HOTEL THAYER, U.S. MILITARY ACADEMY,
WEST POINT, NEW YORK

Report No. 94-196

September 27, 1994

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Department of Defense

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Acronyms

CFSC  Army Community and Family Support Center
MWR  Morale, Welfare, and Recreation
NAF  Nonappropriated Fund
RFP  Request for Proposal
MEMORANDUM FOR AUDITOR GENERAL, DEPARTMENT OF THE ARMY

September 27, 1994


We are providing this report for your review and comments. The report discusses the proposed privatization (public/private partnership) contract for renovation and operation of Hotel Thayer, U.S. Military Academy, West Point, New York. The audit was requested by Senator Joseph I. Lieberman. A separate report is being issued to discuss allegations of possible manipulation in the process to select a contractor to renovate and operate Hotel Thayer. Management comments on a draft of this report were considered in preparing this report.

DoD Directive 7650.3 requires that all audit recommendations be resolved promptly. Therefore, we request that you provide final comments on the two unresolved recommendations by November 28, 1994.

The courtesies extended to the audit staff are appreciated. If you have any questions on this audit, please contact Mr. Michael A. Joseph, Audit Program Director, at (804) 766-9108 or Mr. James H. Beach, Audit Project Manager, at (804) 766-3293. The distribution of this report is listed in Appendix F.

David K. Steensma
Deputy Assistant Inspector General
for Auditing

This special version of the report has been revised to omit source selection and contractor confidential or proprietary information.
INTRODUCTION. In 1987, the U.S. Military Academy (the Academy) determined that Hotel Thayer, West Point, New York, a nonappropriated fund instrumentality located on Academy grounds, needed renovation. The Academy determined that a privatization approach, that is, a public/private partnership, was the most feasible way to renovate and expand the hotel. Awarding the privatization contract to renovate, expand, and operate the hotel has been delayed for nearly 6 years because of a protest concerning criteria used to evaluate proposals, reinstatement of the protesting offeror, and continued allegations of favoritism and manipulation of the award process. Our review of allegations of favoritism and manipulation will be addressed in a separate report.

The proposed renovation and expansion of Hotel Thayer would result in a *-room conference center, for a total cost of $ * million. To finance the $ * million project, the offeror would receive $1 million from the Army Morale, Welfare, and Recreation Fund and would receive $ * million from a sale of * bonds, and would provide $* million in owners’ equity.

OBJECTIVES. The primary objective of this congressionally requested audit was to determine whether the decision to contract for renovation, expansion, and operation of Hotel Thayer was appropriate. The audit also evaluated whether the contract solicitation and contractor selection to renovate and operate the facility were proper. Further, we evaluated the internal controls applicable to the contracting process.

AUDIT RESULTS. Although Hotel Thayer needed renovating, the proposed renovation and expansion project exceeded the needs of the Academy and was based on overly optimistic financial projections. The solicitation for the renovation and expansion project did not adequately describe the Academy’s needs. If the Army Community and Family Support Center awards the proposed contract, the Army Morale, Welfare, and Recreation Fund would face a potential liability of $ * million if the developer defaulted during or after construction. While we see no problems with privatization, the proposal selected for contract award to renovate and expand Hotel Thayer exposes the soldiers’ Army Morale, Welfare, and Recreation Fund to undue risk. This project will benefit less than 1 percent of the military personnel, and will be of little benefit to enlisted personnel.

Review of the contractor selection process since reopening of competition as a result of the Army Review Boards recommendations in 1990 showed that appropriate evaluation and selection procedures were followed. The audit did not identify any material internal control weaknesses.

POTENTIAL BENEFITS OF AUDIT. Implementing the audit recommendations will reduce the risk to the Army Morale, Welfare, and Recreation Fund.

* Contractor confidential or proprietary data has been deleted
Summary of Recommendations. We recommend that the Commander, Army Community and Family Support Center, cancel the request for proposal to renovate, expand, and operate Hotel Thayer, or modify the request for proposal to eliminate or greatly reduce the risk to the Army Morale, Welfare, and Recreation Fund associated with guaranteeing the developer's loan or bond issue. We also recommend that the Superintendent, U.S. Military Academy, perform an in-depth analysis of other less costly alternatives to renovate Hotel Thayer.

Management Comments. The Army nonconcurred with the initial recommendation to cancel the request for proposal or modify the request for proposal to remove all risk to the Army Morale, Welfare, and Recreation Fund, stating that the current proposal is financially viable and does not expose the Fund to unacceptable risk. Modification of the request for proposal to remove all risk would place the Army in an untenable position because sharing of potential risks and rewards is inherent to privatization. The Army stated that credit enhancement (loan guarantee) has been successfully used for three previous hotel construction projects at Fort Bliss, Texas; Fort Drum, New York; and Schofield Barracks, Hawaii. The Army also stated that industry consultants, the Army hospitality management, and the Assistant Secretary of the Army (Financial Management) believe revenue and cost projections are attainable for the project. The Army stated that it had analyzed less costly alternatives but found them not to be financially viable. For a summary of management comments on the finding and the recommendations, see Part II and Appendix D, respectively. The complete text of management comments is in Part IV of this report.

Audit Response. Specific comments provided by the Army did not support the financial viability of the current proposal or the absence of exposure to unacceptable risk. Success or failure of the project could hinge on a variance as small as a 3 percent difference in projected room occupancy. The Army comments did support the fact that privatization inherently involves a sharing of potential risks and rewards by both parties. Debt service guarantees totaling $1.9 million were provided for the Forts Bliss and Drum projects for the first 2 years, and the developer’s total loan amount for the hotel at Schofield Barracks was $12.5 million. Clearly, the risk to the Army Morale, Welfare, and Recreation Fund for the three hotel projects was substantially less than the risk for Hotel Thayer ($1.2 million plus per year for 7 years) and the bond risk at year 10 of $* million. Therefore, we modified our initial recommendation to recommend cancellation or modification of the request for proposal to eliminate or greatly reduce the risk to the Army Morale, Welfare, and Recreation Fund associated with guaranteeing the developer's loan or bond issue.

Army charts showing less costly and less risky renovation alternatives did not use standard data input, thus results are not comparable to the expansion alternative. Also, industry data show that development cost per room of the expansion alternative exceeds the average cost per room of the three most expensive hotels sold in the United States in 1993. Army revenue and cost projections on hotel projects are not always good indicators of success. The Armed Forces Recreation Center-Europe in FYs 1991 and 1992 had losses of $36.5 million on revenues of $34 million and an occupancy rate of nearly 90 percent. Also, the Armed Forces Recreation Center-Orlando is losing money monthly while the occupancy rate is 95 percent, even though projections were that a profit would occur (see Prior Audits and Ongoing Reviews in Part I).

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Although the Army concurred with the recommendation on less costly alternatives, the Army did not provide support that less costly alternatives had been analyzed and found to not be financially viable. See Appendix D for a detailed discussion of management comments and audit responses.

We request that the Army reconsider its position and provide comments on the final report by November 28, 1994.
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This report was prepared by the Logistics Support Directorate, Office of the Assistant Inspector General for Auditing, Department of Defense.
Part I - Introduction
Introduction

Background

Hotel Thayer, located on the grounds of the U.S. Military Academy (the Academy), West Point, New York, is owned by the Government and is managed by the Academy as a nonappropriated fund (NAF) instrumentality. NAF instrumentalities are financially self-supporting entities that act in their own name to provide or assist other DoD organizations to provide morale, welfare, and recreational programs for DoD military personnel and civilians. Hotel Thayer, a 188-room facility, has been in operation since 1926. A 43-room annex was added to the hotel in 1948. The hotel provides accommodations and food, beverages, and related services for visitors to the Academy and local area residents. As of April 1994, 197 guest rooms were available for occupancy.

In 1987, the Academy determined that Hotel Thayer required extensive renovation and expansion. The Academy decided that a privatization approach was the most feasible way to renovate and expand the hotel. The Academy submitted its plan to the Army Community and Family Support Center (CFSC), currently under the Office of the Assistant Chief of Staff for the Army for Installation Management. CFSC prepared the request for proposal, evaluated offerors' proposals, and conducted contract negotiations. The request for proposal (NAFB-1-89-R-0001, March 1989) required an offeror to finance, design, renovate, construct, operate, and maintain Hotel Thayer. The request for proposal and the subsequent 16 amendments specified:

- that the offeror would contribute equity equal to at least 10 percent of total project cost,
- that the offeror would pay 1 percent of gross revenues, on a quarterly basis, to the Army Morale, Welfare, and Recreation (MWR) Fund (the MWR Fund),
- that the offeror would establish a capital replacement fund and default reserve of $500,000,
- that the MWR Fund would donate $1 million to help fund realignment of Thayer Road and Buffalo Soldier Field,
- that the offeror would establish a standby operating fund to cover hotel operating deficits,
- that the offeror would post a $500,000 offer guaranty,
- that credit enhancement (guarantee of debt payment) by the MWR Fund was available,
- the criteria by which all proposals would be evaluated,
Introduction

- the criteria for determining the amount of performance and payment bonds required during construction, and
- the default and the MWR Fund buy back provisions.

Proposals that CFSC received in response to the request for proposal included one for a conference center and one for an upgraded hotel with conferencing facilities, including expanded dining, ballroom, meeting, and recreation facilities.

In January 1990, the contracting officer notified one of the two offerors that the offeror had been eliminated from competition and that contract award would be made to the other offeror. In May 1990, the eliminated offeror on the Hotel Thayer project submitted a letter to the Commander, CFSC, protesting the proposed contract award. On September 10, 1990, the Assistant Secretary of Army (Manpower and Reserve Affairs) directed that the protesting offeror be restored to competition and that negotiations be reopened. In July 1992, the two offerors submitted best and final offers, and the Source Selection Evaluation Board reviewed both offers and found deficiencies. The two offerors resubmitted best and final offers, and the Source Selection Evaluation Board reviewed both offers again, recommending on June 4, 1993, that the contract be awarded to the offeror originally selected for award in 1990. Award of the contract has been held in abeyance pending congressional approval.

Objectives

The audit objectives were to determine whether the decision to contract for renovation and operation of Hotel Thayer was appropriate and to evaluate the contract solicitation and contractor selection to renovate and operate the hotel. The audit also evaluated the internal controls applicable to the contracting process.

Scope and Methodology

We reviewed the Hotel Thayer project contracting files and market and economic analyses studies located at the NAF Contracting Office, CFSC. See Appendix A for a listing of the primary studies reviewed. The project contracting files covered the acquisition process for the Hotel Thayer project from March 1989 through December 1993. We also reviewed the Hotel Thayer project files at the Academy and obtained the hotel’s financial statements for 1986 through 1993. In addition, we reviewed and analyzed additional data received after June 10, 1994, from CFSC. Our review of the process for evaluating offerors' proposals and selecting a contractor for the Hotel Thayer Project was limited to the period following reopening of competition in 1990.
Introduction

We discussed privatization, offer guaranty, and revenue and financial analyses with personnel from the NAF Contracting Office and the Resource Management Division, CFSC. We discussed the Hotel Thayer project financing with the CFSC financial consultants, Basile Baumann Prost & Associates, Inc. We discussed hotel operations and renovation plans with the Hotel Thayer manager and comptroller. We also contacted representatives from both offerors.

This economy and efficiency audit was made from March 1994 through June 1994 in accordance with auditing standards issued by the Comptroller General of the United States as implemented by the Inspector General, DoD. The audit did not rely on use of computer-processed data. Appendix E lists the organizations visited or contacted during the audit.

Internal Controls

We evaluated internal controls at CFSC related to NAF contracting procedures for the renovation and operation of Hotel Thayer following the reinstatement of the protesting offeror in 1990. We also evaluated the CFSC implementation of its Internal Management Control Program as it applies to the audit objectives. The audit did not identify any material internal control weakness; however, although CFSC implemented the Internal Management Control Program for NAF contracting procedures, the applicable internal control checklist was not updated as required by Army Regulation 11-2, "Internal Management Control," September 14, 1990.

Prior Audits and Ongoing Reviews

No audits were performed of Hotel Thayer operations or renovation during the past 5 years. However, the General Accounting Office and the Army Audit Agency have recently conducted audits on related issues that may have an impact on the feasibility of the proposed renovation of Hotel Thayer. The Inspector General, DoD, is also performing an audit to evaluate actual and forecasted financial statements, hotel room rate structure, and the lease terms and approval process of the Armed Forces Recreation Center-Orlando, Florida (Project No. 4CK-5012). The Inspector General, DoD, also performed an audit of the Armed Forces Recreation Center-Europe.

General Accounting Office Report No. NSIAD-94-120 (OSD Case No. 9621) "Morale, Welfare, and Recreation - Declining Funds Require DoD to Take Action," February 28, 1994, reports that the financial outlook of the DoD MWR program appears to be worsening. Military exchange store income has declined since 1989, revenue is likely to decrease in the 1990s because of downsizing and increased private-sector competition, and the DoD decentralized management approach may not be well suited to the receding patronage and funding.
Army Audit Agency Report SR 94-C17, "Review of Nonappropriated Fund Cash Levels," reports that the Army's NAF cash balances were within reasonable limits for FYs 1993 and 1994. However, forecasted NAF cash balances decreased below a sound financial position for FYs 1995 through 1998. The report also states that CFSC personnel did not appropriately show NAF cash balances and solvency ratios in their NAF cash flow statement.

Inspector General, DoD, Report No. 94-047, "Armed Forces Recreation Center Europe," February 28, 1994, states that the Armed Forces Recreation Center Europe was not capable of being self sustaining without appropriated fund support even though the Center operated at near capacity. For FYs 1991 and 1992, the Center had $34 million of revenues and operating losses of $36.5 million before appropriated fund contributions. The report recommended that the Army determine whether the Center was necessary and could exist as a self sustaining operation. The Army agreed to conduct a study.
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Part II - Finding and Recommendations
Hotel Thayer Renovation and Expansion Exceeds Needs

The Army's proposed renovation and expansion of Hotel Thayer exceeded the Academy and public needs and was based on overly optimistic financial projections. The renovation and expansion project was excessive because:

- the CFSC request for proposal did not adequately define the Academy needs,
- the Academy did not adequately consider less costly renovation alternatives, and
- the CFSC request for proposal did not adequately protect the MWR Fund from potential liabilities associated with the proposed contract.

Awarding the proposed contract would, in the event of contractor default, result in the MWR Fund facing a potential liability of $48 million, for a project that will benefit less than 1 percent of the military personnel and will be of little, if any, benefit to enlisted personnel.

Background

DoD Directive 1015.1, "Establishment, Management, and Control of Nonappropriated Fund Instrumentalities," August 19, 1981, provides policies for establishing and disestablishing NAF instrumentalities and assigns responsibilities for their management and control. According to the directive, Hotel Thayer would be a category VIII-supplemental mission services NAF instrumentality. Category VIII includes all NAF instrumentalities that provide MWR services as adjuncts to training, health billeting, or other mission support programs.

Proposed Renovation

In 1987, the Academy determined that Hotel Thayer, a NAF instrumentality located on the Academy grounds, required extensive renovation to alleviate customer complaints about the small size of guest rooms and to eliminate certain safety hazards. The Academy determined that privatization, a public/private partnership approach to design, develop, renovate, and operate Hotel Thayer, was the most economical means of renovating the hotel. The CFSC Source Selection Board recommended for contract award a privatization proposal for a *-room hotel with conference facilities that greatly exceeded historical Academy and public needs and that was based on optimistic financial projections.

Academy and Public Needs. The historical Academy and public room demand at Hotel Thayer did not support the need for a *-room facility. The 1992 Delta Research Corporation Market Analysis Revalidation (Appendix A) shows that, for 1991, Hotel Thayer had an average weekday room occupancy rate of about 50 percent and an average weekend room occupancy rate of about 80 percent for 197 rooms. The Delta Research Corporation revalidation and the 1988 Market Economic Feasibility Study for Hotel Thayer by KPMG Peat Marwick Main and Company calls for a strategy of increasing the weekday room demand by renovating and expanding the hotel as a first-class conference facility. Figure 1 shows that the average monthly room occupancy rate for the current 197-room hotel for 1989 through 1993 was especially weak for the months of December, January, and February.

![Average Monthly Room Occupancy Rate For 1989 Through 1993](image)

Figure 1. Average Monthly Room Occupancy Rate For 1989 Through 1993

According to the Hotel Thayer comptroller, the 1993 average room occupancy rate was 56 percent. Arthur Andersen's mid-year 1993 edition of "The Host

* Contractor confidential or proprietary data has been deleted
Hotel Thayer Renovation and Expansion Exceeds Needs

Report," a nationwide report on hotel operating statistics, stated that the national average for the first half of 1993 was about 62 percent. Projected cash flow statements for the proposal recommended for contract award forecasted an annual occupancy rate, starting in year 7 of operations, of * percent for a *-room hotel. The forecasted *-percent occupancy rate represents an increase of * rooms rented annually, or an increase of 59 percent from the number of rooms rented by Hotel Thayer in 1993.

Potential Conference Business. The hotel's community, Highland Falls, New York, did not have sufficient commercial activity to support a conference center. The nearest commercial activity, consisting of light industry and offices, was located in and around Newburgh, in Orange County, New York, about a 30-minute drive from Hotel Thayer. The light industry in and around Newburgh would be more attracted to a hotel with meeting rooms, several of which were in or around Newburgh, rather than a conference facility. In addition, the most accessible airport, Stewart International, is about 20 miles closer to Newburgh than to Hotel Thayer.

During the late 1980s and early 1990s, Stewart International Airport officials attempted to negotiate a lease with Clarion Hotels for a 185-room hotel with 5,500 square feet of conference space. The negotiations failed because financing could not be secured. In a May 4, 1994, letter to CFSC, Delta Research Corporation stated that, according to the director of Orange County Tourism, the county had made a concerted, but futile, effort to attract a major hotel chain to other locations in Orange County. Delta Research Corporation further stated in the letter that lending institutions were extremely wary of investments in the hotel industry since the over-building of the 1980s. Orange County's failure to attract a major hotel chain, lack of an appreciable commercial activity base, and location cast doubt on Hotel Thayer's ability to achieve the room occupancy rates needed to make proposed hotel operations profitable.

Financial Projections. The proposal selected by CFSC for contract award was based on optimistic financial projections. CFSC did not adequately evaluate issues related to debt per room, average daily room rate, project loan value, private financing availability, and conference center criteria in regard to the potential success of the Hotel Thayer project. The offeror selected for contract award based its financial projections on a plan to market Hotel Thayer as a conference center. This plan gave the proposal a speculative characteristic because the success of the venture depended on attracting new business rather than on capitalizing on the hotel's established market segment; that is, transients (tourists). The risk to the MWR Fund was that the offeror would default because the hotel did not attract sufficient conference business to support the cost associated with the expansion and renovation of the hotel and conference facilities. If the offeror defaulted after contract execution, the MWR Fund, under the terms of the request for proposal, would take immediate possession and physical control of Hotel Thayer and operate the hotel business to ensure payments of debt (to include annual debt service).

Debt Per Room. Results of the 1992 Delta Research Corporation Market Analysis Revalidation should have cast doubt on the economic viability

* Contractor confidential or proprietary data has been deleted
of both proposals considered for contract award, because total debt per room, per proposal, was about $\ast$ and $\ast\ast$, respectively. The Delta Research Corporation Market Analysis Revalidation cited Pannell Kerr Forster's, "Trends in the Hotel Industry 1991," showing that many hotels are carrying a debt of more than $100,000 per room. According to the Pannell Kerr Forster report, these same hotels probably based their operating cash flow analyses on occupancy rates close to 70 percent, the hotel standard during the 1980s. With 1991 occupancy rates at about 63 percent nationwide, about 60 percent of all hotels were unable to fully meet their debt service. Consequently, Pannell Kerr Forster analysts believed that developers, hotel owners, or both would restructure their debt, and that the debt per room would drop to the $50,000 to $60,000 range.

The large amount of debt per room projected in both contract proposals would require Hotel Thayer to substantially increase the average daily occupancy rate and the room rates to sustain hotel operations. Slight differences in either of these variables can cause significant changes in projected cash flow. Should Hotel Thayer achieve an actual occupancy rate of 68 percent rather than the *percent projected (only a 3 percent difference) by the proposal selected for contract award, the hotel would experience a cumulative net loss situation from year 6 through year 20 of operations. Appendix B shows the offeror's projected cash flow if the forecasted occupancy rate is not achieved.

**Average Daily Room Rate.** The average daily room rate Hotel Thayer would need to support the financing and operations of the proposed *-room hotel would be detrimental to the hotel's Academy and transient market segments, which are very price sensitive. Figure 2 shows Hotel Thayer's market segments for 1991, based on the Delta Research Corporation Market Analysis Revalidation.

![Figure 2. Hotel Thayer 1991 Market Segments as a Percent of Room Occupancy](image)

* Contractor confidential or proprietary data has been deleted
Hotel Thayer Renovation and Expansion Exceeds Needs

According to the Director of Operations, Hospitality Management Directorate, CFSC, the hotel transient market is very price sensitive; therefore, a significant increase in room rates could lessen the hotel's transient business. The Hotel Thayer average daily room rate in 1991 was $64.44, while the per diem rate for DoD military and civilian personnel was $44, or $20 below the average daily room rate. The proposal recommended for contract award forecasted an average daily room rate of $ * during year 7, considered to be the first stabilized year of operations. The forecasted average daily room rate of $ * reflected an increase of 92 percent from year 1 to year 7. The Delta Research Corporation Market Analysis Revalidation stated that hotels would be able to increase room rates by as much as 4 and one-half percent by 1993. Based on data in the Delta Research Corporation Market Analysis Revalidation, the proposal forecasted average daily room rate increases of more than three times the expected national average during the first 6 years of operation. The optimistic average daily room rate increases were needed to generate sufficient cash flow to service the debt associated with a *-room hotel with conference facilities. However, as a result of the forecasted room rate increases, the hotel would likely lose a portion of its transient and Academy market. The loss of this steady business segment, which in 1991 represented 76 percent of Hotel Thayer's total business, would make it increasingly difficult for the hotel to service its debt and, therefore, would increase the risk to the MWR Fund.

If Hotel Thayer was able to achieve the estimated occupancy rate of * percent, but the average daily room rate increased only at the national average, the operating cash flow analyses would reflect significant net losses throughout the entire lease period. Appendix C shows the offeror's projected cash flow if the forecasted average daily room rate is not achieved. By year 10 of operations, Hotel Thayer would experience a cumulative net loss of about $18.5 million and the offeror probably could not expect to * (For a discussion of the bond issue, see Potential MWR Fund Liability later in the finding.) Should Hotel Thayer suffer significant cumulative net losses, the offeror could possibly default by the end of year 4, thus causing the MWR Fund to assume operation of the hotel and liability for repayment of the $ * million bond issue.

**Project Loan Value.** The offeror's forecasted net operating income in the stabilized year of hotel operations (year 7) did not support a $ * million project loan value. According to Hospitality Valuation Services *Hotel Valuation Journal*, fall 1991 issue, hotel buyers and sellers generally based their estimate of loan value on the net return to the property (net income before depreciation and debt service). According to the *Hotel Valuation Journal*, one of several procedures for determining loan value is the band-of-investment technique. This technique combines the mortgage and equity capital requirements into an overall rate of return that reflects the capital composition of the investment. We applied the band-of-investment technique to the forecasted stabilized net operating income as shown on the operating cash flow statements of the proposal recommended for contract award along with the proposed contractor equity. The highest project loan value derived from applying the band-of-investment technique was $38 million, substantially less (about $ * million) than the estimated loan amount of $ * million.

* Contractor confidential or proprietary data has been deleted
Private Financing Availability. Private financing could be difficult to obtain for proposals submitted to CFSC for Hotel Thayer renovation, expansion, and operation. During 1991, Hospitality Valuation Services surveyed 64 lenders with a total of 1,088 outstanding hotel loans. Of the 64 lenders surveyed, more than two-thirds had been involved in hotel lending for more than 10 years. The average hotel loan amount engaged by these lenders was $7.3 million, with the loan amount ranging from $0.2 million to $138 million. Collectively, the 1,088 outstanding loans represented about $9 billion. Of the 64 lenders surveyed, 67 percent would not consider new loans for existing hotels. The lenders who would not consider new loans cited such reasons as "too much risk" and that "returns are low in the hospitality industry." Two-thirds of the lenders who would not consider new loans on existing hotels did not plan to return to hotel lending at all. Lenders who stated that they would return to hotel lending noted that they would place specific requirements on hotel borrowers. For example, the lenders would require more equity up front and more working capital, lower loan-to-value ratios, stronger guarantors, and better documented appraisals. Only a few lenders would accept a cash-flow mortgage (a mortgage based on projected net income) similar to what the Hotel Thayer project would need to obtain financing. The minimum cash equity percentage that the lenders would consider was approximately 30 percent, whereas the MWR Fund was only requiring 10-percent equity. The results of the survey indicated that few lenders would be willing to take the risk that the proposed contract award posed to the MWR Fund.

Conference Center Criteria. The proposed Hotel Thayer renovation and expansion did not meet the criteria for the operation of a successful conference center. The success of the proposed project was contingent on increasing room demand by marketing the hotel as a conference center. However, based on Hospitality Valuation Services' conference center criteria, the proposal would put Hotel Thayer at a competitive disadvantage to its nearest competitors. The disadvantages are that:

- conference space would be ancillary to a larger hotel operation;
- tourism, Academy cadet functions, and normal hotel food business would distract from a conference center environment;
- less than 70 percent of the space would be dedicated to business rooms;
- Hotel Thayer would lack outdoor recreational amenities; and
- Hotel Thayer would have a more rural location and would lack a local commercial activity base.

According to the Delta Research Corporation Market Analysis Revalidation, Hotel Thayer would mainly compete with Arrowwood Conference Center, Rye Brook, New York, and Tarrytown House Executive Conference Center, Tarrytown, New York, for conference business. Hotel Thayer would be at a competitive disadvantage because the two facilities are dedicated conference
Hotel Thayer Renovation and Expansion Exceeds Needs

centers, offer a higher range and quality of amenities, and are only 30 miles from New York City (Hotel Thayer is about 60 miles from New York City). Based on its lack of conference facilities, its location, and its nearby competition, we question whether a renovated and expanded Hotel Thayer could increase its annual room demand by 59 percent through its marketing as a conference center.

Request For Proposal

The request for proposal issued by CFSC did not adequately define the needs of the Academy. While adequately describing a need for a renovated hotel, the request for proposal left the resulting hotel size and cost parameters undefined. Federal Acquisition Regulation 36.204, "Disclosure of the Magnitude of Construction Projects," requires solicitations for construction projects to state the magnitude of the requirement in terms of physical characteristics and estimated price range. While NAF contracts are not bound by the provisions of the Federal Acquisition Regulation, Army Regulation 215-4, "Nonappropriated Fund Contracting," October 10, 1990, also requires solicitations for construction (which includes alteration and repair) to state the magnitude of the requirement in terms of physical characteristics and estimated price range. Failure to describe the cost constraints and number of rooms needed to satisfy Academy and transient needs in the request for proposal resulted in offerors submitting proposals that contained costs and rooms that exceeded actual needs. Figure 3 shows that the historical room demand did not support the need for a *-room hotel.

![Diagram showing historical and forecasted room demand]

Figure 3. Forecasted (First Year of Stabilized Operations) Versus Historical (1987 through 1993) Room Demand

* Contractor confidential or proprietary data has been deleted
The request for proposal allowed the offerors to submit proposals including design and estimated development costs that may be excessive. In addition, the request for proposal allowed offerors to submit a financing plan based on 100 percent of the debt being guaranteed by the MWR Fund. Because the request for proposal did not define project size and cost parameters, the offeror could possibly inflate estimated project costs to cover their equity (10 percent of project cost) and profit. This inflation of estimated project costs could shift 100 percent of the project risk onto the MWR Fund because the offeror would recoup its equity and a profit through the proposed financing plan before completing construction and renovation. If the Academy had determined the number of rooms needed to satisfy the Academy and transient room demand, then the project size and cost parameter could have been defined in the request for proposal. This definitization of requirements would have resulted in meeting the needs of the Academy and transients at the lowest possible cost to the Government.

Renovation Alternatives

The Academy and CFSC did not adequately consider less costly renovation alternatives for meeting Academy and transient needs. After establishing the need for renovation of the Hotel Thayer, the Academy considered four alternatives.

- Close the hotel.
- Maintain the hotel in current condition.
- Renovate the current structure of the hotel.
- Renovate and expand the hotel through privatization.

Of the four alternatives, the Academy opted to renovate and expand Hotel Thayer through privatization. While we agree with the Academy that the first two alternatives were not feasible, we did not find any evidence that the third alternative, to renovate the current structure of the hotel, had been adequately considered before the decision had been made to renovate and expand Hotel Thayer through privatization.

CFSC Renovation Analysis. The Academy estimated that renovating the existing hotel structure would cost about $20 million and, because of the needed room size expansion, the number of rooms would be reduced from the current 197 rooms to 110 rooms. The Resource Management Division, CFSC, performed two cost analyses in 1993 that showed that, based on a 1995 projected average daily room rate of $112, income from 110 rooms would not support the $20 million loan for renovation. CFSC did not provide documentation to show how the Resource Management Division estimated renovation costs of $20 million and the resulting 110 rooms. However, a review of the Academy's 1987 Hotel Thayer Master Plan alternatives showed
that the hotel and annex could be renovated for about $6 million with a resulting 145 rooms. We found no evidence that the Academy or CFSC evaluated the 1987 Master Plan alternative for the 145-room renovation.

**Deficiencies in CFSC Analyses.** The CFSC cost analyses contained several deficiencies that invalidated the conclusion that renovating the current hotel structure was not economically feasible. The deficiencies are as follows.

- Annex renovation was not considered, which would have resulted in a 145-room hotel instead of a 110-room hotel.
- CFSC did not validate the $20 million renovation cost, resulting in 110 rooms. Further, a 1993 Corps of Engineers real property appraisal estimated that renovation and expansion costs of $20 million would result in a 200-room hotel.
- CFSC did not consider Hotel Thayer retained earnings as monies available for renovation (September 1993 retained earnings were over $4 million).
- CFSC used an average daily room rate of $112 for the first stabilized year of operations, while the offerors were allowed to project rates at least $20 higher.
- The room occupancy rate that CFSC used in its cost analyses was understated. Applying the average number of rooms rented in 1993 to the newly renovated 145 rooms, the yearly occupancy rate would be 77 percent rather than the 69 percent used in the CFSC cost analyses.
- The CFSC cost analyses used loan payments based on a 20-year mortgage, whereas the proposal selected for contract award used a 30-year debt payment in its projected financial analyses.

The Hotel Thayer manager and comptroller believed that renovating the hotel in three phases (similar to phase II of the Academy’s 1987 Hotel Thayer Master Plan) was possible using funds from Hotel Thayer retained earnings and income. The Hotel Thayer manager projected an occupancy rate between 70 and 75 percent for a renovated 145-room hotel. Renovating the existing hotel structure would reduce the risk to the MWR Fund while still meeting the demonstrated needs of the Academy and public.

**Potential MWR Fund Liability**

The safeguards established in the request for proposal did not adequately cover the potential liability to the MWR Fund. CFSC identified the liabilities associated with the project and established clauses in the request for proposal to protect the MWR Fund at best and final offer, contract execution, and beneficial occupancy (the first day of operations after completion of construction and renovation). While CFSC had established clauses in the request for proposal to protect the MWR Fund from the liabilities that had been perceived, in our
opinion, the greatest liability faced by the MWR Fund resulted from the MWR Fund’s 10-year guaranty of the $* million bond issue, referred to as credit enhancement.

**Best and Final Offer.** The proposed offer guaranty at best and final offer did not adequately protect the MWR Fund. The request for proposal required that all contract offerors submit an offer guaranty of $500,000 at the time of the best and final offer. The $500,000 offer guaranty would cover contract expenses the MWR Fund incurred up to the time of contract execution. If the offeror, after receiving conditional notice of award, withdrew the offer or was unable to secure financing, the $500,000 offer guaranty would be forfeited to the MWR Fund. As of September 1993, CFSC and Hotel Thayer had already spent about $1.2 million on the renovation project; therefore, the $500,000 offer guaranty would not cover incurred costs.

**Contract Execution.** Proposed contract provisions did not provide sufficient protection for the MWR Fund in the event of contractor default during construction and renovation. At contract execution, the request for proposal required the offeror to establish a $500,000 default reserve and to present evidence of availability of the required performance and payment bonds. If the offeror did not meet operational expenses, the Army could default the contract and receive the $500,000 default reserve. The performance and payment bonds were to cover costs of default during hotel construction and renovation. However, neither the default reserve nor the performance and payment bonds would protect the MWR Fund in the event of construction cost overruns. A significant cost overrun would increase the possibility of default by the offeror and create additional potential liability to the MWR Fund.

**Beneficial Occupancy.** Proposed contract provisions are not sufficient to adequately protect the MWR Fund at beneficial occupancy of the hotel. After the completion of renovation, the request for proposal required the offeror to establish a standby operating fund. According to the criteria in the request for proposal, the standby operating fund was to have been about $1.8 million and would cover any hotel operating deficits. Also, when in a deficit situation, the offeror could defer the required annual payment to the MWR Fund and could pay later with accrued interest. However, the amount required for the standby operating fund would not cover the estimated annual debt service of about $* million starting in year 4, which would be paid by the MWR Fund when proceeds from hotel operations were insufficient to cover such debt.

**Credit Enhancement.** Credit enhancement features included $* could result in potential liability to the MWR Fund. The proposed financing plan required the MWR Fund to guaranty or credit-enhance the debt service of a *, $* million *, for a 10-year period. Under this proposal, while the MWR Fund would face the possibility of making an average of $1.4 million ($* million less reserves and deferrals averaging $* million per year) in debt service payments starting in year 4, for any year when hotel cash flows were insufficient for such payment, the greatest risk would occur at the end of the MWR Fund’s 10-year credit enhancement.

* Contractor confidential or proprietary data has been deleted
Without the MWR Fund guaranty, a probability exists that the
at the same interest rate, and a possibility exists that they could not be
remarketed at all. As a result, the MWR Fund’s liability under the credit
ensure (about $ * million assuming 10 percent debt reduction) would be
triggered or the * at a higher interest rate
commensurate with the increased risk to the * . Higher interest rates
would adversely impact hotel cash flows, increasing the risk that the offeror
would default on its debt service or hotel operating provisions.

Our assumptions about the * are contingent on the MWR Fund receiving a
* . However, because the MWR Fund is not backed by the full credit
and faith of the Government, obtaining a * may not be possible. If a
* for the MWR Fund cannot be obtained, the likelihood of the offeror
being able to obtain the funding to renovate and expand the hotel would be
doubtful.

Lack of Benefit of Expanded Hotel Thayer to Active-Duty
Military

The majority of active-duty military will not benefit from the expansion of the
Hotel Thayer to a conference center. The Army shows that about 6,800 room
nights per year are related to the Academy and military groups. This number is
less than 1 percent of active-duty military. Although not quantified, we do not
believe that many enlisted personnel would have the desire or would be able to
afford to stay at Hotel Thayer. The expanded Hotel Thayer plan is to attract
association and corporate markets into the additional rooms. The Army is
assuming a $ * million risk to the soldiers’ Army MWR Fund to subsidize
competition with other commercial conference centers.

Conclusion

Renovation and expansion of Hotel Thayer, as proposed, would create a
speculative commercial venture that exceeds Academy and public needs and

* Contractor confidential or proprietary data has been deleted
places the soldiers' MWR Fund at significant risk for a project that will benefit less than 1 percent of the military personnel. The excessive cost, operational uncertainty, and substantial risk associated with this project makes its feasibility and advisability questionable. Less costly alternatives could meet Academy needs to renovate Hotel Thayer, thereby eliminating or substantially reducing the risk to soldiers' money in the MWR Fund.

Recommendations, Management Comments, and Audit Response

Management Comments on the Finding. For a summary of the Army comments on the finding, see Appendix D. For the complete text of management comments, see Part IV.

Revised Recommendation. As a result of management comments, we revised draft Recommendation 1. to consider comments regarding privatization.

1. We recommend that the Commander, Army Community and Family Support Center, Office of the Assistant Chief of Staff of the Army for (Installation Management), either cancel the request for proposal for the renovation and operation of Hotel Thayer or modify the request for proposal to eliminate or greatly reduce the risk to the Army Morale, Welfare, and Recreation Fund associated with guaranteeing the developer's loan or bond issue.

Management Comments. The Army nonconcurred with the draft recommendation to cancel the request for proposal or modify the request for proposal to remove all risk to the Army MWR Fund, stating that the current proposal is financially viable and does not expose the Army MWR Fund to unacceptable risk. Modification of the request for proposal to remove all risk would place the Army in an untenable position because sharing of potential risks and rewards is inherent to privatization. The Army stated that credit enhancement (loan guarantee) has been successfully used for three previous hotel construction projects at Fort Bliss, Texas; Fort Drum, New York; and Schofield Barracks, Hawaii. The Army also stated that industry consultants, the Army hospitality management, and the Assistant Secretary of the Army (Financial Management) believe revenue and cost projections are attainable for the project.

Audit Response. The Army comments are not responsive because they did not support the financial viability of the current proposal or the absence of exposure to unacceptable risk. Success or failure of the project could hinge on a variance as small as a 3 percent difference in projected room occupancy. The Army comments did support the fact that privatization inherently involves a sharing of potential risks and rewards by both parties. Debt service guarantees totaling $1.9 million were provided for the Forts Bliss and Drum projects for the first 2 years, and the developer's total loan amount for the hotel at Schofield Barracks was $12.5 million. Clearly, the risk to the Army MWR Fund for the three hotel projects is substantially less than the risk for Hotel Thayer
($1.4 million a year for 7 years) and the * risk at year 10 of $ * million. The Armed Forces Recreation Centers Europe and Orlando hotels were both losing money despite optimistic Army statements and revenue and cost projections provided to us.

We modified our initial recommendation to recommend cancellation or modification of the request for proposal to eliminate or greatly reduce the risk to the Fund associated with guaranteeing the developer’s loan or bond issue. We also revised the recommendation to show the current organizational alignment of the Army Community and Family Support Center. We request that the Army comment on the revised recommendation in response to the final report.

2. We recommend that the Superintendent, U.S. Military Academy, perform in-depth analyses of less costly alternatives for the renovation and operation of the Hotel Thayer.

Management Comments. The Army concurred in principle, stating that the Army has analyzed less costly alternatives and found them not to be financially viable. The Army further stated that the alternatives would require a greater cash outlay from the Army MWR Fund than will occur from successful operations by the selected developer.

Audit Response. Although the Army concurred in principle with the recommendation, its comments are considered nonresponsive because data presented in support of the analyses of less costly alternatives contained overstated project costs, understated food and beverage revenues, and overstated operational expenses (Appendix D). Therefore, we request that the Army reconsider its position in responding to the final report.

* Contractor confidential or proprietary data has been deleted
Part III - Additional Information
Appendix A. Market and Economic Studies For Hotel Thayer

Hotel Thayer Master Plan, November 1987. EGL Associates prepared the Hotel Thayer Master Plan for the Academy under contract with the Army Corps of Engineers. EGL Associates prepared the Hotel Thayer Master Plan to explore renovation alternatives because of recurring customer complaints about the small size of guest rooms, the inadequacy of bathroom facilities, and the inefficiency of public areas. The Academy funded preparation of the Hotel Thayer Master Plan.

Laventhol and Horwath Preliminary Findings, March 8, 1988. The Laventhol and Horwath Preliminary Findings explored the assumption that a new hotel would be built and that the existing Hotel Thayer would cease operations. The Association of Graduates funded and donated this study to the Academy.

KPMG Peat Marwick Main and Company, "Market Economic Feasibility Study for the Hotel Thayer," June 14, 1988. The purpose of the KPMG Peat Marwick Main and Company study was to determine the economic feasibility of the Hotel Thayer Master Plan to expand and to renovate the hotel. The study also explored the feasibility of implementing a new marketing concept to reposition the hotel to capture a share of the conference center market. The Academy funded the study.

Delta Research Corporation, "Market Analysis Revalidation, The Hotel Thayer, West Point, New York," January 31, 1992. The purpose of the Market Analysis Revalidation was to revalidate the identified future market demand for hotel accommodations and conference and meeting facilities in the West Point area set forth in the KPMG Peat Marwick Main and Company "Market Economic Feasibility Study for the Hotel Thayer." CFSC funded this revalidation study.

H. R. Fountain and Company Real Property Appraisal, Hotel Thayer, February 3, 1993. The real property appraisal was performed to estimate the market value and rental value of Hotel Thayer and to assist in evaluating the feasibility of leasing the existing hotel to a private developer. The Army Corps of Engineers funded this appraisal.
Appendix B. Offeror Projected Cash Flow With Forecasted Occupancy Rate Not Achieved

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Rooms</th>
<th>Average Occupancy (percent)</th>
<th>Occupied Roomnights</th>
<th>Average Room Rate</th>
<th>Net Cash Flow⁽¹⁾ (millions)</th>
<th>Cumulative Cash Flow⁽¹⁾ (millions)</th>
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¹Details showing revenues and expenses used to calculate net and cumulative cash flows available upon request.

²Percent of average occupancy used by offeror in operating cash flow statement.

³Projected occupancy based on average for all types of hotels.

* Contractor confidential or proprietary data has been deleted
Appendix C. Offeror Projected Cash Flow With Forecasted Average Room Rate Not Achieved

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<tr>
<th>Year</th>
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<th>Average Occupancy (percent)</th>
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<th>Average Room Rate</th>
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<sup>1</sup>Details showing revenues and expenses used to calculate net and cumulative cash flows available upon request.

<sup>2</sup>Average room rate used by offeror in operating cash flow statements.

<sup>3</sup>Projected room rates based on 4.5 percent annual increase.

* Contractor confidential or proprietary data has been deleted
Appendix D. Management Comments on the Finding and Audit Response

This section provides detailed audit responses to Army comments on the finding. The Army's comments consisted of a summary followed by a detailed discussion. Our response follows the order of the Army's detailed discussion. The full text of the Army comments is in Part IV.

Methodology Selected for the Acquisition Process

Management Comments on Method. The Army stated that privatization methodology requires sufficient flexibility in the request for proposal (RFP) to facilitate business creativity by the offerors, existing market conditions, change in market conditions, alternate uses that could increase economic return for the project, and constraints and opportunities from economic analysis.

Audit Response. We disagree with the Army's statement that privatization methodology requires sufficient flexibility in the RFP to facilitate the five factors listed in its response. "The Privatization Review," volume 4, number 1, 1988: A Year in Review, published by The Privatization Council, Inc., states clearly that design work should be sufficiently flexible to allow adaptation to the five factors listed by the Army before preparing the RFP, rather than in the RFP as stated by the Army. While we agree that some flexibility in design is necessary, we do not agree that the RFP should have been issued without size and cost parameters.

Management Comments on Objective. The Army stated that the objective of the project was to attract a private developer who would expand the operation to be financially viable (currently 40,213 room nights per year). A *-room hotel with meeting space will produce a renovated historic hotel that will continue to attract 40,000-plus annual room nights of the existing market segment, while the newly constructed conference facilities will attract *-plus annual room nights of new conference-related business. The Army stated that integrating the new conference facilities into the historical hotel satisfies the requirements for conference industry standards and the proposed expanded market.

Audit Response. We disagree with the Army's statement that the objective of the project was to attract a private developer that would expand the operation to be financially viable. A review of the hotel's financial statements from 1986 through 1993 showed that the hotel made a profit for every year up to 1993 and had accumulated retained earnings in excess of $6 million. The decline in the hotel's profitability is directly attributable to the decision to have a private developer renovate and operate the hotel and the delays in selecting a developer.

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Since the decision to privatize the hotel was made, the majority of hotel maintenance was deferred, causing the hotel to be less attractive to guests. Further, Hotel Thayer has paid the costs associated with the privatization effort, which largely contributed to the hotel's financial statement loss in 1993 and further reduced funds available for maintenance.

We also disagree with the Army's statement that the integration of new conference facilities into the hotel satisfies conference industry standards and will allow the hotel to maintain its current market of 40,000-plus annual room nights while attracting an additional * plus room nights of conference related business. As shown in the Conference Center Criteria section of this audit report, the proposed project clearly does not meet the requirements given by Hospitality Valuation Services as being necessary for successful conference center operations. Footnotes to Figure 3 in the Army comments show an increase of 26,000 room nights is projected. This 26,000-room-night increase is composed of 15,000 room nights for corporate/association business (not the * plus room nights as stated above) and 11,000 room nights for transient business. The Army's projected 67,000 annual occupied room nights equates to the hotel renting at least 184 rooms a night for every night of the year, or 74 more rooms per night than the current nightly average of 110 rooms. As shown in our audit report, the Army's ability to achieve its projected annual room occupancy is doubtful, especially in the winter months, and information provided by the Army after we completed our audit work did not invalidate the report's finding and conclusions.

Management Comments on the RFP. The Army stated that the RFP was purposely broad to allow for a developer to propose a methodology and approach to finance, design, construct, operate, and maintain Hotel Thayer. The RFP was written to allow the offerors to examine the market studies and to propose a business operation that would meet the overall objective of the project.

Audit Response. Allowing offerors to examine market studies and propose a business operation that would meet the overall objective of the project should not negate the requirements contained in Army Regulation 215-4, "Nonappropriated Fund Contracting." As shown in the Request For Proposal section of this report, Army Regulation 215-4 requires solicitations for construction (which includes alteration and repair) to state the magnitude of the requirement in terms of physical characteristics and estimated price range.

Management Comments on Evaluation. The Army stated that its Source Selection Evaluation Board recommended for contract award a privatization proposal that optimized the hotel's current position, while providing expanded facilities and amenities to attract additional market segments, which would complement the traditional needs of the Academy while serving public needs during the current low mid-week occupancy period.

Audit Response. We disagree that the proposal recommended for contract award will attract additional market segments during the mid-week periods without being detrimental to the largest current market segment. The Average Daily Room Rate section of the audit report shows that the transient market is

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Appendix D. Management Comments on the Finding and Audit Response

the largest segment of the hotel's current business. This section further shows
that the proposed development would be detrimental to the transient market
segment because room rates would significantly increase. Currently, the low
mid-week occupancy period is during the winter months (November through
February); the proposed development and associated higher room rates would
most likely further lessen the transient segment room demand during these
months. Further, as shown in the Potential Conference Business section of our
audit report, the lack of a local commercial activity base would hinder the
attraction of new conference business during the low mid-week occupancy
winter months.

Management Comments on Selected Proposal. The Army stated that the
selected proposal for a *-room hotel was within the parameters of the
predevelopment market study provided with the RFP, and the proposal was
evaluated as a hotel with meeting space as opposed to a conference center. The
Army's premise is that the current hotel operation will expand into the
conference market without detracting from the ongoing operation that produces
a 56-percent annual occupancy rate.

Audit Response. We disagree with the Army's statement that the selected
proposal for a *-room hotel is within the parameters of the predevelopment
market study. Two predevelopment market studies were provided with the
RFP. One study, the KPMG Peat Marwick Main and Company "Market
Economic Feasibility Study for the Hotel Thayer," June 14, 1988, showed that
a 295-room conference center was required and that anything less would not be
viable. The second study, Laventhal and Howath Preliminary Findings,
March 8, 1988, showed that a 225- to 250-room first class hotel with
conference facilities was needed but stressed that viability was based on the
current hotel ceasing operations and a brand new hotel being built. Therefore,
the proposed facility did not fall within the parameters of either predevelopment
market study.

Consideration of Less Costly Renovation Alternatives

Management Comments on Current Revenue Potential. The Army stated
that the current hotel operation will never produce sufficient revenue to create
the capital needed to renovate the existing structure without a planned expansion
of the facility, its amenities, and market position. To support its position, the
Army cited four renovation scenarios developed by Delta Research Corporation
with renovation projects smaller and less expensive than proposed by the
selected developer. Using the four renovation scenarios, as shown in Figure 2
of the Army comments, the Army concluded that any renovation was not
deemed economically feasible.

Audit Response. We disagree with the Army's conclusion that the selected
proposal was the only financially viable alternative. As shown in the

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Appendix D. Management Comments on the Finding and Audit Response

CFSC Renovation Analysis section of our audit report, the Army has not properly evaluated the 1987 Master Plan alternative for the 145-room renovation.

Additionally, we question the validity of the four renovation scenarios shown in Figure 2 in the Army's comments (page 54) because the internal rate of return and net present value for privatization is inflated for comparison purposes (20-year project life used instead of the 20 years used for renovations). We also question the validity of the renovation scenarios because income and expense ratios used to develop data for the scenarios were substantially different from Hotel Thayer's historical income and expense ratios. The four renovation scenarios were presented to CFSC by Delta Research Corporation in their "Response to Areas of Concern, The Hotel Thayer, West Point, New York", May 31, 1994. However, between May 31, 1994, when CFSC received the four renovation scenarios, and August 23, 1994, when we received the Army's comments to the audit report, the project cost of each scenario was increased by an average of $2.3 million.

The presentation of incorrect internal rates of return and net present values, use of unsupported income and expense ratios, and arbitrary increases in project costs cast considerable doubt as to the usefulness and validity of the renovation scenarios shown in the Army comments. In fact, if the privatization scenario is compared at an equal project life of 20 years, the Army renovation scenario number 3 becomes the most viable alternative, and renovation scenario number 1 is within $900,000 of the privatization scenario. Renovation scenario numbers 1 and 3 are less risky and cost $37 million and $33 million less than the privatization scenario. As shown in the Renovation Alternatives section of our audit report, we still believe CFSC has not adequately considered less costly renovation alternatives for meeting Academy and transient needs.

Management Comments on Hotel Thayer Master Plan Estimate. The Army took exception with the audit report statement that the Hotel Thayer Master Plan 145-room renovation alternative would cost $6 million in 1986 dollars. The Army stated that, using the final FY 1986 Hotel Thayer Master Plan estimated construction cost of $13.6 million, inflated at 4 percent per year to the project construction mid-point, construction costs would be $18.6 million.

Audit Response. In our review of the Hotel Thayer Master Plan, we were not provided the estimated FY 1986 construction cost of $13.6 million cited by the Army. In June 1994, the Army provided data that showed that the Army had taken estimated costs for renovation of the main building under Phase III and added costs of all major systems, including those major systems applicable to an expanded new annex. However, the renovation costs shown in the Hotel Thayer Master Plan for Phase III included costs associated with demolishing the annex and replacing it with a larger structure with a total of 185 rooms. Phase III also included the addition of a ball room, 20 convention rooms, a parking garage, and a health facility, including an indoor swimming pool.

We still believe, as shown in the CFSC Renovation Analysis section of the audit report, the renovation scenario in the Hotel Thayer Master Plan resulting in 145 rooms at a cost of $8 million ($6 million in 1986 dollars escalated at

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Appendix D. Management Comments on the Finding and Audit Response

4 percent per year) is financially viable, as shown in our cash flow analyses separately submitted to CFSC in May 1994, and should be evaluated as a feasible alternative to current proposed project.

Management Comments on $20 Million Renovation Estimate. The Army stated that the $20 million renovation cost questioned by our audit was the result of an independent Government estimate performed by Delta Research Corporation in 1992.

Audit Response. The briefing package presented to us by CFSC during the audit showed that renovation of the existing hotel would cost $20 million and would not be economically feasible because of the income loss caused by the reduction of hotel rooms from 197 to 110. However, as shown in the CFSC Renovation Analysis section of our report, we could not determine how CFSC derived the $20 million renovation cost and the resulting 110 rooms, nor has documentation been provided since we completed our audit.

The Army now states that the $20 million renovation cost used as support for renovation not being financially viable was derived from an independent Government estimate performed by Delta Research Corporation in 1992. The Army’s admission that the $20 million renovation cost wasn’t obtained until 1992 supports our contention that less costly renovation alternatives were not considered before the Army decided to renovate and expand the hotel through privatization. The Army now states that the costs used to support its position were not obtained until 1992, 5 years after the decision was made to pursue renovation and expansion of the hotel through privatization.

Management Comments on Appraisal Estimate. The Army took exception to our audit report citing the 1993 Corps of Engineers appraisal as a source document for renovation costs. The Army stated that the study was intended to determine the current value of the Hotel Thayer for fair market value/out-lease purposes, not to estimate the alternatives or evaluate proposals for privatization.

Audit Response. The Army’s statement that the 1993 Corps of Engineers appraisal was intended to determine the current value of the Hotel Thayer for fair market value/out-lease purposes is partly correct. The appraisal also determined the highest and best use of the Hotel Thayer. The appraisal concluded, using 1988 construction costs inflated to 1997 dollars, that the hotel could be rehabilitated for an estimated $13.5 million. Further, the appraisal projected that the rehabilitated hotel would generate sufficient revenues for a $6.2 million expansion, resulting in the hotel’s highest and best use as a renovated 200-room hotel, with 15,000 square feet available for meeting or service facilities, at a cost of about $20 million. We used this scenario to illustrate our contention that other less costly renovation alternatives were not adequately considered, and not as a definitive estimate of construction cost.

Protection of the Army MWR Fund From Potential Liability

Management Comments on Safety Mechanisms Within the RFP and Their Application. The Army stated that the safeguards set forth in the RFP
adequately protect the Army MWR Fund from financial exposure. The Army cited the following six provisions present in the proposal of the selected developer as means of providing funds to meet obligations once the hotel is operational:

- the cumulative cash from operations,
- the debt service reserve fund,
- the reduction of fees paid to the contracted hotel management group,
- the developer's standby operating fund,
- the monies due the Army MWR Fund or support from the Army MWR Fund by means of a liquidity support agreement, and
- the Army MWR Fund's first call on all future cash flow, if Army NAF financial assistance was required.

The Army stated that the six provisions put the selected developer's equity at risk, provide incentive for the equity partners and hotel management to perform well, and insulate the Army MWR Fund from the need to provide capital for the annual debt service.

**Audit Response.** We disagree with the Army's statement that the six provisions shown above adequately protect the Army MWR Fund from financial exposure. The basis for our disagreement is as follows.

**Cumulative Cash From Operations.** The selected developer's cash flow projections showed that, in year 4 of the project, about $ * million in cumulative cash would be available to help fund the debt service or any operational deficits. The only way the developer could accumulate the $ * million in cumulative cash is to capitalize the first 3 years of debt service (about $ * million) to be paid out of proceeds from the $ * million bond sale. If the developer did not use bond proceeds to pay the 3 years of debt service, and did use cash proceeds, the developer, at year 4 of the project, would still have a cumulative deficit of about $2.6 million. If the developer defaulted under these circumstances, the Army MWR Fund would be financially exposed. Further, as shown in Appendix B of our audit report, if the annual occupancy rate is 3 percent less than projected, the hotel would have a negative cumulative cash flow for year 6 through year 20 of operations. Also, Appendix C of our audit report shows that, if average daily room rates increased only at the national average, the hotel would experience negative cumulative cash flows throughout the entire lease period.

**Debt Service Reserve Fund.** We agree with the establishment of the debt service reserve fund. However, use of the debt service reserve fund towards hotel operational deficits would negate the basis for establishment of the fund and could increase the probability of the developer’s default at year 10 of hotel operations. Amendment 0008 of the RFP requires that at least 10 percent of the debt guaranteed by the Army MWR Fund be amortized by the end of

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year 10 of hotel operations. The selected developer proposes to meet this requirement by depositing, at the beginning of year 4 of hotel operations, $ * million in an interest-bearing account earning at least 9 percent per year. Based on current interest rates, it is doubtful that the developer would be able to obtain an interest-bearing account earning at least 9 percent per year. However, if such an account were obtained, and if monies within the account were withdrawn to cover hotel operational deficits or annual debt service, the developer would be required to replace the funds with an amount larger than withdrawn to recoup lost interest. Also, the use of monies from the debt service reserve fund for other than their intended purpose would increase the probability of developer default under the terms of the RFP.

Reduction of Management Fees. We agree with the Army that the fees paid to the hotel management group could be reduced to meet hotel obligations. However, according to the developer’s cash flow projections, the management fees for the first 10 years of hotel operations would range from $ * in year 1 to $ * in year 10. During the first 10 years of operations, management fees would average about $ * annually, or 11 percent of the annual debt service of $ * million starting in year 4.

Standby Operating Fund. The Army is correct in stating the monies from this fund can be used toward the annual debt service. However, the amount of the standby operating fund, as determined by the provisions set forth in the request for proposal, would not exceed $ * million. Applying $ * million to the annual debt service would still require the Army MWR Fund to finance the remaining $2 million of the $ * million annual debt service starting in year 4.

Monies Due the Army MWR Fund. According to amendments 0008 and 0016 of the RFP, the contracting officer may defer payment of the 1 percent base payment to the Army MWR Fund. The developer is still obligated to pay the deferred monies, plus any interest accrued. Based on the developer’s cash flow projections, the cumulative total of the monies paid to the Army MWR Fund during the first 10 years of hotel operations would be $1.4 million. Therefore, if all monies due the Army MWR Fund were deferred for the first 10 years of hotel operations, the total would not equal one-half of the annual debt service of $ * million in years 4 through 10.

Army MWR Fund First Call. The Army is correct in its statement that, if Army MWR Fund assistance was required, the Fund would have first call on all future cash flows. However, as shown in Appendixes B and C, should the hotel not achieve the projected occupancy or average daily room rates, a negative cash flow would occur.

Based on the discussion in the preceding paragraphs, we disagree with the Army’s statement that the safeguards set forth in the RFP adequately protect the Army MWR Fund from financial exposure. Based on the developer’s cash flow projections, the highest annual amount of monies that could be deferred and used towards hotel operations and the annual $ * million starting in year 4, debt service would occur in year 10 of operations. In year 10, the deferred payment of the hotel management fee ($ * ), the Army MWR Fund base fee ($ * ),

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and the maximum amount that could be required of the standby operating fund ($ * million) would total $ * million, or $1.2 million less than the $ * million annual debt service for years 4 through 10.

Management Comments on Standby Operating Fund. The Army stated that the standby operating fund was not intended to equal the amount of annual debt service and that the amount of the standby operating fund would be established during conditional notice of award.

Audit Response. We agree that the standby operating fund was not intended to equal the annual debt service and that the amount of this fund would be established during conditional notice of award. However, according to the criterion set forth in amendment 0008 of the RFP, the maximum amount of the standby operating fund could not exceed $ * million. Any negotiations by the Army would have to be for $ * million or a lesser amount. The Army's statement that operational deficits would be covered by the standby operating fund is true, as long as the deficits do not exceed $ * million for any given year.

Management Comments on Offer Guarantee. The Army stated that the $500,000 offer guarantee was to provide resources to continue the procurement process in the event the selected developer could not secure adequate financing, not to reimburse the Army MWR Fund. The Army stated that the amount of the offer guarantee was based on past solicitation expenses.

Audit Response. The Army's statement is correct that the $500,000 offer guarantee was based on past solicitation expenses and was to provide resources to continue procurement in the event the selected developer could not secure financing. However, as shown in the Best and Final Offer section of our audit report, by September 1993, $1.2 million had already been spent on this procurement process. Therefore, the amount required for the offer guarantee is less than the amount spent on the procurement.

Management Comments on Performance and Payment Bonds. The Army stated that performance and payment bonds are not designed to cover cost overruns. The RFP has two provisions, the formal design review process and loan disbursement control mechanism, that would prevent cost overruns during construction.

Audit Response. We disagree with the Army's statement that the formal design review process and the loan disbursement control would prevent cost overruns during construction. The formal design review would help prevent any cost increases resulting from design changes; however, the formal design review would have no effect on increases in development, labor, or material costs. Further, the loan disbursement control mechanism would not protect the Army MWR Fund from costs overruns. The Army MWR Fund will be liable for any monies needed to complete the hotel renovation in the event the developer did not have sufficient funds.

Management Comments on Credit Enhancement. The Army stated that credit enhancement has been successfully used for three previous hotel

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construction projects at Fort Bliss, Texas; Fort Drum, New York; and Schofield Barracks, Hawaii. Also, the Army MWR Fund only faces a $ * million liability in year 10 of the project. If the bonds have to be purchased by the Army MWR Fund at year 10, the value of the project would be $81 million (assuming an annual appreciation of 4 percent). Further, if the hotel does not meet operational projections, operational deficits will be covered first by the standby operating fund.

Audit Response. We agree that credit enhancement has been successfully used for construction projects for hotels at Fort Bliss, Fort Drum, and Schofield Barracks. However, for the hotels at Fort Drum, Fort Bliss, and Schofield Barracks, a form of credit enhancement consisting of debt service guarantees with buy-back provisions were used. Debt service guarantees were provided for the first 2 years to underwrite operating losses of up to $1.1 million for Fort Drum and $0.8 million for Fort Bliss. Both the hotel at Fort Bliss and the hotel at Fort Drum have been bought out by the Army MWR Fund at costs of $6.2 million and $5.8 million, respectively. The developer’s total loan amount for the hotel at Schofield Barracks was $12.5 million. Clearly, the risk to the Army MWR Fund for the Fort Drum, Fort Bliss, and Schofield Barracks debt service guarantees are substantially less than the risk resulting from the selected developer’s proposal (an average of $1.4 million a year for 7 years). Likewise, the cost to the Army MWR fund in the event that all three projects have to be bought out ($24.5 million) is substantially less than the potential liability of $ * million during the first 10 years of the Hotel Thayer project.

We disagree with the Army’s statement that, if the * have to be purchased by the Army MWR Fund at year 10, the value of the project would be $81 million (assuming annual appreciation of 4 percent). If the project started in year 10, the cost at that time, assuming annual inflation of 4 percent, might be $81 million; however, it cannot be assumed that the value of the hotel will appreciate to $81 million in 10 years. Buildings are depreciable, not appreciable assets; therefore, application of an appreciation factor to total project costs is not a valid method of estimating future value.

When renovation is complete, the hotel will have a fair market value equal to the present market value, plus the actual cost of renovation/construction. In the case of the proposed contract, that would equate to about $ * million (present market value of $4.3 million plus actual renovation and construction costs of $ * million). Any additional worth in excess of the fair market value of the hotel would depend on the success of the hotel operations. If hotel operations were successful, then the worth as a business would increase, but the increase would depend on net cash flows, not on an arbitrary appreciation rate. However, if actual operations equal or approach the projections shown in Appendixes B or C in our audit report, then the hotel could be worth no more than fair market value. Additionally, if at any time during the first 10 years of operations the developer should default, then it is very probable that hotel operations have not been successful, and the cost to the Army MWR Fund will exceed the value of the hotel.

Management Comments on Nature of Operation. The Army stated that the unique characteristics of Hotel Thayer prohibit comparisons with typical hotels.

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Hotel Thayer's food and beverage operation produces two-thirds of the hotel's gross revenue, while the guest rooms produce one-third, whereas the typical hotel derives two-thirds of gross revenue from guest rooms and one-third from food and beverage operations. The expanded hotel will maintain this differentiating feature.

Audit Response. The Army correctly stated that Hotel Thayer differs from typical hotels in that the food and beverage operations produce two-thirds of gross revenues, while guest rooms produce one-third; this income ratio is the inverse of typical hotels. Although the Army maintained that the renovated and expanded hotel will continue to receive revenues in the same ratios, it did not follow that logic in renovation scenario number 4 of Figure 2 in the Army comments (page 54). To support its contention that renovation scenario 4 is not economically feasible, the Army not only artificially inflated the project cost by $2.6 million but also used an income ratio of 51 percent of gross revenues derived from food and beverage operations, and 47 percent of gross income coming from guest rooms. The two ratios do not reflect the hotel's ratios that the Army contends will be maintained by the selected developer's proposal.

Management Comments on Debt Service Ability. The Army stated that the hotel's ability to meet debt service requirements from operations is the only pertinent evaluation criteria.

Audit Response. We disagree with the Army's statement that the hotel's ability to meet debt service requirements from operations is the only pertinent evaluation criteria. In the evaluation criteria, as set forth in the RFP, the financial program (capitalization plan, operating projections, and cash flow projections) is shown as being one of seven technical evaluation factors and third in order of importance. Further, throughout our audit report, we list various criteria that should have been considered and evaluated when determining the viability of the proposed project.

Management Comments on Occupancy Rate. The Army stated that the Delta Research Corporation analysis of the hotel's potential to attract mid-week patrons supports the annual increase of * -plus room nights. Factors such as additional rooms, quality amenities, developer expertise and market plan, and the up-turn in economic and hospitality conditions within the northeastern region are cited as support for the projected increase in room nights.

Audit Response. We disagree with the Army's statement that the Delta Research Corporation analysis supports the annual increase of * -plus room nights. The Delta Research Corporation analysis cited by the Army makes room demand projections for a 250- and 295-room hotel with conferencing, dining, and recreational facilities. However, the analysis contains certain assumptions that must be met to realize the projected increases in room demand. Delta Research Corporation states the Hotel Thayer's strategy is to attract mid-week business by renovating and expanding the hotel as a first-class conference facility. As shown in the Potential Conference Business and the Conference Center Criteria sections of our audit report, the capability of the developer's proposal to meet the projected increase in mid-week business is

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doubtful because of the lack of local commercial activity and the planned renovation and expansion not meeting the criteria for a successful conference center.

Management Comments on Aggregate Average Daily Rate. The Army stated that the aggregate average daily room rate and the projected increase in transient demand are reasonable and attainable due to factors such as the increased number of rooms and the improved room size and amenities.

Audit Response. We disagree with the Army's statement that the aggregate average daily room rate and the projected increase in transient demand are reasonable and attainable. Based on data presented in Figure 3 (page 61) of the Army comments, the hotel would have to obtain the maximum rate for double occupancy for every projected room night in the corporate/association and transient categories ($133 and $142 respectively) to achieve an average room rate of $131.22 cited as reasonable by CFSC's market consultant. The hotel's ability to achieve this average room rate is doubtful, especially for the corporate/association category, because attendees at meeting or conferences are less likely to be accompanied by their spouses and normally do not share a room with another attendee. Therefore, the hotel cannot expect to obtain the maximum rate for double occupancy on every room rented and cannot expect to achieve the projected average daily room rate. As shown in Appendix C of our audit report, failure to achieve the projected average daily room rate would result in the hotel experiencing a negative cash flow for the entire life of the project.

Management Comments on Transient Demand. The Army stated that increased transient demand would occur from the availability of additional guest rooms during the 32 nights per year that the hotel historically experiences 100 percent occupancy and from improved room sizes, finishes, and amenities.

Audit Response. The Army's statement is true but misleading that transient demand will increase because of additional rooms during the 32 nights per year that the hotel experiences 100 percent occupancy. Even with 100 percent occupancy on these 32 nights, the resulting increase in transient demand would be only 1,600 room nights, or less than 15 percent of the total projected increase in transient demand of 11,000 room nights.

Management Comments on Sensitivity to Room Rate Increase. The Army stated that the report cited outdated information to establish a position regarding the price sensitivity of the transient market. The Army presented Figure 3 in which the low range of the projected 1999 room rate for transients was $111 for a renovated Hotel Thayer and $101 for a non-renovated Hotel Thayer. The Army contended that this comparison supports its premise that the projected increased room rates will not significantly affect transient room demand.

Audit Response. The Army's statement is incorrect and unsupported that our report cited outdated information to establish our position regarding price sensitivity of the transient market. The Army projected transient rates for 1999 applicable to a non-renovated Hotel Thayer of $101 and $111 as the low end of the proposed price range for a renovated/expanded 3-star hotel. The $111 rate will probably not be offered to most transients. The hotel must obtain the maximum rate of $142 to meet the projected average daily room rate needed for
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a positive cash flow. The $142 rate would represent an increase of $41 (40.6 percent) over the rate shown for a non-renovated hotel, which could have a significant effect on transient demand.

Management Comments on Construction Cost Per Room. The Army stated that the developer’s costs, stated in terms of debt per room, are reasonable when compared with the independent Government estimate developed by Delta Research Corporation, as shown in Figure 4 in the Army comments (page 62). The Army stated that our use of the Parnell Kerr Forster forecasted national average debt per room is not discretely applicable to 3-star hotels, but a reflection of costs that apply to economy hotels as well.

Audit Response. We disagree with the Army’s statement that the developer’s costs, in terms of debt per room, are reasonable and that the average debt per room cited in our report is not discretely applicable to 3-star hotels, because costs of economy hotels were included in the average. We also find it inconceivable that the developer’s proposed debt per room could be deemed reasonable and supportable when the cost per room would exceed that of the most expensive hotel sold during 1993. While Figure 4 shows the developer’s proposed costs are only 8.8 percent higher than the Government estimate, we believe comparing the developer’s costs to the hotel industry is more valid. While the Army is correct in stating the average debt per room figure cited in our audit report contains economy hotel costs, we still believe the figure is valid, because it also contains costs of 4-star hotels. A comparison of the developer’s $ * debt per room with the costs per room of all hotels sold in New York, including New York City, since 1989 shows the developer’s costs exceed the state average by about $91,000 per room.

An additional comparison of the reasonableness of the developer’s debt or cost per room can be made from a survey of major hotel sales for 1993 published in the Summer 1994 edition of The Hotel Valuation Journal. The survey showed that the three most expensive hotels, in terms of cost per room, sold in the United States during 1993 were:

- the LaQuinta Golf and Tennis Resort, California, at $213,125 per room,
- the New York Palace Hotel at $209,761 per room, and
- the Inter-Continental Resort, Hawaii, at $205,556 per room.

The cost per room of the New York Palace Hotel sale was $6,000 less than the Hotel Thayer project. The New York Palace Hotel sale was a leasehold transaction, which should make it comparable to the Hotel Thayer project. The other two hotels were straight sales that included the buildings and land.

Management Comments on Competing Conference Centers and Market Assessment. The Army stated that our audit report was correct in citing Delta Research Corporation Market Analysis Revalidation as stating the Hotel Thayer will compete with Arrowwood Conference Center and Tarrytown House Executive Conference Center. Because of the Hotel Thayer’s lower room rates,

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the Hotel Thayer would be attractive to more price-sensitive market segments such as associations. Hotel Thayer will draw its largest conference market from surrounding counties in New York and New Jersey, with supplemental marketing efforts directed at the lower bracket of the existing client base serviced at upscale conference centers closer to New York City.

Audit Response. We disagree with the Army’s statement that the renovated Hotel Thayer will be more attractive to the price-sensitive market segments such as associations and will draw its largest conference business from surrounding counties in New York and New Jersey. According to the Delta Research Corporation 1992 Market Analysis Revalidation, the renovated Hotel Thayer would be placed in the category of an executive conference center and the success of such a center would depend upon the effective marketing of the facility during the business week. The Army states the hotel plans to concentrate on drawing association business, currently the hotel’s smallest market segment. However, the developer’s forecasted marketing expenses were less than half the industry average, as pointed out to the Army by Delta Research Corporation’s "Review of Operating Projections, The Hotel Thayer, West Point, New York." This marketing weakness, along with those cited in the Conference Center Criteria section of our audit report, support our questions about the ability of the Hotel Thayer to increase its annual room demand by 59 percent through its marketing as a conference center. Further, while the Army states the hotel will draw conferencing business from New Jersey, none of the marketing studies performed to support the project identified the competition that the Hotel Thayer would face in New Jersey.

Management Comments on New Developments Within Surrounding Market. The Army stated that our report correctly cited Delta Research Corporation concerning failed attempts to establish hotel ventures in Orange County, New York. The Army disagreed that the failed attempts cast doubt on the proposed renovation. The failures were attributed to the unavailability of hotel financing for new projects. The Army cited the Delta Research Corporation report that no new developments were ongoing in Orange County to compete with the Hotel Thayer. The Army felt that the lack of planned development in Orange County reduces the uncertainty associated with the proposed expansion program.

Audit Response. While the Army is correct that failed attempts to establish hotel ventures are attributable to lack of financing, we disagree that the lack of planned development reduces the uncertainty associated with the project. As shown in the Potential Conference Center section of our audit report, Delta Research Corporation reported lending institutions were extremely wary of investments in the hotel industry. We still contend this supports our position that the failure to attract a major hotel chain in Orange County, along with the unavailability of financing, cast doubt on the Hotel Thayer’s ability to achieve the room occupancy and rates needed to make the proposed operations profitable.

Management Comments on Inclusive Review of Development Studies. The Army stated that our report was based on the five studies listed in Appendix A of the report. The Army further stated that it has performed many other reviews, analyses, and research studies that form the basis of the Army’s opinion that the risk to the Army MWR Fund is acceptable. According to the
Appendix D. Management Comments on the Finding and Audit Response

Army, a clearer understanding of the decision to privatize the Hotel Thayer could have been gained through an inclusive review of all project documentation.

Audit Response. The Army is partly correct in that the Scope and Methodology section of our report stated that Appendix A contains a list of all studies reviewed. However, this statement did not accurately characterize the total extent of our review. Two of the five studies were provided to potential offerors with the RFP while the other three were cited as sources for data in our audit report. Our review included all Hotel Thayer project and contracting files, including all reports, studies, analyses, and memos contained therein, located at CFSC and the Academy.

Management Comments on Army’s Lender Survey. The Army stated that its survey of lenders from the first quarter of 1994 showed investors would consider a capitalization rate of 9 and 10 percent, given the unique features of the Hotel Thayer project. Also, the Army’s literature search of the source used in our report showed no consistent statement regarding debt to equity ratios. Further, its financial analysis concluded that the project’s net operating income could support the hotel’s value after development costs of $* million are incurred. The Army also stated that its recent survey of lenders and underwriters showed that financing is available with less than 30 percent equity. Underwriters were reluctant to make definitive statements, but they would consider including the Hotel Thayer project in their portfolio.

Audit Response. We disagree with the Army’s statements. The Army surveyed four lenders in regard to capitalization rates. The first lender estimated, if hotel operations were stabilized, a capitalization rate of 10 percent or possibly 9 percent with the provision it would be based on stabilized cash flow after management fees, reserves, and debt service. The second lender would not make a definitive statement without being provided with details on the nature of the deal. The third lender stated that a 10 percent capitalization rate would be no problem, as long as the debt was guaranteed. The fourth lender estimated between a 10 percent and 13 percent capitalization rate on cash flow after reserves.

The Hospitality Valuation Services survey cited in our audit report did not make a definitive statement regarding debt to equity ratios but did state that lenders wanted more equity up front and lower loan-to-value ratios. The Army surveyed six lenders about equity requirements. Four of the six lenders cited equity requirements of between 10 percent and 25 percent, one lender stated that an equity of between 5 percent and 15 percent would be required, and the remaining lender made no definitive statement regarding the minimum amount of equity acceptable. During all of our discussions with CFSC personnel, it was always stated that, without credit enhancement, the project could not go forward because private financing would not be available. If the Army survey on equity requirements was accurate, it would support our recommendation that credit enhancement be withdrawn or reduced to lessen the risk to the Army MWR fund.

* Contractor confidential or proprietary data has been deleted
Appendix D. Management Comments on the Finding and Audit Response

The Army's financial analysis showing that net operating income could support hotel development costs of $ * million was overstated. CFSC's financial consultant provided us an analysis showing a project value $58.9 million, using a 9-percent capitalization rate. The comments contained in the Army's lender survey showed that the only lender who would consider a capitalization rate of 9 percent would do so on cash flow after management fees, reserves, and debt service. This provision was ignored by the CFSC financial analyst. Using the same year of hotel operations used by the CFSC financial analyst (year 14), and subtracting the debt service, and using a 9-percent capitalization rate, the project value would only be $14.7 million. This value is about $44.2 million less than the value calculated by the CFSC financial analyst and supports our contention that doubt exists about the financial viability of the developer's proposal.

Management Comments on Project Loan Value. The Army stated that we incorrectly applied the band-of-investment technique to determine project loan value. The technique is not used in the manner prescribed within our report, but rather it is an approach to set the capitalization rate to establish project value. Correct application of the technique supports the Army position that the Hotel Thayer is sufficiently profitable for lenders.

Audit Response. We disagree with the Army's statement that we incorrectly applied the band-of-investment technique and that the correct application supports the Army's contention that the Hotel Thayer is sufficiently profitable for lenders. The Army correctly states, as we do in the Project Loan Value section of our audit report, that the band-of-investment technique is used to set the capitalization rate to establish project value. Further, as stated in the Project Loan Value section of our audit report, the highest project value we could derive from using this investment technique was $38 million. This figure was probably overstated, because we used net operating income, before debt service, for year 7 of the project, capitalized at 9.75 percent. As stated previously, the only lender surveyed by the Army who would consider a 9 percent capitalization rate would do so on operating cash flows after debt service, management fees, and reserves; thus, our project value was possibly overstated. Even overstated, our value of $38 million is substantially less than the project's $ * million development costs. We still doubt the Army's position that the project is sufficiently profitable for lenders, as lenders have not shown a willingness to finance the project without the Government guarantee.

Management Comments on Comparative Risk Analysis. The Army stated that the cumulative value of either the annual debt service guarantee (estimated to be an average of $1.4 million for 7 years) or the principal of the bond offering at the retender point ($ * million) is less than the project cost of $ * million. The probability of both these liability provisions occurring at their full value is remote. The most viable of three alternative proposals, renovation scenario number 3, could cause an outlay of $22 million. The Army offered this comparison as support to its premise that the selected proposal is financially viable and exposes the Army MWR Fund to acceptable levels of risk.

Audit Response. We disagree with the Army's statement that the cumulative value of the debt service or the principal of the bond offering at the retender point is less than the project cost of $ * million and that the probability of both

* Contractor confidential or proprietary data has been deleted
these liability provisions occurring at their full amount is remote. We still believe, as stated in the Financial Projections section of our report, that CFSC has not adequately evaluated all the issues affecting the potential success of the Hotel Thayer project. As shown in Appendixes B and C of our report, a slight variance in achieving the forecasted average room rate or occupancy rates has a negative impact on the project's profitability. For this and the other reasons cited throughout our audit report, we believe the possibility exists that the Army MWR Fund liability provisions will be invoked. Because of the liability provisions, the Army MWR Fund could face a cumulative liability of $57.8 million ([an average of $1.4 million x 7 years] + $ * million) at the point. While this $57.8 million might be less than future construction costs, assuming current project construction was delayed 10 years, it would still be higher than the current project cost of $ * million.

Management Comment on General Accounting Office and Army Audit Agency Findings. The Army stated that its response to the General Accounting Office audit report refutes the findings, and provides corrections to financial data, terms, and statements presented by General Accounting Office.

Audit Response. We were not provided the Army response to the General Accounting Office report. The Army data is input to a proposed draft official position of DoD. Since, it is a draft and not an official DoD position we cannot assess the validity of the Army's position on the General Accounting Office findings.

Management Comments on $1 Million Donation. The Army stated that the analysis in our report dealing with the $1 million donation is inexact. The Army stated that the existing Hotel Thayer will contribute $1 million to the project development to pay for ancillary work associated with reorientation of the playing fields and hotel parking.

Audit Response. We disagree with the Army's statement that the analysis in our report dealing with the $1 million donation is inexact. Our statement that the "MWR Fund" (versus Hotel Thayer) would contribute $1 million was derived from amendment 0008 to the RFP, which stated, in reference to Thayer Road and the Buffalo Soldier Field Complex, "Subject to departmental and congressional approval the Fund will provide no more than $1 million in support of the revised scope requirement as stated above." Further, under section 1.15 of the RFP, the Fund is defined as the Army Morale, Welfare, and Recreation Fund, which is a nonappropriated fund instrumentality of the United States, and includes all its assignees, designees, and successors in interest.
Appendix E. Organizations Visited or Contacted

Office of the Secretary of Defense
Office of the Assistant Secretary of Defense (Force Management and Personnel),
Washington, DC
Office of the Deputy Under Secretary of Defense (Environmental Security),
Arlington, VA

Department of the Army
Office of the Assistant Secretary of the Army (Manpower and Reserve Affairs),
Washington DC
Army Community and Family Support Center, Office of the Assistant Chief of Staff of
the Army (Installation Management), Alexandria, VA
U.S. Military Academy, West Point, NY
Hotel Thayer, West Point, NY

Non-Government Organizations
Basile Baumann Provost & Associates, Inc., Annapolis, MD
Thayer Gate Development Corporation, West Point, NY
Hudson River Partners, Potomac, MD
Appendix F.  Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense for Personnel and Readiness
Comptroller of the Department of Defense
Assistant to the Secretary of Defense (Public Affairs)

Department of the Army

Secretary of the Army
Inspector General, Department of the Army
Auditor General, Department of the Army

Department of the Navy

Auditor General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, National Security Agency
Inspector General, Central Imagery Office
Inspector General, Defense Intelligence Agency
Inspector General, National Security Agency
Director, Defense Logistics Studies Information Exchange

Non-Defense Federal Organizations

Office of Management and Budget
National Security and International Affairs Division, General Accounting Office
    Technical Information Center
    Defense and National Aeronautics and Space Administration Management Issues
    Military Operations and Capabilities Issues

Chairman and Ranking Minority Member of Each of the Following Congressional
    Committees and Subcommittees:
    Senate Committee on Appropriations

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Non-Defense Federal Organizations (cont'd)

Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on Defense, Committee on Appropriations
House Committee on Armed Services
House Committee on Government Operations
House Subcommittee on Legislation and National Security, Committee on Government Operations
Senator Joseph I. Lieberman, U.S. Senate
Congressman Hamilton Fish, Jr., U.S. House of Representatives
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Part IV - Management Comments
MEMORANDUM FOR INSPECTOR GENERAL, DEPARTMENT OF DEFENSE, ASSISTANT INSPECTOR GENERAL FOR AUDITING
ATTN: LOGISTICS SUPPORT DIRECTORATE

SUBJECT: Draft Inspector General, Department of Defense (DODIG) Quick Reaction Report on the Audit of the Hotel Thayer, U.S. Military Academy (USMA), West Point, NY (Project No. 4LF-5020) -- INFORMATION MEMORANDUM

The Army response to the subject report is enclosed at TAB A. This report contains source selection information which is proprietary in nature. This information may not be released to the public or to anyone within the Government not having a legitimate interest or a need to know.

The financing, restoration, expansion, and operation of the Hotel Thayer through the proposed privatization contract is the optimum solution to the requirement to provide a safe, modern, and financially viable hotel at the United States Military Academy (USMA). The U.S. Army Community and Family Support Center, serving as project manager at the request of the USMA, has conducted extensive research and analysis of Public-Private Development requirements and has structured the Hotel Thayer project in a manner best suited to achieve the project's objectives. We agree that a degree of risk is inherent in this project. We are convinced, however, that the degree of risk to the Army Morale Welfare and Recreation Fund (AMWRF) is acceptable. The proposed contract is structured so as to substantially reduce the risk of loss by either party. This has been accomplished by including in the proposed contract a series of safety mechanisms. The Army is satisfied that the proposed contract will create a genuine unity of interests, minimize the risk, and maximize the potential for success.
Regarding the DODIG draft findings:

- The audit did not identify any material internal control weakness in relation to nonappropriated fund (NAF) contracting procedures.
  Concur;

- USMA should analyze less costly alternatives.
  Concur; The Army has analyzed less costly alternatives but found them not to be financially viable.

- Project scope and cost requirements were never quantified.
  Nonconcurs; The Army’s use of privatization methodology sought a commercial solution so as to create a successful operation based on a verifiable market.

- Privatization initiative exceeds Army’s needs.
  Nonconcurs; successful offeror’s scope was substantiated by reputable hospitality industry consultants and two market surveys.

- Financial projections are overly optimistic.
  Nonconcurs; reputable hospitality industry consultants, Army Hospitality Management and the office of the Assistant Secretary of the Army (Financial Management) believe projections are reasonable and attainable.

- Selected proposal unduly risky -- potential liability $48 million.
  Nonconcurs; as presented, $48 million liability is present only in the 10th year, during bond retendering, if the bonds can not be resold. The probability of this liability occurring is unlikely.

- Cancel or modify procurement; eliminate risk to AMWRF.
  Nonconcurs; current proposal is financially viable and does not expose AMWRF to unacceptable risk.

We note that the DODIG draft report has expressed concept approval of privatization, while at the same time opposed the acceptance of any risk by the AMWRF in
a privatization venture. This position is untenable for the Army. Privatization inherently involves a sharing of potential risks and rewards by both parties.

The Army, on the other hand, with its experience in hotel privatization projects at Forts Drum and Bliss and Schofield Barracks, with its extensive experience in hotel operations, and with the opinions of reputable hotel and financial consultants, has concluded that the proposed privatization contract balances the magnitude and probability of any risk against the anticipated benefits.

Privatization accomplishes the required renovation of the Hotel Thayer while extending the use of limited monies for the Army’s NAF worldwide construction program for the benefit of soldiers and their families. Conversely, the alternatives, which eliminate all risk to the AMWRP, require unacceptable levels of initial investment at the expense of other projects which do not lend themselves to Public-Private Development. Additionally, such expenditures will do nothing to resolve the Hotel Thayer’s main problems: an outdated physical plant, limited ability to generate revenue and inability to fund recurring expenses needed to maintain the facility.

This response has been coordinated with the Office of the Assistant Secretary of the Army (Manpower and Reserve Affairs), the Office of the Assistant Secretary of the Army (Financial Management), the Office of the Army General Counsel, and the USMA.

JOHN G. MEYER, JR.
Brigadier General, USA
Commanding

Enclosure

COL Michaliga/325-9784
Army Response

to

Quick Action Report on the Audit of the Hotel Thayer,
U.S. Military Academy, West Point, New York
Project No. 4LF-5020

Community and Family Support Center,
Alexandria, VA

19 August 1994
## CONTENTS

### SECTION I

Response to DODIG Draft findings and recommendations.

### SECTION II

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<th>Description</th>
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</thead>
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<td>Part 1</td>
<td>A discussion of the effectiveness of privatization to finance, design, develop, construct, operate and maintain public facilities.</td>
</tr>
<tr>
<td>Part 2</td>
<td>Critical analysis factors used in development of the Army position that privatization is the most practical solution to the challenge created by the need to renovate the Hotel Thayer.</td>
</tr>
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</table>
SECTION I
RESPONSE TO DODIG DRAFT FINDINGS AND RECOMMENDATIONS

DODIG FINDING: HOTEL THAYER RENOVATION AND EXPANSION EXCEEDS NEEDS "The Army’s proposed renovation and expansion of Hotel Thayer exceeded the Academy and public needs and was based on overly optimistic financial projections. The renovation and expansion project was excessive because:

- the CFSC request for proposal did not adequately define the Academy needs,
- the Academy did not adequately consider less costly renovation alternatives and,
- the CFSC request for proposal did not adequately protect the MWR fund from potential liabilities associated with the proposed contract.

Awarding the proposed contract would result in the MWR Fund facing a potential liability of $* million in the event of contractor default." (page 8 of DODIG draft report Draft)

ARMY RESPONSE: ADDITIONAL FACTS

These additional facts are provided to clarify the Army’s position with regards to:

I. Methodology selected for the acquisition process
II. Consideration of less costly renovation alternatives
III. Protection of the AMWRF from potential liability

I. METHODOLOGY SELECTED FOR THE ACQUISITION PROCESS

"........ o the CFSC request for proposal did not adequately define the Academy needs......"

1. METHOD Privatization methodology requires sufficient flexibility in the request for proposal (RFP) to facilitate: (1) business creativity by the offerors, (2) existing market conditions, (3) change in market conditions, (4) alternative uses which could increase economic return for the project, and (5) constraints and opportunities identified from economic analysis.

* Contractor confidential or proprietary data has been deleted.
2 **OBJECTIVE** The Army purposely sought to attract a private developer that would expand the operation to be financially viable (which is currently 40,213 room nights per year as shown in Figure 1). The selected developer's proposal will produce a renovated historic hotel which will continue to attract 40,000-plus annual room nights of the existing market segment, while the newly constructed conference facilities will attract *annual room nights of new conference related business. The proposed design accomplishes a single cohesive facility which will compliment the surrounding historic site of the United States Military Academy (USMA). The integration of the new conferencing facilities into the historic hotel satisfies the requirements for conference industry standards and the proposed expanded market.

3 **RFP** The RFP was purposely broad to allow for a developer to propose a methodology and approach to finance, design, construct, operate, and maintain the Hotel Thayer. The privatization methodology sought a commercial solution to create a successful operation based on a verifiable market. The RFP was written to allow the offerors to examine the market studies, and propose a business operation that would meet the overall objective of the project. The proposed contract is structured so as to substantially reduce the risk of loss by either party. This has been accomplished by including in the proposed contract a series of safety mechanisms. The Army is satisfied that the proposed contract will create a genuine unity of interests, minimize the risks, and maximize the potential for success.

4. **EVALUATION** The Army's Source Selection Evaluation Board (SSEB) recommended for contract award a privatization proposal that optimized the hotel's current market position, while providing expanded facilities and amenities to attract additional market segments, which would compliment the traditional needs of the Academy while serving public needs during the current low mid-week occupancy period.

5. **SELECTED PROPOSAL** The selected proposal for a *room hotel is within the parameters of the predevelopment market study provided with the RFP. The proposed operation was evaluated as a hotel with meeting space as opposed to a conference center. The underlying and survey supported premise is that the current operation will expand into the conference market, without detracting from the ongoing operation that produces a 56% annual occupancy rate. The projections are reasonable and attainable as supported by the Army's Hospitality Directorate and commercial consultants.

* Contractor confidential or proprietary data has been deleted.
II. CONSIDERATION OF LESS COSTLY RENOVATION ALTERNATIVES

"......o the Academy did not adequately consider less costly renovation alternatives, and......"

1. CURRENT REVENUE POTENTIAL

The current hotel operation will never produce sufficient revenue potential to create the capital necessary to renovate the existing structure without a planned expansion of the facility, its amenities and market position. In order to evaluate the feasibility of modest upgrades, Delta Research Corporation developed a study of four renovation scenarios. The scopes of these renovation projects are smaller and less extensive than the redevelopment and new construction project proposed by the selected developer. None of the renovation scenarios addressed in this study were deemed economically feasible (Figure 2), as none have the potential to produce sufficient income to meet the costs associated with current or future capital improvement requirements.

2. HOTEL THAYER MASTER PLAN ESTIMATE

The DODIG draft report cites a pre-1986 Hotel Thayer Master Plan containing a renovation cost of $6 million. The final FY86 revised Hotel Thayer Master Plan estimated the construction cost at $13,590,000 (excluding asbestos abatement costs of approximately $1 million). When escalated four percent per year to the mid-point of construction for the project (01/1997), it results in a $18,600,000 construction cost.

3. $20 MILLION RENOVATION ESTIMATE

The DODIG draft report questions the source of the $20 million renovation estimate used by the Army during the 1992 and 1993 phase of the development and procurement process. Independent government estimates (IGE) conducted by Delta
Research Corporation in 1992 were used as the basis of the $20 million renovation cost. The Army was conducting negotiations in good faith during this period, and deliberately decided not to contract for formal IGE's, but to utilize available resources.

4. **APPRASIAL ESTIMATE** The DODIG report cites the 1993 Corps of Engineers appraisal as a source document for renovation costs. This study did not include a construction estimate of renovation costs, but an estimate of a feasible investment level using an income capitalization approach. The study was intended to determine the current value of the asset to the government for fair market value/lease purposes, not to estimate alternatives nor evaluate the developers' proposals for the privatization initiative.

**FIGURE 2**

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<th>LINE</th>
<th>ALTERNATIVE(1)</th>
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<th>#2</th>
<th>#3</th>
<th>#4</th>
<th>#5</th>
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<td>Army</td>
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<td>Occupancy Rate</td>
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<td>Interest Rate Charged on Debt (4)</td>
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<td>Net Cash Produced Excluding Debt Service (6)</td>
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<td>13</td>
<td>Internal Rate of Return (7)</td>
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<td>14</td>
<td>Net Present Value (8)</td>
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<td>($9.1M)</td>
<td>($14.5M)</td>
<td></td>
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* Contractor confidential or proprietary data has been deleted.
NOTES TO FIGURE 2:

1. Each alternative has data displayed for the first 20 years. Data is from pro formas developed by two different consultants. Alteration has occurred to the project cost (line 2) to make the data congruent in terms of scope and methodology. No change was made to the contractor developed estimates and forecasts of operations.

2. Net of revenue and expenses before debt service/interest and any capital reserve set aside.

3. For Alternatives #1-4, debt service represents payments of principal and interest on a conventional 20-year loan borrowed from internal Army nonappropriated fund resources. For Alternative #5, *

4. Interest rates present in pro formas. Financial markets will determine actual rate at time of securing financing. Rates are reasonable at this time.

5. Line 6, Net From Operations, less Debt Service/Interest and Capital Replacement Expenditures.

6. Same as Note (5) without Debt Service/Interest being deducted.

7. Internal Rate of Return (IRR): Calculation, expressed as a percentage, which compares cash outflows vs. inflows over the project life (20 years). If negative, does not necessarily indicate that there is a loss from operations but that initial and subsequent capital expenditures are not recouped. In certain cases when the IRR is severely negative, the formula will not produce a percentage. This has occurred with Alternative #4. (NOTE: Calculations for Alternatives #1-4 are for a 20-year project life, *

8. Net Present Value (NPV): Compares the financial result produced by the project against having left the capital cost on deposit in the bank drawing interest. Please see NOTE in item (7) above as relates to project life.

* Contractor confidential or proprietary data has been deleted.
III. PROTECTION OF THE AMWRF FROM POTENTIAL LIABILITY

".......O the CFSC request for proposal did not adequately protect the MWR fund from potential liabilities associated with the proposed contract.......".

"...Awarding the proposed contract would result in the MWR Fund facing a potential liability of $48 million in the event of contractor default....."

1. SAFETY MECHANISMS WITHIN THE RFP The Army has determined that the safeguards set forth in the RFP adequately protect the AMWRF from financial exposure, without placing un-due burdens upon the developer's financial proposal. In addition to safety mechanisms during construction, provisions are present in the event a cash flow deficiency develops once the hotel is operational. * as listed below:

   a. The cumulative cash from operations.

   b. The debt service reserve fund.

   c. Reduction of fees paid to the contracted hotel management group which will equate to * of total revenue.

   d. The developers' standby operating fund. This requires the selected developer, in the form of a letter of credit or other unconditional commitment to ensure funds are available for operational expenses in the event cash from operations is deficient. The amount to be designated for this purpose will be negotiated according to the final financial terms (See point #3 below).

   e. *

   f. *

* Contractor confidential or proprietary data has been deleted.
2. **APPLICATION OF SAFETY MECHANISMS** The provision of the safety mechanisms puts the equity of the selected developer at risk, places incentives on the hotel management to perform, and denies cash to the equity partners until a deficit condition is satisfied. These safeguards insulate the AMWRF against the potential for needing to supply capital for the annual debt service. The potential necessity for an AMWRF guarantee of capital at the end of year ten is lessened by these safeguards. The nature of the safeguards serve as a strong incentive to the equity partners and the hotel management to perform well.

* 

3. **STANDBY OPERATING FUND** The amount of the standby operating fund will be based upon the Army's analysis of the potential cash-flow deficit in the hotel's operation. The establishment of a standby operating fund, provided by the developer in the form of a letter of credit or other unconditional commitment, ensures funds are available for hotel operational expenses in the event that hotel cash flow does not meet actual operating cost. The level of this "additional equity commitment is calculated in accordance with the terms set forth in the RFP. The funding level of the standby operating fund was never intended to be equal to the amount of annual debt service. It will be equal to the amount of any projected shortfall in cash flow from the operation, may be reviewed at any time but must be reviewed at least annually, and may be re-negotiated during the life of the contract. The amount of the standby operating fund is a product of the final financial terms of the contract. The Army has conducted sensitivity analysis to determine the potential for and magnitude of cash shortfalls in the future operation. The Army's final negotiation position will be established during conditional notice of award.

4. **OFFER GUARANTEE** The $500,000 offer guarantee required at best and final offer, is directly related to the Conditional Notice of Award. The offer guarantee was placed in the RFP to ensure that the offeror brought the financing to the project prior to contract execution. The $500,000 would provide resources to continue the procurement process, not to reimburse the AMWRF for costs already incurred. Past expenses were used for historical purposes to determine any cost, if a resolicitation had to occur.

5. **DEFAULT RESERVE** The default reserve (viewed primarily as transition capital) was established to provide the AMWRF with resources in the event of default to continue the day-to-day operations of the hotel.

6. **PERFORMANCE AND PAYMENT BONDS** The performance and payment bonds required by the contract were established to provide protection during the construction period. Performance and payment bonds

* Contractor confidential or proprietary data has been deleted.
are not designed to cover cost overruns in any construction contract. The
AMWRF has however, established in the RFP two safety mechanisms to
prevent cost overruns during the construction period, namely the formal
design review process and the loan disbursement control mechanism. The
New York District Corps of Engineers will provide technical support for both
of these requirements.

7 CREDIT ENHANCEMENT Credit enhancement underwritten by the
Army Morale Welfare Recreation Fund (AMWRF) has been successfully used
for three previous hotel construction projects for Inns at Fort Bliss, Fort
Drum and Schofield Barracks.

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The Army has reviewed the selected developer's
proposed operation and contends that the projections are achievable. However,
in the unlikely event that the hotel does not meet its operational projections,
potential operational deficits will be covered first by the standby operating fund.

8. NATURE OF OPERATION The proposed renovation and expansion
program for the Hotel Thayer is the essence of a private hotel development
project; however, this is where the comparison to typical hotels end.
Characteristics of the Hotel Thayer operation differs significantly from those
in industry, for example, the food and beverage operation produces two-
thirds of the hotel's gross revenue, while the guest rooms produce one-third,
whereas a typical hotel operation will generate one-third of the hotel's gross
revenue from food and beverage operations, while the guest rooms will
produce two-thirds. The expanded operation will maintain the same
differentiating features, thus cannot be compared or evaluated against
standard evaluation criteria.

9. DEBT SERVICE ABILITY The hotel's ability to meet debt service
requirements from operations has been analyzed, found reasonable and is
the best gauge for success. This is the only pertinent evaluation criteria for
the Hotel Thayer's irregular operation. Reputable hospitality industry
consultants, Army Hospitality Management, and Assistant Secretary of the
Army (Finical Management) believe projections are reasonable and
attainable.

10. OCCUPANCY RATE The current occupancy rate is indicative of both the
condition of the physical plant and the lack of amenities necessary to draw a
mid-week market. The high occupancy rate achieved on weekends is
indicative of the captured market that the Hotel Thayer enjoys. Delta

* Contractor confidential or proprietary data has been deleted.
Research Corporation has conducted extensive analysis of the hotel's potential to attract mid-week patrons. The room nights annual increase is reasonable in light of: the additional rooms, quality amenities, the developers operational expertise and market plan, the intangible and tangible assets (provided by the historic academy) involved in the development concept, the soundness of the market assessments for the geographic region, and the up-turn in economic and hospitality conditions within the north-eastern region.

11. **AGGREGATE AVERAGE DAILY RATE (ADR)** Seventeen percent of the current market is military groups who are sold rooms at a steeply discounted rate, which drives down the current ADR. The future operation will sell approximately the same number of room nights to the military market. However, a greater number of room nights will be sold to transient and corporate/association markets, which increases the aggregate ADR. The disparity between current and projected rates are justifiable by the additional amenities and increased quality created by the proposed renovation. Figure 3 shows a comparative analysis of room rates for proximate 3 Star properties, a renovated Hotel Thayer and current Hotel Thayer in years 1992 and 1999.

12. **TRANSIENT DEMAND** The market studies conducted by commercial consultants support the proposed renovation by presenting a detailed demand build-up resulting in occupancy rates slightly higher than those projected by the selected developer. The Hotel Thayer will unquestionably lose some demand from transient clientele who typically choose economy-grade accommodations. However, increased transient demand would be attracted to the Hotel Thayer by additional guest room availability during periods which are currently at 100% occupancy (32 nights annually), and improved room size, finishes, and amenities.

13. **SENSITIVITY TO ROOM RATE INCREASE** The DODIG draft report cites out-dated information internal to the negotiation and evaluation process to establish a position regarding the price sensitivity of the transient market. Projected transient rates for CY1999 for a non-renovated 1 Star Hotel Thayer are $101, which is only $10 less than the low end of the proposed price range of $111-$142 for a renovated/expanded 3 Star operation in the same year (Figure 3).

14. **CONSTRUCTION COST PER ROOM** An independent government estimate (IGE), was developed by Delta Research Corporation at the Army's request. The developer's costs (Figure 4 and 5) are reasonable when compared with those estimates. The national average attributed to Pannell

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* Contractor confidential or proprietary data has been deleted.
Kerr Forster is not discretely applicable to 3-Star hotels, but a reflection of costs which include economy lodges.
# ANALYSIS OF ROOM RATE INCREASE BY MARKET SEGMENT FOR COMPARABLE 3 STAR PROPERTIES, PROPOSED 3-STAR HOTEL THAYER AND THE CURRENT 1-STAR HOTEL THAYER

<table>
<thead>
<tr>
<th>Year</th>
<th>Property</th>
<th>Rack/Transfer</th>
<th>Corporate Average</th>
<th>Government</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Single</td>
<td>Double</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>Westchester Market</td>
<td>$140</td>
<td>$130</td>
<td>$130</td>
</tr>
<tr>
<td>1995</td>
<td>Skidmore College</td>
<td>$105</td>
<td>$105</td>
<td>$105</td>
</tr>
<tr>
<td></td>
<td>Hotel Thayer Proposed, 3 Star</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td></td>
<td>Hotel Thayer Current, 1 Star</td>
<td>$77</td>
<td>$77</td>
<td>$77</td>
</tr>
</tbody>
</table>

NOTES:
- RACK RATE APPLICABLE TO STUGS IN ADMISSION PROCESS
- ALL RATES ARE PROPOSED
- RACK RATE FOR PROPOSED 3-STAR HOTEL THAYER IS $135-180
- RACK RATE FOR CURRENT 1-STAR HOTEL THAYER IS $77

FIGURE 3
* Contractor confidential or proprietary data has been deleted.
III. PROTECTION OF THE AMWRF FROM POTENTIAL LIABILITY

"...... o the CFSC request for proposal did not adequately define the Academy needs......"

1. COMPETING CONFERENCE CENTERS The DODIG draft report correctly cites Delta Research Corporation's *Market Analysis Revalidation* in saying that the Hotel Thayer will compete with Arrowood Conference Center, Rye Brook, New York, and Tarrytown House Executive Conference Center, Tarrytown, New York. However, the pricing at both competing centers clearly differentiates their markets from the proposed Hotel Thayer operation (Figure 3). Room rates for a single at Tarrytown House in CY1992 were $242-$269 ($318-$354 projected at 4 percent per annum to CY1999 dollars). The Hotel Thayer will offer substantially lower rates, making it attractive to more price-sensitive market segments for conferences (e.g. Associations).

2. MARKET ASSESSMENT The Hotel Thayer is more accessible to northern New Jersey and corporate parks on the west side of the Hudson River, and will draw its largest conference market from surrounding counties in New York and New Jersey.

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3. NEW DEVELOPMENTS WITHIN SURROUNDING MARKET The DODIG draft report correctly cites Delta Research Corporation concerning failed attempts to establish hotel ventures in Orange County. These do not however "cast considerable doubt" on the viability of the proposed renovation. Instead, these failures reflect the unavailability of hotel financing for new projects, where the market drawn to the USMA can not be captured by off-post hotels. Land acquisition cost which is absent in our privatization proposal, was also a major disadvantage for private development projects. Business endemic to USMA adds additional market potential not present in off-post developments. Delta Research Corporation reported these failed ventures after a survey to determine whether other new properties, which could compete with a renovated Hotel Thayer were currently under development. No competing new developments were found to exist. The lack of other planned hotel development reduces the uncertainty associated with the proposed expansion program.

* Contractor confidential or proprietary data has been deleted.
4. **OFF-POST CONSTRUCTION** Delta Research Corporation has quantified the market potential and the impediments to off-post construction to include: real estate acquisition costs, development of infrastructure, the inability to capture the Hotel Thayer market, and reluctance to finance new hotel developments. These impediments prevent financing new hotel developments which can not duplicate the market drawn to the Hotel Thayer's historic location.

5. **INCLUSIVE REVIEW OF DEVELOPMENT STUDIES** The DODIG draft report was based on a review of five studies in support of the project development process (DODIG draft report appendix A). The Army developed and conducted many other reviews, analyses and research studies to validate and support the privatization process. These studies form the basis of the Army's opinion that the risk to the AMWRF is acceptable. In considering the Army's decision to privatize the Hotel Thayer, a clearer understanding could have been gained through an inclusive review of all project documentation, direct discussions with the entire Army project team and comprehensive review of all project documentation, to include functional reviews with hospitality and financial consultants.

6. **ARMY'S LENDER SURVEY** The Army's survey of lenders from the first quarter of 1994 (DODIG draft report is based on information dated from the fall of 1991) revealed that investors would consider a capitalization rate of 9 and 10 percent, given all of the unique features of the Hotel Thayer project. In addition, a literature search from the same source used by the DODIG draft report produce no consistent statement regarding debt/equity ratios. Our financial analysis concludes that the project's net operating income could indeed support the hotel's value after development costs of $* million are incurred (of which $* million is financed by debt). The Army's recent survey of lenders and underwriters indicates the availability of financing with less than 30 percent equity, given the unique features of the Hotel Thayer project. Underwriters were reluctant to make definitive statements, but it is clear that no industry standard exists for this type of project and that they would consider including this project in their portfolio.

7. **PROJECT LOAN VALUE** The DODIG draft report is based on incorrect application of the band-of-investment technique to determine project loan value. This technique is not used in the financial arena in the manner prescribed within the DODIG draft report, rather it is an approach to set the capitalization rate to establish project value. Correct application of the band-of-investment technique actually supports the Army's contention that the Hotel Thayer is sufficiently profitable for lenders.

* Contractor confidential or proprietary data has been deleted.
8. **COMPARATIVE RISK ANALYSIS**

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The most viable of three alternative proposals (alternative #3) could cause an outlay of $22 million (see Figure 2). The stark difference in cash outlay between this scenario and a successful operation by the selected developer can be seen in figure 4. The selected proposal is financially viable and exposes the AMWRF to acceptable levels of risk.

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* Contractor confidential or proprietary data has been deleted.
9. **GAO/AAA FINDINGS** The Army differs with DODIG draft report regarding the GAO/AAA audit on related issues that may impact on the feasibility of the proposed project. Regarding the concern expressed in the DODIG draft report for the AMWRF's current financial position, we have previously provided the Army's response to the GAO audit which refutes the GAO findings, and provides corrections to financial data, terms and statements presented by GAO.

10. **MILLION DONATION** The analysis in the DODIG draft report dealing with the $1 million donation is inexact. The existing Hotel Thayer nonappropriated fund instrumentality (NAFI) will contribute $1 million to the project development to pay for ancillary work associated with the reorientation of the playing fields impacted by the realignment of the Thayer Road and hotel parking.

**RESPONSES TO DODIG RECOMMENDATIONS**

**DODIG RECOMMENDATION 1:** "We recommend that the Commander, Army Community and Family Support Center, Office of the Deputy Chief of Staff of the Army (Personnel), either cancel the request for proposal for the renovation and operation of Hotel Thayer or modify the request to remove all risk to the Army Morale, Welfare and Recreation Fund." (page 20)

**ADDITIONAL FACT:** The U.S. Army Community and Family Support Center is a Field Operating Agency under the Assistant Chief of Staff for Installation Management, not the "Deputy Chief of Staff of the Army (Personnel)."

**ARMY RESPONSE:** Nonconcur. The current proposal is financially viable and exposes AMWRF to acceptable risk for value received. The financing, restoration, expansion and operation of the Hotel Thayer through the proposed privatization contract, is the optimum solution to the requirement to provide a safe, modern, and financially viable hotel at the United States Military Academy (USMA). CFSC, serving as project manager at the request of USMA, has conducted extensive research and analysis of Public-Private Development (PPD) requirements and has structured the Hotel Thayer project in a manner best suited to achieve the project's objectives. We agree that a degree of risk is inherent in this project. We are convinced however, that the degree of risk to the AMWRF is acceptable for the value received for the project. The proposed contract is structured so as to substantially reduce the risk of loss by either party. This has been accomplished by including in the proposed contract a series of safety mechanisms, which are
triggered prior to AMWRF monies being employed. The Army is satisfied that the proposed contract will create a genuine unity of interests, minimize the risks, and maximize the potential for success.

We note that the DODIG draft report has expressed concept approval of privatization, while at the same time opposed the acceptance of any risk by the AMWRF in a privatization venture. This position is untenable for the Army. Privatization, by definition, involves a sharing of both potential risks and rewards by both parties. The Army's decision on whether to proceed with a privatization venture balanced the magnitude and probability of any risks against the anticipated benefits of the project.

The DODIG draft report has found that privatization, which inevitably must include an element of risk, is an unacceptable solution to the needs of the Hotel Thayer. The Army on the other hand, with its experience with hotel privatization projects at Forts Drum, Bliss and Schofield Barracks, extensive experience in hotel operations, and the opinions of reputable hotel consultants, has concluded that the proposed privatization contract is financially feasible.

The use of privatization in the Hotel Thayer project permits extension of limited nonappropriated funds (NAF) resources making other monies available to support the Army's NAF worldwide construction program for the benefit of soldiers and their families, while achieving the necessary facility at West Point. Conversely, the alternatives which eliminate all direct risk to Army NAF, require unacceptable levels of initial investment at the expense of other projects which do not lend themselves to PPD and will do nothing to resolve the Hotel Thayer's main problems: an outdated physical plant; limited ability to generate revenue; and inability to fund reoccurring expenses needed to maintain the facility.

DODIG RECOMMENDATION 2: "We recommend that the Superintendent, U.S. Military Academy, perform in-depth analyses of less costly alternatives for the renovation and operation of the Hotel Thayer." (Page 21)

ARMY RESPONSE: Concur in principal. The Army has analyzed less costly alternatives and found them not to be financial viable (reference Army's response to recommendation 1). If funded directly by the AMWRF, they all represent a greater cash outlay than will occur from successful operations by the selected developer.
SECTION II

Part 1. A discussion of the effectiveness of privatization to finance, design, develop, construct, operate and maintain public facilities.

Part 2: Critical analysis of factors used in development of the Army position that privatization is the most practical solution to the challenge created by the need to renovate the Hotel Thayer.
Part 1: A discussion of the effectiveness of privatization to finance, design, develop, construct, operate and maintain public facilities

Public-private development (PPD) of public facilities is a part of the privatization phenomenon that is leading the U.S. government's capital expenditure program into the 21st century. The PPD of facilities has gained a track-record for successfully saving the government, educational institutions and the military, a tremendous amount of time and money. Privatization is no longer a new approach, but a tried and tested solution to overburdened capital expenditure budgets at the federal, state and local government level. In an environment of dwindling resources and ongoing initiatives to reduce the federal deficit, privatization has become a viable solution for expanding communities and replacing aging facilities.

The U.S. Army Community and Family Support Center (CFSC), which is the provider of Morale, Welfare, Recreation (MWR) programs for the Department of the Army, is confronted with the critical need to renovate a 68 year-old nonappropriated fund instrumentality facility, namely the Hotel Thayer, on the grounds of the United States Military Academy (USMA). The Army accepts the congressional mandate to provide first-class accommodations required to satisfy both the military and academic mission of the USMA. In its current condition, the Hotel Thayer does not meet the minimum requirements of an academic institution, a military installation, or a public hotel.

The Army analyzed the requirement, considered several alternatives and selected privatization as the optimum solution to a very difficult situation. Privatization is a partnership between the public and private sectors. Privatization typically satisfies the public sector's need utilizing private resources. Risk is inherent in any partnership, and the Army evaluated and balanced the magnitude and probability of risk against the anticipated benefits of the project.
Part 2: Critical analysis of factors used in development of the Army position that privatization is the most practical solution to the challenge created by the need to renovate the Hotel Thayer.

Differing opinions continue to be debated regarding privatization, the leveraging of soldiers' dollars, market potential and commercial financing. In the meantime, the Hotel Thayer continues to deteriorate, exposing the government and the AMWRF to the risk of considerable tort liability. The Army supports this privatization initiative, has analyzed possible alternatives, has articulated the project objective in an RFP, and is willing to share acceptable risk. The Army considers the probability and magnitude of financial exposure to be acceptable and strongly supports the innovative solution for the Hotel Thayer, West Point, New York. The following paragraphs describe the critical analysis factors and the compelling logic that led to the Army's decision.

The Army demonstrated, that of the five available alternatives, renovation of the Hotel Thayer through an expansion program is the only alternative that meets the needs of the Academy and market demand in the surrounding geographic area. The other four alternatives consisted of the following: (1) do nothing; (2) close the hotel; (3) rely on private hotel development off the installation; or, (4) renovate as-is. In addition, the Army demonstrated that the renovation and expansion alternative has the potential to produce sufficient income, to meet the costs associated with the hotel's current and future capital improvement requirements, while providing a positive return on investment.

Renovation and expansion requirements for the Hotel Thayer presents three sources of available financing: use a private developers funds for the capital improvements, use the Army Morale Welfare Recreation Program (AMWRF) to finance the capital improvements, or use Appropriated Funds.

There are five reasons why private developer's would view the Hotel Thayer project as attractive: (1) lack of acquisition costs and land lease payments; (2) the presence of a cumulative cash flow from an existing hotel during the first three years of renovation and expansion; (3) the opportunity to expand upon an existing market while capturing or penetrating new market segments; (4) the significant tax shelter benefits which could be derived by investors, given the hotel's historic status; and, (5) the expressed willingness of the Army to provide guarantees and commitments as a demonstration of partnership and the sharing of risk and rewards. However, assessments of the financial lending market indicate there are conditions within the project that would dissuade private investment without inducements: title to the building stays with the federal government; title to the land stays with the federal government, and the
building is on a federal installation and could be subject to future downsizing or closure actions.

The Army's assessment of these "dissuading" factors demonstrated that only two financing options were reasonable viable to lenders: either a developer must invest a disproportionately large amount of equity into the transaction to obtain a favorable loan rate, or a developer could provide a lower amount of equity in conjunction with a government body guaranteeing the balance of the development debt. Research of the lending market indicated that as much as 30% of the project cost would be required as equity to obtain financing. The research also indicated that it was very unlikely that a developer could, now or in the foreseeable future, obtain such high levels of equity at an affordable rate. Therefore, the credit enhancement by the AMWRF is the most reasonable and preferred method to obtain affordable financing.

The Army had two choices: provide the required annual debt service guarantee for a private loan during the credit enhancement time period of ten years, or use AMWRF resources to fund the renovation and expansion program.

Regarding the provision of the annual debt service guarantee, the Army has demonstrated why this is most viable and offers the least risk to the AMWRF in terms of financial exposure. Regarding the use of AMWRF to directly fund the renovation and expansion program, the Army has demonstrated the negative impact on the funding of other critical capital improvement requirements, which directly benefit a greater number of the Army's MWR patrons.

Regarding the annual debt service guarantee, from a practical and financial perspective, the Army would be remiss not to consider the use of private funds to improve an Army facility. Four financial concepts support the use of private funds: (1) opportunity costs; (2) time value of money; (3) present value; and, (4) return on investment. Each of these concepts, when analyzed against the condition and requirements of the Hotel Thayer project, support the opportunity for a private developer and a public partner to successfully join resources to the mutual benefit of both parties. Use of private funds extends the Army's ability to improve its capital asset base, whereas, use of the AMWRF to directly fund the renovation and expansion program reduces funds available for other critical capital improvement requirements that could directly benefit a greater number of the Army's MWR patrons.
INTERNET DOCUMENT INFORMATION FORM

A. Report Title: Hotel Thayer, U.S. Military Academy, West Point, New York

B. DATE Report Downloaded From the Internet: 03/15/99

C. Report's Point of Contact: (Name, Organization, Address, Office Symbol, & Ph #): OAIG-AUD (ATTN: AFTS Audit Suggestions)
Inspector General, Department of Defense
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D. Currently Applicable Classification Level: Unclassified

E. Distribution Statement A: Approved for Public Release

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