U.S. Department of Transportation
Federal Transit Administration

Federal Transit Administration

Financing Techniques for Public Transit

February 2000

A Message From the Acting Administrator

President Clinton's Executive Order on Infrastructure Investment (E. O. 12893), signed on January 26, 1994 was our call to arms as we developed the Innovative Financing Initiative. The Executive Order established a federal agenda for what is essentially a local function - the provision of safe, comfortable, and effective public transit service. The Innovative Financing Initiative was then able to connect capital investment with a variety of methods for managing capital flows or attracting new capital for transit systems nationwide.

The techniques in this handbook involved over $3 billion in transit assets. Grant Anticipation borrowing is expected to accelerate over $1 billion more in transit investments in the next few years. I am confident, therefore, that transit operators will discover techniques in this publication that they can use to meet the public transit needs of our communities well into the next century.

Nuria I. Fernandez

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INTRODUCTION

Innovative Financing has been a necessity since the inception of the Federal transit program. Since 1974, transit operators have used Joint Development to increase their local sources of revenue. In the early 1980s, Safe-Harbor Leases were common for the larger transit agencies. Then, in the early 1990s, Cross-border Leases became attractive.

All of these transaction types had one end in view - to leverage private capital through the use of federally funded (tax-exempt) assets. The techniques were able, in the aggregate, to add about five percent to the capital budgets of the transit operators who used them. However, this merely generated "found money", and it seemed to serve mostly large transit operations. This was because the transactions generally involved assets valued in the tens of millions of dollars. It did not necessarily make the transit capital programs more efficient, nor did it address the funding needs of major capital projects.

The techniques outlined in this handbook may help transit operators to better manage their long-term capital needs, through a combination of lease, debt, and cash flow management. While previous techniques relied upon existing assets and cash expenditures, the newer techniques in this booklet rely on Guaranteed Funding levels in TEA-21, use of private capital markets, and closer links between a transit operator's ongoing capital flows and its ever-growing capital needs.

TECHNIQUES

This handbook will address the following financing mechanisms:

- State Revolving Loan Funds
- Joint Development
- Bonds and Certificates of Participation
- Delayed Local Match
- Super Turnkey
- Lease with Maintenance
- Cross-Border Lease
- Domestic Leasehold
- Grant Anticipation Financing
- TIFIA

This handbook presumes a somewhat different perspective - rather than benefiting from found opportunities, transit systems should prepare themselves to take full advantage of the transaction types available to them. This should occur, not when the facility or asset is being delivered, but well beforehand, when the planning is undertaken. When this is done correctly, joint development can be accelerated, thus leading to faster increases in ridership and more certain revenues from property near the transit facility. Grant anticipation debt can be used to minimize project delays, to the same end. Or, Certificates of Participation and pooled procurements can be used to reduce acquisition costs. The advanced planning can ensure that multiple techniques can be used within a single project, such as Turnkey, delayed local match and joint development, for example.

Transit operators are encouraged to view these techniques as beginning points - ideas - and to develop their own ways of applying or enhancing these techniques. After all, most of the techniques included in this booklet were first proposed by transit operators.

DENVER'S 16TH STREET MALL

STATE REVOLVING LOAN FUND

"Federal grant funds may be used to support State or local revolving loan funds established in accordance with appropriate State laws."

States have the ability to use FTA grant funds to establish and operate Revolving Loan Funds in support of public and private non-profit transit operators. This mechanism allows the state, as recipient or by agreement with its sub-recipients, to aggregate Section 5310, 5311, or 5307 funds, pool purchases of vehicles and either lease or sell these to the transit operators, or make loans to transit operators for vehicle and facilities acquisitions. The revolving loan fund allows pooled vehicle purchases that may help reduce acquisition costs. It provides a mechanism for the State to make loans (with interest if necessary) or leases to transit operators who might not be able to arrange such transactions on their own. And, it provides an ongoing source of local capital in support of the State's transit operators.

The interest payments and lease payments returned to the State's revolving loan fund are considered to be "program income" in the context of the FTA grant program. These income streams are therefore not required to be returned to the U.S. Treasury, and may be used to make additional loans, leases, and grants to eligible transit grantees. The local grantees are able to use subsequent years' rural or urban grant funds to make loan or lease payments, including reasonable interest.

Some transit operators are using proceeds from Joint Development projects to establish revolving funds for land acquisition in support of ongoing, transit-oriented development programs. This combines the concepts of project eligibility under joint development with long-range capital management. While joint development plans are often limited by grant funds availability, using program income to enhance the viability of needed transit facilities for joint development can produce significant dividends.

ARKANSAS DOT WAS THE FIRST TO ESTABLISH A REVOLVING LOAN FUND FOR RURAL AND SPECIALIZED TRANSIT SERVICES, USING A COMBINATION OF FTA AND FHWA-PROVIDED FUNDING.

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JOINT DEVELOPMENT

"Capital Program funds can be used for a variety of joint development activities, so long as they are physically or functionally related to a transit project and they enhance the effectiveness of the transit project."

This was the essence of FTA's Joint Development policy, which was incorporated into the definition of a Capital Project in TEA-21. Thus, transit capital funding may be used to provide space for day care, senior care, public health, safety and security services, and the transit operator is expected to generate a reasonable return on the space that is made available for these services.

Santa Clara County Transit Authority (TA) requested regulatory flexibility to use excess land (an 11-acre park-and-ride lot) adjacent to a light rail station for a transit/housing joint development project. FTA capital funds were used to make improvements to the park-and-ride lot and provide a bus transfer facility. This investment attracted a private developer to build the housing development, and was projected to generate between $200,000 and $300,000 annually in lease revenues for the transit district. At current interest rates (5%), such a revenue stream has a net present value of between $2.6 and $4.3 million in the first 25 years of the project's life. This does not include fare revenues from increased transit system use.

This project was particularly successful because it attracted the attention of a private land owner next door who ultimately chose to participate in the development. As currently under way, the Ohlone Chynoweth development is now over 17 acres in size, and includes three distinct activity centers around which are built mixed-use retail/commercial space and a variety of medium to low-density housing. All offices and residences will be within walking distance of the light rail station.

ARTIST'S RENDERING OF THE SANTA CLARA JOINT DEVELOPMENT PROJECT AT OHLONE-CHYNOWETH STATION.

BONDS AND COPS

"Certificates of Participation (COPs) are a type of leasing arrangement in which bonds are issued to finance the purchase of transit assets."

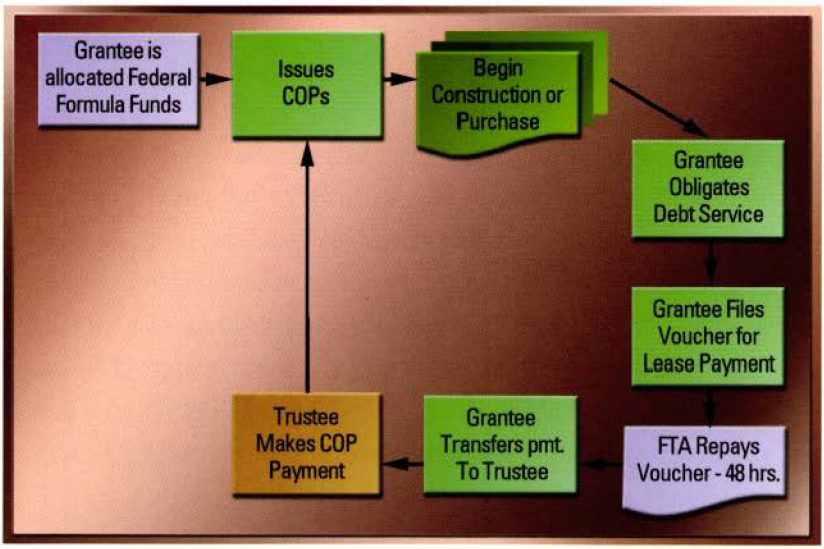
(Federal Register, Vol. 60 No. 89, May 9, 1995)

COPs are tax-exempt bonds, issued by State entities, that are usually secured with a specified revenue source such as an equipment or facilities lease. A purpose-formed State entity issues tax exempt bonds with maturities that match the lease term of assets that are purchased by the State entity with the proceeds from the bond issue. The State entity then leases the equipment to one or more transit systems. The resulting lease payments, most often made with a combination of formula grant funds and local matching share, are then "passed through" to the bondholders by the State entity. The combination of larger vehicle order size, COPs with varying maturities, and lease arrangements, reduce and stabilize current capital costs significantly.

Several examples are provided by the California Transit Finance Corporation (CTFC), which provided funding for the bus purchases of several California grantees, including the Sunline Transit Commission, which replaced its entire fleet of diesel fuel buses with buses that operate on Compressed Natural Gas (CNG). The CTFC issued COPs, secured by a lease on the buses that were purchased. Because the transaction involved 40 buses, the local gas utility provided a high-speed

fueling facility with a favorable capital lease arrangement. The following diagram illustrates the transaction.

CERTIFICATE OF PARTICIPATION (COP) STRUCTURE (SIMPLIFIED)



Not all communities need the COPs structure, because they have the ability to issue bonds which may be just as marketable. However, in the CTFC example, local matching funds were used to establish a reserve fund for the transaction, which reduced the actual interest cost significantly, while providing a way for the transit operators to make ongoing matching payments for the Federal grant expenditures. Each lease payment included 80 percent Federal grant funds and 20 percent local funds. Since the local funds were deposited at interest, this reduced the cash burden on the various transit districts.

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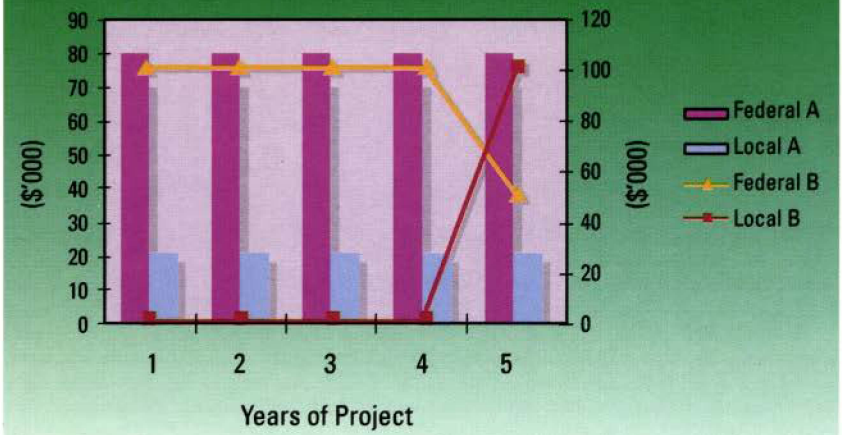
DELAYED LOCAL MATCH

"FTA permits grantees to defer the payment of the local share of transit projects."

Transit systems may wish to delay the application of their local matching funding, particularly if they are trying to maximize the use of their locally available funds. This could occur because the funds are invested in a short-term security, for example, or otherwise encumbered. However, there may also be a situation where the grantee is seeking to arrange construction period financing or some other innovative financing mechanism which could be facilitated through an uneven expenditure of Federal and matching funds. In the example chart below, the delayed local match would allow the grantee to earn $2.45 million on its local share, at current interest rates. Additional benefits could be generated through innovative project financing, or other means.

The FTA grants process generally is based on a level outflow for a specific project. For every 20 percent expended by the locality, 80 percent in Federal funds are expended. Little value can be added to such a cash stream through the assistance of private capital markets. However, if the Federal dollars are expended first, say for 100 percent of the design, engineering, or environmental reviews, then the construction period can be financed with some private participation. In this instance, local funds can be "banked", or pledged as additional security for construction period financing. This is all possible because there are no arbitrage concerns with the local funds as there might be with the Federal funds. The benefit of delayed local match is in that it may help assure the smooth progress of a major transit infrastructure project without any increase in Federal outlays.

EFFECT OF DELAYED LOCAL MATCH



The preceding chart compares two notional cash flows: a standard 80/20 flow throughout the project (A), vs. a delayed local match (B). If a grantee delayed application of its local match to the end of the project construction period, it could generate one of two benefits. It could invest its local match in securities, realizing an increase of $40,000 in available funds by the fifth year (at 7%). Or, if the grantee needed to accrue the local match, it could make sufficient deposits each year to accumulate to the required $100,000. In this case, it would only need to deposit $17,450 per year at 7%, rather than the full $20,000. For smaller transit operators with limited means, this would represent a significant cost savings.

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SUPER TURNKEY

"Grantees can also consider use of vendor financing in procurements, such as super turnkey."

The "Super Turnkey" process (authorized in Section 3019 of ISTEA) is one where the project engineers or project management consortium undertake to build, operate for a time, and transfer a facility to the purchasor. In such a situation, purchasing, deliveries, scheduling, and other critical aspects of the project are directed by the same entity — a Turnkey Manager. As a result, construction delays, start-up difficulties, disagreements about change orders and project timing are minimized, resulting in lower project costs and reduced litigation.

One modification to this "Build/Operate/Transfer" (BOT) process is where the consortium also arranges to provide financing. This technique may be attractive for smaller grantees who may not have the credit history to minimize their borrowing costs. The Turnkey Manager may assist with project financing by accepting delayed compensation (e.g., postponement of progress payments), credit enhancements such as an insured line of credit, or even total project financing through the issuance of their (the consortium's) own bonds. While these financing methods do cost something, they may allow a new transit project to proceed in a timely manner, thus generating time and project savings well in excess of the financing cost.

The Gateway Center in Los Angeles was built on a turnkey basis, with the turnkey manager retaining significant project management responsibility. The Gateway Center provides a multimodal link between intercity trains, the Los Angeles Metro,

and bus service. The building erected above the center houses the headquarters of the Los Angeles County Metro (LACMTA) the transit operator.

The significant benefit from this particular turnkey project was that it allowed the Turnkey Manager, by contract, to make a wide variety of day-to-day management decisions without having to consult with LACMTA or the other project partners. This ensured that the project would be completed on time and within budget. Today, the Gateway Center is a major transit hub, with an attractive retail center on the ground floor which provides restaurants, entertainment, and shops for the hundreds of thousands of transit patrons who pass through its doors.

THIS IS THE SUBWAY PLATFORM AT THE GATEWAY CENTER

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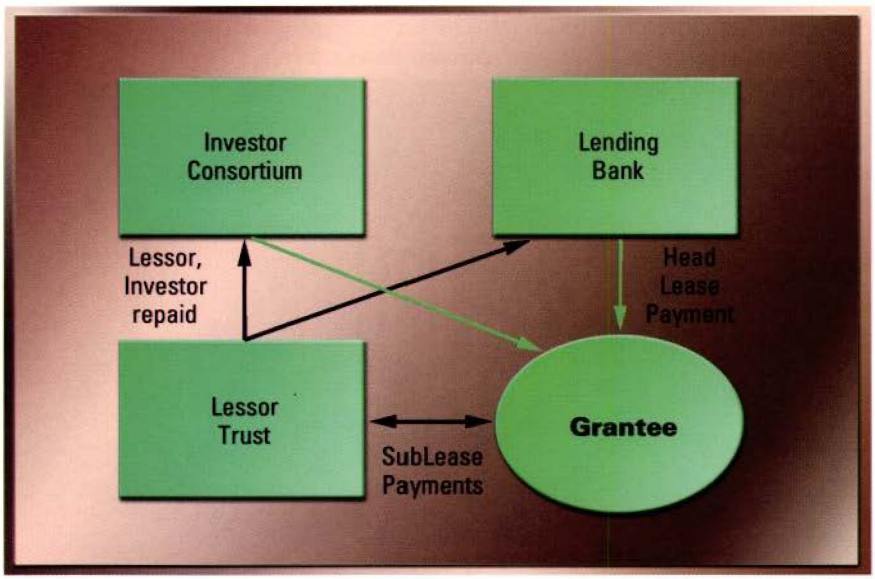
DOMESTIC LEASEHOLD

This is a similar transaction to the Sale/Leaseback, which is made possible by Section 467 of the Internal Revenue Code. It involves a transit system leasing an asset to a private entity (this is called a Head Lease), such as a bank or an investor consortium, then leasing the asset back from that investor (called a Sublease).

The investor prepays the Headlease, and the transit operator must make semi-annual lease payments for the term of the Sublease. The Head Lease prepayment is between 7 percent and 11 percent more than is required for the transit agency to make the lease payments. That amount is the Gross Benefit realized by the transit authority. After transaction costs, the transit agency will realize a Net Benefit of between 6 percent and 9 percent on the transaction. The following diagram illustrates this transaction in simplified form.



This transaction is fairly expensive to undertake. It usually requires at least $50 million in assets to interest an investor, and the transaction costs are likely to exceed $1 million. FTA has reviewed leasehold transactions (often referred to as LILO, for 'Lease-in/Lease-out') as large as $576 million. The transactions are also highly interest rate sensitive. When the transit agency receives the Head Lease payment, it invests most of it in securities that will mature over the term of the Sublease. Thus, a narrow spread between the investor's cost of borrowing and the rate of return on the transit agency's securities will limit the amount of Gross Benefit the transit agency can realize.

Finally, these are fairly long-term transactions. They tend to involve rail rolling stock or facilities, and Sublease terms of at least 12 to 15 years. Currently, IRS rules require the Headlease to be no more than 80 percent of the useful life of the asset, and the Sublease to be no more than 80 percent of the Headlease. In Fiscal 1999, FTA reviewed over $1 billion in leasehold transactions.

In June of 1999 the Internal Revenue Service published its final regulations regarding Section 467 Leases and similar tax-advantaged leases. In essence, the final rule establishes a more stringent test of business purpose, and it designates the IRS Commissioner as the only competent authority to determine the business purpose of such a transaction. Given the defeased nature of these transactions in the transit sector, and the fact that tax deferral provides the investors with significant benefit, FTA does not anticipate that many more of these transactions will be proposed.

If, in specific instances, there are multiple purposes for the leasehold structure, such as to attract private sector interest in operating and maintaining an entire bus garage or multiple transit routes, then it may be worthwhile for transit operators to pursue this form of lease structure. Otherwise, the predominance of tax benefit over other business benefits will make this transaction type unattractive both to private sector investors and to transit boards of directors.

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Lease With Maintenance

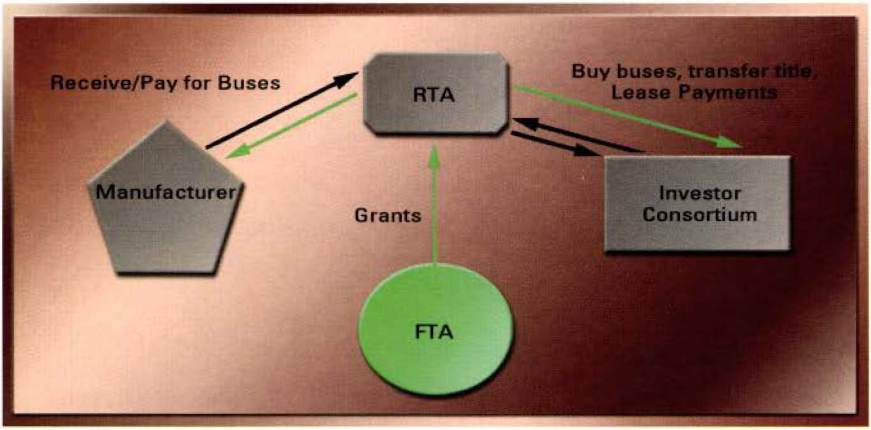
The Federal Transit Administration developed a policy in the mid-1990's, which was eventually incorporated into law, allowing the entire capital cost of vehicles to be supported with Federal grant funds. In this case, entire capital cost included preventive maintenance. In response to this policy, the New Orleans Regional Transit Authority (RTA) requested FTA's help in acquiring up to 175 buses by means of a lease that would include preventive maintenance for the life of the buses (12 years).

New Orleans faced a particular challenge, in that it was not allowed to incur an obligation of more than one year's duration without seeking approval of the State legislature. This would have taken considerable time. Thus, RTA requested bids for a one-year lease, renewable every year for 12 years. The lease would include maintenance, to be performed at RTA's new A. Phillip Randolph Operations Facility.

THE RIVERFRONT TROLLEY LINE, NEW ORLEANS

RTA ultimately accepted the bid of Penske Truck Leasing Company. That firm agreed not only to assume delivery of 100 buses that RTA had already ordered, but to smoothly deliver an additional 75 buses. Also, Penske agreed to lease the unionized employees already working at the Randolph facility. This allowed the employees (members of the IBEW Local 1700-4) to retain their State

pension and medical benefits. Further, Penske agreed to renegotiate labor contracts at the facility every three years, as RTA had done before.



To undertake the structure described above, RTA had to do two things. It had to prove to FTA that the transaction, lease and maintenance, would be cost effective. It also had to show that it would retain effective continuing control of the buses, despite having given up title to them.

The lease component was completed at an average interest cost of just under 7 percent. This yielded a marginally cost-effective vehicle lease. However, the maintenance cost savings, resulting from management and training improvements to be instituted by Penske, were projected to generate over $2 million per year in cost savings in the first three years. This made the transaction highly cost-effective for RTA.

Although it made the transaction more complex, working through a financial intermediary assured RTA of a viable transaction that would attract a private investor.

SALIENT FEATURES

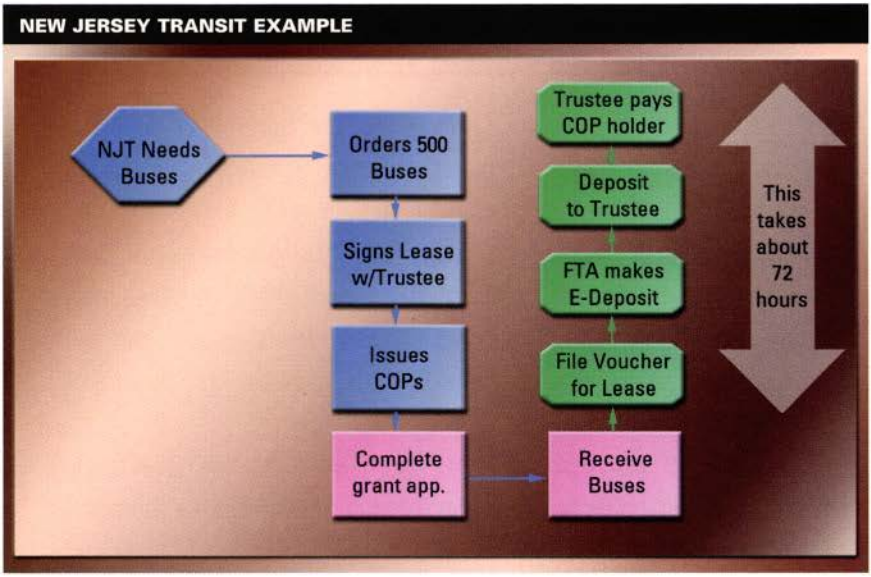
- **a** Cost-beneficial to transit agancy
- **b** RTA retains effective control of assets
- **c** Protect existing labor agreements
- **d** Be flexible

GRANT ANTICIPATION

TEA-21 represents a significant departure from prior surface transportation authorizations. Rather than providing a maximum authorization, which appropriations committees may or may not meet with each year's appropriations Act, TEA-21 provided a floor, known as the 'Guaranteed Funding Level.' This funding level is not guaranteed, as such, but its use is limited to transportation. Thus, there is very little incentive for the appropriations committees to appropriate less than the guaranteed level.

This guaranteed funding level had two effects - it provided greater predictability of grant funds for transit providers and State Departments of Transportation; and it gave rating agencies on Wall Street the added security needed to consider grant funds when rating a credit issue. Boston and New Mexico were the first to test this mechanism, using Highway funds to secure medium-term debt. New Jersey Transit was the first transit provider to use the mechanism for a transit acquisition.

NJT IS USING GRANT ANTICIPATION FOR ITS RAIL FLEET AS WELL.



New Jersey Transit faced a common difficulty. Significant portions of its urban and commuter bus fleets were being operated beyond their useful lives. To replace 500 of these buses with cash would require several years of formula grant funds, and would allow no other projects to proceed. Discussions with the New Jersey Treasurer's office yielded a possible solution - buy the vehicles with debt.

However, NJT could not issue debt without a specific authorization of the State legislature. So, it was decided to proceed with a Certificate of Participation (COP). This is a security, issued to the public, providing participation in a stream of lease revenues. Usually, COPs are secured by a lien on the assets, and the pledge of a revenue stream to service the lease. Since Federal funds may not be pledged, NJT promised to use its formula grant funds to make the required lease payments.

Rating agencies rated the $151 million COPs issue A-1 and A+. As a result, NJT sold its COPs in the marketplace at an average interest rate of just 4.2 percent. The COPs will mature over the next 8.5 years, at which time NJT will own the buses outright.

TIFIA

The Transportation Infrastructure Financing and Innovation Act (TIFIA) was authorized in TEA-21. It is a major new program that is intended to support large, nationally significant capital projects. TIFIA allows the Department of Transportation (and therefore FTA) to make loans, loan guarantees, and issue lines of credit, for up to one-third of the cost of such projects. The assumption behind the program is that such projects may have an associated revenue stream, such as tolls or local sales taxes, that would be used to repay debt issued by the project.

The concept for this program came from a line of credit that was issued by DOT in support of a $2.3 billion project known as the Alameda Corridor - a construction project to lower the railroad to below grade, in order to avoid grade crossings, delays, and traffic accidents. The Federal line of credit was used to secure up to $1.2 billion in Senior and Subordinated debt on the project. The debt will be repaid from a millage on rail freight containers that use the line. The project has National significance because it will increase the U.S. export potential significantly from California, while reducing the social cost of freight movements along the corridor.

TIFIA loans and guarantees are limited to projects of National Significance, projects that exceed $100 million in cost, and projects that exceed 50 percent of a State's regular Federal Aid Highway apportionments for a year. Projects involving the introduction of Intelligent Transportation Systems, exceeding $30 million in cost may also be supported. Loans may be repaid over as long as 40 years, and the first repayments may be delayed until five years after substantial completion of construction. All surface transportation modes are eligible for TIFIA loans, with the exception of airports and harbor facilities.