EB/CB/MTG/94/2

DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

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COMMITTEE ON THE BUDGET

September 16, 1994

Meeting 94/2

Approval: 9/23/94

11:00 a.m., March 21, 1994

R. D. Erb, Acting Chairman

Executive Directors	Alternate Executive Directors
M. Al-Jasser	A. A. Al-Tuwaijri
H. Fukui	T. Fukuyama
J. E. Ismael	
D. Kaeser	
	A. V. Mozhin
K. Lissakers	J. M. Abbott, Temporary
R. Marino	
M. Mwananshiku	
	E. Wagenhoefer
E. L. Waterman	

J. W. Lang, Secretary
S. L. Yeager, Assistant

Also Present	
	M. Sirat
	P. Cailleteau, Temporary
J. Bergo	J. Prader
	C. Gaseltine, Temporary
K. P. Geethakrishnan	L. E. N. Fernando
A. Kafka	M. Giulimondi, Temporary
	M. A. Hammoudi, Temporary
	O. Havrylyshyn
	D. Saha, Temporary
A. S. Shaalan	Y. Y. Mohammed
	R. Rainford, Temporary
	Wei B.
	A. F. Jiménez de Lucio

Also Present

Administration Department: G. Rea, Director; T. Cole, Deputy Director; H. O. Struckmeyer, Deputy Director; P. Gerridge, G. Vaughan. External Relations Department: M. Kelly, Deputy Director. Legal Department: J. S. Powers. Treasurer's Department: D. Williams, Treasurer; G. Wittich, Deputy Treasurer; B. E. Keuppens, C. P. McCoy, M. M. Nilssen. Western Hemisphere Department: S. T. Beza, Counsellor and Director. Office of the Managing Director: A. Coune, C. Gibbs, P. J. McClellan, P. J. McPhillips, J. Prust, L. A. Wolfe; Office of Internal Audit and Review: M. Caiola, Director. Advisors to Executive Directors: G. M. Blome, A. Chang Fong, S. K. Fayyad, M. F. Melhem, R. Meron. Assistants to Executive Directors: R. N. A. Ally, M. A. Brettschneider, J. M. Burdiel, G. Z. El-Masry, S. Ishida, T. Kanada, E. Kouprianova, G. J. Matthews, S. del C. Olgiati, M. Ryan, A. Sighvatsson, R. von Kleist.

1. FUND'S FUTURE SPACE NEEDS

The Committee considered a staff paper on the Fund's future space needs (EBAP/94/9, 2/28/94; Cor. 1, 3/2/94; and Sup. 1, 3/15/94) together with a staff paper on controls over Phase III-related projects (EBAP/94/15, 3/14/94) and on the Phase III construction budget (EBAP/94/16, 3/15/94).

The Acting Chairman said that he hoped that the Committee could come to a view on the proposed decisions and recommendations put forward in the staff papers regarding the Phase III project and the options for accommodating personnel who could not be housed within the extended headquarters building. With regard to the latter, he observed that the purchase option--the Cafritz building--was located on the northern side of Eye Street between 17th and 18th Streets.

The Director of Administration recalled that seven years earlier the Board had authorized a small expenditure to begin negotiations on the purchase of the Western Presbyterian Church site so as to allow for the Phase III addition to the headquarters building. At present, a decision was needed on whether to proceed with Phase III, and in that regard, the staff strongly recommended proceeding with the construction of an addition to the headquarters building on the church site, which would be vacated within a month. The completion of the Phase III extension would allow some 600 staff, out of the approximately 1,300 currently housed in leased space, to return to the expanded headquarters building.

The staff was also looking to the Board for guidance on long-term arrangements for housing the remaining 700 staff members currently housed in leased space, the Director of Administration continued. One option was the purchase of the Cafritz building, on the corner of 18th and Eye Streets, for the construction of a permanent annex. The staff had negotiated a purchase arrangement for the site, and a decision on whether to proceed with that option was needed within 90 days, after which the purchase arrangement would expire. In the interim, some additional costs would be incurred, so an early decision would be desirable. The alternative was to enter into a long-term leasing arrangement with the George Washington University for occupancy of the PEPCO building at 19th Street and Pennsylvania Avenue.

The relative merits, advantages, and disadvantages of the two options, as well as a comparison of their cost with the current commercial leasing arrangements at International Square had been set out in the staff paper, the Director of Administration observed. The Cafritz site offered the financial advantages of ownership compared with a long-term--say, 60-year--lease of the PEPCO building. In the staff's view, there was a strong case for acquiring occupancy of the PEPCO building because it offered the unique advantage of proximity and of forming an enlarged headquarters' complex separated only by a street. The staff would welcome the Board's guidance on how to proceed on that matter as well as Phase III.

The Acting Chairman said that he too had a strong preference for the PEPCO option, for the reasons cited by the staff.

Mr. Kafka observed that the World Bank had numerous buildings in the vicinity, which were nearer to Fund headquarters than the Cafritz building. He wondered whether it would be possible to come to an agreement with the Bank on exchanging the Cafritz building at some future time for a Bank building.

The staff representative from the Administration Department said that such possibilities had been explored with the World Bank. The Bank, however, was interested in consolidating its offices on the south side of Pennsylvania Avenue and would not be interested in acquiring more space on the north side of Pennsylvania Avenue.

Mr. Fernando observed that the PEPCO building would require various improvements, including fitting out, which involved considerable outlays. He wondered whether the amounts shown in the Table 2 of EBAP/94/9, the comparative financial analysis of long-term office space options, reflected those costs.

The staff representative from the Treasurer's Department said that the calculations presented in Table 2 were all inclusive.

Mr. Al-Jasser remarked that, for the purposes of comparison with the long-term lease option, he would be interested to know the appraised value of the PEPCO building.

The staff representative from the Administration Department recalled that when, two years earlier, the staff had asked an outside consulting firm to assess the fair market value of the PEPCO building from a buyer's point of view, the value had been set at $45-55 million. At current prices--around $120 per FAR foot--the value of that site, compared with the Cafritz site, was about $55 million, excluding the value of the building.

Mr. Fukui said that he understood that there was some possibility of purchasing the PEPCO building from the University but that such negotiations were likely to be difficult. In the circumstances, the final price could be much greater than the fair market value assessment suggested. He would appreciate some elaboration on the prospects for purchasing the PEPCO building.

The staff had indicated that the PEPCO building would be available for occupancy only in 2004, Mr. Fukui remarked. He wondered what were the prospects for an earlier occupancy. If there were some retrenchment in staff, what would be the prospects for leasing any surplus space? Also, he noted that the construction of Phase III was expected to take three years; was there any possibility that it would be completed in a shorter time?

The staff representative from the Administration Department recalled that during earlier negotiations on the PEPCO building, the George Washington University had shown no interest in selling the site for as much as $95 million. At the time, however, the University understood that the Fund was interested in leasing the building.

The fact that the PEPCO building could not be occupied until 2004 was reflected in the estimated purchase price, the staff representative from the Administration Department explained. If the building could be occupied immediately, it would be worth more than $55 million to the Fund. The comparative cost of leasing in the event of earlier occupancy would depend on PEPCO's future plans and the cost of buying out PEPCO. Whether the building was purchased or leased, any surplus space could be let out. On the prospects for completing Phase III prior to the target date of May 1997, the staff considered that, without increasing costs substantially by requiring overtime work, the current schedule was realistic.

The Acting Chairman remarked that while the preferred option would be to buy the PEPCO building, depending on the price, discussions with University President Trachtenberg and other university officials in which he had explored various options for buying and exchanging property, indicated that the University attached a high value to ownership of the PEPCO building. He therefore doubted that the University would be interested in selling the property, even on very favorable terms.

The Director of Administration commented that one reason why it might be difficult to persuade PEPCO to vacate earlier was the extremely generous lease terms that it enjoyed; in the current market situation, its leasing costs were significantly below market price. If, however, PEPCO saw that its lease was not likely to be renewed, that could be an incentive to make new arrangements for housing its staff earlier rather than later. The low lease cost also depressed somewhat the current market value of the building.

Ms. Lissakers said that she understood that the proposed new International Finance Corporation (IFC) building was expected to have excess capacity. She wondered whether that building could be another possible option for "Phase IV." It would presumably be somewhat cheaper than the PEPCO option and might also allow for relocating some staff into nearby space before 2004.

The idea of buying a site, while attractive from an economic viewpoint, might be politically difficult at present, Ms. Lissakers observed. Currently, the IFC, the World Bank, and the Fund were all undertaking construction that the District of Columbia viewed as a net loss of tax revenue. If the Fund were to purchase yet another site, which was currently a tax-paying commercial site, for a building that did not yield revenue, that would probably raise a tremendous public outcry, which might not be worth the cost. Moreover, there was the possibility of a cutback in staffing in the future, especially if the Fund did its job well. One of the attractions of the IFC option was that it would leave some flexibility to reduce the size of the Fund's staff when conditions warranted.

The staff representative from the Administration Department remarked that the staff had been exploring the possibility of leasing space from the IFC. The new building, which was in a very preliminary stage of schematic design, was expected to have as much as 200,000 square feet of excess capacity when completed. That space would accommodate only 300-400 of the 700 staff remaining at International Square following the completion of Phase III. One advantage of the IFC building was that it would not be subject to real estate taxes, which was likely to reduce leasing costs. Any lease was likely to be short term--say, five-year, multiple renewal--in view of the IFC's recent rapid rate of growth. Moreover, the Fund would be competing with the World Bank, which had already expressed an interest in the IFC space.

Mr. Waterman said that he endorsed Ms. Lissakers's comments about the need to allow for as much flexibility as possible, particularly in respect of Phase IV, in view of the uncertainty regarding total staff numbers. He agreed that if the Fund did its job well, it should see some diminution in total staff size over the coming decade. As to the two options, the PEPCO site might involve a major capital works project to prepare the building for occupancy by Fund staff.

The staff representative from the Administration Department commented that the staff had looked in detail at the PEPCO building together with several architects and engineers. Among other things, the roof leaked and the mechanical/electrical system needed to be replaced. The staff estimated the cost of capital improvements at $35-40 million.

Mr. Al-Jasser recalled that when the Board first discussed Phase III, he had been among those Directors who indicated that their support was dependent on housing all staff under one roof. Subsequently, the growth of the Fund staff had necessitated the consideration of other, additional options.

The first option for Phase IV--the PEPCO building--raised some concern, Mr. Al-Jasser continued. The University had everything to gain from the Fund's involvement in view of the building's condition. It would have no incentive to sell the building as long as the Fund was ready to lease it for $55 million and invest $40 million in renovations. Moreover, the University's attachment to the PEPCO site appeared to have more to do with the Fund's needs and its weak negotiating position than with the University's own financial and investment decisions.

The availability of alternatives was therefore important to the Fund's negotiating position, Mr. Al-Jasser considered. In that context, he wondered what were the prospects of finding a site that would cost less than Phase III and Phase IV together and, at the same time, allow for accommodating all staff in two buildings.

The staff representative from the Administration Department said that Mr. Al-Jasser had raised a difficult question, in that it involved a moving target. The staff had studied the market a number of times, and its most recent study had concluded that no site was available in the immediate vicinity that was of sufficient size to house 1,300 staff. That was not to say that a suitable site would not become available over the course of the coming months. For instance, a year earlier, the staff had investigated the possibility of buying International Square at a time when one of the owners, the Carr Company, had been in some financial difficulty. International Square was approximately as large as the headquarters building would be when Phase III was completed, which meant that one half of the building would be excess capacity and would have to be leased out. The staff had concluded that option to be impractical.

Mr. Fernando remarked that he understood that the headquarters building, which was designed to house 1,800 staff, contained slightly more than 2,000 staff, and that the leased space at International Square housed approximately 1,300 staff. How did those figures compare with those given in the staff paper with respect to the total maximum requirement for the year 2002? Also, why would the 200,000 square feet likely to be available in the IFC building be inadequate to meet the Fund's space requirements for Phase IV?

The staff representative from the Administration Department observed that in the past, as many as 2,100 staff had been housed in the current headquarters building. A number of staff had subsequently been moved to leased space in preparation for the possible building of Phase III, thereby reducing the number of staff currently housed at headquarters to 1,800. Following the completion of Phase III, about 300,000 additional square feet would be needed to house the 700 staff remaining outside the headquarters building.

The Director of Administration said that in the past, more than 1,800 staff had been housed in the headquarters building on a temporary basis as the size of the staff had increased. Moreover, staff, units, and entire departments had, at times, been scattered over several floors, and had been moved from one location to another at considerable expense. Filling the building well above design capacity was not acceptable over the long term. On the basis of a more stable staff size of 3,100, it was expected that 1,800 staff could be housed in Phases I and II, and about 1,300 staff would have to be housed elsewhere.

It was true that the George Washington University had the advantage of holding property in close proximity to two institutions that were in need of additional space and committed to a permanent presence in the area, the Director of Administration stated. Moreover, the World Bank had been pressing for some years to acquire all available office space in the vicinity--currently, it had offices in 22 different buildings--on short-term lease while it expanded its headquarters complex. The Fund also needed additional space, but in the staff's view, leasing on terms such as those available at International Square would not be appropriate for the longer term. The University was certainly in a position to take advantage of the Fund's situation. At the same time, it wanted to hold on to every piece of land it currently owned as an institution committed to a permanent presence in the area.

It was also true that, once the PEPCO lease expired, the University would face considerable renovation expenditure to bring the building up to a marketable leasing standard, the Director of Administration commented. That was one reason why it was willing to consider a long-term leasing arrangement with the Fund. The Fund, for its part, would want to make sure that the term of the lease was sufficiently long to exhaust all value of any renovations. Over a period of 60 years, a second major fitting out or even complete reconstruction of the building would be needed, especially as the physical life of the building was about 30 years.

Mr. Al-Jasser said that he would be interested to know why the University was unwilling to sell the PEPCO building, especially when it could buy a few buildings with the sale proceeds.

The Acting Chairman observed that he had asked that very question many times. From an economic point of view, the University would be far better off if it were to sell the property, but its unwillingness in that respect seemed to be more emotional than rational. The possibility that the University saw the Fund as having no alternative other than the PEPCO building had been one reason why the staff had looked at other options and their cost. Another reason had been to better determine what price the Fund might have to pay for the PEPCO building.

The staff representative from the Administration Department stated that the University's tenacity could be explained in part by the importance it attached to a Pennsylvania Avenue address: the PEPCO building was the jewel in its real estate crown. Moreover, the University had, in the past, obtained zoning for a campus within the Foggy Bottom area, and when the Fund encroached on that zone, secretly accumulating land for the current headquarters building, it had led to a confrontation with the University. That remained a strong emotional issue. The University had shown no interest in swapping the PEPCO site for another site on the north side of Pennsylvania Avenue. He therefore agreed with the Acting Chairman that the University was not likely to respond positively to reasonable economic incentives in discussions on purchasing the PEPCO site.

Mr. Havrylyshyn said that he wondered whether the World Bank's H Building was also operated under a lease arrangement with the University. Also, how did that arrangement compare with the long-term lease estimates for the PEPCO building?

He agreed with the staff on the reasons underlying the University's unwillingness to sell the PEPCO site, Mr. Havrylyshyn stated. It was not simply a matter of exchanging real estate assets, rather it was a matter of the University's agreement with the District of Columbia Government on its designated potential campus. A reading of the University's history revealed that the dream of a "Harvard on the Potomac" was an old and enduring one. In strict economic terms, there was room for flexibility, but in terms of the University's objective and mission, the flexibility was limited.

The staff representative from the Administration Department recalled that the World Bank had leased the H Building site from the George Washington University for a period of 40 years and had paid for the construction of the building. At the end of the leasing period, the building would revert to the University for a preagreed price, in yesterday's dollars.

Mr. Kafka said that it was clear to him that the Fund should proceed with Phase III. On Phase IV, he would be interested to know the difference between the cost of leasing the PEPCO building and the cost of continuing to lease space at International Square. In considering the options for Phase IV, account should be taken of the fact that International Square was closer to Fund headquarters than the Cafritz building and that the PEPCO building would not be available for several years.

Mr. Waterman remarked that the Fund might consider offering the headquarters building to the University and moving to the suburbs, or, if Governors were prepared to change the Articles, relocating to another member country.

Ms. Lissakers said that she understood that the current staffing level was closer to 2,700 staff years than 3,100 staff years. She would appreciate some clarification on that point.

She also understood that the IFC used a 7 percent annual growth rate of staff in projecting its own space needs, Ms. Lissakers commented. In fact, in recent years the growth rate had been closer to 3 percent. That raised some serious questions as to whether the IFC would need as much space as currently projected when it moved into its new headquarters.

The staff representative from the Administration Department said that as indicated in Table 1 of EBAP/94/9, total authorized staff resources for FY 1994 was 2,738 staff years, but as the table also showed, there were additional demands on space, bringing the adjusted total demand to 3,040 staff-years--the current authorized staff ceiling--for purposes of determining the Fund's space requirements.

The staff representative from the Treasurer's Department remarked that in net present value terms, commercial leasing costs at International Square would exceed the cost of the nearby site by about $28 million and the cost of long-term leasing of the PEPCO building, by about $12-13 million, as shown in Table 2 of EBAP/94/9.

Mr. Marino observed that the objective of housing all staff under one roof was no longer a realistic one in view of the increase in staffing to over 3,000 persons. He wondered whether the Fund should proceed with Phase III when International Square could house all 1,300 staff that could not be accommodated in Phases I and II. As the staff would continue to be housed in several different buildings for about ten years under the options before the Committee, he would be interested in exploring more thoroughly the possibility raised by Mr. Al-Jasser of housing the staff in two buildings--namely, the headquarters building and International Square.

The Acting Chairman stated that in view of expenditures on Phase III to date, abandoning that option meant that the cost of housing staff in another building would shift upward even more dramatically.

The staff representative from the Administration Department remarked that as he had indicated earlier, currently, there was no space available that would be a suitable substitute for Phase III plus Phase IV. As to the option of purchasing International Square, the Fund currently occupied 500,000 square feet at that complex. When Phase III was completed, the space freed up would have to be disposed of, which would present a significant problem for the Fund.

Mr. Jiménez de Lucio observed that the staff had argued consistently in the various papers before the Committee on the advantages of owned space compared with leasing. He therefore found it surprising that the Committee seemed to be interested in pursuing the option of leasing the PEPCO building, and that, from a position of weakness. Notwithstanding the arguments in support of that course of action, the pursuit of that option required changing the George Washington University's perception of the Fund's interests. For example, the Committee might consider recommending that the Managing Director be authorized to make a final offer to acquire the PEPCO site at a cost acceptable to the Fund and to indicate that no lease option would be pursued thereafter. In his view, that was one option the Board should pursue.

He shared Ms. Lissakers's and Mr. Waterman's view on staff retrenchment over the long term, Mr. Jiménez de Lucio remarked. If the Fund was efficient in pursuing its goals, its staffing requirements could be expected to diminish in coming years. It would, however, be useful to clarify, for discussion purposes, the implications for housing costs of a 10-15 percent increase in staff in some 15 or 20 years owing to unforeseen circumstances.

Mr. Havrylyshyn said that in connection with the alternative called "suburban headquarters," which was presumably in the category of an alternative that would bring all staff under one roof, he wondered what was meant by "suburban."

The Director of Administration remarked that it was true that the staff had argued in favor of ownership, and that was still its preference. If it were possible to purchase the PEPCO site, the staff would advocate doing so, but the Fund did not have that option nor the option of purchasing any other site of similar proximity to the headquarters building.

If the size of the Fund was to expand further and the Fund had taken a long-term lease of the PEPCO building, it would be necessary to find some reasonable short- or long-term arrangement for housing any additional staff, the Director of Administration continued. At the worst, that meant housing staff in commercially leased premises several blocks from the expanded headquarters building, which was precisely the case for 1,300 staff at present. In that event, the Fund would not be worse off as a result of having taken the decisions that the staff was recommending to the Board. The staff was, however, working on the assumption that the Fund had reached a point where the pressure to expand further could be contained.

As to a possible reduction in staff, that would be complex process, Director of Administration observed. For example, in the Administration Department, fewer staff would be needed in the Graphics Section in the coming years owing to the introduction of a new system of electronic printing. Developing a program to lay off eight people in that Section would be a fairly large undertaking for the Fund. Moreover, it was likely that in the end, the eight staff-years that would become available would be allocated to areas with higher work load pressures within or outside the Department. While he did not foresee a noticeable drop in the demands being made on the institution in the coming few years, if there were a reduction in force, somewhat less space would be needed than would be provided by the expanded headquarters building plus the PEPCO building, and it would be necessary to sublet a portion of the latter. That was likely to be an easy task because of its desirable location.

While both the possibility of expansion and contraction of the Fund's size had to be considered, the staff did not feel that those possibilities should be regarded by the Board as a sufficient basis for delaying action on the Fund's future space needs, the Director of Administration concluded.

The staff representative from the Administration Department observed that the staff had reviewed a few possible suburban sites in the Dulles and the Interstate 270 corridors. By suburban, the staff meant a location about 40 minutes to an hour away--in nonrush-hour traffic--from downtown Washington.

Mr. Rainford said that as the George Washington University would eventually face some major costs in relation to the PEPCO building, it might be desirable to keep alive the Cafritz or some similar option as a means of exercising leverage on the University with a view to moving it toward the point of outright sale, or at least the inclusion of an option in the lease that would allow for outright purchase of the building during the life of the lease.

The staff representative from the Administration Department remarked that it was difficult to say what would be needed to induce the University to sell. Although the University was well aware of the fact that the Fund had been looking at alternative sites, that had not inclined it toward a willingness to sell.

The Acting Chairman observed that the staff had already tried various bargaining strategies. If the Fund was to make a final purchase offer to the University, indicating that it would not be interested in a leasing arrangement, one consideration would be the price to be offered. That price was probably at least in the $90 million range, if not higher. He suspected, however, that the University would refuse such a purchase offer. In that event, and having foreclosed the possibility of leasing, it would be necessary to pursue an alternative site. That had been one reason for developing the Cafritz site option.

The staff representative from the Administration Department stated that in assessing price, one factor was the fact that the PEPCO building could not be occupied until 2004. In earlier simulations, the staff had estimated that it would be worth $15 million to buy the current tenant out in order to speed up the process--say, to allow for occupancy in 1998. That amount, added to the estimated fair market price of $55 million, and the value of proximity, had led to an offer in the range of $90 million.

The Acting Chairman observed that a large part of the cost of all options was the interim rental cost, as indicated in Table 2.

Ms. Lissakers said that, with regard to Phase IV, she would recommend that the Fund foreclose the new-site option, that it actively pursue the IFC-lease option, even if on a short-term basis, and that the staff prepare a detailed analysis of the potential cost of the IFC option compared with the PEPCO option. Moreover, looking at the figures in Table 2, the cost of leasing the PEPCO building and the cost of leasing space in International Square seemed to be roughly comparable: namely, $560 million to house 1,300 staff at International Square compared with $288 million to house 700 staff in the PEPCO building. If the PEPCO negotiations were put on the back burner, the University might rethink the purchase option. If it did not, nothing would be lost: the fallback was to continue leasing space, but less space, at International Square, following the completion of Phase III.

Mr. Kaeser commented that he would be interested to hear the consequences of postponing a decision on the Cafritz site by, say, six months.

Mr. Jiménez de Lucio remarked that the staff papers made clear that continuing to rely on commercially leased space was by far the most expensive option--costing almost twice as much as any other option. The Board had a responsibility to try to find a lower-cost alternative.

He understood that proceeding with Phase III was the cheapest alternative available at present, and the Committee might be able to agree to recommend that course to the Board, Mr. Jiménez de Lucio considered. As to Phase IV, a number of questions still had to be addressed regarding the options that had been presented, and there was scope for pursuing other options as well.

The staff representative from the Administration Department stated that the cost of delaying Phase III, which was currently expected to be completed by May 1, 1997, would be approximately $1 million owing to additional leasing costs.

Mr. Mwananshiku said that he would be interested to hear the staff's views on the prospects for freezing new staff positions, creating new positions, or reducing the current staff ceiling.

The staff representative from the Administration Department stated that the numbers in the staff papers assumed that authorized staff positions were frozen. No increase in staff had been built into the assumptions. If staff were reduced by 100, 200, or 300 staff-years, it would still be cost-effective to proceed with Phase III. Moreover, the figures did not take into account any income from subleasing space in the event of a reduction in work force.

Mr. Al-Jasser remarked that in his view, the advantages of purchasing International Square as an alternative to Phases III and IV should be given serious consideration.

The Acting Chairman said that if members of the Committee so wished, the staff would explore that option further. It was, however, necessary to narrow the options before the Board, including a decision on Phase III and on whether to hold on to the nearby site, with the attendant expenditures.

Ms. Lissakers stated that in her view, the Fund should give up the Cafritz site. Moreover, while she was not opposed to going ahead with Phase III, she had a few questions in that regard.

The Phase III extension appeared to be an expensive structure, Ms. Lissakers continued. Some of the reasons for the exceptional expense--for example, the need to meet the same standards as for Phases I and II and landscaping costs owing to city zoning requirements--were understandable. The $5 million extension of the porte cochere, however, appeared to be an expensive security gain. Were there other, lower-cost alternatives to achieve that objective?

It was important that all costs be clearly laid out, Ms. Lissakers considered. If the Fund failed to provide square-foot cost comparisons for the project, others would. In order to satisfy congressional oversight, in particular, somewhat clearer side-by-side comparisons of the projected cost of the Fund building, the new IFC headquarters, and the World Bank headquarters renovation project would be needed. She would also be interested in more information on the steps that had been, or could be, taken to pare Phase III construction costs.

On controls, the staff paper provided a delineation of responsibilities and an organizational chart, but it did not make entirely clear who had overall responsibility for cost control, Ms. Lissakers observed. She understood that the audit unit had conducted a review of the construction of the new Western Presbyterian Church and its cost. It would be useful for the Committee and perhaps the Board to look at that report so as to gain some sense of how the Fund's cost controls had worked so far. She therefore requested that the audit report be made available to the Board.

Mr. Havrylyshyn remarked that the control procedures appeared to focus on cost control. He would be interested to hear how time schedules would be controlled, in view of their cost implications.

The staff representative from the Administration Department observed that the Appendix to EBAP/94/9 compared the proposed costs of Phase III and those of the Bank project. Comparing costs was, however, difficult because of differences in the scope of work being compared. For example, the square-foot cost of Phase III, a building of 405,000 square feet, was $264. That cost reflected a landscape plan, the square footage of which was not included in the 405,000 square foot figure, and alterations to Phase I and II where the buildings join the square footage of which was also not included. If the square footage of these alterations and the landscaping were included, total square footage would increase to 490,000, or a project cost of $218 per square foot. Thus, the figures had to be treated with care. As the new IFC building was in the schematic-design stage, the staff would not be in a position to compare cost data until reasonable cost estimates for that building became available.

The staff had already taken some major cost-cutting measures with respect to Phase III, the staff representative commented. There had been a significant change in the atrium design because of the disruptions it involved. Much of the savings achieved through that redesign effort were reflected in savings in leasing rather than construction costs.

It was too early to say what other measure could be taken to pare back costs, the staff representative stated. It should be noted, however, that the proposed construction budget was based on estimates that reflected the middle range of the market cost of each component. When bids were received, it was hoped that in many cases the low bid would be acceptable.

One of the first lines of cost control was managing the construction budget, the staff representative observed. Every part of the project would go out to bid. The Fund staff, the architects, and the contractor would jointly review each bid and decide on which bid to accept. Thus, at each stage, for every item, the Fund was in full control of costs. Moreover, each bid would be fixed-price so that the subcontractor bore the burden of any cost overruns.

Changing the 19th Street entrance was estimated to cost $2.5 million, the staff representative from the Administration Department stated. Part of the rationale for that change was building security. The staff had been advised that if a car bomb exploded under the porte cochere, the atrium could be destroyed and the damage to those in the atrium and in the offices overlooking it would be severe. In addition, during Interim Committee and Annual Meetings, there was considerable crowding around the front entrance. The design changes aimed at improving security and opening up the area.

Mr. Jiménez de Lucio said that he had some difficulty understanding the various construction costs for Phase III. It was important that all factors bearing on costs be presented in an integrated and transparent manner. For example, costs strictly associated with Phase III should be separated from costs for improvements to Phases I and II. Phase III costs could then be divided by the number of incremental staff to be housed, rather than by varying figures regarding square footage, so as to facilitate comparisons.

The staff representative from the Administration Department remarked that the widely divergent figures regarding comparative cost reflected the complexity of the task and the factors to be taken into consideration. For example, owing to zoning, Phase III included a landscape plan and an expanded Visitors' Center; in comparing construction costs, should such items be included? Moreover, as part of the landscaping plan, all of the space under the current sidewalk had to be waterproofed; should that cost, which would have been incurred in any event, be excluded from the cost of landscaping? The treatment of overlapping items was particularly difficult. For example, the cost of renovating the kitchen in Phase I owing to the addition of Phase III had been included in the construction costs, but most of the equipment in the existing kitchen, which was built in 1970, would have to be replaced in any event. In presenting cost estimates, the staff had attempted to capture the complexity of the issue and to avoid over-simplification that could be misleading.

Mr. Fukui said that he agreed that the decision on Phases III and IV should be taken up separately. As to Phase IV, he was very much inclined toward purchasing a new site rather than leasing space from a financial standpoint. If the two decisions were taken separately, and in view of the fact that the PEPCO building would not become available until 2004, he wondered whether that would allow more time to intensify the search for a suitable purchase site.

The staff representative from the Administration Department explained that the Fund had signed a letter of intent regarding the nearby site. As part of that letter of intent, the Fund was committed not to negotiate for alternative sites. If the Board desired to explore other options, it would first have to foreclose the Cafritz option. Currently, the Fund was contractually bound to decide whether to purchase the Cafritz site within 90 days. Within the coming week, it was expected that the letter of intent would be converted into a contract, and that during the subsequent 90 days, the Fund would have to undertake further legal and environmental studies, at some cost to the Fund. At the end of that 90-day period, it was unlikely that the staff would know anything more about prospective sites than it did at present.

The Director of Administration remarked that the terms of the purchase arrangement for the Cafritz site were probably as good as could be obtained for a comparable building site. It could therefore be regarded as a proxy for any other site of similar size, similarly located. While it was possible that another site might become available that was somewhat closer to headquarters than the Cafritz site, it would not be as close as the PEPCO building.

The price that had been negotiated for the Cafritz building was a good one, and the price per square foot of a comparable building would probably tend to be higher, the Director of Administration observed. Delaying a decision was therefore unlikely to be of any advantage in that respect. Moreover, the staff could not guarantee that the George Washington University would commit itself to a long-term lease of the kind that the staff envisaged, because it had never been asked to make a firm commitment on that basis. A delay there risked losing that option, especially as the PEPCO lease approached its end. One advantage of early action by the Fund with respect to the PEPCO building was that once an agreement was reached, the Fund could start negotiating with PEPCO on vacating the building before its lease expired in 2002.

The Acting Chairman remarked that at one stage the staff had considered the option of buying and holding the Cafritz site, while continuing to explore other options. In the end, the staff had decided not to include that possibility in the papers before the Committee because it represented a departure from the Fund's traditional approach to land acquisition. The buy-and-hold option could be put back on the table, if Directors so wished.

Mrs. Wagenhoefer stated that she could go along with separating the decisions on Phase III and Phase IV. In that regard, she would be pleased to see construction on Phase III commence as early as possible. In that connection, she wondered what was the probability that the closing of the alley between the headquarters building and the church would be approved.

As to Phase IV, she was inclined to give up the nearby site option, Mrs. Wagenhoefer remarked. For reasons clearly pointed out by the staff, she would prefer to see the Fund pursue the PEPCO option. In that regard, she wondered how firm the PEPCO leasing option was.

The staff representative from the Administration Department said that the Fund's external legal counsel had advised the staff that the prospects for obtaining the alley closing were good. All impediments to a favorable finding had been removed. Although the alley closing had been used as a means to keep the church from moving to its new site, the church would be moving on April 17. A hearing would be held on the alley closing on April 22, and the staff was confident that it would be approved. If not, the staff had sought the Board's approval for pursing the matter in court.

The staff had a gentlemen's understanding with the George Washington University, the staff representative continued. The University had indicated an interest in a $55 million payment for a 60-year lease and had committed itself to informing the Fund if it received another offer. As the staff had not heard from the University, it assumed that the agreement was still viable. It should be noted that the staff had also considered the option of buying and holding the Cafritz site in order to strengthen the Fund's bargaining position with respect to the PEPCO option.

As to leasing part of the future IFC building, it would be difficult to get a signed agreement for some time, and then the Fund would be competing with the World Bank for space, the staff representative from the Administration Department commented. A firm agreement with the IFC was unlikely for at least two to three years.

The Director of Administration said that his counterpart in the Bank had indicated an interest in the IFC building. Because of the recent controversy regarding its construction project, the Bank was unlikely to pursue another building project for several years. In the circumstances, the Bank would be competing aggressively for leased space on relatively favorable terms from an entity that did not pay taxes, such as the future IFC building. In view of the close relationship between the Bank and the IFC, it was likely that the IFC would tend to favor the Bank's bid in any competition for leased space.

The Committee on the Budget agreed to adjourn and to resume its discussion in the afternoon.

The staff representative from the Treasurer's Department said that it would be useful to clarify the relative costs of the Phase IV options, especially in terms of their effect on the budget. Once Phase III was completed, the cost of housing 700 staff members under a commercial lease would be $11.1 million, which would need to be absorbed on an annual basis in the budget. The cost to house the same 700 staff on a nearby site would be $3.3 million on an annual basis, which would also have to be absorbed in the budget. The cost to house the same staff under the PEPCO leasing option would be about $5.5 million, which would have to be absorbed in the annual budget over time. In contrast, the cost of purchasing land--namely, the Cafritz site--would be considered as an exchange of assets and would not be absorbed in the budget, because the value of land did not diminish. The cost of holding land would only be reflected in a marginal increase in the cost of remuneration.

Looking at the impact of the three options on the annual budget, commercial leasing was almost three times as expensive as ownership, and about twice as expensive as the PEPCO lease, while the PEPCO lease, compared to outright ownership, was about 50 percent more expensive, the staff representative from the Treasurer's Department commented. Table 2 of EBAP/94/9 set out the budgetary effects of the three options, including the impact in terms of basis points.

Mr. Abbott observed that even if there was an exchange of assets, when cash that was currently lent out to members and earning an SDR rate of return was invested in a piece of property, the opportunity cost had to be considered. In his view, present value calculations would be more meaningful than the staff's presentation.

The staff representative from the Treasurer's Department said that it was true if cash was exchanged for another asset, the cost of remuneration would increase. The impact, however, would be minimal. For example, for the acquisition of the Cafritz site, it would be about two tenths of a basis point. That effect would be mostly lost in the rounding when setting the rate of charge.

There was a secondary effect, the staff representative from the Treasurer's Department commented. Since ownership or a long-term lease was considerably less expensive than commercial leasing, within a certain period, the effect on remuneration would be reversed, because the cash outlays for leasing--in the order of $11.1 million--would not be incurred.

Mr. Abbott remarked that it still was not clear to him that on a per square foot basis, reduced to present value calculations, and factoring in various considerations, including the opportunity cost of money, there was much advantage to a long-term lease on the PEPCO building compared with commercial leasing.

The staff representative from the Treasurer's Department observed that comparing columns 3, 4, and 5 of Table 2, the total net present value of the nearby site and the long-term PEPCO lease was $28 million and $13 million less, respectively, than commercial leasing. That calculation took into account a significant amount of interim rental cost, which pushed up the net present value cost of both options. At occupancy, when there would be no more interim rental costs, those two options were much more attractive than commercial leasing.

The annual charge to income as presented in that Table was all inclusive, the staff representative explained. The amount charged to the budget, in the case of leasing, included the amortization of the PEPCO building over 60 years as well as the amortization of the fit-out costs. In addition, the estimated costs of keeping the respective properties in a comparable condition had been included--namely, set-aside amounts to periodically renew the buildings.

Since the adoption by the Fund of depreciation accounting, assets such as land and buildings would be capitalized and would be depreciated over their estimated useful life, the staff representative from the Treasurer's Department stated. Because there was no residual value for the lease at the end of the period, the full amount of the lease had to be absorbed in the Fund's income statement, whereas with ownership, no pro rata depreciation charge was needed because the land was not likely to diminish in value. The opportunity cost of the monies invested in purchasing the land were reflected in the total net present value costs as well as in the computation of the effect in basis points and the annual charge to income.

Mr. Fernando said that in his view, the advantage of the nearby site was that it would be available for occupancy much earlier than the PEPCO site. That meant a savings in commercial leasing costs, but it would also require a quick decision to go into construction on the site.

The staff representative from the Treasurer's Department observed that two factors made the nearby site more attractive than leasing. One was the fact that the costs of land ownership did not flow through the Fund's income statement. The second was that the nearby site would be available much earlier than the PEPCO site.

Mr. Fernando commented that currently, the Fund was leasing 530,000 square feet of space: 500,000 at International Square and 30,000 at 2121 K Street. He would be interested to hear how much of the leased space at International Square came up for renewal in 1998 and how much was available up to 2001.

The staff representative from the Administration Department said he wished to clarify that currently, the Fund was leasing approximately 470,000 square feet of space at International Square and about 60,000 square feet of space at 2121 K Street. One lease at International Square, for approximately 300,000 square feet, would expire in January 1998 and was designed to coincide with the completion of Phase III. A second lease, for approximately 170,000 square feet, would expire in 2002. The lease for K Street was for five years and renewable.

The Fund owned and leased enough space for the current authorized staffing level shown in Table 1 of EBAP/94/9, the staff representative from the Administration Department stated. When Phase III was completed, approximately 180,000 square feet of space at International Square would be released. The reason for the difference in footage between Phase III--about 325,000 square feet of office space--and that released at International Square, was that at International Square, the Fund only leased the space occupied.

Mr. Jiménez de Lucio remarked that in view of the high cost of commercial leasing, even if the Committee did not reach a decision on Phase IV at the current meeting, it should return to the matter in the near future. As to the alternatives for Phase IV, he was inclined to forgo the nearby site. In that regard, he would be interested to know the walk-away costs and whether they would change if a decision was delayed for a few weeks.

It was clear from the discussion that the PEPCO building was the preferred choice because of its proximity to the existing headquarters, Mr. Jiménez de Lucio commented. It would be useful to put a value on that proximity so as to be very clear about the premium that would be paid vis-à-vis other alternatives.

Mr. Kafka said that in his view, the Committee should come to a decision to proceed with Phase III. As to Phase IV, the Cafritz option should not be given up until a decision had been reached on the PEPCO building. He was somewhat uncertain about the position to be taken with respect to International Square; possibly the Fund should assure, through an additional lease term, that it would have the space needed after 1998 for housing its staff.

Mr. Kaeser remarked that he shared the views of Mr. Kafka and Mrs. Wagenhoefer.

He understood that the construction cost of Phase III was $230 per square foot in current dollars, Mr. Kaeser stated. He had difficulty understanding how that cost estimate could be brought down to $160 per square foot under different assumptions, as was suggested in the staff paper. He also wondered to what extent the Board would be involved in cost control. According to EBAP/94/15, an internal unit would review cost slippages and would refer matters to the Board only if they could not be resolved within the unit. In his view, the Board should be involved more deeply in the control of the building project and should review progress periodically, say, every three or six months. It would also be useful in assuring double checking on project developments through the architect.

Mr. Havrylyshyn said that his chair favored proceeding with Phase III. One important argument at the current stage was that any further delays could be problematic and perhaps costly. On Phase IV, he was inclined to favor the PEPCO option unless he heard compelling reasons why other alternatives might be better, and feasible, in the short run. He would be concerned about lengthy delays to explore further alternatives, such as leasing space in the future IFC building.

On balance, the advantages of the PEPCO site included proximity and an opportunity that might not again be available, Mr. Havrylyshyn stated. Moreover, while the costs were somewhat higher than ownership, they were by no means prohibitively higher in terms of annual charges. The PEPCO option also offered some degree of flexibility: if some space was not needed, it could be easily leased.

It was clear that the Fund was not in a good negotiating position with respect to buying the PEPCO site because of the University's unwillingness to sell at any price, Mr. Havrylyshyn commented. The Fund's advantage might lie in the fact that the University was probably looking for a client that was willing to take a long-term lease of the entire building.

As to Phase III construction costs, he concurred with Mr. Kaeser on the importance of a more explicit role for the Board in the control process, perhaps through periodic progress reports, Mr. Havrylyshyn remarked. On other costs, he wondered why architectural design costs came out to be exactly $25.9 million for all options.

The staff representative from the Administration Department said that it was difficult to estimate design costs for all sites, except Phase III, where the exact cost was known. As the nearby site, Phase III, and the PEPCO building were similar in size, it was assumed that there would be repetitive design costs.

As to the PEPCO lease, it should be noted that the University was looking for a considerably shorter term than 30 or 60 years, the staff representative from the Administration Department commented. The staff was seeking a longer period that would allow for exhausting renovation costs, namely, about 30 years.

Mr. Mwananshiku observed that discussions of the Fund's future space needs dated to June 1987, when the Executive Board approved the first expenditure to study the feasibility of acquiring the Western Presbyterian Church site as a preparatory step to the construction of Phase III. Since that time, more financial resources had been expended on acquiring the site, building a replacement church, and obtaining zoning approval. However, for one reason or another, the Executive Board had not been able to approve the construction of Phase III. In the meantime, the need already evident in 1987 had become even more compelling with the expansion in Fund membership and the intensification by the Fund of its collaboration with its membership in the context of increased surveillance and programs. Consequently, the number of staff and staff positions had grown, including the size of the Executive Board itself.

Tables 1 and 2 of EBAP/94/9 showed the consequential challenge facing the institution in terms of space needs, Mr. Mwananshiku stated. Whereas space was needed for a staff of about 3,040, the existing headquarters building could house only 1,800. The remaining 1,300 staff were to be housed in leased space, at considerable cost to the Fund. Even if the Fund were to reorganize itself and reduce the number of staff positions, it would not be possible to eliminate some 1,300 staff positions without affecting the efficiency of the institution. He therefore believed that the problem of additional space was real and must be addressed in a serious manner.

The staff had provided a number of options for dealing with the problem, Mr. Mwananshiku commented. From Table 2 of EBAP/94/9, it was clear that the only feasible option was Phase III. All other options were more expensive or impractical at the moment. In fact, construction of Phase III would reduce the remaining problem, especially if it was supported by a freeze on new positions over the coming few years and a selective reduction in the number of existing vacancies. The remaining space requirements could then be provided by either taking advantage of the PEPCO option, which could also provide for any future growth in the size of the Fund, or by leasing reduced space. With the Fund having reached universality in its membership, it was unlikely that future expansion would be substantial.

With regard to the Phase III construction budget, the estimates were reasonable in the current circumstances, Mr. Mwananshiku considered. If the project had been implemented earlier, the cost would have been lower. If it was again delayed, the cost would only increase further.

As to control over Phase III construction, the arrangements described in EBAP/94/15 appeared satisfactory, Mr. Mwananshiku remarked. The Executive Board and the Committee should be kept informed about the progress of the project and any difficulties that might arise in its execution. He supported the implementation of Phase III.

Ms. Lissakers observed that the interim rental cost associated with the PEPCO option appeared to be $148 million, namely, the net present value of leasing commercial space until 2004, when the PEPCO building would be available for occupancy. That also appeared to be the upper limit for a purchase offer on the PEPCO site, if PEPCO vacated the building before its lease expired. If her calculations were correct, the Fund appeared to have considerable bargaining leverage vis-à-vis the University.

The staff representative from the Administration Department said that if the PEPCO site could be made available at approximately the same time as the lease at International Square expired, say, 1998, the Fund would save approximately $10-11 million a year for the period 1998-2004. It would be unrealistic to assume an earlier occupancy of the PEPCO building. PEPCO currently paid an annual rent of about $1.5 million. That amount would be one measure of the cost of buying the PEPCO building--say, $1.5 million a year for four to five years.

Responding to Ms. Lissakers's suggestion that the Fund offer PEPCO the Cafritz site, the staff representative from the Administration Department observed that PEPCO would need much more space than offered by that site. As PEPCO was spread out in several buildings, it was likely that it would seek to consolidate its staff when it relocated. The possibility of purchasing another site for the purpose of a swap with PEPCO could, however, be explored before entering into negotiations on an early occupancy of the PEPCO site.

Ms. Lissakers remarked that as the Fund was about to embark on a major building project, she wondered whether it would be feasible to undertake a second large building project simultaneously.

The staff representative from the Administration Department said that a second major construction project could be managed by hiring more outside help for that purpose. However, the greater the reliance on non-Fund staff, the less the control over the project.

Mr. Al-Jasser observed that whereas 600 staff were housed in 180,000 square feet at International Square, they would occupy some 400,000 square feet in Phase III. The ratio of staff to gross space seemed to be large.

The staff representative from the Administration Department remarked that the comparable figures were 180,000 and 325,000. However, the square footage for Phase III included the cafeteria expansion, an atrium, a large Visitors' Center, an auditorium, and multipurpose rooms. The square footage for International Square represented office space only.

Mr. Kafka recalled that when the Board first started thinking about Phase III, he had asked whether the design would be put out to international bidding. At the time, he had been told that the design had to fit into the design of Phases I and II. He wondered whether the design of any Fund annex would be put out for international bidding.

The staff representative from the Administration Department said that because the design of Phase III had to fit Phases I and II, it was more cost effective to use the same architectural firm to finish the headquarters complex. The selection of the construction manager/general contractor had, however, been accomplished through international bidding. If the Fund were to undertake another building project, it would put both the design and the construction to international bidding.

Mr. Wei remarked that he could endorse Phase III. On Phase IV, he supported the purchase of the nearby site because of the lower financial cost to the Fund.

Ms. Gaseltine stated that her chair wished to reserve its position on Phase IV. It was clear that the Committee was far from a perfect solution, and her chair would make its position on the matter clear at the subsequent Board discussion.

On Phase III, she shared Ms. Lissakers's concerns about the cost of construction vis-à-vis comparable buildings, including the World Bank's and, on the basis of current tentative numbers, the IFC's as well, Ms. Gaseltine continued. She appreciated the constraints imposed by zoning requirements and the desire to match the building design and quality of Phases I and II, but she expected that some of those constraints also applied to the World Bank and the IFC buildings. On a specific point, she would have liked to see some cost-benefit analysis regarding the Fund's concrete ceilings, particularly to demonstrate their effectiveness in terms of ease of future renovation, as they represented a large initial up-front cost.

She agreed that the construction budget needed to be realistic, but at the same time, it must represent a discipline to encourage cost consciousness in those involved with the project, including an early identification of possible areas for savings, Ms. Gaseltine remarked. Specifically, she hoped that incentives had been built into the fee structure for the construction manager and general contractor to ensure that their interests matched the Fund's. She also supported Ms. Lissakers's views on control mechanisms. The World Bank experience showed a crucial need to ensure that accountability was clear, including overall accountability, so that neither overlap nor, more important, gaps in responsibility, occurred. She agreed that the Board should monitor progress closely and, as Mr. Mwananshiku had suggested, that the Committee would be a suitable forum for that purpose.

The Director of the Office of Internal Audit and Review said that all the reports on the Western Presbyterian Church project prepared by the Office of Internal Audit and Review had been released to management, to the department involved, and to the External Audit Committee. Under the Fund's By-Laws, the External Audit Committee visited the Fund once a year, supported by external auditors. The External Audit Committee had access to all the audit reports of the Fund.

Regarding specifically the Church project, when in 1988 the Board approved the project, it approved an overall, the Director observed. Moreover, the Church project was initiated before the June 1993 revision of General Administrative Order No. 2 to enhance budgeting and expenditure control. The project was also initiated before the Office of Budget and Planning was reorganized in 1992 and before the emergence of problems with construction projects in other international institutions.

Since 1988, the control mechanisms for the Church project had been strengthened, the Director of the Office of Internal Audit and Review stated. Two audits had been conducted, one in 1992 and the other in 1993. Another audit was being prepared, and the project appeared to have been carried out within the budget. That report would be reviewed by management and then by the External Audit Committee. Once the project was completed--when final expenditures were made and the Church had moved to its new location--an overall project audit would be conducted.

The Acting Chairman said that the question of making audit reports available to the Board would have to be taken up as a general policy issue as that had not been the practice in the past.

The general lessons gained from the experience of other international financial institutions were reflected in the control system that had been put in place to oversee Phase III construction, the Acting Chairman observed. More generally, the Fund's concern about tightening budget controls was reflected in the revisions made to its internal budget and planning process as well as to internal procurement practices over the past three or four years.

Ms. Lissakers remarked that the creation of the Committee on the Budget was also part of the improved budgeting and control process, and in that light, it might be appropriate to circulate audit reports to the Committee. With regard to the conclusion of the Church project (WPC) audit, according to EBAP/94/15, "since the beginning of FY 1993, four formal audits on WPC and Phase III projects have been concluded." She wondered whether those were partial audits.

The Director of the Office of Internal Audit and Review said that the first audit report on the Church project, in 1992, had recommended that the responsibility of the parties involved in the "de-construction" and construction of the Church should be defined more clearly. The second audit, in the beginning of 1993, had focused on how to better define estimates to complete the project, had introduced a new control mechanism, and had codified the reporting system between the construction manager and the Office of Budget and Planning. The forthcoming audit, to be finalized once the project was completed, would be a summary of the project experience.

Mr. Al-Jasser remarked that he agreed with Ms. Lissakers that when the audit was completed, the question of circulating it to the Board or to the Committee should be revisited. As the Fund was embarking on a large building project, it would be beneficial to members of the Committee as well as the Board to consider the lessons to be gained from the Church project.

Ms. Lissakers observed that as the Board, together with management, had responsibility for budget decisions, it should analyze carefully their results. The failure to do so might explain why some other institutions had run into serious problems in that area. The Fund should not put itself in a similar position.

The Director of the Office of Internal Audit and Review observed that the recommendations of the External Audit Committee, which was appointed by the Governors and by the Executive Board, were reported to management, to the Executive Board, or to the Board of Governors. The previous External Audit Committee had looked at the Fund's space needs and at Phase III, and it was expected that the forthcoming external audit would address those issues. Moreover, the Board would be informed periodically about progress on Phase III construction in the context of staff reports on the capital budget and on the medium-term budget outlook.

Mr. Cailleteau said that he broadly supported the views of Mr. Kaeser, Mr. Kafka, Mr. Havrylyshyn, and Mrs. Wagenhoefer.

Mr. Kaeser stated that he supported Ms. Lissakers's request regarding audit reports.

Mr. Jiménez de Lucio said that in addition to his question on walk-away costs, he would be interested in the cost of moving the entire staff to a suburban headquarters, compared with undertaking Phases III and IV.

The staff representative from the Administration Department remarked that if the Fund walked away from the Cafritz site option that day, the only costs incurred would be the current "sunk" costs--namely, the cost of space planning and design work, as well as legal fees--of about $150,000. If the contract continued for 90 days, the Fund could withdraw at no cost other than the sunk costs, which would increase during that period to about $300,000. After the 90-day period, the Fund would face forfeiture costs if it failed to complete the purchase transaction.

As to other questions that had been raised, on assuring space at International Square, the Fund could renew either or both leases, the staff representative from the Administration Department commented. On reporting to the Board on Phase III construction, it should be noted that the proposed decision on Phase III provided for periodic reports. On the cost of the Fund's ceilings, he recalled that renovation costs for the headquarters building had been $15 per square foot, whereas renovation costs for a typical building with a hung ceiling was about $30 per square foot. Depending on the frequency of renovation, the Fund's ceiling construction quickly provided a payback.

The staff representative from the Treasurer's Department stated that Table 2, column (6) indicated the costs of building a suburban headquarters and the annual charge to income. Assuming a number of hypothetical variables--for example, selling the current headquarters building for the assessed value of about $190 million--the total cost on an annual basis would be about $12 million, to be charged to the budget. That was about $1 million less than all other options combined.

For the nearby site, the residual value of land had been included in the total net present value cost of that option, the staff representative from the Treasurer's Department remarked. A number of assumptions had to be made regarding the appreciation of land in order to make a comparison with other options.

The Acting Chairman observed that Committee members supported proceeding with Phase III. He did not see support for the Cafritz option. Moreover, there was not much to be gained from keeping that option open for a 90-day period in view of the additional expenses that would be incurred and the fact that the Fund would be precluded from negotiating with the University, PEPCO, or the IFC, during that period.

The staff would enter into discussions with the University and PEPCO regarding the early leasing of the PEPCO site, and with the IFC to clarify the IFC option and its comparative cost, the Acting Chairman remarked. As to the buy-and hold option, it had not received much support and, in the staff's view, it could prove expensive if it failed to influence other negotiations as envisaged.

Mr. Al-Jasser said that he shared concerns about the Fund's negotiating position vis-à-vis the University. He would be much more comfortable if the buy-and-hold option were pursued before entering into negotiations on the PEPCO building.

Mr. Marino remarked that it would be helpful to know the impact of the buy-and-hold option on the rate of charge. He agreed with Mr. Al-Jasser that the best option was ownership, and he therefore supported the purchase of the nearby site or the PEPCO building.

Mr. Wei said that he fully agreed with Mr. Al-Jasser on the advantages of ownership. Even if the Fund's staffing requirement declined in coming years, the surplus space provided by an additional building could be leased out.

The Director of Administration remarked that from an investment viewpoint, the Cafritz option offered the best return. If, however, the concern was maintaining an effectively functioning institution, proximity became an important factor. The cost comparisons in Table 2 did not attempt to place a value on proximity. There were, however, direct financial costs associated with housing the staff some distance from the headquarters building. Experience with International Square showed that cost in terms of staff time lost in shuttling between the two buildings and the need to duplicate services at each site. Moreover, the provision of a shuttle service between buildings not only had failed to ameliorate such inconvenience, it had also proved to be expensive.

Ms. Lissakers observed that the risk associated with the buy-and-hold option was that if the University was determined not to sell, the Fund would end up holding a site that was less than optimal. In her view, it did not make sense to tie up resources with the buy-and-hold option at the current stage.

Mr. Kafka asked whether there was any way that the Fund could assure itself of a fallback position before starting negotiations on the PEPCO site without giving up the Cafritz option.

The Director of Administration stated that the Fund had a contractual obligation with the owners of the Cafritz building that precluded negotiations on other properties. The agreement also assured the Fund an established price for the Cafritz building, to which the owners were bound. The Fund therefore could not explore other options until a decision had been reached on the Cafritz option.

The Acting Chairman said that the staff had entered into an agreement on the Cafritz building in order to present to the Board as concrete a set of options as was possible. In that connection, it was for the Board to decide the advantages of proximity versus ownership. Although some speakers had indicated their strong support for pursuing the Cafritz option, there did not appear to be broad support for that option.

Mr. Waterman said that he was also concerned about a fallback position in the event that the PEPCO leasing arrangement proved to be too expensive. He wondered what other options might be available in that event.

The Director of Administration remarked that the alternative was to continue with commercial leasing while pursuing the possibility of leasing space in the new IFC building.

As to the prospects for obtaining the PEPCO site, a figure of $55 million had been discussed by the University's Finance Committee, and the University was ready to negotiate with the Fund on that basis, the Director of Administration commented. But it was not clear how long that offer would hold if the Fund delayed entering into an agreement with the University. It should be noted that the sum of $55 million had been reached with the help of real estate experts, and it was unlikely that a better price could be negotiated at a later time. As the Fund would be leasing the land and buying the building, which in due course would revert back to the University, overall costs were less than for commercial leasing of an entire building.

The staff representative from the Treasurer's Department, commenting on the cost of the buy-and-hold strategy, said that there would be no administrative cost in holding the land, because there would be no depreciation. While it was difficult to quantify exactly the impact on remuneration expense--which depended on a number of variables such as outstanding Fund resources and SDR interest rates--the estimated effect on the rate of charge would be less than half of one basis point.

Mr. Rainford remarked that in his view, the buy-and-hold strategy involved a relatively costless switching of assets and could increase the prospect of negotiating a better deal with the University on the PEPCO site. Moreover, it provided the Fund with a fallback position. His chair would be interested in supporting an approach that allowed such flexibility, without necessarily going to the point, as suggested by Mr. Al-Jasser in support of Mr. Jiménez de Lucio, of taking a decision up-front on a buy-or-leave approach.

Ms. Lissakers observed that under the buy-and-hold option, there was no guarantee that the Fund would be able to sell the property at the same price as was paid for it. There was thus some downside risk beyond the carrying cost. Moreover, if the University refused to sell under that scenario, the Fund might have to build on the Cafritz site, an outcome for which there was little support in the Committee. She understood that the World Bank had used the buy-and-hold strategy in the past and would be interested to know more about its experience with that technique.

The staff representative from the Administration Department remarked that the Bank had not purchased with the objective of strengthening its negotiating position but rather in anticipation of its need for additional space.

The Director of Administration observed that the Fund had in the past secretly purchased property in the area in which it had no real interest so as to have some leverage in dealing with the George Washington University, which owned several parcels in the block where the current headquarters building was located. Thus, the Fund had, in fact, successfully used the buy-and-hold strategy, but under different circumstances.

Mr. Al-Jasser said that if the Committee was to recommend forgoing the Cafritz site, it was locking itself into a long-term lease of the PEPCO building, which appeared to be an expensive option. On another point, there was nearly a $10 million difference between the present value of the land and building and the total cost of the PEPCO option, suggesting that the residual value at the end of the leasing period was only $10 million, which appeared to be overly conservative.

The staff representative from the Treasurer's Department explained that in computing net present value, the staff had assumed that the value of land would increase at a real rate of 1 1/2 percent. That real rate of increase was less than had actually been experienced in the downtown area in Washington--around 3 percent in real terms--and also somewhat less than consultants' forecasts of the real appreciation of land over the coming three to five years. The residual value of land was certainly higher than the acquisition costs of $61.7 million, which was assumed, and it was certainly more than the $10 million that Mr. Al-Jasser suggested would be represented in the net present value computation.

Although it was difficult to predict the residual value of a building in the coming 60 years, the staff had assumed for the purposes of its computations that the building would remain in good condition, and it had also assumed an upkeep cost of the building, the staff representative from the Treasurer's Department remarked. It had further assumed that the building would be "consumed" after a 60-year period. Thus, there was no or little residual value for a 60-year old building in the staff's calculation.

Mr. Waterman said that apart from the present value calculation, he assumed that the University would be getting a building in reasonably good condition at the end of the lease arrangement.

The Director of Administration observed that a commercial developer or a commercial real estate holder usually viewed a 40-year old building as a candidate for demolition. In that context, it should be noted that the purchase price of the Cafritz building included the cost of demolition.

Mr. Marino remarked that the Fund had already incurred some of the transaction costs involved in acquiring the Cafritz site. Moreover, the staff believed that the Fund was getting a good deal on the property, based on expert advice. He therefore doubted that there was much downside risk to the buy-and-hold option. He would be interested to know what additional costs would be incurred under that option.

The staff representative from the Administration Department recalled that the transaction cost through the 90-day period could amount to $300,000. The cost of the land was about $62 million. The cost of holding the land for an indefinite period of time had not yet been calculated.

Ms. Lissakers said that she would like to see a short staff paper exploring the buy-and-hold option so that the Committee and the Board would have some concrete information on its potential costs before taking a decision on Phase IV.

Mr. Havrylyshyn commented that he saw three possible benefits to the buy-and-hold option. The first was negotiating leverage vis-à-vis the PEPCO site. That benefit appeared to be negligible in view of the University's unwillingness to sell, at least at a reasonable price. The second was negotiating leverage vis-à-vis lowering the cost of leasing the PEPCO site. He would be interested to hear the staff's views on the prospects in that regard and the possible extent of savings. The third benefit was ownership. In that regard, he would be interested to have an assessment of the value of proximity. For that purpose, he would be interested to know the estimated value of the PEPCO property at the end of 60 years; and, if the Fund was to invest the $6.7 million savings from the purchase option, how much more would have to be invested annually under the leasing option to realize the equivalent increase in assets.

The staff representative from the Treasurer's Department remarked that a comparison of column 4, the ownership option, and column 5, the leasing option, in Table 2 gave an idea of the cost differential--assuming that the Cafritz building was a proxy for every ownership option--namely, about $2 million. The opportunity cost of leasing versus buying was therefore likely to be about $2 million a year. The opportunity cost of holding the land would not be reflected in the annual administrative budget; instead, it would be reflected in a marginal increase in the rate of charge--less than one half of a basis point--which would translate into remuneration payments equal to about $1 million.

Mr. Jiménez de Lucio said that he shared Mr. Havrylyshyn's concern about the value of proximity. As to negotiations with the University regarding the PEPCO site, he understood that the leasing cost--$55 million--was part of a gentlemen's agreement that needed only to be formalized. In that event, the value of a fallback position was almost irrelevant.

Mr. Waterman remarked that he would welcome more time to consider the options for Phase IV. Moreover, he would be prepared to spend an additional $150,000 to keep the Cafritz site option open, if it helped the Board to reach the right decision. Nonetheless, he shared Ms. Lissakers's concern about the possibility of getting involved in two construction projects at the same time.

The Director of Administration said that under the buy-and-hold option, the Fund would be paying $61.7 million for the Cafritz site, free of its existing building. The site would then be held, unless it was decided to use it as a parking lot, until a decision on Phase IV had been reached. The purchase would not involve acquiring any additional building rights; if a decision was taken to build on the site, only the exterior design would have to be approved by the city government.

The Acting Chairman stated that while there was a clear preference for leasing the PEPCO building, some Committee members were strongly attracted to the buy-and-hold option as a fallback option. In view of the broad consensus at the current meeting on Phase III, he suggested the proposed decision on Phase III be circulated to the Board for approval on a lapse of time basis. As to Phase IV, the staff would prepare a brief background note on the buy-and-hold option, including the costs and risks of that strategy, which aimed at strengthening the Fund's negotiating position vis-à-vis the George Washington University, and offered an insurance policy in the event that the University decided not to lease the PEPCO building to the Fund. It was hoped that the Board could reach a decision regarding Phase IV in the coming week.

The Committee accepted the Acting Chairman's suggestion and adjourned its meeting at 5:00 p.m.

APPROVAL: September 23, 1994