San Diego (City of) CA
City's decision to suspend payment on capital lease has limited credit implications

On September 1, the City of San Diego (Aa2 stable) opted not to make a capital lease payment on a property known as 101 Ash Street (101 Ash St.), which the city expected to house various municipal departments. The non-payment has limited implications for the city’s credit quality and publicly issued debt. But it is an example of a governance breakdown, with the city showing weak oversight of its real estate department, the branch of government primarily responsible for the transaction. Notably, the lease revenue stream was not securitized by the city and does not back any publicly issued debt. The transaction was private between the city and a real estate developer.

The city’s rationale for not making the payment is that asbestos contamination prevents it from using the building. The contamination does not fall under the lease’s relatively limited abatement provisions, and therefore the non-payment is not a legal compulsion, as it might be for a traditional, municipal abatement lease in California. The non-payment is likely rooted in financial and political considerations specific to this particular transaction.

There are aspects of the lease agreement that may not be compliant with state law. While such legal questions should have been addressed by the city prior to entering into the legal agreement, the failing speaks more to the lack of due diligence by some city departments rather than the city’s general willingness and ability to ensure continued debt service payment on its publicly issued debt. City management recognizes the deficiency and is in the process of implementing new processes and procedures regarding capital-related transactions. If the governance breakdown were to happen again, which we do not expect, we would consider it a more serious failure that would have negative credit implications.

If the lease were securitized by the city and offered to the public capital markets, there would have been more oversight throughout the process. The city’s finance department, including its debt management team, would have been highly involved in the process and would have provided additional oversight in conjunction with a financing team of professionals that have a reputational stake in the continued success of the transaction. This process includes proper due diligence on all financing documents and disclosure of all material risks to potential investors.

The repairs required to make 101 Ash St. usable are estimated at $66.0 million and up to $115.0 million to replace all of the building’s systems and related components as most are past their useful life. These amounts are well above the $25.6 million the city initially invested to make improvements to occupy the building. The magnitude of the cost suggests a quick resolution to the city’s unwillingness to make payments on the lease is highly unlikely.
The city is both a plaintiff and defendant in lawsuits related to 101 Ash St. The potential financial impact from the lawsuits, the additional cost of repairs to the property should the city continue with the lease-purchase of the building, and uncertainty about the lease's compliance with state law are risks that will develop over time.

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