A Report to the Maryland General Assembly

Senate Budget and Taxation Committee

and

House Appropriations Committee

2009_p 214_STO_STATUS OF STATE CENTER LEASE

Nancy K. Kopp
State Treasurer
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Purpose of this Report

Chapter 484 of The Acts of 2009, at Section 52 – Status of State Center Lease states:

> 52. AND BE IT FURTHER ENACTED, That no funds may be expended for, nor may the master development agreement for the proposed State Center project be submitted to the Board of Public Works for approval, until:
>
> (1) The State Treasurer has consulted with the Comptroller, bond counsel, and the bond rating agencies and considered whether the State Center project constitutes a capital lease and the potential impact the project would have on State debt affordability limits. The Treasurer shall outline the results of this assessment in a report to be submitted to the budget committees no later than May 15, 2009; and
>
> (2) The budget committees shall complete all review and comment by May 29, 2009

This report focuses solely on the requirement included by the General Assembly in Section 52 of the FY 2010 Operating Budget Bill. It is not intended to opine on the need for the State Center or on the merits of the proposed plans for this project. Furthermore, this report is not intended as a recommendation to proceed or not to proceed with the Master Development Agreement.

Overview of State Center Redevelopment

A brief review of the plans and financing for the redevelopment of the State Office complex on Preston and Eutaw Streets from information provided by the Department of General Services (DGS) will enable the reader to better understand the responses in this Report to the specific questions posed by the General Assembly.

Construction Plan

The mixed-use development would be completed in five phases over ten years or more and would consist of new buildings plus the re-skinning and rehabilitation of existing office buildings.

Financing Plan[1],

The total cost for acquisition, hard costs, soft costs, and contingency is estimated at $1.43 billion. This will be paid from:

[1] Source: Maryland DGS and DOT Response to DLS State Center Briefing dated February 19, 2009
The amounts for construction and the amounts and sources for financing have changed throughout the planning stages of this project. The amounts are included in this Report for illustrative purposes to demonstrate both the magnitude of the project and the many sources of financing. These amounts are for the whole project, not just the State's portion.

$885 million in loans secured by rental income on the property and proceeds from condominium property sales
$170 million in Tax Increment Financing
$ 55 million parking bonds issued by the State and City
$145 million in State and federal tax credit programs and
$175 million in equity from the developer and institutional investors

Leases at State Center

There are two draft primary lease documents that DGS provided to the State Treasurer's Office (STO) on April 15, 2009 and that were noted as "not final and subject to change".

1. In the Ground Lease the State owns the land and present improvements and leases them to the development company as tenant (ground lessee) for 50 years with two 20 year renewals. At the end of this lease the land and improvements revert to the State.
2. In the occupancy lease, the development company would lease office space in the improved or new buildings to the State as tenant (lessee). The terms of these leases and the amounts of the lease payments were not identified in the draft that the STO received. According to DGS, the economics of the leases have not been negotiated – they would be negotiated after the Developer completes the design of each phase and presents the State with an offer to lease space. The occupancy lease is at issue in this request from the General Assembly and is the focus of this Report.

Background – Criteria and Accounting for Leases

Criteria for Capital Leases

According to generally accepted accounting principles (GAAP), if a lease meets one or more of the following four criteria at its inception, the lease must be classified as a capital lease.

(1) The lease transfers ownership of the property to the State (lessee) by the end of the lease term

(2) The lease allows the State (lessee) to purchase the property at a bargain price at fixed points in the term of the lease and for fixed amounts.

(3) The term of the lease is 75% or more of the estimated useful economic life of the property.

(4) The present value of the State's lease payments is 90% or more of the fair value of the property occupied by the State.

Accounting Treatment of Operating and Capital Leases, Inclusion in Debt Affordability Analyses

Understanding the accounting treatment of these leases and their effect on the State's debt affordability is essential to understanding the importance of the request made by the General Assembly in Section 52 of the FY 2010 Operating Budget Bill.

<u>Capital Lease</u>: Accounting Treatment and Inclusion in Debt Affordability Analysis:
On its balance sheet, the lessee records the asset generally at cost and a corresponding liability for the obligation to make the lease payments. The lease payments are allocated between interest expense and a reduction of the lease liability. The State records capital leases on its balance sheet and the Capital Debt Affordability Committee (CDAC) includes tax-supported capital leases in its analyses of debt affordability.

<u>Operating Lease</u>: Accounting Treatment and Current Exclusion in Debt Affordability Analysis:
If the lease is accounted for as an operating lease, no asset or liability is recognized on the balance sheet. Rather, the lessee records lease payments under an operating lease as rent expense. At this time, operating leases are not included in the CDAC analyses.

Consideration Whether the State Center Project Constitutes a Capital Lease

The State Treasurer's Office consulted with the State's independent auditor, the General Accounting Division in the Comptroller's Office, financial advisors (who also spoke directly with rating agencies), and bond counsel to determine whether the draft occupancy lease associated with State Center should be considered either operating or capital.

Accountants and Independent Financial Auditor

The STO consulted with a principal with S B & Company, the State's independent financial auditor, and the Director of General Accounting and the Assistant Director of Accounting Operations and Financial Reporting in the General Accounting Division. They had the opportunity to review the draft leases provided by DGS on April 15, 2009. The accountants and the auditor agreed that the ground lease is an operating lease. The discussion focused on the occupancy lease and whether that is a capital or operating lease.

There was agreement that to determine whether this occupancy lease meets one or more of the capital lease criteria, more information is needed. For instance, the draft lease does not include the term of the lease nor any renewal options, although DGS has indicated that there would be various leases for different State agencies with terms ranging up to 15 years. Furthermore, lease payments for each phase and the value of the State-occupied property for each phase are not available because, as noted above, all lease economic terms will be determined at the time each phase is designed. Without this critical information, it is not possible to make a determination whether the occupancy leases are capital or operating.

The independent auditor noted that the parties involved in the development could attempt to initially structure the lease as operating to avoid inclusion on the State's balance sheet and in the Capital Debt Affordability Committee's (CDAC) affordability analyses. But as the developer seeks financing, the lender could demand lease terms that would give the lease capital characteristics. Especially in the present economic environment, it is questionable whether a developer can get financing without the State as a committed long term anchor tenant especially because very significant amounts of the total commercial office space at the site is expected to be leased to the State.

One might argue that because the lease is cancelable and subject to appropriation it, therefore, is for a short term and doesn't meet the economic life test. For the same reasons, the present value of the lease payments would not equal 90 % of the value of the property. However, the expectations of the State, its employees, the developer, and the community appear to be that the State will stay at State Center indefinitely. This location has been the largest concentration of State government offices for 50 years; a radical change is not expected. This intention was included in a Draft Report dated April 20, 2009 when DGS commented that "the Master Development Agreement (MDA) anticipates … that the State will make best efforts to retain a workforce of approximately 3,500 employees on site." The State's independent auditor noted that the State's intent would have to be considered in the determination of the type of lease and while the terms in a document may be for a short term, history would indicate that the State would be a long term tenant. Finally, because of the economic impact of the project, it would be unlikely for the State to move from this location.

Two of the criteria that classify a lease as capital focus on the reversion of the property either outright or as a bargain purchase. Even though such a reversion is included in the ground lease as drafted, it would not affect the occupancy lease and therefore does not automatically make the occupancy lease a capital lease.

The auditor also pointed out that there are complexities in this project that should be considered when measuring the lease for the fourth criterion, i.e., the present value of the lease payments relative to the fair value of the property. This test determines who is really paying for the State's share of the building. The auditor cautioned that the calculation should reflect the total transaction. Therefore, the value of the building shells that the developer receives from the State as the phased development progresses (301 and 201 Preston St.) should be added to the State's lease payments and the value of the completed building occupied by the State should be reduced by the allocable tax credits. If all the lease information were available and final, the calculation would be expressed as the following fraction:

$$\frac{\text{Present value of lease payments } \textit{plus} \text{ the building shell that the developer acquires with the ground lease}}{\text{Cost of the State's share of the building } \textit{less} \text{ the allocable tax credits}}$$

Finally, current accounting standards for leases may be changing. On March 19, 2009, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued a joint discussion paper on accounting for leases by lessees which would require all leases to be treated by lessees as capital leases.[2] Many financial statement users believe that the distinction between capital leases and operating leases is an artificial one and that operating leases, like capital leases, give rise to assets and liabilities that should be recognized on a lessee's balance sheet. In summary, the Boards believe that the right to use leased property is an asset and the obligation to make lease payments is a liability. The opinion of the independent auditor is that the Governmental Accounting Standards Board (GASB) will follow the lead of FASB and that existing leases will not be "grandfathered in", that is, once the accounting change is effective the lessee will have to record operating leases as capital leases.

Rating Agencies

There appear to be no rating agency reports focused specifically on State and Local Governments' leasing activity. However, in a report on operating leases for higher education and not-for-profit organizations[3], Moody's stated that, "Because operating leases are a financial obligation, our credit analysis incorporates these leases to evaluate the true credit risk of an institution." The report continues, "Moody's views the operating leases as a financial obligation similar to other forms of debt, such as bonds, lines of credit, capitalized leases and notes payable." Among the key questions posed in Moody's analysis of leases are:

- Why did management use an operating lease?
- Are the assets core facilities or non-core facilities?
- Are the leases negotiated annually or longer-term? Are leases typically renewed at maturity? What is the average term of similar leases?
- Who bears the residual value risk?

A further indication of how Moody's evaluates leases was evident in a recent Credit Outlook[4] when it announced the proposed accounting board changes and commented, "This would more closely align companies' officially-reported results with our 'adjusted view' of financial statements, which already considers operating leases to be on-balance sheet financing arrangements." While the focus of these weekly reports is generally corporate debt, the report does provide overall insight into what Moody's states are the flawed existing accounting rules for operating leases. "We believe the changes being contemplated by the two [FASB and IASB accounting] boards could represent a significant step forward in providing more meaningful financial information to investors". Their report further states that, "The current accounting model is based on arbitrary bright-line tests … As a result, companies are often able to structure transactions to achieve

[2] Refer to http://www.fasb.org/draft/DP_Leases.pdf for the discussion paper.
[3] "Off Balance Sheet But On Credit", August 2004
[4] Moody's Weekly Credit Outlook, March 30, 2009, pages 14 and 15

the particular accounting and reporting outcomes they desire, even though the economic distinction between capital and operating leases is often insignificant."

The State's Financial Advisor consulted with two of the rating agencies on how operating leases affect their analysis of a government's credit. The financial advisor made two points. First, the rating agencies do look at operating leases but to date most governments report a relatively small amount of operating leases and thus the rating agencies do not directly include them in their debt calculations. However, the financial advisor cautioned that if a government starts using operating leases in significant amounts, it will get noticed and factored into the government's credit analysis. Second, a credibility issue with the rating agencies could occur if a government attempts to obfuscate its long term obligations with operating leases. This may impact the perception of the State as an issuer.

Bond Counsel
The State Treasurer's Office has consulted with two firms which represent the State as bond counsel. Neither firm considered the question of the type of lease to represent a legal issue. However, each did caution that the facts and circumstances of each lease should be evaluated when making a determination as to whether a lease is capital or operating. As noted above, not all the requisite information is presently available.

Consideration of the Potential Impact the Project Would Have on State Debt Affordability Limits

Preliminary affordability ratios as of May 2009, based on current assumptions, indicate that the debt outstanding to personal income ratio is within the 4.0% benchmark through 2019. However, by 2017 the debt service to revenues ratio would be virtually at the 8.0% benchmark. Addition of this project either as direct debt or indirectly because the CDAC determines that it is a long term obligation of the State would likely cause the debt service to revenues ratio to exceed the CDAC threshold within the 10 year time period analyzed by CDAC. It must be noted, however, that underlying assumptions are likely to change with time.

On the CDAC agenda for the July 14, 2009 meeting is a discussion on capital and operating leases and how operating leases might be treated in the affordability analyses. In the last year, this has become a critical topic because of the financing considerations of the State Center project and the DHMH Public Health Lab. The magnitude of the State Center project might itself also call for such a deliberation. In Fiscal 2008, the State made approximately $66 million in lease payments on operating leases.[5] Lease payments for the space at State Center at completion, according to DGS, would cost approximately $27.7 million per year in 2014 escalating to $46.4 million in 2028.[6]

[5] 2008 CAFR, page 82
[6] DGS schedule of TOD Development Impact on the State Budget, 5-14-09

Other Concerns

While this report is deliberately and narrowly focused on the General Assembly's request concerning the status of the State Center lease, it seems appropriate to mention concerns that have arisen as a result of our research and study.

The overriding concern of the State Treasurer's Office is a need for a clear and defined process that evaluates the financing for capital projects and sets forth the procedures for entering into capital leases, operating leases and Public Private Partnerships. Furthermore, the State needs to understand its risks and benefits in these ventures both generically and for each specific project and their impact on the State's overall debt portfolio, management and standing.

In addition, several questions have arisen regarding this particular project:

> We understand that two of the three members of the originally-selected Limited Liability Company are no longer partners in the project. Since it appears there has been a material change in the development company, should the State re-select a development team? If the State allows replacement members to be added to the LLC, will the new members of the development team agree to the terms already negotiated with the State? Will the new members have the same vision and commitment to the proposed development plan?
>
> If the development of State Center is underway or completed, what happens if the development team dissolves or experiences financial stress?
>
> If the lease is structured as an operating lease, will it cost the State more overall than if the structure were more closely aligned with typical State development of capital projects? What are the pros and cons of the alternatives?
>
> Are appraisals available to determine the value of the land and improvements that the State will transfer under the ground lease?
>
> If the State goes forward with the Master Development Agreement, will it own the studies, design work and reports if the project does not begin, or is terminated at any point?
>
> Do the pre-development studies reflect the current economic environment? Specifically, are there updated market studies, lease-up timelines, construction costs, current sales prices and rental rates for the housing units, financing terms and rates, comparable rental rates for office space, and office vacancy rates in Baltimore City?
>
> Finally, in the effort to structure the financing to fit the parameters of an operating lease, have all the development and financing options been considered and analyzed so that the financial benefit and cost to the State is adequately compared and the State's best interest is achieved?

Conclusion

This report is not intended to endorse or not endorse this project which appears to have many desirable characteristics. The project would appear to hold the potential of improving deteriorated office buildings and also enhancing the quality of life in the surrounding community. It incorporates transit, bridges communities, and brings access to retail. The economic revitalization that the improved and expanded office space, retail development, low and moderate income housing, and parking will bring to this area in Baltimore is potentially considerable.

A recommendation on whether to move forward with the project was not requested by the General Assembly and this report is not intended to make such a recommendation. Instead, it has focused solely on the accounting treatment of the occupancy lease and the potential impact of the project on the CDAC affordability analyses.

As noted above, at this time there is not enough information to definitively determine whether the anticipated occupancy leases are capital or operating. *However, based on internal discussions and consultations with experts, the Treasurer's assessment is that the prudent approach at this time is to assume that the State Center occupancy leases are, or will be, capital leases and that they will impact debt affordability.*