Partnership**

Except as provided in the partnership agreement, a partner may lend money to and transact other business with the limited partnership and, subject to other applicable law, has the same rights and obligations with respect thereto as a person who is not a partner.

Article 2: Formation; Certification of Limited Partnership

Section 201. **Certificate of Limited Partnership**

(a) In order to form a limited partnership, a certificate of limited partnership must be executed and filed in the office of the Secretary of State. The certificate shall set forth:

(1) the name of the limited partnership;

(2) the address of the office and the name and address of the agent for service of process required to be maintained by Section 104;

(3) the name and the business address of each general partner;

(4) the latest date upon which the limited partnership is to dissolve; and

(5) any other matters the general partners determine to include therein.

(b) A limited partnership is formed at the time of the filing of the certificate of limited partnership in the office of the Secretary of State or at any later time specified in the certificate of limited partnership if, in either case, there has been substantial compliance with the requirements of this section.

Section 202. **Amendment to Certificate**

(a) A certificate of limited partnership is amended by filing a certificate of amendment thereto in the office of the Secretary of State. The certificate shall set forth:

(1) the name of the limited partnership;

(2) the date of filing the certificate; and

(3) the amendment to the certificate

(b) Within 30 days after the happening of any of the following events, an amendment to a certificate of limited partnership reflecting the occurrence of the event or events shall be filed:

(1) the admission of a new general partner;

(2) the withdrawal of a general partner; or

(3) the continuation of the business under Section 801 after an event of withdrawal of a general partner.

(c) A general partner who becomes aware that any statement in a certificate of limited partnership was false when made or that any arrangements or other facts described have changed, making the certificate inaccurate in any respect, shall promptly amend the certificate.

(d) A certificate of limited partnership may be amended at any time for any other proper purpose the general partners determine.

(e) No person has any liability because an amendment to a certificate of limited partnership has not been filed to reflect the occurrence of any event referred to in subsection (b) of this section if the amendment is filed within the 30 day period specified in subsection (b).

(f) A restated certificate of limited partnership may be executed and filed in the same manner as a certificate of amendment.

Section 203. **Cancellation of Certificate**

A Certificate of limited partnership shall be canceled upon the dissolution and the commencement of winding up of the partnership or at any other time there are no limited partners. A certificate of cancellation shall be filed in the office of the Secretary of State and set forth:

(1) the name of the limited partnership;

(2) the date of filing of its certificate of limited partnership;

(3) the reason for filing the certificate of cancellation;

(4) the effective date (which shall be a date certain) of cancellation if it is not to be effective upon the filing of the certificate; and

(5) any other information the general partners filing the certificate determine.

Section 204. **Execution of Certificates**

(a) Each certificate required by this Article to be filed in the office of the Secretary of State shall be executed in the following manner:

(1) an original certificate of limited partnership must be signed by all general partners.

(2) a certificate of amendment must be signed by at least one general partner and by each other general partner designated in the certificate as a new general partner; and

(3) a certificate of cancellation must be signed by all general partners.

(b) Any person may sign a certificate by an attorney-in-fact, but a power of attorney to sign a certificate relating to the admission of a general partner must specifically describe the admission.

(c) The execution of a certificate by a general partner constitutes an affirmation under the penalties of perjury that the facts stated therein are true.

Section 205. **Execution by Judicial Act**

If a person required by Section 204 to execute any certificate fails or refuses to do so, any other person who is adversely affected by the failure or refusal, may petition the [designate the appropriate court] to direct the execution of the certificate. If the court finds that it is proper for the certificate to be executed and that any person so designated has failed or refused to execute the certificate, it shall order the Secretary of State to record an appropriate certificate.

Section 206. **Filing in Office of Secretary of State**

(a) Two signed copies of the certificate of limited partnership and of any certificates of amendment or cancellation (or of any judicial decree of amendment or cancellation) shall be delivered to the Secretary of State. A person who executed a certificate as an agent or fiduciary need not exhibit evidence of his [or her] authority as a prerequisite to filing. Unless the Secretary of State finds that any certificate does not conform to law, upon receipt of all filing fees required by law he [or she] shall:

(1) endorse on each duplicate original the word "Filed" and the day, month, and year of filing thereof;

(2) file one duplicate original in his [or her] office; and

(3) return the other duplicate original to the person who filed it or his [or her] representative.

(b) Upon the filing of a certificate of amendment (or judicial decree of amendment) in the office of the Secretary of State, the certificate of limited partnership shall be amended as set forth therein, and upon the effective date of a certificate of cancellation (or a judicial decree thereof), the certificate of limited partnership is canceled.

Section 207. **Liability for False Statement in Certificate**

If any certificate of limited partnership or certificate of amendment or cancellation contains a false statement, one who suffers loss by reliance on the statement may recover damages for the loss from:

(1) any person who executes the certificate, or causes another to execute it on his behalf, and know, and any general partner who knew or should have known, the statement to be false at the time the certificate was executed; and

(2) any general partner who thereafter knows or should have known that any arrangement or other fact described in the certificate has changed, making the statement inaccurate in any respect within a sufficient time before the statement was relied upon reasonably to have enabled that general partner to cancel or amend the certificate, or to file a petition for its cancellation or amendment under Section 205.

Section 208. **Scope of Notice**

The fact that a certificate of limited partnership is on file in the office of the Secretary of State is notice that the partnership is a limited partnership and the persons designated therein as general partners are general partners, but it is not notice of any other fact.

Article 3: Limited Partners

Section 301. **Admission of Additional Limited Partners**

(a) A person becomes a limited partner:

(1) at the time the limited partnership is formed; or

(2) at any later time specified in the records of the limited partnership for becoming a limited partner.

(b) After filing of a limited partnership's original certificate of limited partnership, a person may be admitted as an additional limited partner:

(1) in the case of a person acquiring a partnership interest directly from the limited partnership, upon compliance with the partnership agreement or, if the partnership agreement does not so provide, upon the written consent of all partners; and

(2) in the case of an assignee of partnership interest of a partner who has the power, as provided in Section 704, to grant the assignee the right to become a limited partner, upon the exercise of that power and compliance with any conditions limiting the grant or exercise of the power.

Section 302. **Voting**

Subject to Section 303, the partnership agreement may grant to all or to a specified group of the limited partners the right to vote (on a per capita or any other basis) up any matter.

Section 303. **Liability to Third Parties**

(a) Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he [or she] is also a general partner or, in addition to the exercise of his [or her] rights and powers as a limited partner, he [or she] participates in the control of the business. However, if the limited partner participates in the control of the business, he [or she] is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.

(b) A limited partner does not participate in the control of the business within the meaning of subsection (a) solely by doing one or more of the following:

(1) being a contractor for or an agent or employee of the limited partnership or of a general partner or being an officer, director, or shareholder of a general partner that is a corporation;

(2) consulting with and advising a general partner with respect to the business of the limited partnership;

(3) acting as surety for the limited partnership or guaranteeing or assuming one or more specific obligations of the limited partnership;

(4) taking any action required or permitted by law to bring or pursue a derivative action in the right of the limited partnership;

(5) requesting or attending a meeting of partners;

(6) proposing, approving or disapproving, by voting or otherwise, one or more of the following matters:

(i) dissolution and winding up of the limited partnership;

(ii) the sale, exchange, lease mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership

(iii) the incurrence of indebtedness by the limited partnership other than in the ordinary course of its business;

(iv) a change in the nature of the business;

(v) the admission or removal of a general partner;

(vi) the admission or removal of a limited partner;

(vii) a transaction involving an actual or potential conflict of interest between a general partner and the limited partnership or the limited partners;

(viii) an amendment to the partnership agreement or certificate of limited partnership; or

(ix) matters related to the business of the limited partnership not otherwise enumerated in this subsection (b), which the partnership agreement states in writing may be subject to the approval or disapproval of limited partners;

(7) winding up the limited partnership pursuant to Section 803; or

(8) exercising any right or power permitted to limited partners under this Act and not specifically enumerated in this subsection (b).

(c) The enumeration in subsection (b) does not mean that the possession or exercise of any other powers by a limited partner constitutes participation by him [or her] in the business of the limited partnership.

(d) A limited partner who knowingly permits his [or her] name to be used in the name of the limited partnership, except under circumstances permitted by Section 102(2), is liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.

Section 304. **Person Erroneously Believing Himself [or Herself] Limited PARTNER**

(a) Except as provided in subsection (b), a person who makes a contribution to a business enterprise and erroneously but in good faith believes that he [or she] has become a limited partner in the enterprise is not a general partner in the enterprise and is not bound by its obligations by reason of making the contribution, receiving distributions from the enterprise, or exercising any rights of a limited partner, if, on ascertaining the mistake, he [or she]:

(1) causes an appropriate certificate of limited partnership or a certificate of amendment to be executed and filed; or

(2) withdraws from future equity participation in the enterprise by executing and filing in the office of the Secretary of State a certificate declaring withdrawal under this section.

(b) A person who makes a contribution of the kind described in subsection (a) is liable as a general partner to any third party who transacts business with the enterprise (i) before the person withdraws and an appropriate certificate is filed to show withdrawal, or (ii) before an appropriate certificate is filed to show that he [or she] is not a general partner, but in either case only if the third party actually believed in good faith that the person was a general partner at the time of the transaction.

Section 305. **Information**

Each limited partner has the right to:

(1) inspect and copy any of the partnership records required to be maintained by Section 105; and

(2) obtain from the general partners from time to time upon reasonable demand (i) true and full information regarding the state of the business and financial condition of the limited partnership, (ii) promptly after becoming available, a copy of the limited partnership's federal, state, and local income tax returns for each year, and (iii) other information regarding the affairs of the limited partnership as is just and reasonable.

Article 4: General Partners

Section 401. **Admission of Additional General Partners**

After the filing of a limited partnership's original certificate of limited partnership, additional general partners may be admitted as provided in writing in the partnership agreement or, if the partnership agreement does not provide in writing for the admission of additional general partners, with the written consent of all partners.

Section 402. **Events of Withdrawal**

Except as approved by the specific written consent of all partners at the time, a person ceases to be a general partner of a limited partnership upon the happening of any of the following events:

(1) the general partner withdraws from the limited partnership as provided in Section 602;

(2) the general partner ceases to be a member of the limited partnership as provided in Section 702;

(3) the general partner is removed as a general partner in accordance with the partnership agreement;

(4) unless otherwise provided in writing in the partnership agreement, the general partner: (i) makes an assignment for the benefit of creditors; (ii) files a voluntary petition in bankruptcy; (iii) is adjudicated a bankrupt or insolvent; (iv) files a petition or answer seeking for himself [or herself] any reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law, or regulation; (v) files an answer or other pleading admitting or failing to contest the material allegations of a petition filed against him [or her] in any proceeding of this nature; or (vi) seeks, consents to, or acquiesces in the appointment of a trustee, receiver, or liquidator of the general partner or of all or any substantial part of his [or her] properties;

(5) unless otherwise prohibited in writing in the partnership agreement, [120] days after the commencement of any proceeding against the general partner seeking reorganization, arrangement, composition, readjustment, liquidation, dissolution or similar relief under any statute, law or regulation, the proceeding has not been dismissed, or if within [90] days after the appointment without his [or her] consent or acquiescence of a trustee, receiver, or liquidator of the general partner or of all or any substantial part of his [or her] properties, the appointment is not vacated or stayed or within [90] days after the expiration of any such stay, the appointment is not vacated;

(6) in the case of a general partner who is a natural person,

(i) his [or her] death; or

(ii) the entry of an order by a court of competent jurisdiction adjudicating him [or her] incompetent to manage his [or her] person or his [or her] estate;

(7) in the case of a general partner who is acting as a general partner by virtue of being a trustee of a trust, the termination of the trust (but not merely the substitution of a new trustee);

(8) in the case of a general partner that is a separate partnership, the dissolution and commencement of winding up of the separate partnership;

(9) in the case of a general partner that is a corporation, the filing of a certificate of dissolution, or its equivalent, for the corporation or the revocation of its charter; or

(10) in the case of an estate, the dissolution by the fiduciary of the estate's entire interest in the partnership.

Section 403. **General Powers and Liabilities**

(a) Except as provided in this Act or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners.

(b) Except as provided in this Act, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to persons other than the partnership and other partners. Except as provided in this Act or in the partnership agreement, a general partner in a partnership has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.

Section 404. **Contribution by General Partner**

A general partner of a limited partnership may make contributions to the partnership and share in the profits and losses of, and in distributions from, the limited partnership as a general partner. A general partner also may make contributions to and share profits, losses, and distributions as a limited partner. A person who is both a general partner and a limited partner has the rights and powers, and is subject to the restrictions and liabilities, of a general partner and, except as provided in the partnership agreement, also has the powers, and is subject to the restrictions, of a limited partner to the extent of his [or her] participation in the partnership as a limited partner.

Section 405. **Voting**

The partnership agreement may grant to all or certain identified general partners the right to vote (on a per capita or any other basis), separately or with any or all classes of the limited partners, on any matter.

Article 5: Finance

Section 501. **Form of Contribution**

The contribution of a partner may be in cash, property, or services rendered, or a promissory note or other obligation to contribute cash or property or to perform services.

Section 502. **Liability for Contribution**

(a) A promise by a limited partner to contribute to the limited partnership is not enforceable unless set out in writing signed by the limited partner.

(b) Except as provided in the partnership agreement, a partner is obligated to the limited partnership to perform any enforceable promise to contribute cash or property or to perform services, even if he [or she] is unable to perform because of death, disability, or any other reason. If a partner does not make the required contribution of property or services, he [or she] is obligated at the option of the limited partnership to contribute cash equal to that portion of the value, as stated in the partnership records required to be kept pursuant to Section 105, of the stated contribution which has not been made.

(c) Unless otherwise provided in the partnership agreement, the obligation of a partner to make a contribution or return money or other property paid or distributed in violation of this Act may be compromised only by consent of all partners. Notwithstanding the compromise, a creditor of a limited partnership who extends credit, or otherwise acts in reliance on that obligation after the partner signs a writing which, reflects the obligation, and before the amendment or cancellation thereof to reflect the compromise, may enforce the original obligation.

Section 503. **Sharing of Profits and Losses**

The profits and losses of a limited partnership shall be allocated among the partners, and among classes of partners, in the manner provided in writing in the partnership agreement. If the partnership agreement does not so provide in writing, profits and losses shall be allocated on the basis of the value, as stated in the partnership records required to be kept pursuant to Section 105, of the contributions made by each partner to the extent they have been received by the partnership and have not been returned.

Section 504. **Sharing of Distributions**

Distributions of cash or other assets of a limited partnership shall be allocated among the partners and among classes of partners in the manner provided in writing in the partnership agreement. If the partnership agreement does not so provide in writing, distributions shall be made on the basis of the value, as stated in the partnership records required to be kept pursuant to Section 105, of the contributions made by each partner to the extent they have been received by the partnership and have not been returned.

Article 6: Distributions and Withdrawal

Section 601. **Interim Distributions**

Except as provided in this Article, a partner is entitled to receive distribution from a limited partnership before his [or her] withdrawal from the limited partnership and before the dissolution and winding up thereof to the extent and at the times or upon the happening of the events specified in the partnership agreement.

Section 602. **Withdrawal of General Partner**

A general partner may withdraw from a limited partnership at any time by giving written notice to the other partners, but if the withdrawal violates the partnership agreement, the limited partnership may recover from the withdrawing general partner damages for breach of the partnership agreement and offset the damages against the amount otherwise distributable to him [or her].

Section 603. **Withdrawal of a Limited Partner**

A limited partner may withdraw from a limited partnership at the time or upon the happening of events specified in writing in the partnership agreement. If the agreement does not specify in writing the

time or the events upon the happening of which a limited partner may withdraw or a definite time for the dissolution and winding up of the limited partnership, a limited partner may withdraw upon not less than six months' prior written notice to each general partner at his [or her] address on the books of the limited partnership at its office in this state.

Section 604. **Distribution Upon Withdrawal**

Except as provided in this Article, upon withdrawal any withdrawing partner is entitled to receive any distribution to which he [or she] is entitled under the partnership agreement and, if not otherwise provided in the agreement, he [or she] is entitled to receive, within a reasonable time after withdrawal, the fair value of his [or her] interest in the limited partnership as of the date of withdrawal based upon his [or her] right to share in distributions from the limited partnership.

Section 605. **Distribution in Kind**

Except as provided in the partnership agreement, a partner, regardless of the nature of his [or her] contribution, has no right to demand and receive any distribution from a limited partnership in any form other than cash. Except as provided in writing in the partnership agreement, a partner may not be compelled to accept a distribution of any asset in kind from a limited partnership to the extent that the percentage of the asset distributed to him [or her] exceeds a percentage of the asset which is equal to the percentage in which he [or she] shares in distributions from the limited partnership.

Section 606. **Right to Distribution**

At the time a partner becomes entitled to receive a distribution, he [or she] has the status of, and is entitled to all remedies available to, a creditor of the limited partnership with respect to the distribution.

Section 607. **Limitations on Distributions**

A partner may not receive a distribution from a limited partnership to the extent that, after giving effect to the distribution, all liabilities of the limited partnership, other than liabilities to partners on account of their partnership interest, exceed the fair value of the partnership assets.

Section 608. **Liability Upon Return of Contribution**

(a) If a partner has received the return of any part of his [or her] contribution without violation of the partnership agreement or this Act, he [or she] is liable to the limited partnership for a period of one year thereafter for the amount of the returned contribution, but only to the extent necessary to discharge the limited partnership's liabilities to creditors who extended credit to the limited partnership during the period the contribution was held by the partnership.

(b) If a partner has received the return of any part of his [or her] contribution in violation of the partnership agreement or this Act, he [or she] is liable to the limited partnership for a period of six years thereafter for the amount of the contribution wrongfully returned.

(c) a partner receives a return of his [or her] contribution to the extent that a distribution to him [or her] reduced his [or her] share of the fair value of the net assets of the limited partnership below the value, as set forth in the partnership records required to be kept pursuant to Section 105, of his contribution which has not been distributed to him [or her].

Article 7: Assignment of Partnership Interests

Section 701. **Nature of Partnership Interests**

A partnership interest is personal property.

Section 702. **Assignment of Partnership Interests**

Except as provided in the partnership agreement, a partnership interest is assignable in whole or in part. An assignment of a partnership interest does not dissolve a limited partnership or entitle the assignee to become or to exercise any rights of a partner. An assignment entitles the assignee to receive, to the extent assigned, only the distribution to which the assignor would be entitled. Except as provided

in the partnership agreement, a partner ceases to be a partner upon assignment of all his [or her] partnership interest.

Section 703. **Rights of Creditor**

On application to a court of competent jurisdiction by any judgment creditor of a partner, the court may charge the partnership interest of the partner with the payment of the unsatisfied amount of the judgment with interest. To the extent so charged, the judgment creditor has only the rights of an assignee of the partnership interest. This Act does not deprive any partner of the benefit of any exemption laws applicable to his [or her] partnership interest.

Section 704. **Right of Assignee to Become Limited Partner**

(a) An assignee of partnership interest, including an assignee of a general partner, may become a limited partner if and to the extent that (i) the assignor gives the assignee that right in accordance with authority described in the partnership agreement, or (ii) all other partners consent.

(b) An assignee who has become a limited partner has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a limited partner under the partnership agreement and this Act. An assignee who becomes a limited partner also is liable for the obligations of his [or her] assignor to make and return contributions as provided in Articles 5 and 6. However, the assignee is not obligated for liabilities unknown to the assignee at the time he [or she] became a limited partner.

(c) If an assignee of a partnership interest becomes a limited partner, the assignor is not released from his [or her] liability to the limited partnership under Sections 207 and 502.

Section 705. **Power of Estate of Deceased or Incompetent Partner**

If a partner who is an individual dies or a court of competent jurisdiction adjudges him [or her] to be incompetent to manage his [or her] person or his [or her] property, the partner's executor, administrator, guardian, conservator, or other legal representative may exercise all the partner's rights for the purpose of settling his [or her] estate or administering his [or her] property, including any power the partner had to give an assignee the right to become a limited partner. If a partner is a corporation, trust, or other entity and is dissolved or terminated, the powers of that partner may be exercised by its legal representative or successor.

Article 8: Dissolution

Section 801: **Nonjudicial Dissolution**

A limited partnership is dissolved and its affairs shall be wound up upon the happening of the first to occur of the following:

(1) at the time specified in the certificate of limited partnership;

(2) upon the happening of events specified in writing in the partnership agreement;

(3) written consent of all partners;

(4) an event of withdrawal of a general partner unless at the time there is at least one other general partner and the written provisions of the partnership agreement permit the business of the limited partnership to be carried on by the remaining general partner and that partner does so, but the limited partnership is not dissolved and is not required to be wound up by reason of any event of withdrawal, if, within 90 days after the withdrawal, all partners agree in writing to continue the business of the limited partnership and to the appointment of one or more additional general partners if necessary or desired; or

(5) entry of a decree of judicial dissolution under Section 802.

Section 802. **Judicial Dissolution**

On application by or for a partner the [designate the appropriate court] court may decree dissolution of a limited partnership whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement.

Section 803. **Winding Up**

Except as provided in the partnership agreement, the general partners who have not wrongfully dissolved a limited partnership or, if none, the limited partners, may windup the limited partnership's affairs; but the [designate the appropriate court] court may wind up the limited partnership's affairs upon application of any partner, his [or her] legal representative, or assignee.

Section 804. **Distribution of Assets**

Upon the winding up of a limited partnership, the assets shall be distributed as follows:

(1) to creditors, including partners who are creditors, to the extent permitted by law, in satisfaction of liabilities of the limited partnership other than liabilities for distribution to partners under Section 601 or 604;

(2) except as provided in the partnership agreement, to partners and former partners in satisfaction of liabilities for distributions under Section 601 or 604;

(3) except as provided in the partnership agreement, to partners first for the return of their contributions and secondly respecting their partnership interests, in the proportions in which the partners share in distributions.

Article 9: Foreign Limited Partnerships

Section 901. **Law Governing**

Subject to the Constitution of this State, (i) the laws of the state under which a foreign limited partnership is organized govern its organization and internal affairs and the liability of its limited partners, and (ii) a foreign limited partnership may not be denied registration by reason of any difference between those laws and the laws of this state.

Section 902 **Registration**

Before transacting business in this State, a foreign limited partnership shall register with the Secretary of State. In order to register, a foreign limited partnership shall submit to the Secretary of State, in duplicate, an application for registration as a foreign limited partnership, signed and sworn to by a general partner and setting forth:

(1) the name of the foreign limited partnership and, if different, the name under which it proposes to register and transact business in this State;

(2) the State and date of its formation;

(3) the name and address of any agent for service of process on the foreign limited partnership whom the foreign limited partnership elects to appoint; the agent must be an individual resident of this State, a domestic corporation, or a foreign corporation having a place of business in and authorized to do business in this State;

(4) a statement that the Secretary of State is appointed the agent of the foreign limited partnership for service of process if no agent has been appointed under paragraph (3) or, if appointed, the agent's authority has been revoked or if the agent cannot be found or served with the exercise of reasonable diligence;

(5) the address of the office required to be maintained in the state of its organization by the laws of that state, or if not so required, of the principal office of the foreign limited partnership;

(6) the name and business address of each general partner; and

(7) the address of the office at which is kept a list of the names and addresses of the limited partners and their capital contributions, together with an undertaking by the foreign limited partnership to keep those records until the foreign limited partnership's registration in this State is canceled or withdrawn.

Section 903. **Issuance of Registration**

(a) If the Secretary of State finds that an application for registration conforms to law and all requisite fees have been paid, he [or she] shall:

(1) endorse on the application the word "filed," and the month, day and year of the filing thereof;

(2) file in his [or her] office a duplicate original of the application; and

(3) issue a certificate of registration to transact business in this state.

(b) The certificate of registration, together with a duplicate original of the application, shall be returned to the person who filed the application or his [or her] representative.

Section 904. **Name**

A foreign limited partnership may register with the Secretary of State under any name, whether or not it is the name under which it is registered in its state of organization, that includes without abbreviation the words "limited partnership" and that could be registered by a domestic limited partnership.

Section 905. **Changes and Amendments**

If any statement in the application for registration of a foreign limited partnership was false when made or any arrangements or other facts described have changed, make the application inaccurate in any respect, the foreign limited partnership shall promptly file in the office of the Secretary of State a certificate, signed and sworn to by a general partner, correcting such statement.

Section 906. **Cancellation of Registration**

A foreign limited partnership may cancel its registration by filing with the Secretary of State a certificate of cancellation signed and sworn to by a general partner. A cancellation does not terminate the authority of the Secretary of State to accept service of process on the foreign limited partnership with respect to [claims or relief] [causes of action] arising out of the transactions of business in this State.

Section 907. **Transaction of Business Without Registration**

(a) A foreign limited partnership transacting business in this State may not maintain any action, suit, or proceeding in any court of this State until it has registered in this State.

(b) The failure of a foreign limited partnership to register in this State does not impair the validity of any contract or act of the foreign limited partnership or prevent the foreign limited partnership from defending any action suit, or proceeding in any court of this State.

(c) A limited partner of a foreign limited partnership is not liable as a general partner of the foreign limited partnership solely by reason of having transacted business in this State without registration.

(d) A foreign limited partnership, by transacting business in this State without registration, appoints the Secretary of State as its agent for service of process with respect to [claims for relief][causes of action] arising out of the transaction of business in this State.

Section 908. **Action by [Appropriate Official]**

The [designate the appropriate official] may bring an action to restrain a foreign limited partnership from transacting business in this State in violation of this Article.

Article 10: Derivative Actions

Section 1001. **Right of Action**

A limited partner may bring an action in the right of a limited partnership to recover a judgment in its favor if general partners with authority to do so have refused to bring the action or if an effort to cause those general partners to bring the action is not likely to succeed.

Section 1002. **Proper Plaintiff**

In a derivative action, the plaintiff must be a partner at the time of bringing the action and (i) must have been a partner at the time of the transaction of which he [or she] complains or (ii) his [or her] status as a partner must have been devolved upon him [or her] by operation of law or pursuant to the terms of the partnership agreement from a person who was a partner at the time of the transaction.

Section 1003. **Pleading**

In derivative action, the complaint shall set forth with particularity the effort of the plaintiff to secure initiation of the action by a general partner or the reasons for not making the effort.

Section 1004. **Expenses**

If a derivative action is successful, in whole or in part, or if anything is received by the plaintiff as a result of a judgment, compromise or settlement of an action or claim, the court may award the plaintiff reasonable expenses, including reasonable attorney's fees, and shall direct him [or her] to remit to the limited partnership the remainder of those proceeds received by him [or her].

Article 11: Miscellaneous

Section 1101. **Construction and Application**

This Act shall be so applied and construed to effectuate its general purpose and to make uniform the law with respect to the subject of this Act among states enacting it.

Section 1102. **Short Title**

This Act may be cited as the Uniform Limited Partnership Act.

Section 1103. **Severability**

If any provision of this Act or its application to any person or circumstance is held invalid, the invalidity does not affect other provisions or applications of the Act which can be given effect without the invalid provision or application, and to this end the provisions of the Act are severable.

Section 1104. **Effective Date, Extended Effective Date or Repeal**

Except as set forth below, the effective date of this Act is _____ and the following [list existing limited partnership acts] are hereby repealed:

(1) The existing provisions for execution and filing of certificates of limited partnerships and amendments thereunder and cancellations thereof continue in effect until [specify time required to create central filing system], the extended effective date, and Sections 102, 103, 104, 105, 201, 202, 203, 204 and 206 are not effective until the extended effective date.

(2) Section 402, specifying the conditions under which a general partner ceases to be a member of a limited partnership, is not effective until the extended effective date, and the applicable provisions of existing law continue to govern until the extended effective date.

(3) Sections 501, 502 and 608 apply only to contributions and distributions made after the effective date of this act.

Appendix C: Draft Military Family Housing Revitalization Act of 1995

Title 10, United States Code, in amended by adding the following new chapter:

Chapter 170-Alternative Provision of Family Housing and Facilities
SUBCHAPTER I-GENERAL PROCEDURES AND REQUIREMENTS

Section 2871. Definitions.
The following shall apply for purpose of this chapter:

(a) The term "construction" means the construction of additional family housing units, or the replacement or renovation of existing family housing units, including supporting facilities and infrastructure.

(b) The term "supporting facilities" includes related facilities such as day care centers, community centers, housing offices, maintenance complexes, tot lots and parks, primarily used by the occupants of the family housing. The term "supporting facilities" does not include commercial facilities which could not otherwise be constructed using funds appropriated to the Department of Defense.

(c) The term "Secretary concerned" means the Secretary of Defense, the Secretaries of the Army, Navy and Air Force, and their respective designees.

(d) The term "contract" includes any contract, lease or other agreement entered into under the authorities of this chapter.

Section 2872. General Limitations and Authorities.
(a) Use of authorities. The Authorities of this chapter may be used singly or in conjunction with any other provisions or authorities provided in this chapter.

(b) Term. A contract entered into under this chapter may be for any period determined by the Secretary concerned to be in the best interests of the United States.

(c) Phased occupancy. A contract may provide for phased occupancy of completed family housing units under one or more interim leases during the period of the construction or renovation of the family housing. In no case shall any such interim lease extend beyond the construction or renovation period.

(d) Unit size and type. Family housing units acquired or constructed under this chapter shall not be subject to the provisions of section 2826 of this title. Room and floor area size of such housing units should generally be comparable to private sector housing available in the locality. Additionally, when acquiring existing family housing in lieu of construction under section 2824 of this title, the Secretary concerned may vary the number and types of units to be acquired as long as the total number of units would be substantially the same as authorized by law.

(e) Location. The authorities under this chapter are applicable on or near a military installation within the United States, its territories, and possessions, as those terms are defined in section 101 of Title 10, United States Code.

(f) Notification and reports. Upon entering into a contract under this chapter, the Secretary concerned shall submit to the appropriate committees of the Congress a report explaining the transaction. The notification will include a justification of the financing methods chosen. Annually, with the budget justification, the Secretary of Defense will submit a report detailing the expenditures and receipts of the fund authorized in section 2873. The annual report shall also include a description of the Department's objectives for providing housing benefits to military members and their families, including performance measures to be used in determining the successful implementation of the authorities contained in this Act.

(g) Assignments to family housing. The Secretary concerned may, in accordance with the provisions of section 403 (b) of title 37 United States Code, assign service members to any family housing acquired, constructed, leased, financed, or guaranteed under this Chapter; provided that, in the case of housing which is not owned or leased by the United States, a member assigned to such housing shall be entitled to receive any basic allowance for quarters and variable housings allowance to which the member would otherwise be entitled.

(h) Allotments. The Secretary concerned may require service members to pay rent by allotment, under section 701 of title 37, as a condition of living in family housing obtained under the authorities in this chapter.

(i) Supporting facilities. Any contract entered into under this chapter may include provision for supporting facilities.

(j) Authorities to outlease or sell land, family housing, and supporting facilities. The Secretary concerned may lease and/or sell land, family housing and supporting facilities for the purpose of providing additional family housing or improving existing family housing under this chapter.

(1) Authority to lease or sell property under this chapter may not be exercised at any military installation approved for closure.

(2) A sale or lease under this chapter may be made for such consideration and upon such terms and conditions as the Secretary concerned shall determine to be consistent with the purposes of this chapter and the public interest. The acreage and legal description of any property leased or conveyed under this chapter shall be determined by a survey, or any other method, satisfactory to the Secretary concerned.

(3) Leases and sales under this Chapter may be made without regard to the provisions of the Military Leasing Act, 70 A Stat. 150, as amended; the Federal Property and Administrative Services Act of 1949, 63 Stat. 378, as amended; the Stewart B. McKinney Homeless Assistance Act, 101 Stat. 484; and section 321 of the Economy Act of June 30, 1932, 47 Stat. 412.

(4) As part or all of the consideration for the sale or lease, the Secretary concerned may enter into agreements to encourage owners of family housing units to provide priority to military members and their dependents in the leasing of existing or new housing. Such agreements may provide for the payment of security or damage deposits.

Section 2873. Family Housing Improvement Fund.

(a) Establishment. There is hereby established on the books of the Treasury an account to be known as the Department of Defense Family Housing Improvement Fund, which shall be administered by the Secretary of Defense as a single account. Funds in the account are authorized to be appropriated to be available without fiscal year limitation.

(b) Deposits. There shall be deposited into the Fund--

(1) Funds authorized for and appropriated into the Fund.

(2) The Secretary of Defense is authorized, to the extent that transfer authority is provided in appropriations Acts, to transfer to the Fund from funds appropriated to the Department of Defense for family housing, except that such funds may be transferred only after the Secretary transmits written notice of, and justification for, such transfer to the appropriate committees of Congress.

(3) Proceeds received from conveyance or lease of any property under the provisions of this chapter, any income from operations conducted under this chapter, including refunds of deposits, and any return of capital or return on investments entered into under this chapter; provided that such proceeds shall be available for obligation only to the extent and in the amounts provided in advance in appropriations Acts.

(c) Use of funds. The Secretary of Defense may use funds in the Fund to effect the authorities of this chapter or a combination thereof; provided that the total value in budget authority of all contracts and investments undertaken using these authorities shall not exceed one billion dollars.

(d) Direct loans and loan guarantees. Direct loans and loan guarantees may be entered into under the provisions of this chapter only to the extent that appropriations of budget authority to cover their costs (as defined in section 502 (5) of the Federal Credit Reform Act of 1990 (2 U.S.C. 661a(5)) are made in advance, or authority is otherwise provided in appropriations Acts. No loan guaranteed to any one borrower shall exceed 80% of the outstanding principal of the loan. If such appropriation or other authority is provided, there is authorized to be established a financing account or accounts (as defined in section 505 (7) of the Federal Credit Reform Act of 1990), which shall be available for the disbursement of direct loans or payment of loan guarantee claims and all other cash flows to and from the Government resulting from the direct loans or loan guarantees authorized by this chapter.

SUBCHAPTER II-FAMILY HOUSING FINANCE AND ACQUISITION AUTHORITIES

Section 2874. Guarantees and Direct Loans.

(a) The Secretary concerned may enter into contracts that provide for direct loans, guarantees, insurance, or other contingent payments to owners or mortgagors or assignees of family housing and supporting facilities that are made available for use by military personnel.

(b) Contingencies under which payments may be made under such a contract may include, without limitation:

(1) Failure to pay interest and/or principal on mortgages, generally or as a result of a base closure or realignment, a reduction in force, an extended deployment of assigned forces or similar contingencies.

(2) Failure to achieve specified occupancy levels of, or rental income from, family housing units covered by a contract.

(c) Such contracts may be on such terms and conditions as the Secretary concerned considers necessary or desirable to induce the provision of family housing and supporting facilities on or near a military installations, whether by acquisition or construction, for use by military personnel, and to protect the financial interests of the United States.

Section 2875. Commitments.

(a) Leases. The Secretary concerned may enter into a contract for the lease of family housing units to be acquired or constructed on or near a military installation. Such a contract may provide for the owner of the property to operate and maintain the facilities.

(b) Differential payments. In entering into contracts under this chapter, the Secretary concerned is authorized to enter into contracts that commit to pay a differential payment in addition to rental payments made by individual service members.

Section 2876. Investments.

(a) The Secretary concerned may make investments in non-governmental entities involved in the acquisition and/or construction of family housing and supporting facilities on or near a military installation for such consideration and upon such terms and conditions as the Secretary concerned determines to be consistent with the purposes of this chapter and the public interest.

(b) Such investments may take the form of limited partnerships, stock, debt instruments, or a combination thereof.

(1) In entering into any investment under this section, the Secretary concerned may contribute, in cash, up to 35 percent of the capital costs on an acquisition or construction project.

(2) In the event the Secretary concerned conveys land or buildings as all or part of an equity contribution under such an investment, such contribution may exceed 35 percent of the capital cost of the

project, provided that the total Government equity contribution does not exceed 45 percent of the capital cost of the project.

(c) Collateral incentive agreements. The Secretary concerned may also enter into collateral incentive agreements in connection with such investments to ensure that a suitable preference will be afforded military families to rent, lease, or purchase, at affordable rates, a reasonable number of the family housing units covered by the investment contract.

Note: The following paragraphs are included in the act, but not in chapter 170.

1. Authorization of appropriations. There is authorized to be appropriated to the Department of Defense Family Housing Improvement Fund for fiscal year 1996, $22,000,000.

2. The Secretary of Defense shall, not later than March 1, 2000, provide a report to the appropriate committees of Congress on the utilization and effectiveness of the authorities provided in this Act.

3. The authority to enter into contracts and make investments under the provisions of Chapter 170 of Title 10, United States Code, as added by section b of this Act, shall cease to be effective five years following the enactment of this Act.

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