Article Title: Criteria | Governments | U.S. Public Finance: Federal Leases Data: (EDITOR'S NOTE: —On March 14, 2022, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) Private developers continue to show a strong interest in using the capital markets to finance construction, or refinance existing mortgages by using federal lease payments as security. However, credit quality on these transactions can vary widely depending on the contractual, lease-term, and structural provisions of the lease. S&P; Global Ratings rates transactions that are backed by lease rental payments from several different U.S. agencies. Although all of these structures are secured by lease rentals paid by the U.S. government, some transactions carry more risk. For further clarity on the interplay of the federal lease criteria and federal future flow securitization criteria, see the "Frequently Asked Questions" section. Most federal lease agreements are not structured with a public debt financing in mind. Each federal lease has different features and needs to be evaluated on a case-by-case basis. Most prominent in many of the federal lease transactions is the risk associated with the involvement of an unrated developer as lessor. To mitigate the developer risk, S&P; Global Ratings generally requires that the lessor be a single-purpose corporation or limited partnership (SPE) with restrictions on future indebtedness and its operations limited to the leased property. In addition, S&P; Global Ratings typically will require a non-consolidation opinion between the SPE and its principals. However, significant developer risk exists with the construction and operation of the facility. Four key areas are evaluated: Appropriation risk; Structural risks; Cash flow risks; and Construction risk. Appropriation Risk As with municipal leases where the lease extends for the full term of the bonds, the most important factor in determining credit quality is the government's obligation to make lease payments subject to the government's access to the facility, as well as the lessor's successful performance of all of its obligations under the lease. This is defined as the appropriation risk. Certain government leases do not carry the appropriation risk in that the government's obligation is absolute and unconditional, subject to the terms of the lease. If this is the case, in most instances, an opinion likely will be required from the agency's general counsel's office stating that the lease rental payments are general obligations of the U.S. government, backed by its full faith and credit. As long as the structural, cash flow, and construction risks associated with the contract have been fully mitigated, such absolute and unconditional obligations will carry a rating equivalent to that of the U.S. There are two types of appropriation risk that federal leases carry. In some instances, the obligation to make lease payments is subject to Congress making an appropriation to the agency for a specific function, such as military housing. Under this scenario, the military department is obligated to make the lease payment if Congress appropriates any funds to the agency for housing military personnel. The only way the military department would not be obligated to pay is if Congress appropriated the funds for military housing and included specific language stating that the specific lease or class of leases were not to be paid. The essentiality of the function to the government is important. The second type of appropriation risk is that of the congressional line item. This type of appropriation is more visible and would undergo an analysis of essentiality. Risks associated with the congressional line item appropriation involve not only the funding of specific governmental programs but also the importance of a single site to the delivery of services provided by the program. Since demographics and cost structures change over time, it could have an impact on where and how the government wants to provide services. Structural Risk The lease structure governs the environment under which the government's lease payments are made. There are four basic elements that could have an impact on credit quality: The match of the lease-term to the term of the debt obligation; Lessor obligations under the lease; Rent off-set rights by the government; and The government's termination rights under the lease. Historically, the term of a federal lease has matched the term of the debt obligation. However, this has recently become the exception rather than the norm due to increased federal budgetary pressure. A securitization can receive an investment-grade rating even if the term of the lease is not equal to the debt maturity. Some federal leases are structured with a limited term, but give the government the option of renewing the lease one or more times during a fixed period. Developers have securitized the government's lease payments over the entire period rather than for the current lease-term. However, there is a risk that the government will not exercise its option to renew the lease if circumstances change, such as finding a lower-cost facility, or a program is not renewed. In these instances, the essentiality of the leased asset, and any factors present that may mitigate the renewal risk, will be the key factors in determining whether the securitization receives an investment-grade rating. A real estate analysis risk assessment may also be performed (see "Mitigating the Renewal Risk" table). In general, rated municipal leases are triple net with the government responsible for maintenance, taxes, and utilities. However, most federal leases do not carry this feature and the lessor can be responsible for one or all of these obligations. Federal lease payments are structured in one of two ways, with each based on the amount of space leased--either the government pays a single rent payment that takes care of both debt service and operations, or lease payments are bifurcated into two separate streams. These two rent streams are base rental payments, typically used to pay debt service, and operations and maintenance rent. If the lessor defaults on his obligations under the lease, the government's remedies can range from rental offset to termination of the lease. The cash flow analysis plays an important part in evaluating this risk. However, if the government has the right of termination, it could have severe rating implications. Strong cash flows, coupled with a sufficient cure period, could partially mitigate this risk, given that the lessor will have an incentive to operate and maintain the facility properly. When the government's rights for lessor non-performance are limited to rent offset, credit quality is also severely impaired if the offset rights could affect base rental payments—the portion of the lease rental payment used for debt service. If the offset rights only affect the operating rent, there are two scenarios that could enable the transaction to achieve an investment grade: The government has the right to offset operating rents and perform the obligation itself; or The government has the right to offset operating rents but cash flow coverage is deemed to be sufficiently strong enough to mitigate risk. Some federal leases will contain clauses that allow the government to vacate portions of the leased space and offset rent proportionately. Whether the government will exercise its right to vacate is speculative and, as such, would make any transaction that contained the clause speculative. Another risk prominent in federal leases is that of damage and destruction. The government usually will have the right to abate rents during periods of nonoccupancy. In some cases, although not all, the government may have the right to terminate the lease. To achieve an investment grade rating, the lease generally contains several features that minimize the risks associated with damage and destruction: The lease typically requires that the government gives the lessor ample time to repair or replace the facility; The government will generally continue to occupy and pay rent on the useable portion of the facility; and The government will ordinarily resume the entire contracted rent payments when restoration is complete. To mitigate the lessor's liability and costs associated with damage and destruction, S&P; Global Ratings typically requires the lessor to have rental interruption insurance for a period in excess of the time it would take to rebuild the facility, as well as casualty insurance at replacement value or not less than the par amount of the indebtedness outstanding. In general, the insurance provider should carry a rating on its claims-paying ability that is no less than one category below the rating on the transaction and, at minimum, is investment grade. In addition, S&P; Global Ratings is likely to require a debt service reserve fund equivalent to at least two months' base rent payment for the insurance claim process to finalize. Termination rights are provided for in most federal leases. Termination with respect to damage or destruction and non-performance of lessor obligations may be mitigated by either insurance or other restrictions on the government or strong cash flows, respectively. Some leases contain a termination-for-convenience clause that gives the government the right to end the lease and its obligations at any time. This risk can be mitigated by the determination that the essentiality of the project is strong or the government has stated that it will pay off any outstanding indebtedness if it exercises its rights under the convenience clause. This allows the developer to achieve an investment-grade rating on the transaction. Cash Flow Risk The cash-flow analysis evaluates the lessor's ability to fulfill all of its financial obligations under the lease and make timely payments to the bondholders. Given that each federal lease transaction has different characteristics with respect to the lessor's obligations and the government's remedies, S&P; Global Ratings has not established a coverage test for its cash flow analysis. In determining cash-flow adequacy, it is important to make sure that government lease payments will match debt service due dates. Most federal leases are structured with monthly lease payments made in arrears. Most federal leases are also structured with a base rent component and an operating rent component. To achieve an investment grade rating, base lease payments will need to equal or exceed debt service requirements. If the lessor has operating or maintenance responsibilities, S&P; Global Ratings evaluates the operating rents under conservative expenditure estimates with reliance on historical costs for similar buildings in the area. In addition, an operating reserve equivalent to a minimum of one month's rent is typically required. S&P; Global Ratings also evaluates the ability of the lessor to make the required capital repairs on the facility during the life of the bonds. To do this, an independent engineer's report may be required. If annual cash flows are not sufficient to make the required capital repairs in each year, S&P; Global Ratings will require a capital reserve fund that can either be funded upfront or from excess cash flow over the life of the bonds. Construction Risk Construction risk occurs when the government's lease rental payment is dependent on the completion of the project to its specification. If construction risk is present, S&P; Global Ratings requires a construction risk analysis be performed. Payment and performance bonds alone, given the historical lack of timeliness and sufficiency of such payouts, are insufficient to fully mitigate construction risk. For further clarification, refer to Public Finance Criteria: Assessing Construction Risk In Public Finance. Public Private Partnerships S&P; Global Ratings has rated transactions where the bonds are secured by a pledge of the rent payments under a lease between the maintenance and operations (M&O;) contractor and the developer and not between the federal government and the developer. The credit risks associated with this type of transaction include: The private nature of the projects being financed; The initial term of the lease not extending to the life of the bonds; and The lack of a marketability of the project. To achieve rating separation from the private developer and an investment grade rating for this type of structure the following elements are generally present: Strong legal structure The term of the lease has sufficient renewal options to extend to the life of the bonds; There must be an executed contract between the federal government and the M&O; contractor to manage the facility which may or may not extend to the term of the lease; The financed facilities should be owned by a single-purpose, bankruptcy-remote entity. The facilities may than be leased back to the private operator. The obligation to make debt service payment on bonds sold to finance these projects should be a special obligation of the issuing entity and payable solely from the revenues of the trust estate; The contract with the federal government, along with the revenues associated with those contracts, should be assigned to the single-purpose, bankruptcy-remote entity and, in turn, pledged to a third-party collateral agent as part of the collateral security for the bonds; Confirmation that the contract revenues supporting the transactions would not be property of the bankruptcy estate of the private operator or subject to the automatic stay provisions were the private operator to file for bankruptcy; Payments from the contract revenues should, in the first instance, be used to pay debt service on the bonds; second, to make any required property tax or insurance premiums; third, to replenish all required reserve accounts and, last, to flow back to the operator for facility operations; and Confirmation that the operator can be terminated and replaced in the event of a default by the operator under any of the contracts with the federal government. Strong project essentiality The project facility should be of an essential nature meeting the stated mission of the contracting federal department. Strong lease revenue stream The lease payments typically originate from rental reimbursement payments due the M&O; contractor from the federal government under the M&O; contract. The contracting federal department, as part of its consent to and acceptance of the lease, must acknowledge that the rent under the lease, together with other operating expenses are allowable reimbursable expenses under the M&O; contract. Rent payments Rent payments should be paid directly to the Trustee by the contracting federal department thru the Federal Assignment of Claims Act. Requirement to renew If the M&O; contract does not extend for the term of the lease, the M&O; contractor must generally provide that as long as its M&O; contract with the contracting federal department remains in force and effect, the M&O; contractor will exercise each of the extension options, which should match the extension options of the lease. Operator substitution If the private operator fails to meet the requirements of the M&O; contract with the contracting federal department, that contract may be terminated. The transaction should be able to rely on the government department or a number of other private operators being available to assume the role of operator. The M&O; contractor should agree under the lease that any replacement operator responsible for the management of the facility enters into a replacement lease for the property with the same terms and conditions as set forth in the lease. As such, the payments from the contracting federal department in support of the debt service payments on the bonds will continue regardless of who the M&O; contractor is. Strong monitoring of the facility Details surrounding the procedures and requirements of the facilities will also be evaluated. The contracting government department should regularly monitor the facilities and have measures in place that will rapidly address any contract violations. Frequently Asked Questions What is the interplay between these criteria and "Federal Future Flow Securitization" methodology (FFF criteria) published March 12, 2012? We take a two-step approach to analyze federal leases. First, we apply the FFF criteria in order to set the maximum rating. Second, we apply the "Federal Leases" criteria to address transaction-specific issues. For federal leases, the first step (i.e., the application of the FFF criteria) establishes a cap, or the highest rating that the issue can receive, i.e. a certain number of notches below the U.S. sovereign rating (see table 1 of the FFF criteria and an application example in Appendix 1, Section VII. F). As a result, the rating determined through the application of the second step of the analysis can be the same or lower than that indicated by the FFF criteria. Revisions And Updates This article was originally published on June 18, 2007. Changes introduced after original publication: On March 17, 2016, we added a "Frequently Asked Questions" section and updated our author contact information. Following our periodic review completed on Feb. 3, 2017, we made minor clarifications to the text and updated our author contact information. During previous periodic reviews, we added the "Related Criteria And Research" section, made minor clarifications to the text, and updated the description in the third paragraph of the rating that the federal leases will carry. Following our periodic review completed on Jan. 26, 2018, we added the "Revisions And Updates" section, corrected a typo, and made a minor clarification in the text. On March 22, 2019, we republished this criteria article to make nonmaterial changes to the contact information. On March 15, 2021, we republished this criteria article to make nonmaterial changes to the contact information. On March 14, 2022, we republished this criteria article to make nonmaterial changes to the contact information. Related Criteria And Research Related Criteria Federal Future Flow Securitization, March 12, 2012 Principles Of Credit Ratings, Feb. 16, 2011 Public Finance Criteria: Assessing Construction Risk, June 22, 2007