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WTW [Welfare to Work] / DBE [Disadvantaged Business Enterprise]: ISTEPA [Intermodal Surface Transportation Efficiency Act] - Financing

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Responses to Questions Raised at March 7, 1997 Meeting on Federal Credit

March 10, 1997

1. Are there other precedents of a single borrower receiving both Federal Credit and Tax-Exempt Bond Proceeds?

There is ample precedent for projects drawing upon Federal assistance in conjunction with tax-exempt debt. The Federal participation takes a variety of forms:

- Federal Equity with tax-exempt debt funding the non-Federal match;
- Federal Equity credit-enhancing tax-exempt debt;
- Federal Guarantees securing underlying loans backing tax-exempt debt;
- Partial Federal subsidization of tax-exempt debt service;
- Partial Federal credit enhancement of tax-exempt debt service; and
- Side-by-side Federal Credit and tax-exempt debt.

Brief summaries follow below:

a. *Federal Equity with tax-exempt debt funding the Federal match.* The state/local match for assistance under the Federal-aid highway program and Federal Transit Administration capital grants is routinely met through the issuance of tax-exempt debt. Estimated volume is four to five billion dollars per year.

b. *Federal Equity credit-enhancing tax-exempt debt.* The Wastewater and Drinking Water State Revolving Funds (SRF) involve capitalization grants which credit enhance obligations which may be tax-exempt, and where the non-Federal match frequently is funded with tax-exempt debt. State Infrastructure Banks are funded with 80% Federal funds, and may be used to guarantee tax-exempt obligations. The College Construction Loan Insurance Association (Connie Lee), which was capitalized in part with Federal appropriations, provides financial guarantees on college revenue bonds, many of which are tax-exempt.

c. *Federal Guarantees securing underlying loans backing tax-exempt debt.* Section 149(b) of the Internal Revenue code expressly states that tax-exempt proceeds in combination with loans insured or guaranteed by the following Federal agencies will not constitute a "Federal guarantee" which would undermine the tax status of the bonds:

- Federal National Mortgage Association
- Student Loan Marketing Association
- Federal Housing Administration
- Veterans Administration
- Federal Home Loan Mortgage Corporation
- Government National Mortgage Association

d. *Partial Federal Payment of tax-exempt debt service.* This would include the Administration's proposal for the School Construction loan program, where the Treasury will use \$ 5 billion to "buy down" the interest rate on tax-exempt bonds issued to finance schools, effectively providing a partial guarantee of debt service.

e. *Partial Federal credit enhancement of tax-exempt debt service.* The Transportation Corridor Agencies (TCA) obtained legislation in both FY 1995 (for Foothills-Eastern toll road) and in FY 1996 (for San Joaquin Hills toll road, amending earlier legislation) enabling TCA to secure in excess of \$ 2.6 billion of tax-exempt project debt with Federal standby lines of credit. Repayments of draws have a claim on project revenues that is *junior* to that of TCA's bondholders. (Even with the two \$ 120 million lines of credit, both projects are still rated only BBB, reflecting the limited value of the line.)

f. *Side-by-side Federal Credit and tax-exempt debt.* Several examples are listed below:

- *WMATA.* The Administration approved Washington Metropolitan Area Transit Authority's refinancing of a third of its \$ 1 billion taxable Federally-guaranteed bonds with tax-exempt non-guaranteed bonds. This resulted in side-by-side Federal credit and tax-exempt debt.
- *Alameda Corridor.* Alameda anticipates being able to access the tax-exempt market for at least a portion of its capital markets debt financing under current law. Dating back to the initial Alameda term sheet in April, 1996, which was approved by OMB and DOT, there never has been any prohibition concerning how Alameda raises the capital using its project revenue bonds.
- *District of Columbia.* The District of Columbia has issued General Obligation bonds both to the general public on a tax-exempt basis as well as directly to the Federal government.
- *Farmers Home Administration.* FmHA has directly funded Federal loans to water and sewer districts which also have issued tax-exempt debt, including on a junior lien basis. FmHA permits local water districts to repay tax-exempt construction loans with long-term Federal takeout loans under its Water and Waste Disposal program.

2. Is the Federal government going to be left bearing all the risk if a Federal loan has a 10 year deferral feature?

No. The issuer's rate covenant will require it to set rates and charges sufficient to meet scheduled debt service on *both* its capital markets debt and the Federal loan. The deferral feature will help in the event that raising rates and charges is "revenue negative" to the project, and it is necessary to allow time for traffic levels to grow.

Even in the extreme case where there are absolutely *no* loan repayments on the Federal loan over the first 10 years, the capital markets debt will continue to bear a large degree of risk. For example, if the Federal loan initially was at the maximum amount (33%) and the capital markets debt for the remaining 67% was structured with 30 year level debt service (which is typical), at the end of 10 years the respective percentages of outstanding debt would be 54% Federal and 46% private. As the two debt instruments would be on parity at that point, there would be continued risk-sharing over the life of the project.

3. How do we ensure the risk scoring of each project is accurate?

Last year, OMB requested that DOT develop a methodology for evaluating the risk of surface transportation projects which is independent, objective and conservative. For large, complex, one-of-a-kind projects like toll roads, we believe the most appropriate method for scoring the loans is to out-source the analysis to the rating agencies. They evaluate hundreds of different infrastructure projects each year, and are more qualified than DOT or OMB to analyze the risk.

We propose using the "capital reserve" approach that the rating agencies use for assessing the claims-paying ability of municipal bond insurers. The insurers' portfolios of guarantees (totaling over \$ 550 billion par amount) are analagous to the Federal government's \$ 970 billion portfolio of Federal Credit loans and loan guarantees. Each loan's capital reserve would be based on the project's rating. The capital reserve then can be expressed as a series of annual cash flows for insertion into the OMB model.

It is important to recognize that the financial assumptions for bond insurers are much more rigorous than required for scoring pursuant to the Federal Credit Reform Act. The rating agencies subject insurers to a "stress test" of a 1930's-era Depression scenario, evaluating not only the insurers' ability to pay claims but also their resources to continue writing new guarantees as an ongoing AAA rated concern. In contrast, FCRA utilizes *expected* outcomes of cash flows at the time the loan is made relating to repayments, delinquencies, defaults, and recoveries. For example, Fitch concluded that a 5% reserve would be appropriate for BBB rated toll projects. Yet over the last 40 years, actual toll road defaults have amounted to only 1% of new money issues (excluding refundings) and unrecovered losses net of recoveries have amounted to just *three-tenths of one percent*.

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Principals Mtg - /STEX

3-10-97

2 / 1498

Q1: Stated but says you shouldn't supplement tax if report debt has several exceptions (Guaranteed housing & student loans).

school constructions - grants to buy down, etc.

~~Mr. J.~~

~~Mr. J.~~

Q3: Fitch meth. assumes large & diverse portfolio of loans

~ 26% subsidy rate

rules on mixed projects
(why is school const. OK?; Wash Metro debt)

factual (1) Vof - precedents for combining loans &
Vof exempt debt.

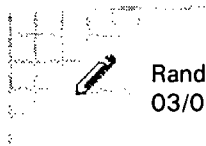
policy { (2) Do we want to be in this business? Resol.
Q judge agency @ #5

(3) Given likely scoring, is it worth doing?

THE WHITE HOUSE
WASHINGTON

CDBG 108 program
(

NTF \$ wld be the
Security/Control



Randolph M. Lyon
03/06/97 05:16:35 PM

Record Type: Record

To: Michael Deich/OMB/EOP

cc: See the distribution list at the bottom of this message

Subject: Re: subordination, linkage, tax-exempt debt and government loans

I follow your logic and think it has a lot of merit. Ordinarily, one would expect an 80% loan to be more attractive to the Federal government than an 80% grant.

The one piece that may be left out, though, is that this could be viewed as a precedent for allowing Federal enhancement of credit on tax-exempt bonds. In the limit, such bonds could be as safe as Treasury debt, which would impose an external cost (higher Federal borrowing costs for our trillions of dollars of debt) that is not reflected in the credit subsidy for the particular enhancement.

In this particular case, the revenue bonds would not be as good as Treasury debt. On the other hand, the total cost of the tax-exempt bonds plus our credit subsidy would be greater than a credit subsidy for taxable bonds.

Hope this helps.

Message Copied To:

Barry B. Anderson/OMB/EOP
Harry E. Moran/OMB/EOP
Joseph J. Minarik/OMB/EOP
mazur_m @ a1 @ cd @ lngtwy
Dorothy Robyn/OPD/EOP
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Daniel M. Tangherlini/OMB/EOP

INTRO:

The DOT proposal would subsidize transportation projects of national economic significance. All agencies agree that the Federal government properly should subsidize such projects. At issue is the form such subsidies should take.

Under the DOT proposal, the Federal government would offer flexible payment loans to sponsors of transportation projects of national significance (projects with interstate economic effects). Loan up to 33 percent of total project costs. For first 10 years... etc.

Issue 1: does the fact that the Federal loans provide deferral, while the non-Federal loans require continuous payments, impermissibly subordinate a Federal loan to non-Federal loans?

Yes:

No:

Issue 2: should the program require the non-Federal loans to be taxable, tax-exempt but governmental, or private activity tax-exempts?

Taxable: pro/con

Governmental Tax-exempt: pro./con

Private Activity: pro/con.

DOT'S TRANSPORTATION CREDIT PROGRAM

The Department of Transportation would like the Administration's ISTEA reauthorization proposal to include a provision allowing the Federal government to make loans with flexible repayment provisions. These loans would subsidize revenue-generating transportation projects of regional and national economic consequence. All agencies agree that the Federal government properly should subsidize such projects. At issue is the form such subsidies should take.

Under current law, the Department of Transportation provides direct grants to cover 80 percent of a project's cost; a public authority generally issues tax-exempt bonds to cover the remaining 20 percent of project costs. The Administration's reauthorization proposal includes an 'innovative financing' title providing the Secretary with \$100 million per year to allocate for credit subsidies.

OPTION 1 - Direct Federal Loans with Flexible Repayment provisions

The Federal government would offer flexible payment loans to public sponsors of transportation projects with interstate economic effects. The Federal loans could cover up to one-third of total project costs. Repayment would begin after "substantial completion" of the project. For first 10 years the Secretary of Transportation could defer repayment of principal and/or interest on the Federal loan if the cash flows from the project were insufficient to cover these items. Any deferred payments would be added to the balance of the loan and would accrue interest at the Federal cost of funds. A State or local authority would cover the remaining project costs by issuing tax-exempt bonds subject to current law restrictions on use of proceeds.

By replacing Federal grants with loanable funds, this proposal would leverage the Federal investment in transportation projects. It would encourage the imposition of user charges, and increase the efficiency with which transportation infrastructure is used. Finally, the provision of flexible repayment terms address a possible market failure: the absence of similarly-structured private loans may reflect the fact that private lenders have a too short a time horizon to offer loans similar terms; in contrast, the Federal government may be in a position to offer "patient capital" for these projects. However, this option raises two issues:

Can any Federal loans be provided without violating OMB financing rules by creating an implicit guarantee of the remaining tax-exempt debt?

Some argue that any Federal loan provides a implicit guarantee to the non-Federal tax-exempt debt, because markets will assume that the Federal government will not allow the project to fail and the Federal loan to go into default. In addition, some regard the Federal loan as subordinate because it allows the deferral of payments on the Federal debt without requiring a similar deferral on the non-Federal debt. The deferral also may be seen as an enhancement of the non-Federal debt, because it increases the likelihood that the non-Federal debt will be repaid.

It is true that bondholders might lobby to have the Federal government forgive the Federal loans or otherwise protect the project. Yet similar lobbying occurs for grant-supported projects: project sponsors routinely try to get additional funds to continue projects that go over budget. And under credit reform, legislation to forgive the debt would score in the same fashion as legislation to help a project through added direct appropriations.

Under Option 1, the Federal government would never pay either interest or principal to the tax-exempt bondholders, so no direct guarantee exists. Moreover, the financial support given to tax-exempt bondholders through the flexible payment option is less than the support given by the direct grants for 80 percent of project costs that are now provided under current law.

Can OMB adequately measure the risk associated with the proposed Federal loans?

Critics argue that it is difficult to measure the risk associated with these projects, for they are infrequent, lumpy projects. Yet this merely implies that the uncertainty of OMB estimates would be large, and the associated credit subsidy estimate should reflect that uncertainty. Critics also argue that toll projects have a history of default. Since 1961, however, projects have defaulted on about 1 percent of the \$39 billion in revenue bonds issued for transportation toll projects. Traffic forecasts are most uncertain for projects where no comparable traffic patterns exist. The DOT proposal would be limited, however, to projects that expand capacity on some of the most congested corridors in the nation (e.g., rebuilding the Woodrow Wilson Bridge). In these situations, traffic forecasts have far less uncertainty.

Critics also argue that OMB should measure political risk, i.e., the probability that Federal government will allow Federal loans to default in order to protect private bondholders. In the case of default, however, the Federal government will be able to liquidate the assets that secure the Federal loan. In addition, if Congress provides relief by forgiving a the Federal loan, such action would score for budget purposes.

OPTION 2 - Create Discretionary State Infrastructure Bank Fund

Under this option, the Secretary would have the discretion to allocate the \$100 million to State Infrastructure Banks to subsidize specific projects. This approach would avoid all of the scoring problems associated with Option 1. Fewer projects would be subsidized, however, for project sponsors would have to pay the private sector rather than the public sector cost of capital. In addition, funds raised in private markets would include a premium reflecting the fact that these 10-year, flexible payment bonds are not a standard financing instrument.



THE DEPUTY SECRETARY OF TRANSPORTATION

FAX COVER SHEETTotal No. of Pages – including this page: 11 Date: 3/7/97

To : Michael Derch Ph #: _____
To : _____ Ph #: _____
To : _____ Ph #: _____
To : _____ Ph #: _____

From : Jane Garvey
Ph # : _____

Re : _____

Message : _____

The number for this telefax is (202) 366-3937. If you have any problems receiving this fax, please call 366-2222.

How would candidate projects be evaluated and selected for assistance under the Federal credit program?

A. Threshold Eligibility Criteria

To qualify for Federal credit assistance, a project must at a minimum meet the following criteria:

1. National Significance -- The project generates broad economic benefits, supports international commerce, or otherwise enhances the National transportation system. Specific factors would include the extent to which the project:

- (a) is part of NHS system and related connectors;
- (b) advances high priority corridors (NAFTA, trade corridors), intermodal connectors and border facilities, or otherwise promotes regional, interstate or international commerce;
- (c) enables U.S. manufacturers to deliver their goods to domestic and foreign markets in a more timely, cost-effective manner;
- (d) stimulates new economic activity and job creation;
- (e) reduces traffic congestion, thereby increasing workforce productivity; and
- (f) protects the environment by enhancing air quality through the reduction of congestion and decreased fuel and oil consumption.

2. Eligibility -- The project must be eligible for Federal assistance under the eligibility criteria for projects as set forth in NEXTEA.

3. Public Ownership -- The project must be owned by a public entity (State or local government or an agency thereof.)

4. State/Local Support -- The project is included in the State transportation plan and in the approved State Transportation Improvement Program. The project application is submitted by a State or the State's designated agent (such as a State Infrastructure Bank.)

5. Project Size -- The project must cost at least \$100 million or 50 percent of the State's most recent annual apportionment of Federal-aid highway funds, whichever is less.

6. User Charges -- Project financings must be payable in whole or in part by user charges or other non-Federal dedicated revenue sources.

7. Creditworthiness -- The project must receive an investment grade rating agency assessment.

B. Project Selection Criteria

Qualified projects meeting the initial threshold eligibility requirement then will be evaluated and selected according to more qualitative criteria relating to economic benefits and national goals. Such factors would include:

- 1. *Project Advancement*** -- The project moves forward at an earlier date and with lower financing costs than otherwise would be possible.
- 2. *Innovative Technologies*** -- The project utilizes or promotes innovative technologies in enhancing access, mobility, productivity and safety.
- 3. *Private Participation*** -- The project creates opportunities for Public-Private partnerships and induces private investment.
- 4. *Credit Cost*** -- The amount of budget authority required to assist the project (which is a function of credit amount and subsidy rate) is a necessary selection factor given the need to allocate limited Federal budgetary resources among candidates.

How would the credit risk of projects be analyzed and scored?

Given the complexity and heterogeneity of major surface transportation projects, DOT recommends that the credit evaluation be out-sourced to private sector experts in the field. Specifically, we believe the best expertise in this discipline is found at the three major bond rating agencies (Moody's, Standard & Poor's and Fitch.). They have universal credibility among investors for objective and accurate credit analysis of the risk associated with project debt.

The rating agencies also have developed financial models for analyzing the credit-worthiness of major institutions with exposure to infrastructure projects, such as municipal bond insurers (MBIA, AMBAC, FGIC). These guarantors' claims-paying ability is rated "AAA" (virtually riskless) based on various factors, most importantly the adequacy of their capital reserves. In essence, the Federal government's \$970 billion credit portfolio could be likened to the bond insurers' \$450 billion credit portfolio. The insurers and the Federal government share a common objective of ensuring that the expected losses over time can be readily met from the reserves or budgetary resources set aside at the outset.

Each candidate project would be required to obtain a preliminary rating opinion letter from one of the three rating agencies, taking into account the project cash flows including the Federal loan. Based on the Project's rating, the Project would then be assigned a capital reserve charge similar to the reserve requirements assessed to bond insurers on like-rated bonds they guarantee. The capital charge would be expressed as a series of annual anticipated cash flows that would be placed in the OMB credit model and discounted at the relevant baseline Treasury rates to derive a present value subsidy cost for scoring purposes.

This technique would rely upon credible, independent third-parties to perform the credit analysis, and would completely avoid the risk of politicization of the scoring calculation. Moreover, it removes the burden from DOT and OMB of having to develop the in-house expertise to score the loans. Our approach has the advantages of being market-based, determined by acknowledged experts, and predicated on transparent and objective criteria.

We have included a copy of the Fitch Investors' Service report on how the scoring process could be conducted. Moody's and Standard & Poor's use similar techniques which could also be drawn upon, if desired.

How risky are toll roads generally?

Historically, toll road projects have been considered relatively low-risk over the long-term, although there may be uncertainty as to the growth of revenues in the early years ("ramp-up"). Since 1961, there have been \$ 39.1 billion of "new money" (non-refunding) bonds issued to finance toll roads, bridges and tunnels. There have only been a half-dozen documented payment defaults on toll revenue bonds over the last 40 years, involving 6 projects and \$ 412 million of bonds (1.05% of total issuance.) This rate of default is consistent with the assumptions used in Fitch's analysis, included as an attachment.

Of the bonds that went into default, \$ 297 million of them eventually paid off in full, with interest. *The ultimate unrecovered losses are negligible as a percent of total investment: 0.30%, or three-tenths of one percent of total new money financing.*

LIST OF TOLL ROADS WHICH DEFAULTED OVER LAST 40 YEARS

Chesapeake Bay Bridge and Tunnel District	\$ 100 MM Series C	7/1/60	Refinanced in 1991	Fully repaid with interest
City of Chicago Calumet Skyway	\$101 million	1/1/55	Refinanced in 1995	Fully repaid with interest
West Virginia Turnpike Authority	\$ 96 million	3/1/52	Refinanced in 1993	Fully repaid with interest
Houston Ship Channel (Harris Co. TX)	\$100 million	3/1/85	Refinanced in 1994	Partially repaid; no recoveries assumed
Other: Venice-McKinley Bridge, ILL.; Nebraska Bridge	\$ 15 million (est.)	?	?	Assumed no Recoveries
Total	\$ 412 million			

ILLUSTRATIVE CONGESTION RELIEF PROJECT CANDIDATES FOR FEDERAL CREDIT ASSISTANCE*

(dollars in millions)

PROJECT	PROJECT DESCRIPTION	LOCATION	TOTAL COST
<i>Woodrow Wilson Bridge</i>	Replacement of the deteriorating Interstate 495 drawbridge across the Potomac River with an expanded capacity toll bridge facility consisting of twin six-lane drawbridges spanning 70 feet above the Potomac.	Virginia-Maryland	\$1,700
<i>Foothills-South Transportation Corridor Agency</i>	Implementation of planned Foothill/South extension of TCA's network of congestion reliever toll roads.	Orange County, CA	\$1,500
<i>SR 125 Toll Road</i>	Enhancements for construction of planned 10-mile toll road east of San Diego, providing improved access to Mexico. Already under concession agreement via California's AB 680 public-private concession program.	San Diego, CA	\$400
<i>Hampton Roads Bridge-Tunnel</i>	New toll bridge-tunnel connecting peninsula cities of Newport News and Hampton with Portsmouth, Norfolk, and Virginia Beach to address growing congestion along the existing I-64 Hampton Roads bridge-tunnel.	Virginia	\$2,000
<i>Texas SH 121</i>	A 32-mile toll road extension of SH 121 from IH 35 to US 67.	Dallas/Fort Worth, TX	\$330
			\$5,930

*This list represents surface transportation projects whose scale, financial structure, accessibility benefits, and economic importance are indicative of the types of projects the Federal credit program is designed to serve. DOT has not performed any credit analysis of the candidates or undertaken any specific research to determine the forms of Federal credit that would be most appropriate for individual projects. The list, which has been derived from direct inquiries to DOT as well as industry sources and publications, is for illustrative purposes only.

FITCH INVESTORS SERVICE RISK ASSESSMENT MODEL FOR DOT'S PROPOSED FEDERAL CREDIT PROGRAM

DOT is considering a Federal credit program as a more cost effective alternative to its current use of grants to finance startup toll roads and other transportation infrastructure projects. The program may include direct loans and standby lines of credit repayable on a junior lien basis with flexible repayment terms. As part of this study, Fitch Investors Service L.P. (Fitch) was asked to develop a model for evaluating the default risk for such a credit program. This attachment critiques the current approach for scoring transportation loans and proposes a new approach adapted from Fitch's model for evaluating the capital adequacy of private, for-profit bond insurance companies. Fitch also recommends specific scores or capital charges for projects that are rated differently.

Critique of Current Methodology for Scoring Transportation Loans

The Alameda Corridor loan was scored using a yield premium approach to assess potential default cost. The loan was assumed to be made at an interest rate equal to the U.S. Treasury bond yield. The net present value of loan repayments on the project was then calculated, discounted at both the Treasury yield and the assumed market yield, based on the project's preliminary rating (105 basis points above the Treasury yield). The difference in net present values was deemed to represent the cost of the default risk. In our opinion, the yield spread approach is not a valid measure of the expected default risk. The yield spread takes into account other factors beside default risk, such as liquidity risk and call risk. Since liquidity risk and call risk are not relevant factors in the cost of the program to the Federal Government, the yield premium results in a cost estimate that is too high.

The fact that market yield spreads overestimate default risk is evidenced by the existence of a private, for-profit bond insurance industry that guarantees the principal and interest on municipal bonds, as well as asset-backed and mortgage-backed securities. Bond insurers guarantee municipal bonds that have mostly A and BBB underlying ratings; the insurance raises the bonds' public ratings to AAA. The premiums on these policies, which are usually paid by the issuer, amount to about half of the issuer's interest cost savings as a result of the higher credit rating.

The yield spread between the insured AAA and the uninsured bonds is sufficient to support premiums that cover the bond insurers' default risk plus an adequate profit margin. From January 1, 1992, through June 30, 1996, the bond insurers guaranteed a total of \$544.4 billion in par. Premiums written over this period totaled \$4.5 billion, or 0.8 percent of par insured. Losses from bond defaults over this period totaled \$129.9 million, or 5.7 percent of premiums earned and 0.03 percent of average par outstanding (premiums for municipal bonds are typically written in the form of a one-time, up-front payment, but income is earned over the outstanding life of the bond). Bond insurers incur other costs besides losses, such as underwriting, surveillance, and administration; however, during the period from

1992 to mid-year 1996, bond insurers averaged 13.1 percent return on equity (income after expenses and taxes, divided by average shareholder's equity).

Bond insurers do not currently insure startup toll roads because they tend to avoid stand-alone projects with construction risk and ramp-up risk. In our opinion, however, the shortcomings of the yield premium approach also apply to these risks as well. In other words, it should be possible for the Federal Government to provide credit for startup toll road projects at a lower cost than the yield premium would imply.

The fact that the yield premium method overestimates the expected default cost means a different methodology is required. We propose a method derived from that used by the rating agencies to determine how much capital bond insurers need to allocate for their insurance policies. This will result in a more direct measure of the default risk on the projects.

Fitch's Bond Insurance Capital Adequacy Model

Fitch rates the claims-paying ability of the bond insurers. A large part of this analysis focuses on the insurers' capital adequacy. To measure capital adequacy, Fitch uses a stress test model that subjects a bond insurer's portfolio to an economic downturn that produces an extraordinary level of bond defaults. For an insurer to receive a AAA claims-paying ability rating, it must be able to pay all projected claims through the peak years of the stress period and be left with sufficient resources to write new business when more stable economic conditions resume.

Claims during the stress period are forecast using capital charges that Fitch developed based on bond defaults experienced during the Great Depression of the 1930's. Fitch has adjusted the capital charges to reflect regulatory changes and the relative probability and severity of defaults for the types of insured risks in today's market. For example, current banking laws enacted after the Great Depression reduce the potential severity of another depression. However, in the 1930's all municipal bonds were backed by a general obligation pledge; most municipals today are revenue bonds which have potentially greater risk. For this reason, Fitch has developed different benchmark capital charges for various types of insured bonds. For example, transportation bonds on existing facilities are more risky and, therefore, have higher benchmark capital charges than tax-backed and water and sewer bonds. They are, however, less risky and have lower benchmark capital charges than private higher education and hospital bonds. These benchmark capital charges are then adjusted further based on Fitch's evaluation of the actual credit quality and diversity of the bonds within each sector of the individual insurer's portfolio.

Capital Charges for Start-Up Toll Roads

Bond insurers do not currently insure startup toll roads. Fitch developed capital charges for this category specifically for this report. Our methodology for developing these charges is described in the following paragraphs.

Based on historical evidence, while some startup toll road projects experience late payment delinquencies in years 1 through 5, and less frequently in years 6 through 10, almost all do get built, begin operations, and eventually pay off their debt, including interest on interest. Subordinate lenders to projects of investment-grade quality should get paid as well, although perhaps over a somewhat longer time frame than the senior bondholders. It is estimated that only about 1 percent of the loans rated BBB will not be recovered within a reasonable time frame, which for discussion purposes is defined as 30 years.

A project is rated below investment grade (lower than BBB-) if there is a foreseeable risk that it will not be successfully completed on time or generate sufficient revenues to fully pay creditors. Indeed, default rates are much higher for unrated and below investment-grade municipal bonds than they are for investment-grade bonds. Because startup toll roads have only recently started getting ratings, there is little empirical data on default rates specifically for this sector. Based on the default experience in other sectors of the municipal market, Fitch estimates that a portfolio of loans on startup toll road projects rated BB will experience a 4 percent loss rate and startup toll road projects rated B an 8 percent loss rate (net of recoveries).

Highly rated financial institutions not only require enough capital for an expected level of losses, but for a multiple of such losses. Fitch has concluded that for startup infrastructure projects, a multiple of 4 to 5 times expected losses is needed to provide our highest credit standard of AAA. Multiplying the expected losses by 5 produces the capital charges that should be used on loans to start-up toll road projects; these charges (expressed as a percentage of original principal) are shown in Table 2-1. The capital charges can also be expressed as annual cash flows for inclusion in the OMB credit model, as shown in Table 2-2.

Table 2-1
Capital Charges for Startup Infrastructure Projects

Project Rating	Expected Loss (%)	Multiplier	Capital Charge AAA Scenario (%)
BBB	1.0	5	5.0
BBB-	1.6	5	8.0
BB+	2.6	5	13.0
BB	4.0	5	20.0
BB-	5.0	5	25.0
B+	6.4	5	32.0
B	8.0	5	40.0

Fitch recognizes that, in many cases, the Federal loan will be junior to the senior debt, but believes the same capital charges are applicable for subordinate, flexible payment debt. The flexibility in the Federal credit program reduces the demands on a project to make timely payments; however, full repayment is still required. An important element in Fitch's capital charge calculation is that most loan defaults

that occur during the initial 10-year period will be recovered. Fitch assumes that interest on delinquent loan payments is equal to the U.S. Treasury rate, so timing defaults will not affect the net present value cost of the loan credit program. The same analysis should hold true whether the Federal credit takes the form of a direct loan, a guaranteed loan, or a contingent standby line of credit.

It should also be noted that the capital charge methodology for private, for-profit bond insurers applies to a large and diversified portfolio of loans. If an insurer were to guarantee loans to only a handful of projects, and one of these projects defaulted, then the overall cost could conceivably be higher than the weighted average capital charge. Fitch would require considerably more capital to assign a rating of AAA to a private company insuring only a small, non-diversified portfolio of loans. Considering the fact that the Federal government has no liquidity constraints and these transportation loans would be only one piece of a \$300 billion existing diversified portfolio of Federal government loans and guarantees in a wide range of industry sectors, this capital charge method is considered appropriate.

Suggested Rating Category for the Federal Credit Program Portfolio

The capital charges Fitch recommends are consistent with AAA security. For an ongoing Federal credit program that encompasses a portfolio of loans and guarantees, the likelihood of underestimating default cost is remote. In other words, the capital reserves should absorb all anticipated default risk, in essence representing a proxy for Federal subsidy cost. This makes it a useful and conservative tool for budgeting purposes.

TABLE 2-2
STRESS SCENARIO CASH FLOWS (BBB Project)

Loan Amount Term (Years) Coupon Rate		\$1,000,000 30 7.00%								
(A)		(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
Scheduled Payments		Delinq. Rate	Timely Payments	Shortfall	Recoverable	Repayment of Recoverables (Incl. Int.)	Total Payments Received	7.00% Discount Factor	NPV of Scheduled Payments	NPV of Actual Payments
Year										
1	80,588	5%	78,557	4,028	0	0	78,557	0.93458	75,314	71,549
2	80,588	10%	72,528	8,059	4,028	0	72,528	0.87344	70,387	63,349
3	80,588	20%	64,469	18,117	12,088	0	64,469	0.81630	65,783	52,826
4	80,588	30%	58,410	24,178	20,147	0	58,410	0.76290	61,478	43,035
5	80,588	45%	44,323	38,264	32,235	0	44,323	0.71299	57,457	31,601
6	80,588	45%	46,740	33,846	29,817	703	47,443	0.66634	53,698	31,613
7	80,588	42%	48,158	31,428	27,399	2,811	51,969	0.62275	50,185	32,384
8	80,588	39%	51,575	29,011	24,982	6,325	57,800	0.58201	46,802	33,899
9	80,588	38%	53,993	26,594	22,564	11,947	65,940	0.54393	43,834	35,867
10	80,588	33%	58,410	24,176	20,147	17,148	73,558	0.50835	40,866	37,393
11	80,588	30%	59,834	20,852	18,923	21,927	81,561	0.47508	38,288	38,749
12	80,588	28%	62,857	17,728	13,700	26,284	88,142	0.44401	35,761	38,580
13	80,588	22%	68,081	14,508	10,478	30,220	98,301	0.41498	33,440	38,981
14	80,588	18%	69,304	11,282	7,253	33,734	103,038	0.38782	31,253	39,960
15	80,588	14%	72,528	8,059	4,028	36,686	109,213	0.36245	29,208	39,584
16	80,588	10%	74,139	8,447	2,418	38,372	112,512	0.33873	27,297	38,112
17	80,588	8%	78,557	4,028	0	38,091	114,648	0.31857	25,512	38,295
18	80,588	5%	78,557	4,028	0	35,842	112,399	0.29586	23,843	33,255
19	80,588	5%	78,557	4,028	0	30,923	107,480	0.27651	22,283	29,719
20	80,588	5%	78,557	4,028	0	26,144	102,701	0.25842	20,825	28,540
21	80,588	5%	78,557	4,028	0	21,365	97,922	0.24151	19,463	23,649
22	80,588	5%	78,557	4,028	0	17,007	93,565	0.22571	18,189	21,119
23	80,588	5%	78,557	4,028	0	13,072	89,629	0.21095	16,899	18,907
24	80,588	5%	78,557	4,028	0	9,558	86,115	0.19715	15,887	16,977
25	80,588	5%	78,557	4,028	0	6,606	83,163	0.18425	14,846	15,323
26	80,588	5%	78,557	4,028	0	4,217	80,774	0.17220	13,877	13,909
27	80,588	5%	78,557	4,028	0	2,389	78,847	0.16093	12,869	12,705
28	80,588	5%	78,557	4,028	0	1,124	77,682	0.15040	12,120	11,583
29	80,588	5%	78,557	4,028	0	422	78,979	0.14058	11,327	10,820
30	80,588	5%	78,557	4,028	0	0	78,557	0.13137	10,586	10,057
Nominal Total			2,048,508	389,086	248,208	432,817	2,481,423		1,000,000	950,000
2,417,582										

Notes:

Column A is the level annual repayment required for \$1,000,000 borrowed for 30 years at an interest rate of 7.00%.

Column B is based on Fitch estimates of start-up toll road delinquencies and recoveries under a stress scenario.

Column C = Column A x (1 - Column B).

Column D = Column A - Column C.

Column E = Column D less 5% of Column A, which is not recoverable (capital charge for 'BBB' project).

Column F is the amount received from recoverables in each year. Recoverables are assumed to be deferred for four years with payments amortized over a ten year period.

Column G = Column C + Column F.

Column I = Column A x Column H.

Column J = Column G x Column H.

DOT'S TRANSPORTATION CREDIT PROGRAM

The Department of Transportation would like the Administration's ISTEA reauthorization proposal to include a provision allowing the Federal government to make loans with flexible repayment provisions. These loans would subsidize revenue-generating transportation projects of regional and national economic consequence. All agencies agree that the Federal government properly should subsidize such projects. At issue is the form such subsidies should take.

Under current law, the Department of Transportation provides direct grants to cover 80 percent of a project's cost; a public authority generally issues tax-exempt bonds to cover the remaining 20 percent of project costs.

OPTION 1 - Direct Federal Loans with Flexible Repayment provisions

The Federal government would offer flexible payment loans to public sponsors of transportation projects with interstate economic effects. The Federal loans could cover up to one-third of total project costs. For first 10 years after substantial completion of the project, the Secretary of Transportation could defer repayment of principal and/or interest on the Federal loan if the cash flows from the project were insufficient to cover these items. Any deferred payments would be added to the balance of the loan and would accrue interest at the Federal cost of funds. The State or public authority would cover the remaining project costs by issuing tax-exempt bonds subject to current law restrictions on use of proceeds.

By replacing Federal grants with loanable funds, this proposal would leverage the Federal investment in transportation projects. It would encourage the imposition of user charges, and increase the efficiency with which transportation infrastructure is used. Finally, the provision of flexible repayment terms address a possible market failure: the absence of similarly structured private loans may reflect the fact that private lenders have a too short a time horizon to offer loans similar terms; in contrast, the Federal government may be in a position to offer "patient capital" for these projects. However, this option raises two issues:

Can any Federal loans be provided without violating OMB financing rules by creating an implicit guarantee of the remaining tax-exempt debt?

Some argue that providing any loan provides a implicit guarantee to the nonFederal tax-exempt debt, because markets will assume that the Federal government will not allow the project to fail.

In addition, some regard the Federal loan as subordinate because it allows the deferral of payments on the Federal debt without requiring a similar deferral on the

non-Federal debt. The deferral also may be seen as an enhancement of the non-Federal debt, because it increases the likelihood that the non-Federal debt will be repaid.

It is true that bondholders might lobby to have the Federal government forgive the Federal loans or otherwise protect the project. Similar lobbying occurs now: project sponsors routinely try to get additional funds to continue projects that go over budget. And under credit reform, legislation to forgive the debt would score in the same fashion as legislation to help a project through added direct appropriations.

In addition, the Federal government never pays either interest or principal to the tax-exempt bondholders, so no 'guarantee' exists. Moreover, the financial support given to tax-exempt bondholders through the flexible payment option is less than the support given by the direct grants for 80 percent of project costs that are now provided under current law.

Can OMB adequately measure the risk associated with the proposed Federal loans?

Critics argue that it is difficult to measure the risk associated with these projects, for they are infrequent, lumpy projects. Yet this merely implies that the uncertainty of OMB estimates would be large, and the associated credit subsidy estimate should reflect that uncertainty. Critics also argue that toll projects have a history of default. Since 1961, however, projects have defaulted on about 1 percent of the \$39 billion in revenue bonds issued for transportation toll projects. Traffic forecasts are most uncertain for projects where no comparable traffic patterns exist. The DOT proposal would be limited, however, to projects that expand capacity on some of the most congested corridors in the nation (e.g., rebuilding the Woodrow Wilson Bridge). In these situations, traffic forecasts have far less uncertainty.

Critics also argue that OMB should measure political risk, i.e., the probability that Federal government will allow Federal loans to default in order to protect private bondholders. In the case of default, however, the Federal government will be able to liquidate the assets that secure the Federal loan. In addition, if Congress provides relief by forgiving a the Federal loan, such action would score for budget purposes.

OPTION 2 - Create Discretionary State Infrastructure Bank Fund

Under this option, the Secretary would have the discretion to allocate the \$100 million to State Infrastructure Banks to subsidize specific projects. This approach would avoid all of the scoring problems associated with Option 1. Fewer projects would be subsidized, however, for project sponsors would have to pay the private sector rather than the public sector cost of capital. In addition, funds raised in

private markets would include a premium reflecting the fact that these 10-year, flexible payment bonds are not a standard financing instrument.

• Note:

- SIBS (w/ the math. infra bank)
- but this is fundamentally

(

we wld have resources to look at small #.

• DOT:

- get ready to argue for
- fallback: - ^{grey gives} SIBs &
- cash to buy a deferral plan

If

THE WHITE HOUSE
WASHINGTON

MT. These are ~~below~~ I grade

If it's above that, inst. I can
say they've met their fiduciary
responsibility.

political

①

- loan, by its nature, vs. the fed. govt. subj.
to greater pressure

②

technical: we don't know how to score
these proj's

unlabeled risk

- they're risky
- they're unusual - 1-shot deals

Assume we're thinking about a toll road to be built by a governmental turnpike commission that has the authority to issue governmental (not private-activity) tax-exempt revenue bonds.

Current law: The feds pay 80 percent of project costs in direct cash grants; commission issues revenue bonds to pay the remaining 20 percent of project costs. The commission's ability to borrow depends directly on the fact that it receives federal subsidy for 80 percent of project costs -- in this sense, the tax-exempt debt is 'linked' to the direct grant.

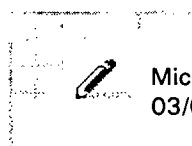
Option 1: The feds make direct loan for 80 percent of project costs. The commission issues revenue bonds to pay the remaining 20 percent of project costs. repayment of fed loan and revenue bonds follow same time path. in case of default, feds and nonfederal lenders share assets that secure the debt in proportion to the amount of their debt outstanding (80/20). in this scenario, the tax-exempt debt is 'linked' to direct federal loan in exactly the same fashion as it is linked to direct grants under current law. if the interest rate were set to cover fed government's cost of borrowing and to reflect the probability of default -- npv of gov't's expected cost would be zero. but despite lowering the federal gov't's expected net cost from 80 percent of project costs to zero, a prohibition against 'linkage' would prevent moving from current law to option 1.

Option 2. Assume reason prevails and we move to option 1. afterwards, dot proposes option 2: same as option 1 except feds make a loan for only 33% of project costs. omb and trs applaud virtue of dot and approve option 2.

Option 3. Same as option 2, except the federal loan is structured as a zero coupon bond, and the interest rate is appropriately changed to reflect different risk associated with new payment stream, so that npv of fed's expected cost is still zero. in case of default, fed and nonfed continue to share real assets in proportion to amount of debt outstanding. omb and trs, being rationale actors, are indifferent between option 3 and option 2.

Option 4. Same as option 3, except the zero coupon bond has a provision that allows the borrower to pay early. interest rate is adjusted accordingly to keep npv of fed's expected cost at zero. omb and trs again shrug with indifference.

In my view, omb and trs rationally could object to a proposal that the federal government move from current law to option 4 only if they believed that we could not compute the appropriate interest rate, i.e., we could not accurately score the credit subsidy. but if that is true, then we are questioning the whole system of scoring govt loans and guarantees, and must oppose the extension of any federal credit.



Michael Deich
03/06/97 03:55:45 PM

Record Type: Record

To: See the distribution list at the bottom of this message

cc:

Subject: subordination, linkage, tax-exempt debt and government loans

Project at issue: a toll road built by a governmental turnpike commission that has the authority to issue governmental (not private-activity) tax-exempt revenue bonds.

Current law: feds pay 80 percent of project costs in direct cash grants; commission issues revenue bonds to pay the remaining 20 percent of project costs. commission's ability to borrow depends directly on the fact that it receives federal subsidy for 80 percent of project costs -- in this sense, the tax-exempt debt is 'linked' to the direct grant.

Option 1: feds make direct loan for 80 percent of project costs. the commission issues revenue bonds to pay the remaining 20 percent of project costs. repayment of fed loan and revenue bonds follow same time path. in case of default, feds and nonfederal lenders share assets that secure the debt in proportion to the amount of their debt outstanding (80/20). in this scenario, the tax-exempt debt is 'linked' to direct federal loan exactly as it is linked to direct grants under current law. if the interest rate were set to cover fed government's cost of borrowing and to reflect the probability of default -- npv of gov't's expected cost would be zero. but despite lowering the federal gov't's expected net cost from 80 percent of project costs to zero, a prohibition against 'linkage' would prevent moving from current law to option 1.

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In my view, omb and trs rationally could object to a proposal that the federal government move from current law to option 4 only if they believed that we could not compute the appropriate interest rate, i.e., we could not accurately score the credit subsidy. but if that is true, then we are questioning the whole system of scoring govt loans and guarantees, and must oppose the extension of any federal credit.

What do you think?

Message Sent To:

Barry B. Anderson/OMB/EOP
Harry E. Moran/OMB/EOP
Joseph J. Minarik/OMB/EOP
Randolph M. Lyon/OMB/EOP
MAZUR_M @ A1 @ CD @ LNGTWY
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COMMENTS ON FEDERAL CREDIT MEMO OF 3/5/97

March 6, 1997

Option 1: Fully Taxable Debt with Flexible Payment Loan

The deferral period should extend from the first 10 years following Substantial Completion of the Project, not the first 10 years of the loan's life, as payments are never due during construction.

Deferrals, if necessary, should cover principal *and/or* interest (not either/or).

Cons:

- Precludes Governmental Project Sponsors which have legal authority to issue tax-exempt bonds from utilizing this source of capital for the non-Federal borrowing needs, increasing borrowing costs by 2.5% to 3% higher.
- The program would end up largely unutilized because of its restrictions.

Option 2: Public Ownership of Project with Flexible Payment Loan and Tax-Exempt Debt

The deferral period should extend from the first 10 years following Substantial Completion of the Project, not the first 10 years of the loan's life, as payments are never due during construction.

Deferrals, if necessary, should cover principal *and/or* interest (not either/or).

Option 3: Public-Private Partnership Projects with Flexible Payment Loans and Tax-Exempt Debt

The deferral period should extend from the first 10 years following Substantial Completion of the Project, not the first 10 years of the loan's life, as payments are never due during construction.

Deferrals, if necessary, should cover principal *and/or* interest (not either/or).

Pros:

Allowing tax-exempt debt for surface transportation projects with private participation would provide a "level playing field" with current tax policy for other modes of transportation (airports, seaports and high speed rail.)

Comment on Interest Rate Subsidy Variation

Providing interest rate subsidies on the Federal loan to offset the higher cost of capital on the non-Federal debt financing would require a subsidy rate in excess of 50%.

TO: Worzala/Tornquist/Schwartz ✓
Barry Anderson
Jane Garvey ✓
Mark Mazur
Dorothy Robyn
Mozelle Thompson ✓

FR: Michael Deich

RE: Background memo for Principals on DOT's proposed credit program

I expect that we will need to call a Principals meeting in order to resolve the outstanding dispute regarding DOT's proposed credit program. I've attached a background memo from Mark Mazur that I hope can be distributed to the Principals tomorrow in preparation for a meeting -- as yet unscheduled -- on Friday. Please get comments to Mark Mazur by 10 a.m. tomorrow (if possible, pls cc: everyone on the distribution list). Thanks.

Four pages follow.

ISTEA INNOVATIVE FINANCING OPTIONS

Option 1: Fully Taxable Debt with Flexible Payment Loan

This option would permit the Federal government to offer flexible payment loans to the sponsors (public or private sector) of certain transportation projects, with loan repayments to be made from project revenue flows. For the first 10 years of the loan's life, the Secretary of Transportation could defer repayment of either principal or interest on the Federal loan, if cash flows from the project are insufficient to cover these items. Any deferred payments would be added to the balance of the loan and would accrue interest at the Federal cost of funds.

The financing cost is a weighted average of fully-taxable bond rates and the Federal cost of funds.

Pros:

Flexible repayment loans may provide increased comfort to potential investors in worthwhile long-term projects as they will be better able to weather unexpected downturns in revenue flows.

This option permits private participation in transportation projects (e.g., ownership of the facility) as well as public project ownership. There may be efficiency gains from private participation that the public sector cannot obtain.

The use of fully-taxable debt provides a market test of whether the project generates sufficient benefits to be a desirable investment.

Cons:

The overall cost of financing under this option may be higher than that available if the project were funded using tax-exempt debt. The higher cost may discourage private sector participation in these projects.

Option 2: Public Ownership of Project with Flexible Payment Loan and Tax-Exempt Debt

This option would permit the Federal government to offer flexible payment loans to States or public authorities that undertakes certain transportation projects. Flexible loan repayments would be made from cash flows from the project, but the Secretary of Transportation could defer the repayment of either principal or interest during the first 10 years of the loan life, if cash flows from the project are insufficient to cover these items. Any deferred payments would be added to the balance of the loan and would accrue interest at the Federal cost of funds. The State or public authority could also issue tax-exempt debt (e.g., revenue bonds) subject to current law restrictions on use of proceeds.

The financing cost is a weighted average of the tax-exempt bond rate and the Federal cost of funds.

Pros:

Flexible repayment loans may provide increased comfort to potential investors in worthwhile long-term projects as they will be better able to weather unexpected downturns in revenue flows.

States may view the ability to borrow from the Federal government under a flexible repayment plan as superior to issuing tax-exempt debt. To the extent this occurs, the projected tax expenditure on tax-exempt bonds will be reduced.

While the flexible payment option may reduce the perceived riskiness of the tax-exempt debt, this is not a "Federal guarantee" in any meaningful sense, since the Federal government never pays interest or principal to the tax-exempt bondholders. Moreover, the financial support given to tax-exempt bondholders through the flexible payment option is so indirect and remote that it should not be viewed as a form of subordination.

The combination of tax-exempt debt and flexible repayment of the Federal loan may allow some projects that otherwise could not raise adequate financing to go forward.

Cons:

This option restricts project ownership to public entities.

A flexible payment option may be seen as subordinating the Federal debt to outstanding tax-exempt debt, resulting in a "guarantee" of tax-exempt debt, contrary to current Federal financing practice. This may occur because the potential for waiving payments to the Federal government provides additional assurance to the holders of the tax-exempt debt that they will be repaid in full.

Option 3: Public-Private Partnership Projects with Flexible Payment Loans and Tax-Exempt Debt

This option would permit the Federal government to offer flexible payment loans for certain transportation projects to a partnership between a State or public authority and a private entity. Flexible loan repayments would be made from cash flows from the project, but the Secretary of Transportation could defer the repayment of either principal or interest during the first 10 years of the loan life, if cash flows from the project are insufficient to cover these items. Any deferred payments would be added to the balance of the loan and would accrue interest at the Federal cost of funds. The State or public authority could also issue tax-exempt debt (e.g., revenue bonds) to finance the project (though this would require a change in the tax law governing private activity bonds that would permit issuance for public-private partnership transportation projects and allow these bonds to be issued without counting against a State's private activity volume cap).

The financing cost is a weighted average of the tax-exempt bond rate and the Federal cost of funds.

Pros:

Flexible repayment loans may provide increased comfort to potential investors in worthwhile long-term projects as they will be better able to weather unexpected downturns in revenue flows.

This option permits project ownership by either public entities or public-private partnerships. There may be efficiency gains from private participation that the public sector cannot obtain.

While the flexible payment option may reduce the perceived riskiness of the tax-exempt debt, this is not a "Federal guarantee" in any meaningful sense, since the Federal government never pays interest or principal to the tax-exempt bondholders. Moreover, the financial support given to tax-exempt bondholders through the flexible payment option is so indirect and remote that it should not be viewed as a form of subordination.

The combination of tax-exempt debt and flexible repayment of the Federal loan may allow some projects that otherwise could not raise adequate financing to go forward.

Cons:

A flexible payment option may be seen as subordinating the Federal debt to outstanding tax-exempt debt, resulting in a "guarantee" of tax-exempt debt, contrary to current Federal financing practice. This may occur because the potential for waiving payments to the Federal government provides additional assurance to the holders of the tax-exempt debt that they will be repaid in full.

Creating a new category of tax-exempt private activity bonds outside of State volume caps is undesirable because tax-exempt debt is an inefficient subsidy mechanism. The current law volume cap places a limit on how much a State can use this subsidy to benefit private sector participants. Creating a new category of tax-exempt private activity debt will increase the pressure for designating additional allowable uses of this debt and for increasing the private activity volume caps.

Possible Variations on the Options Presented

- Limits can be set on the amount of Federal loan participation in a project.
- A higher interest rate can be charged on any amounts deferred into the future.
- The period over which deferrals can be made could be modified.
- An interest subsidy could be offered to offset some of the financing cost of taxable debt, though this would be an expensive proposition.

from DOT

REASONS WHY FEDERAL CREDIT ALONGSIDE TAX-EXEMPT DEBT
DOES NOT CONSTITUTE A FEDERAL GUARANTEE

March 5, 1997

Issue: Treasury is taking the position that if a borrower receives a Federal loan, it should be precluded from arranging Tax-Exempt Debt for the balance of its funding, on the grounds that the loan constitutes a "Federal Guarantee" of the bonds, and is therefore impermissible.

Response:

This argument doesn't stand up in terms of Legal and Financial Analysis, Prior Precedent, and Cost-Effectiveness, as described below.

A. Legal and Financial Analysis

- *FCRA Treatment.* The situation described above does not represent a "guarantee" as defined in the Federal Credit Reform Act of 1990, in that no Federal payment or pledge is being made with respect to the payment of all or a part of any principal or interest on other debt obligations.
- *Tax Treatment.* Under the Internal Revenue Code, such an arrangement does not represent a Federal guarantee, as evidenced by the many favorable bond opinions which have been given in situations where a borrower has received a loan from the Federal government and also has issued tax-exempt bonds.
- *Rating Agency Treatment.* The rating on bonds issued for a project which also has a Federal loan does not reflect a Federal guarantee. Even with a Federal loan, the project debt on most start-ups will be in the BBB range, not AAA (which is how Federal guarantees are rated.) Investors do not view the bonds as "federally guaranteed" and there is no implied liability of the Federal government on other capital markets indebtedness.

B. Prior Precedent

There are numerous other situations where a borrower has used Federal Credit as well as tax-exempt financing.

- *FY98 Budget.* The President's FY 1998 budget proposal for a credit program contains no prohibition against project sponsors raising the balance of their funding through the tax-exempt market if they legally are able to do so.
- *School Construction Program.* The Administration has proposed a \$ 5 billion Interest Rate Buydown proposal for tax-exempt School Construction Bonds which would directly subsidize a portion of interest expense. This would appear to represent more of a "guarantee" than a direct Federal loan alongside project revenue bonds.
- *District of Columbia.* The District of Columbia has issued General Obligation bonds both to the general public on a tax-exempt basis as well as directly to the Federal government. The G.O.

bonds are rated as "junk bonds" (BB), reflecting the District's deteriorated credit, and are not viewed as Federally guaranteed.

- *Alameda Corridor.* Going back to the April 1996 Alameda proposal, which was approved by OMB and DOT, there has never been any prohibition concerning the tax status of ACTA's other capital markets debt.
- *WMATA Refinancing.* The Administration approved Washington Metropolitan Area Transit Authority refinancing a third of its \$ 1 billion taxable federally guaranteed bonds with tax-exempt non-guaranteed bonds. This resulted in side-by-side Federal credit and tax-exempt debt.
- *Federal Grants backing Tax-Exempt Debt.* If a loan is viewed as credit enhancement, then presumably a Federal grant (which can be viewed as a loan which doesn't get repaid) would represent even stronger credit enhancement. Yet there is no restriction against recipients of FHWA or FTA grants financing their local match with tax-exempt debt (which they frequently do), and Treasury expressly approved securing tax-exempt bonds sold by State Wastewater Revolving Funds with Federally-capitalized reserves.
- *Connie Lee.* The College Loan Marketing Association, which was capitalized in part with Federal dollars, provides financial guarantees on college revenue bonds, many of which are tax-exempt.
- *TCA.* TCA obtained legislation in both FY 1995 (for Foothills) and FY 1996 (for San Joaquin) enabling them to secure in excess of \$ 2.7 billion of tax-exempt project debt with federal lines of credit.

C. Cost-Effectiveness.

- *Fiscal Impact.* If Treasury's policy is adopted, many project sponsors will find it more cost-effective to attempt to finance 100% of their needs through the tax-exempt market (like TCA, E-470) rather than only 67%, which would be the case with a 33% Federal loan. The Treasury's proposal actually would result in increased issuance of tax-exempt debt. There is a real risk that no one would avail themselves of the Federal Credit program if it precluded their ability to access lower rates through the municipal bond market. Thus, nationally significant infrastructure investments would be financed more slowly and at greater cost through the municipal market, if at all.
- *Budget Cost.* The counter-proposal to increase the federal share to 49% (up from 33%) of project debt and heavily subsidize the interest rate in order to restore the lost benefit of tax-exemption is prohibitively costly, and unnecessarily intrusive. For example, on the Woodrow Wilson Bridge project, in order to keep the toll rate constant with the current scenario (Federal loan and tax-exempt bonds), it would require increasing the amount of the Federal loan from \$ 324 million to \$756 million. The required budget authority to fund the interest subsidy (the interest rate charged falls from 7% to 4.5%) and credit risk (12.5% assumed) is an additional \$ 371 million--virtually four years' capacity under the proposed legislation. This represents a 54% subsidy cost on the loan.

Here are the ISTE A options
we discussed. Please get
comments to Mark Mazur (x55147)
as soon as possible.

Thanks!

ISTEA INNOVATIVE FINANCING OPTIONS

Option 1: Fully Taxable Debt with Flexible Payment Loan

This option would permit the Federal government to offer flexible payment loans to the sponsors (public or private sector) of certain transportation projects, with loan repayments to be made from project revenue flows. For the first 10 years of the loan's life, the Secretary of Transportation could waive repayment of either principal or interest on the Federal loan, if cash flows from the project are insufficient to cover these items. Any deferred payments would be added to the balance of the loan and would accrue interest at the Federal cost of funds.

This option permits private participation (e.g., ownership of the facility). The use of fully-taxable debt provides a market test of whether the project generates a sufficient return to be a desirable investment.

The cost of financing is a weighted average of fully-taxable bond rates and the Federal cost of funds.

Option 2: Public Ownership of Project with Flexible Payment Loan and Tax-Exempt Debt

This option would permit the Federal government to offer flexible payment loans to a State or public authority that undertakes certain transportation projects. Flexible loan repayments would be made from cash flows from the project, but the Secretary of Transportation could waive the repayment of either principal or interest during the first 10 years of the loan life, if cash flows from the project are insufficient to cover these items. Any deferred payments would be added to the balance of the loan and would accrue interest at the Federal cost of funds. The State or authority could issue tax-exempt debt (e.g., revenue bonds) subject to current law restrictions on use of proceeds.

This option restricts project ownership to public entities.

Some may argue that the flexible payment option subordinates the Federal debt to any outstanding tax-exempt debt, contrary to current Federal financing practice. This may occur because the potential for waiving payments to the Federal government provides additional assurance to the holders of the tax-exempt debt that they will be repaid. The counter-argument is that while the flexible payment option may reduce the perceived riskiness of the tax-exempt debt, this is not a "Federal guarantee" in any meaningful sense, since the Federal government never pays any interest or principal to the tax-exempt bondholders in any event. Moreover, the financial support given to tax-exempt bondholders through the flexible payment option is so indirect and remote that it should not be viewed as a form of subordination.

The cost of financing is a weighted average of the tax-exempt bond rate and the Federal cost of funds.

Option 3: Public-Private Partnership Projects with Flexible Payment Loans and Tax-Exempt Debt

This option would permit the Federal government to offer flexible payment loans for certain transportation projects to a partnership between a State or public authority and a private entity. Flexible loan repayments would be made from cash flows from the project, but the Secretary of Transportation could waive the repayment of either principal or interest during the first 10 years of the loan life, if cash flows from the project are insufficient to cover these items. Any deferred payments would be added to the balance of the loan and would accrue interest at the Federal cost of funds. The State or authority could issue tax-exempt debt (e.g., revenue bonds) to finance the project (though this would require a change in the tax law governing private activity bonds that would permit issuance for public-private partnership transportation projects and allow these bonds to be issued without counting against a State's private activity volume cap).

This option permits project ownership by either public entities or public-private partnerships.

Some may argue that the flexible payment option subordinates the Federal debt to any outstanding tax-exempt debt, contrary to current Federal financing practice. This may occur because the potential for waiving payments to the Federal government provides additional assurance to the holders of the tax-exempt debt that they will be repaid. The counter-argument is that while the flexible payment option may reduce the perceived riskiness of the tax-exempt debt, this is not a "Federal guarantee" in any meaningful sense, since the Federal government never pays any interest or principal to the tax-exempt bondholders in any event. Moreover, the financial support given to tax-exempt bondholders through the flexible payment option is so indirect and remote that it should not be viewed as a form of subordination.

Some may argue that creation of a new category of tax-exempt private activity bonds outside of State volume caps is undesirable because tax-exempt debt is an inefficient subsidy mechanism and current law places a limit on how much of this subsidy each State can use to benefit private sector participants. Creation of a new category of tax-exempt private activity debt will increase the pressure for designating additional allowable uses of this debt and for increasing the private activity volume caps.

The cost of financing is a weighted average of the tax-exempt bond rate and the Federal cost of funds.

Potential Variations on the Options Presented

- Limits can be set on the amount of Federal loan participation in a project.
- An increased interest rate can be charged on any amounts deferred into the future.
- The period over which deferrals can be made could be changed.

(1) - Fully taxable bonds w/ flexible payment

^{DOT:}
- not cheap enough to attract investors

(2) - State ^{issues} ~~tax~~ tax-exempt bonds w/ flexible payment

(3) public-private roads (Bechtel)
tax exempt bonds, outside volume cap,

0 coupon bond
10-yr. loan w/ balloon payment



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*Presentation to the
Office of Management and Budget*

A Federal Credit Program for Surface Transportation

Draft Report

February 4, 1997

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EXECUTIVE SUMMARY

Introduction

The continued growth of the U.S. economy depends, in large part, on a unified and interconnected nationwide surface transportation system. The Nation's growing population and increased shipping demands are straining the capacity of existing facilities. The Federal-aid grant program has enabled the construction of an extensive transportation system; however, the program's financial limitations are becoming evident in the face of growing investment needs and the lack of available public funding to meet those needs. This funding shortfall is particularly acute for large new investments and major expansions of existing highways and other transportation facilities, which can cost hundreds of millions of dollars.

Federal assistance in the form of credit (e.g., direct loans, loan guarantees, and other lending arrangements) rather than outright grants is currently being used to stimulate investment in such sectors as housing, education, and agriculture. Federal credit has achieved important social and economic goals in these areas. A Federal credit program oriented toward large surface transportation projects of national significance would be an important step in closing the current funding gap and supporting the national economy in an era of constrained public resources.

The Nation is experiencing a growing reliance on the transportation system in an era of constrained funding.

The Nation's growing population (which increased 15 percent between 1980 and 1994) and increasing reliance on motor transport are straining the capacity of the Nation's roads and bridges, border crossings, and intermodal transfer facilities.

Total public spending on capital improvements to highways and bridges was approximately \$43 billion in 1995. The U.S. Department of Transportation (DOT) estimates that an additional \$16 billion per year is needed just to maintain the condition and performance of the Nation's highways; however, another \$20 billion in annual investment is justified in terms of direct economic benefits.

Federal budgetary pressures will continue to constrain capital investment.

Although receipts into the Highway Trust Fund from fuel taxes have been growing at a steady rate, Federal budgetary constraints limit the amount of grant assistance that can be distributed to the States. The primary form of Federal assistance--the Federal-aid program--reimburses State capital expenditures on transportation infrastructure at prescribed rates (historically, 80 or 90 percent); the remainder of project costs are covered by the States. Sole reliance on a grant-based reimbursement program may no longer be the most productive approach. This approach is limited in range, slow to accommodate change, unable to leverage sufficient private and non-Federal capital, and not productive enough to meet growing investment needs.

A Federal credit program would complement existing programs.

A Federal credit program for surface transportation projects would complement existing financing techniques by directing resources to transportation investments of critical national importance--such as intermodal facilities, expansion of existing highways, border infrastructure, trade corridors, and other investments with national benefits--that otherwise might be delayed or not constructed at all because of risk or scope. Federal credit would encourage more private sector and non-Federal participation, address important public needs in a more budget-effective way, and take advantage of the public's willingness to pay user fees to receive the benefits and services of transportation infrastructure sooner than would be possible under traditional, grant-based financing.

DOT has designed the Transportation Infrastructure Credit Program to achieve seven key program objectives.

1. Broaden the Availability of Assistance. To date, Federal credit activities in the surface transport sector have been characterized by the ad-hoc efforts of interested State and local entities approaching the Administration and Congress for assistance. In recent years, several large transportation projects have received credit assistance through special legislation. Thus far, the Federal Government has managed to respond to these initiatives, but the success of these transactions has stimulated enormous interest among other project sponsors. A central goal of this program, therefore, is to establish uniform, objective, and transparent criteria for project sponsors to submit applications to DOT for Federal credit and to set forth an orderly process for evaluating and implementing the projects.

2. Target Projects of National Significance. The program is designed to assist transportation projects that are large-scale investments generating major economic benefits, such as trade corridors, intermodal facilities, bi-state connectors, and international border crossings. Given their size, these projects cannot be readily funded through existing government assistance programs, including State Infrastructure Banks (SIBs). The Federal credit program would offer a cost-effective mechanism for financing these important national investments.

3. Identify New Revenue Streams. Typically, the projects receiving credit assistance would confer substantial benefits, enabling them to generate their own revenue streams through user charges, such as tolls or fares, or indirect beneficiary fees, such as special benefit district assessments or dedicated tax revenues. By assisting State and local government sponsors in identifying new project-related revenue streams, the program would allow existing State and Federal resources to be directed toward smaller, more traditional projects that lack the potential to become self-sustaining. This, in turn, would increase the overall level of capital investment.

4. Fill Market Gaps. Large, complex transportation projects frequently encounter market resistance as a result of investor concerns about limited investment horizons, illiquidity, flexibility, risk, and uncertainty. Addressing these risks will reduce the transactional friction associated with financing these projects and facilitate their access to the capital markets.

5. Leverage Substantial Private Co-Investment. Unlike other Federal credit programs, which often entail Federal credit exposure of 80 percent or more of project costs, the proposed Transportation Infrastructure Credit Program has been structured to leverage substantial private capital with only a minority Federal investment position. By offering a secondary source of capital as a minority investor--with the Federal share being capped at 33 percent of project costs--DOT

can attract new funds into infrastructure capital formation in much larger magnitudes from private capital sources.

6. Limit the Federal Exposure. The participation of private capital will help instill market discipline by forcing the selection of only those projects that are financially feasible and have acceptable risk profiles. DOT recommends out-sourcing the risk assessment of each project to the major bond rating agencies. Their analysis will enable the appropriate subsidy cost or capital reserve to be set aside at the outset of a project to cover any anticipated default risk.

7. Enlist State and Local Participation. More than other Federal credit activities, large infrastructure projects depend on State and local government approval and support. The proposed credit program would draw on the active involvement of State and local governmental units throughout the entire process, from the identification of suitable candidates to the ongoing monitoring and servicing of the credit products. The program should be structured to complement existing Federal-State mechanisms by encouraging States to use their SIBs or other State-designated intermediaries as local servicing agents. This strategy would, in turn, assist DOT by providing ongoing local monitoring of project status, ensuring local acceptance, and helping those State entities develop greater expertise and resources.

DOT recommends that three types of credit assistance be offered to manage the different financial needs of projects at various points in their life cycles.

1. Flexible Payment Loans

Given the uncertainty of projected revenue streams and operating costs for startup transportation projects, investors may require an unusually high coverage margin for debt service. The excess coverage constrains the permitted level of annual project debt service, which reduces the amount of debt that can be issued.

Flexible payment loans would be direct loans from DOT to project sponsors to provide long-term, fixed-rate financing of a portion of construction costs. The flexible payment loan could be in an amount up to 33 percent of the cost of a project and have a final maturity date as long as 30 years after construction. The interest rate would be established at the time the loan agreement was executed and would be set at the prevailing yield on U.S. Treasury bonds issued for a comparable term.

Loans would be repayable from project-related revenues. DOT would allow senior debt holders to have a prior claim on the annual flow of revenues, although the Federal Government would have a parity claim on project assets in the event of a default. If annual project revenues were insufficient to meet current debt service on the Federal loan, interest and principal payments could be deferred.

The flexible payment loan should enable the senior debt to demonstrate higher coverage ratios and attain investment-grade bond ratings. This, in turn, will facilitate project access to private capital.

2. Standby Lines of Credit

In certain cases, investors may recognize that a project is likely to experience growth in its revenue stream over time, but they may be uncertain about the timing of the growth, especially during the ramp-up period when there are no secondary sources of private capital.

The standby line of credit would allow a project to meet revenue shortfalls in the first 10 years of operation by drawing on a DOT borrowing line. The line of credit is considered a standby facility in that it represents a contingent source of capital that would be drawn on only if needed to meet debt service payments on the project's long-term bonds.

The standby line of credit would take the form of a future government commitment to make one or more flexible payment loans. The total line could not exceed 33 percent of project costs. Up to 20 percent of the line could be loaned in any given year, and any draws would need to be repaid from project-related revenues within a 30-year period. These loans would be structured in a similar manner as the direct flexible payment loans.

The standby line of credit is intended to assist projects in attaining investment-grade bond ratings and securing bond insurance.

3. Development Cost Insurance Pilot Program

The pre-construction phase of project development is the most speculative stage. During this stage, the project sponsor must complete environmental reviews, secure permits, perform feasibility studies, and carry out various other preliminary tasks required for constructing the facility. To date, these costs have been advanced largely by private developers, but the developers are becoming increasingly reluctant to finance pre-construction costs because of the large exposure, long lead times, and political risks involved.

The development cost insurance pilot program would allow DOT to insure up to 40 percent of pre-construction costs for project sponsors that receive a development mandate from a State or local government. At least 20 percent of the remaining risk would need to be absorbed by the State or local unit. The Federal share would be capped at \$4 million per project. No more than 10 percent of the Federal credit program's annual budget authority could be used for this pilot program. (Although this type of financial assistance may not be considered a true credit product under a strict interpretation of the Federal Credit Reform Act of 1990 (FCRA), it has similar characteristics and achieves similar goals and, therefore, is included as part of this proposal.)

The Secretary would establish quantitative and qualitative criteria for selecting projects to receive Federal credit.

Projects will need to meet certain objectively measurable threshold criteria relating to project size; the potential for user charges; eligibility for authorized transportation purposes; and evidence of State and local support. Qualified projects meeting the initial threshold eligibility criteria would then be evaluated and selected based on the extent to which they offer benefits of national significance, leverage private capital, promote innovative technologies, and meet other program goals.

The funding mechanism should reflect the need for predictability in financing these long-term projects.

Compared with other projects receiving Federal assistance, project candidates for this program will tend to be larger, their financial structures will be more complex, and the majority of their funding will come from private capital predicated on the timely and assured receipt of Federal credit. It is imperative that the commitment of Federal funds be predictable from year to year and that amounts

remain available until expended. DOT believes that contract authority is the budgetary mechanism best suited to accomplish these objectives. Two other options for funding the subsidy costs of Federal credit are to make annual appropriations of no-year budget authority or to allow States to access their unobligated balances of prior years' apportionments.

The Federal credit program should produce vastly improved leverage ratios of investment activity as a result of applying limited Federal resources.

Traditional Federal-aid programs (based on a Federal contribution of 80 percent) have an implicit leveraging ratio of 1.25 to 1.00. Based on rating agency risk assessment models, DOT believes that the Federal budgetary costs for the proposed credit program (as reflected in loan subsidy rates) will average between 5 and 10 percent of total credit for flexible payment loans and standby lines of credit.

Under the Transportation Infrastructure Credit Program, capital investment of more than \$3.5 billion is generated by \$1.2 billion of Federal credit assistance at a budget cost of \$100 million. Those amounts represent leveraging ratios of 36 to 1 for total project costs to the budgetary or subsidy costs of credit assistance.

CHAPTER 1: THE NEED FOR FEDERAL CREDIT

Introduction

The continued growth of the U.S. economy depends, in large part, on a unified and interconnected nationwide surface transportation system. The Nation's growing population and increased shipping demands are straining the capacity of existing facilities. The Federal-aid grant program has enabled construction of an extensive national highway system; however, the program's financial limitations are becoming evident in the face of growing investment needs and the lack of available public funding to meet those needs. This funding shortfall is particularly acute for large new investments and major expansions of existing highways and other transportation facilities, the costs of which can amount to hundreds of millions of dollars.

Federal assistance in the form of credit (e.g., direct loans, loan guarantees, and other lending arrangements) rather than outright grants is currently being used to stimulate investment in such sectors as housing, education, and agriculture. Federal credit has achieved important social and economic goals in these areas. A Federal credit program oriented toward large surface transportation projects of national significance would be an important step in closing the current funding gap and supporting the national economy in an era of constrained public resources.

The Economic Value of Transportation Investment

Technological advancements, the globalization of business, and the emergence of just-in-time delivery methods have changed the nature of economic activity. Today's transportation consumers demand more from the transport system than the simple movement of goods and people. They want greater speed, flexibility, and reliability; improved safety; national and regional access; better intermodal connections; and smooth passage between the U.S., Canada, and Mexico.

The globalization of business and corresponding reduction in technological, economic, and political barriers have created an economic climate in which the U.S. relies increasingly on foreign trade. Between 1970 and 1993, foreign trade as a percent of gross domestic product doubled from 12.4 percent to 24.8 percent.¹ The new global economy requires improved access to air- and seaports, increased investment in intermodal facilities, and enhanced development of trade corridors.

¹ *Transportation Investment and Economic Expansion: Summary Report and Case Studies, Volume I.* Louis Berger International, Inc., October 1995.

New, more demand-responsive just-in-time delivery systems are also placing greater demands on the performance of the Nation's transportation network. Just-in-time delivery service (which usually takes 1 to 3 days) allows for rapid turnover of inventory, thus reducing the costs associated with storing raw and manufactured materials. The cost savings of just-in-time delivery methods provide economic benefits to manufacturers, distributors, consumers, and ultimately, the national economy.

The economic productivity gains from transportation investment are significant. A recent study estimates that in the 4-decade period from 1950 to 1989, U.S. firms realized annual production cost savings of 18 percent from general highway investment (18 cents per dollar invested in all roads) and 24 percent from investment in non-local roads.²

Growing Reliance on the Transportation System in an Era of Constrained Funding

The Nation's growing population (which increased 15 percent between 1980 and 1994) and increasing reliance on motor transport are straining existing facilities. Since 1980, total ton and intercity passenger miles have grown by 30 percent and 60 percent, respectively.³ This comes at a time when limited resources and the normal deterioration of the Nation's roads and bridges are contributing to a shift in national investment from capacity expansion to operation and maintenance of existing facilities. Although this shift has temporarily halted the decline in roadway conditions that occurred during the 1970s, it has resulted in a steady increase in the extent and duration of congestion.

In 1975, only 40 percent of peak hour travel was under congested conditions. Now, 66 percent occurs under congested conditions.⁴ The growth of congestion has significant long-term environmental, safety, and economic effects on the Nation. A recent study estimates that the time losses and wasted fuel associated with congestion cost the average U.S. citizen \$370 annually.⁵ These costs are expected to increase as growing investment needs and shrinking availability of public funding contribute to declining performance.

Total public spending on capital improvements to highways and bridges was approximately \$43 billion in 1995, the most recent year for which data are available. The U.S. Department of Transportation

² *Contribution of Highway Capital to Industry and National Productivity Growth - Executive Summary*. Professor Ishaq Nadiri, New York University, FHWA, 1996.

³ *The Bottom Line: Transportation Investment Needs*, AASHTO, 1996.

⁴ *Our Nation's Highways: Selected Facts and Figures*, FHWA, May 1995.

⁵ *Measuring and Monitoring Urban Mobility*, Texas Transportation Institute, November 1996.

(DOT) estimates that an additional \$16 billion per year is needed just to maintain the condition and performance of the Nation's highways at the current level. Another \$20 billion in annual investment is justified in terms of direct economic benefits.⁶ Postponing investment can be costly. DOT estimates that deferring \$1 in highway resurfacing for just 2 years can result in spending \$4 in highway reconstruction to repair damages.

The spending gap for transit is smaller in actual amount, but similar in relative magnitude to current spending. At least \$2 billion more per year is needed to maintain current conditions and nearly \$7 billion a year more is needed to improve services.

The economic drag created by a deteriorating transportation network could be substantial as shippers and motorists experience increased vehicle maintenance and fuel costs, shipping delays, safety hazards, and time delays associated with congestion and poorly maintained roads.

The Role of Federal Credit

Since 1916, the Federal Government has supported surface transportation through a grant-based funding strategy known as the "Federal-aid" program. Since 1957, revenues derived from the Federal gas tax (presently 18.3 cents per gallon) and other related Federal use taxes have been credited to the Highway Trust Fund (HTF) and allocated among the States pursuant to various formulas for reimbursement of capital and maintenance costs. Under this approach, the DOT reimburses State capital expenditures on transportation infrastructure at prescribed rates (historically, 80 or 90 percent); the remainder of project costs are covered by the States.

Although receipts into the HTF have been growing at a steady rate, Federal budgetary constraints limit the amount of grant assistance that can be distributed to the States. Increasingly, States are recognizing the benefits to be derived from public-private partnerships in developing, building, and operating new transportation infrastructure facilities. These benefits include lower construction costs, faster completion rates, the attraction of private capital, and the equitable and efficient sharing of risks between the public and private sectors. These are particularly relevant concerns for large projects, which have special requirements because of their size and complexity.

Figure 1-1 identifies the various types of projects currently requiring assistance, the potential financing mechanisms, and the typical scope (State-wide, regional, or national) of the projects. The pyramid's shape reflects the number of projects in each funding category. This section classifies these projects, reviews the role of each potential

⁶ 1995 *Status and Condition of the Nation's Surface Transportation System: Condition and Performance*, U.S. Department of Transportation, 1995.

financing option, and identifies the current void that could be filled by a new form of financial assistance--Federal credit.

Although the conventional Federal-aid program has enabled construction of an extensive transportation system, including the Nation's 40,000-mile interstate system, exclusive reliance on a grant-based reimbursement program may no longer be the most productive approach for large projects involving major reconstruction or capacity expansion. This approach is limited in range, slow to accommodate change, and unable to leverage sufficient private and non-Federal capital to meet growing investment needs.

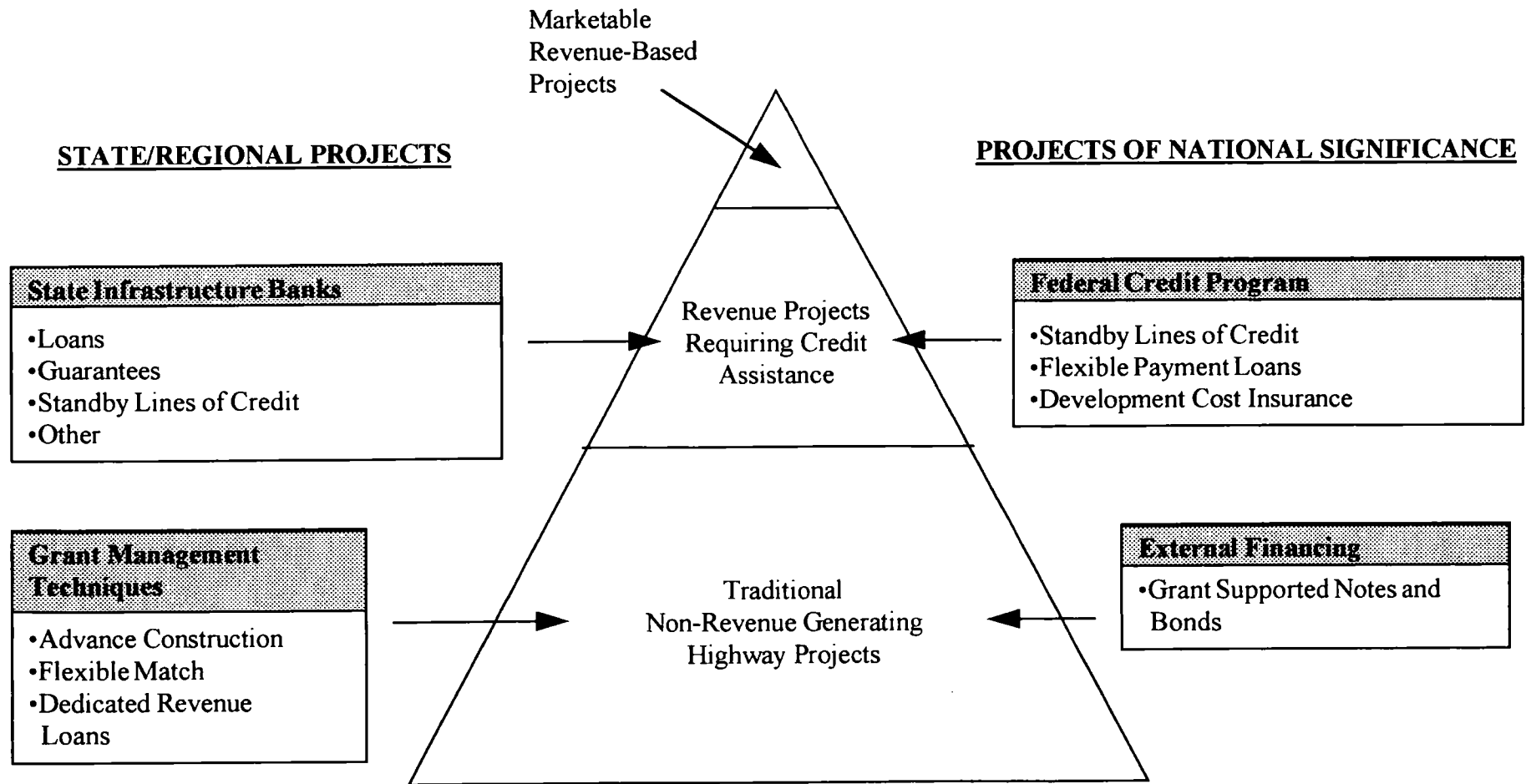
In 1994, the President issued Executive Order 12893, establishing more cost-effective infrastructure investment as a priority for the Administration. Among other things, this measure directed agencies to seek greater private sector participation in infrastructure investment and management. In response, DOT launched an innovative finance initiative (TE-045) which encouraged States to come forward with new financing techniques not generally permissible under traditional Federal programs. DOT's approval of innovative financing solutions has been successful in moving forward numerous high profile projects sponsored by State and local governments. Although these new financing tools have expanded flexibility and promoted private sector participation, they do not squarely address the funding gaps associated with financing large transportation investments.

The National Highway System Designation Act of 1995 authorized DOT to establish the State Infrastructure Bank (SIB) Pilot Program. SIBs are intended to complement traditional transportation programs and provide States with increased flexibility to offer many types of assistance, including low-interest loans, loan guarantees, and standby lines of credit. However, Federal capitalization grants for SIBs currently are limited to 10% of most categories of a State's annual apportionments for fiscal years 1996 and 1997 and \$150 million of "new money" to be shared among the participating States. Moreover, Federal legislation limits the annual disbursement of these funds, thus reducing the capacity of the SIBs to provide large amounts of credit assistance directly in the near term. SIBs will require a number of years to build up sufficient financial resources to gain access to external funding beyond their own contributed capital. Consequently, SIBs, like other startup credit intermediaries, are best suited to assist portfolios of smaller, relatively homogenous, shorter-term projects that are regional or local in scope.

A few completely privately financed, owned, and operated facilities are being developed on high-volume roads where revenue from tolls is sufficient to cover capital costs (e.g., California's SR 91 toll lanes). Although there may be potential to finance some new toll road projects in selected high-density corridors, without public assistance

Figure 1-1

Transportation Infrastructure Financing Mechanisms



the vast majority of such projects will require some form of credit enhancement to be viable in the market.

A Federal credit program would complement existing financing techniques by directing resources to areas of critical national importance--such as intermodal facilities, expansion of existing highways, border infrastructure, trade corridors, and other investments with national benefits--that otherwise might be delayed or not constructed at all because of risk or scope. Federal credit would encourage more private-sector and non-Federal participation, address important public needs in a more budget-effective way, and take advantage of the public's willingness to pay user fees to receive the benefits and services of transportation infrastructure sooner than would be possible under traditional, grant-based financing.

**Background on
Federal Credit**

Federal credit encompasses financial assistance other than grants provided by the Federal Government, such as direct loans and loan guarantees. The Federal Credit Reform Act of 1990 (FCRA) governs the provision of Federal credit assistance. The purposes of FCRA are to: (1) measure more accurately the costs of Federal credit programs, (2) place the costs of credit programs on a budgetary basis equivalent to other Federal spending, (3) encourage the delivery of benefits in the form most appropriate to the needs of the beneficiaries, and (4) improve the allocation of resources among various credit programs and between credit and other spending programs.

Before credit reform (through fiscal year 1991), the costs of Federal credit programs were based on the cash flows associated with loans and guarantees. Thus, the budgeted cost of a direct loan was recorded as the amount of cash disbursed to the borrower at the time of disbursement, regardless of subsequent repayments. The budgeted cost of a loan guarantee was recorded when fees were collected or when cash outlays were made to pay for defaults, regardless of when the Federal commitment was made. This cash-based budgeting overstated the costs of direct loans and understated the costs of loan guarantees at the time of Federal commitment, compared with grant expenditures.

Under FCRA (beginning in fiscal year 1992), the true budgetary costs of providing Federal credit--technically the unreimbursed or subsidized costs on a net present value basis--are scored up front, when the Federal commitment is made. The budgetary costs of direct loans, for example, are composed of default risk costs and, to the extent interest rates charged are less than the rates on comparable Treasury securities, interest subsidy costs. Together, these credit subsidy costs provide a more accurate economic indicator of the Federal resources consumed in offering assistance. Although the subsidy costs of loans and guarantees are included in the budget totals

when those commitments are made, the net cash flows associated with various credit transactions are recorded outside the budget totals as a means of financing. On this basis, Federal credit may be provided only to the extent that budget authority is available in advance to pay the subsidy costs.

In providing credit assistance, the Federal Government faces (and shares) the financial risks associated with loans and guarantees. By and large, the Federal Government has not applied credit assistance to surface transportation investments. Currently, DOT's only significant involvement in credit programs is through the Maritime Administration (MARAD) providing loan guarantees to support shipbuilding. To date, nearly all Federal highway and transit funds have been provided as grants from the Federal Government, either to reimburse costs incurred or capitalize pilot SIBs. The decision to offer credit assistance fundamentally is about whether, how, and to what extent the Federal Government should broaden the forms of assistance it offers to States to include directly extending credit to support major transportation infrastructure investment.

CHAPTER 2: PROGRAM OBJECTIVES AND PRODUCTS

Introduction

In seeking to respond to the special financing issues confronting large-scale transportation infrastructure projects, DOT first sought to identify the strategic goals for a legislative initiative involving Federal credit. Foremost, DOT wished to increase capital investment by leveraging limited Federal resources in a more cost-effective manner than traditional grant programs. Second, it wished to build upon successful working partnerships among Federal, State and local governments. Finally, DOT wished to emphasize an incremental approach, which would represent a natural evolution of existing mechanisms rather than a radical departure. This chapter outlines the key objectives that a Federal credit program for surface transportation is designed to achieve, and describes the specific financial products that would be used to accomplish them.

Program Objectives

DOT has identified seven key objectives in structuring the proposed Federal credit program.

1. Broaden the Availability of Assistance. To date, Federal credit activities in the surface transport sector have been characterized by ad-hoc efforts by interested State and local entities approaching the Administration and Congress for assistance. For example, over the last several years, project sponsors with the Transportation Corridor Agencies (TCAs) in Orange County, California and the Alameda Corridor Transportation Authority (ACTA) in Los Angeles have arranged Federal lines of credit and direct Federal loans through special legislation.¹ Thus far, the Federal Government has managed to respond to these initiatives, but the success of these three transactions has stimulated enormous interest among other project sponsors. A central goal of the program, therefore, is to establish uniform, objective, and transparent criteria for project sponsors to submit applications to DOT for Federal credit, and to set forth an orderly process for evaluating and implementing them.

2. Target Projects of National Significance. The program is designed to assist transportation projects that are large-scale investments generating major economic benefits, such as trade corridors, intermodal facilities, and bi-state connectors. In many cases, these projects are stand-alone facilities with no historical financial performance record. In some cases, they may also be

¹ Through special appropriations, the San Joaquin Hills and Foothills-Eastern toll roads each obtained \$120 million, 10-year standby lines of credit. The Alameda Corridor Project received a \$400 million direct loan repayable over 34 years.

substantial reconstructions of existing facilities backed by new revenue streams. Given their size, these projects cannot be readily funded through existing government assistance programs, including SIBs. The Federal credit program would offer a cost-effective mechanism for financing these important national investments.

3. *Identify New Revenue Streams.* Typically, the projects to be funded would confer substantial benefits, enabling them to generate their own revenue streams. The revenue may come from direct user charges, such as tolls or fares, or indirect beneficiary fees, such as special benefit district assessments or local dedicated tax revenues. Using revenues from beneficiaries to support part or all of the capital costs is recognized as a more equitable and efficient way of funding such projects. By assisting State and local government sponsors in identifying new project-related revenue streams, the program would allow existing State and Federal resources to be directed toward smaller, more traditional projects that lack the potential to become self-sustaining.

4. *Fill Market Gaps.* Generally, a key goal of any Federal credit program is to facilitate the borrower's access to private credit markets by overcoming market imperfections. Large, complex, startup projects frequently encounter market resistance as a result of investor concerns about investment horizon, liquidity, flexibility, risk, or uncertainty. There is an appropriate Federal role for a carefully defined credit program to fill these gaps until the capital markets develop the capacity to evaluate and absorb these risks. Addressing these risks will reduce the transactional friction associated with large and complex project financing, which is reflected in unnecessarily large reserve requirements, coverage levels, capital costs, and transaction fees.

5. *Leverage Substantial Private Co-Investment.* Unlike other Federal credit programs, which often entail a Federal exposure of 80 percent or more of the project costs, the proposed Transportation Infrastructure Credit Program has been structured to leverage substantial private investment with only a limited Federal co-investment. By offering a source of secondary capital as a minority investor, DOT can attract new funds into infrastructure capital formation in much larger magnitudes from private capital sources.

6. *Limit the Federal Exposure.* The participation of private capital will help instill market discipline by forcing the selection of only those projects that are financially feasible and have acceptable risk profiles. Where possible, the risk assessment of the Federal contribution should be based on credit analysis techniques used by the capital markets in assessing the default risk of similar infrastructure loans.

This kind of market-based credit analysis will allow the subsidy costs of the Federal credit to be priced appropriately and in full compliance with FCRA.

7. Enlist State and Local Participation. More than other types of Federal credit activities, large infrastructure projects depend on State and local government approval and support. The program would draw on the active involvement of State and local governmental units throughout the entire process, from the identification of suitable candidates to the ongoing monitoring and servicing of the credit product. The program should be structured to complement existing Federal-State mechanisms by encouraging States to use their SIBs or other existing agencies as local servicing agents. This strategy should, in turn, ensure local acceptance and help those entities develop greater expertise and resources.

**Credit Program
Products**

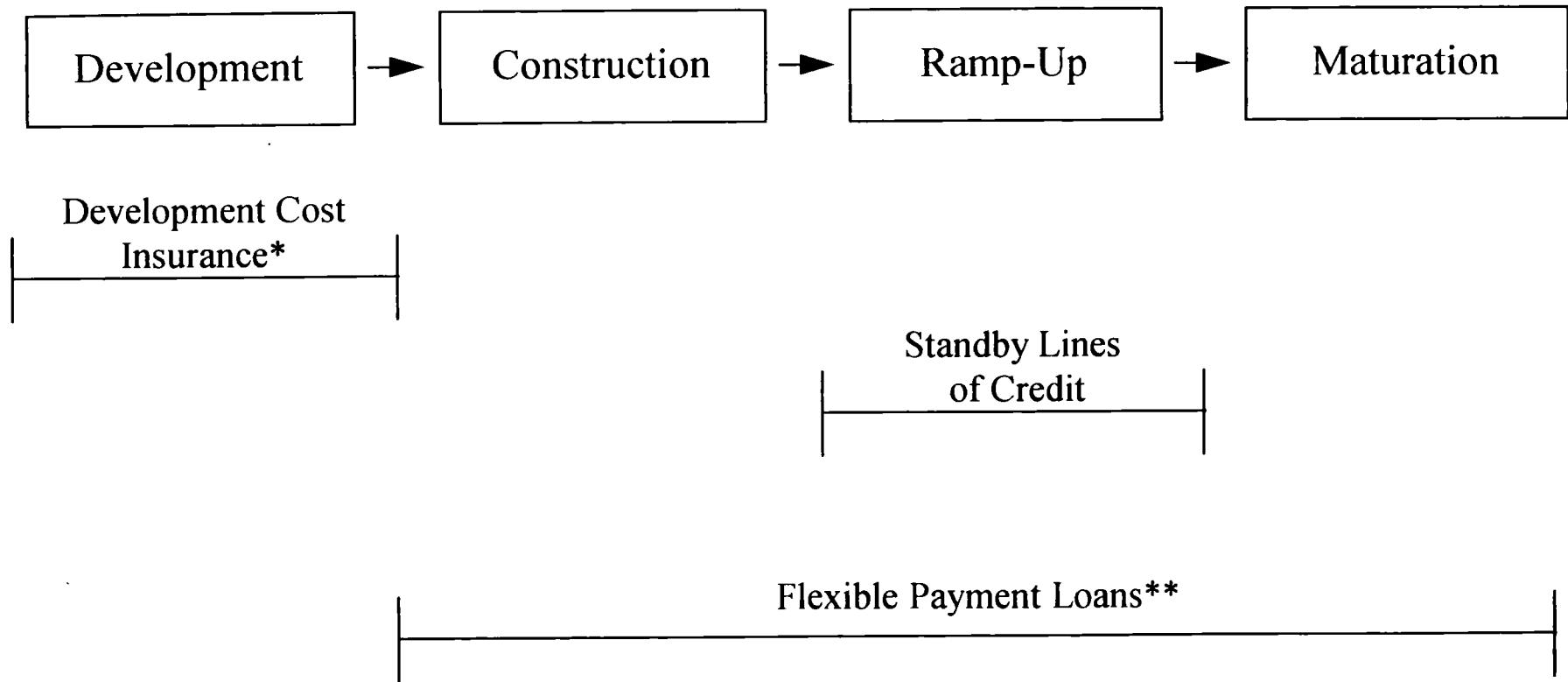
Infrastructure projects have different financing requirements at different stages of their development and operation. Figure 2-1 shows the four stages in the typical life cycle of a major transport facility. These stages are defined as follows:

- The developmental phase is the most speculative stage of any project. In this phase, engineering, financial, and environmental feasibility analyses are conducted and necessary government approvals are secured.
- The construction phase relies on the performance of the developer to complete the project on time and within budget, but is also subject to non-commercial risks, such as weather, litigation, and force majeure.
- When the project is complete, there is typically a ramp-up phase, during which the revenue stream is established. Transportation projects (unlike many environmental projects) are often subject to competing alternatives, and it is difficult to forecast demand accurately in the early years of operation.
- During the final stage, project maturation, the project must generate sufficient revenues over the long-term to cover its operating expenses and amortize its capital costs. For large, capital-intensive projects, a period of 30 years or longer is often required to fully recover the initial investment.

The Federal credit program would consist of three distinct types of financial assistance (i.e., product lines), designed to address a project's varying requirements throughout its life cycle.

- *Flexible payments loans* are direct Federal loans to project sponsors that provide combined construction and permanent financing of initial capital costs.

Figure 2-1
Potential Forms of Federal Credit Assistance
in the Project Life Cycle



* Development cost insurance will account for not more than 10 percent of subsidy budget authority

**Flexible payment loans and standby lines of credit together will account for at least 90 percent of subsidy budget authority

- *Standby lines of credit* represent secondary sources of funding in the form of contingent Federal loans that may be drawn on to supplement project revenues if needed during the ramp-up period.
- *Development cost insurance* provides Federal reimbursement to project sponsors for a portion of the pre-construction development phase costs in the event the project fails to proceed to construction. (Although this type of financial assistance may not be considered a true credit product under a strict interpretation of FCRA, it has similar characteristics and achieves similar goals and, therefore, is included as part of this proposal.)

In absolute terms, the funding needs are greatest for the first two products--flexible payment loans and standby lines of credit, and the major thrust of the program will be oriented to these activities. Due to the uncertainty associated with projects during the development stage, development cost insurance is best offered through an experimental pilot program of limited scope.

In each case, the program will draw on the unique ability of the Federal Government to be a patient investor, with longer-term time horizons, lower liquidity requirements, and fewer funding constraints than private investors. The involvement of the Federal Government will also confer a psychological benefit: Investors take comfort in governmental funding in projects of this magnitude as evidencing public support for the investment. Even in the role of a minority investor, the Federal Government's participation can help instill investor confidence while addressing market gaps, thereby inducing substantial levels of private co-investment.

This section describes how each Federal credit product addresses specific market deficiencies, and summarizes the features of the particular credit instrument.

1. Flexible Payment Loans

Market Gap

Private capital investment is discouraged by the size, complexity, uncertainty, and long-term time horizon associated with large-scale startup projects. Generally, the projects are one-of-a-kind investments that require original substantial analysis to evaluate.

Typically, project revenues are weak in the early years, but are forecast to grow over time. Given the uncertainty of the projected revenue stream and operating costs, investors and rating agencies may require that the project revenue bonds show a relatively high pro-forma coverage margin. Coverage is the annual surplus of net revenues after payment of operating expenses and debt service. A

high coverage factor (such as 1.75 times) constrains the permitted level of annual debt service and reduces the amount of debt that can be supported, leaving a funding gap.

In evaluating startup infrastructure projects, the three major rating agencies have taken the policy position that the maximum attainable rating on such projects' senior debt is lower investment grade (BBB or Baa). While project sponsors could seek to raise additional debt proceeds with a thinner coverage margin (such as 1.10 times), such debt likely would be rated sub-investment grade. The major capital market funding source for debt financing of infrastructure--the municipal bond market--is generally risk-averse, and there is only a limited market for non-investment-grade obligations.

Moreover, capital market investors strongly prefer predictable, periodic payments (such as semiannual). They would be reluctant to accept the initial uncertainty of an uneven or irregular cash flow, which is more likely for obligations that only have access to residual cash flows after senior debt payments are met. The possibility of a payment default on the junior bonds, which would trigger a cross-default on senior debt, undermines the marketability of both series of bonds.

State and local governments are ill-equipped to evaluate the credit-worthiness of such projects, and often lack the resources to make subordinate loans in the magnitude required to assist the project sponsors.

This situation defines the need for a flexible debt instrument that would be payable out of the coverage factor after the senior bonds' annual debt service.

Description

Flexible payment loans would be direct loans from DOT to project sponsors to provide long-term, fixed-rate financing of a portion of construction costs.

Such a loan could be in an amount up to 33 percent of the cost of a project and can have a final maturity date as long as 30 years after construction. The interest rate would be established at the time the loan agreement was executed, and would be set at the prevailing yield on U.S. Treasury bonds issued for a comparable term.

The terms and conditions of each direct loan would be negotiated between DOT and the borrower but would enable DOT to accept a claim on revenues junior to the project's other senior indebtedness. In the event of default, however, the flexible payment loan would have a parity or co-equal claim on project assets with other investors.

If annual project revenues, after paying operation and maintenance costs and senior debt service requirements, were insufficient to meet current debt service on the Federal loan, interest and principal payments could be deferred. The deferred payment would be added to the outstanding loan balance and would continue to accrue interest. The loan agreement would require the borrower to take certain actions to modify its rates and charges or reduce operating expenses to catch up to the original loan repayment schedule.

The loan could be prepaid at any time. As the revenues stabilize after ramp-up, the project's rating may improve to the point at which it would be in the borrower's interest to refinance the flexible payment loan with lower-cost debt sold in the municipal bond market.

The two central features of the loan (junior lien on annual revenues and flexible payment schedule) should assist projects in obtaining investment-grade bond ratings on their senior indebtedness. This will facilitate a project's access to capital and reduce its cost of funding by elevating the rating on a significant portion of the project's debt. By accepting the variability of the coverage factor through the flexible payment loan, the Federal Government would expand the funding capacity of these projects and fill a market gap not adequately covered by existing funding sources.

2. Standby Lines of Credit

Market Gap

In certain cases, investors may recognize that a project is likely to experience growth in its revenue stream, but they may be uncertain about the timing of the growth, especially during the critical ramp-up period. Project-based revenue sources are extremely difficult to forecast with reliability, especially since in the case of toll roads, there is an established network of free highway alternatives that effectively represent competition.

One technique borrowers can use to cushion the uncertainty about available revenues in early years is back-end loaded debt service in the form of zero coupon or capital appreciation bonds (CABs). CABs accrue interest without cash payment until their stated maturity dates. While the capital markets may, to a certain extent, accept an ascending debt service repayment pattern, CABs for lesser rated issues are relatively costly and difficult to market in volume. The majority of the financing will still need to take the form of current interest-bearing bonds. Investors may seek some assurance that the borrower has access to secondary sources of capital in the early years to remain current on such bonds should revenue growth occur at a slower than anticipated rate.

Federal tax law limits the amount of reserves that may be funded with bond proceeds generally to 1 year's debt service, which is insufficient to address this risk. Project sponsors can borrow additional capitalized interest to provide some timing cushion in the event of delays, but this increases the debt burden on the project.

Description

The standby line of credit represents an agreement by DOT to make one or more direct loans to a project in future years. It is a standby line in that it represents a secondary source of capital in the event of certain deficiencies.

In contrast to the flexible payment loan, the standby line of credit would not be used to fund construction costs as part of the project's initial capitalization. Rather, the line is a supplemental source of reserves that could be drawn on if needed to pay debt service on senior debt during ramp up. The line should facilitate a project's access to private capital by enhancing coverage, thereby assisting the borrower in obtaining investment-grade ratings on senior bonds.

Draws on standby lines of credit would have various limitations, including:

- The line could only be drawn on after the project had used up other available revenues and reserves.
- The line could only be accessed after a project had been substantially completed (i.e., opened to commercial operation) and could remain available for draws up to 10 years after the project was substantially completed.
- The total amount of draws could not exceed 33 percent of project costs, as is the case with the flexible payment loans.
- The borrower could draw down up to 20 percent of the line of credit each year (i.e., the entire amount could be drawn down during the first 5 years of a 10-year credit line). In most cases, this should represent roughly half of annual debt service, which affords a substantial margin of error in the revenue projections.

The interest rate for any draw would be established at the time the line of credit was initially arranged, at a rate equal to the then-prevailing yield on 30-year U.S. Treasury bonds. Any draws would need to be repaid within 30 years of the date of such draw. As with the flexible payment loan, a missed semiannual payment would not automatically trigger an event of default. The unpaid balance would be added to the outstanding line and would continue to accrue interest until repaid.

To avoid double-dipping, a borrower could not combine a standby line of credit with a flexible payment loan for any given project.

Although a Federal loan in the form of a standby line of credit should not be construed as a Federal guarantee for purposes of the Internal Revenue Code, separate corrective tax legislation is required in order to enable bond counsel to render an unqualified legal opinion as to the tax-exempt status of project bonds benefiting from such assistance. (See Appendix B: Federal Tax Issues Relating to the Federal Credit Program.)

Flexible Payment Loans vs. Standby Lines of Credit

The flexible payment loan and standby line of credit are intended to address projects with different financial profiles based on their pro-forma capital structures (See Figures 2-2 and 2-3).

The flexible payment loan will be most useful to those projects that must demonstrate to senior debt investors that there is adequate coverage on maximum annual senior debt service at the outset of the project. Project sponsors will find the flexible payment loan attractive if the Treasury rate compares favorably to their own cost of capital on a junior lien basis.

FIGURE 2-2
FLEXIBLE PAYMENT LOAN PROJECT PROFILE

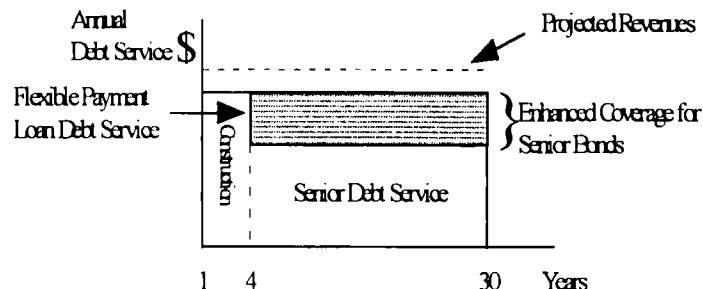
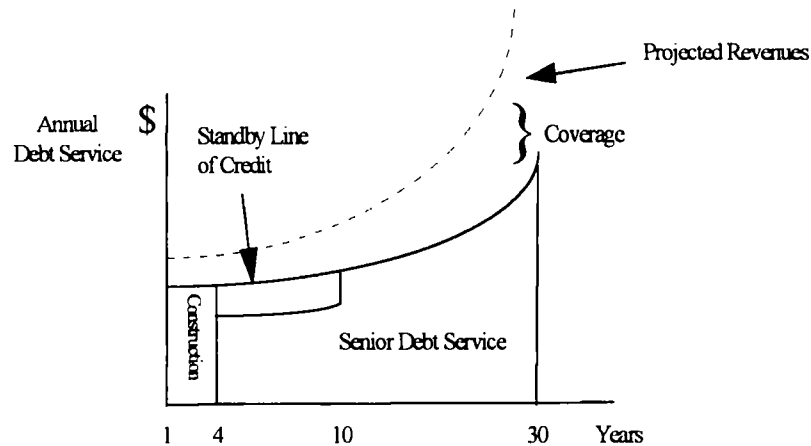


**FIGURE 2-3
STANDBY LINE OF CREDIT PROJECT PROFILE**



A standby line of credit is more likely to be used by projects that are able to demonstrate to investors that their revenue streams are likely to grow substantially over time. It will allow projects to issue senior debt on favorable terms with an ascending debt service pattern, but still have access to contingent sources of capital in the event revenues initially do not grow as quickly as annual payments of principal and interest.

A project sponsor seeking Federal credit will determine which of the two products best meets its needs based on the project's financial structure.

3. Development Cost Insurance

Market Gap

Over the last decade, State and local governments have come to recognize the benefits of using a turnkey process to develop major surface transportation projects. In a turnkey project, the government sponsor enters into a partnership arrangement with one or more private sector firms that take responsibility for designing, constructing, and/or operating the project. The benefits of using a turnkey method include faster development, cheaper construction, enhanced operational efficiency, and transference of risk away from the public sector.

In many cases, the government sponsor awards a mandate to a development team before all the necessary public approvals have been secured. Yet many of the pre-construction development phase activities are under the control of Federal, State or local government. These pre-construction tasks include assembling the site, securing

planning permits, completing environmental reviews, adopting the necessary enabling legislation, and conducting appropriate public dialog with local citizens. All these activities involve inherently non-commercial risks, any one of which can cause a project to fail for reasons completely unrelated to the project's commercial viability or the development team's expertise and efficiency. Developmental phase costs can easily amount to \$5 million or more per project, including preliminary engineering, legal analyses, and market feasibility studies. In essence, this entire phase may be viewed as facing political risks, in that the project's success is subject to government approval rather than market acceptance.

Private venture capital is accustomed to assessing commercial risks but not political risks and has been unwilling to fund this highly speculative stage. Thus far, the only source of venture funds has been a limited amount of strategic capital invested by major construction or engineering firms that have a substantial business interest in the project's construction or operation. Because of the enormous costs, long lead times, and perhaps most important, adverse experience in jurisdictions where political support has changed midstream after substantial private investment, even these firms are now reluctant to fund the development process single-handedly.

As a result, most construction firms have stopped trying to develop new infrastructure facilities unless the government approvals are in hand. State and local governments, still new themselves to the turnkey process, lack the private sector skills and experience needed to perform the role of developer at the crucial phases of conceptualizing and initiating projects. As a result, the forward supply of privately financed transport projects advancing through the development stage has decreased significantly over the last several years.

Description

A development cost insurance program has been designed to fill this market gap. It is structured as a pilot program, using up to 10 percent of the Federal credit program's budget authority. Under this program, the Federal Government would insure a portion of the pre-construction expenses incurred by a development team by offering a development cost insurance agreement, with substantial risk-sharing by other parties. The program offers the following features:

- Development cost insurance will only be available for a development team that has received a mandate from a government project sponsor to build a particular project. (Only costs incurred after selection of the development team by the government sponsor would be covered.)

- No single project could be insured for more than a \$4 million Federal share of development expenses.
- The Federal share would be limited to 40 percent of pre-construction costs and the government sponsor would be required to insure at least 20 percent to establish significant financial (and political) discipline.
- DOT would approve insurance only for those projects that satisfied the defined criteria for projects of national significance.
- Up-front insurance premiums would be collected on execution of the policy, offsetting a portion of the budgetary cost of the program.
- The coverage could be claimed at the end of 5 years if the project had not proceeded to construction; however, if a project did advance at a later date, the Federal insurance coverage would be reimbursable.

Not more than 10 percent of the annual budget authority could be used to fund this development cost insurance pilot program.

In most cases, development cost insurance would be available for projects having pre-construction costs that would otherwise be eligible for outright grants from DOT if they were being developed under conventionally funded public procurements. The projects typically are developed as public-private partnerships precisely because there are funding constraints to traditional approaches. It is appropriate, therefore, that these developmental costs be eligible for partial insurance coverage under the pilot program.

In essence, the program represents a domestic version of the Overseas Private Investment Corporation (OPIC). OPIC insures American companies against the political risk of investing in foreign countries. The development cost program would insure development teams against domestic political or policy change risk as well as other pre-construction risks.

Over time, as government sponsors recognize that it is primarily the public sector's responsibility to advance a project to a buildable stage, the need for the program may subside.

CHAPTER 3: PROGRAM ADMINISTRATION AND PROJECT EVALUATION

Introduction

This chapter describes key decision points, criteria, and information flows associated with the credit program and the process by which a project sponsor could secure credit assistance from DOT. The administrative structure is designed to maximize the likelihood of successful projects, satisfy various Federal budgetary requirements, minimize administrative costs, and ensure a timely and transparent application and selection process to encourage private sector participation.

The credit application/review process will result in a formal agreement among DOT, the project's sponsor, and the State (or State-designated agent) in which the project is located. Project sponsors eligible to receive Federal credit may include private parties, such as corporations, joint ventures, and trusts; government entities, such as public authorities and metropolitan planning organizations; and public-private partnerships.

Using Local Servicers

The credit program has been designed to operate through the States. As with other transportation programs, it emphasizes State/local flexibility in allocating and managing transportation resources. Although DOT will be responsible for credit review and oversight activities, many of the credit origination and servicing activities can and should be undertaken by local servicers. Such activities may include receiving and screening applications, counseling and corresponding with borrowers and collecting, monitoring, and reporting payments.

Coordinating with State Infrastructure Banks (SIBs)

A local servicer may be a State government agency or other government agency with authority delegated by the State, including a SIB. Using a local servicer will facilitate transportation planning and coordination and help ensure ongoing State and local involvement and support. It is anticipated that SIBs, where available, will act as local servicers for the credit program. Providing a meaningful role for SIBs has several strategic advantages:

- SIBs will be able to overcome startup capacity limitations resulting from limited capitalization, small initial portfolios, and lack of credit history and provide substantial assistance to large, complex projects of national significance.
- SIBs will develop in-house financial expertise by participating in the development and financing of projects receiving Federal credit assistance, thereby gaining valuable experience in project financing.

- SIBs are uniquely positioned to coordinate transportation planning and financing resources to help ensure that Federal credit assistance is effectively used and incorporated into existing plans and programs.
- SIBs could be allowed to collect fees from project sponsors for their servicing activities, which would provide an ancillary source of cash flow to support their own credit activities.

Assisting Specific Projects

The Federal credit program has been designed to assist projects directly rather than to assist intermediaries, such as SIBs. As a policy matter, DOT believes SIBs should be capitalized through grants, rather than Federal credit. SIBs should not incur long-term liabilities under the credit program, because that would inhibit their ability to provide financial assistance on favorable terms to other projects. It also would complicate the budget scoring of a loan, if repayment were tied to the SIB's other credit activities. As discussed earlier, the primary purpose of Federal credit is to help advance specific projects where assistance is warranted based on national needs. It is not intended to directly assist SIBs, which focus on smaller State and local projects. Over time, SIBs should develop sufficient resources to gain access to markets and ultimately may be in a position to arrange external financing for larger projects.

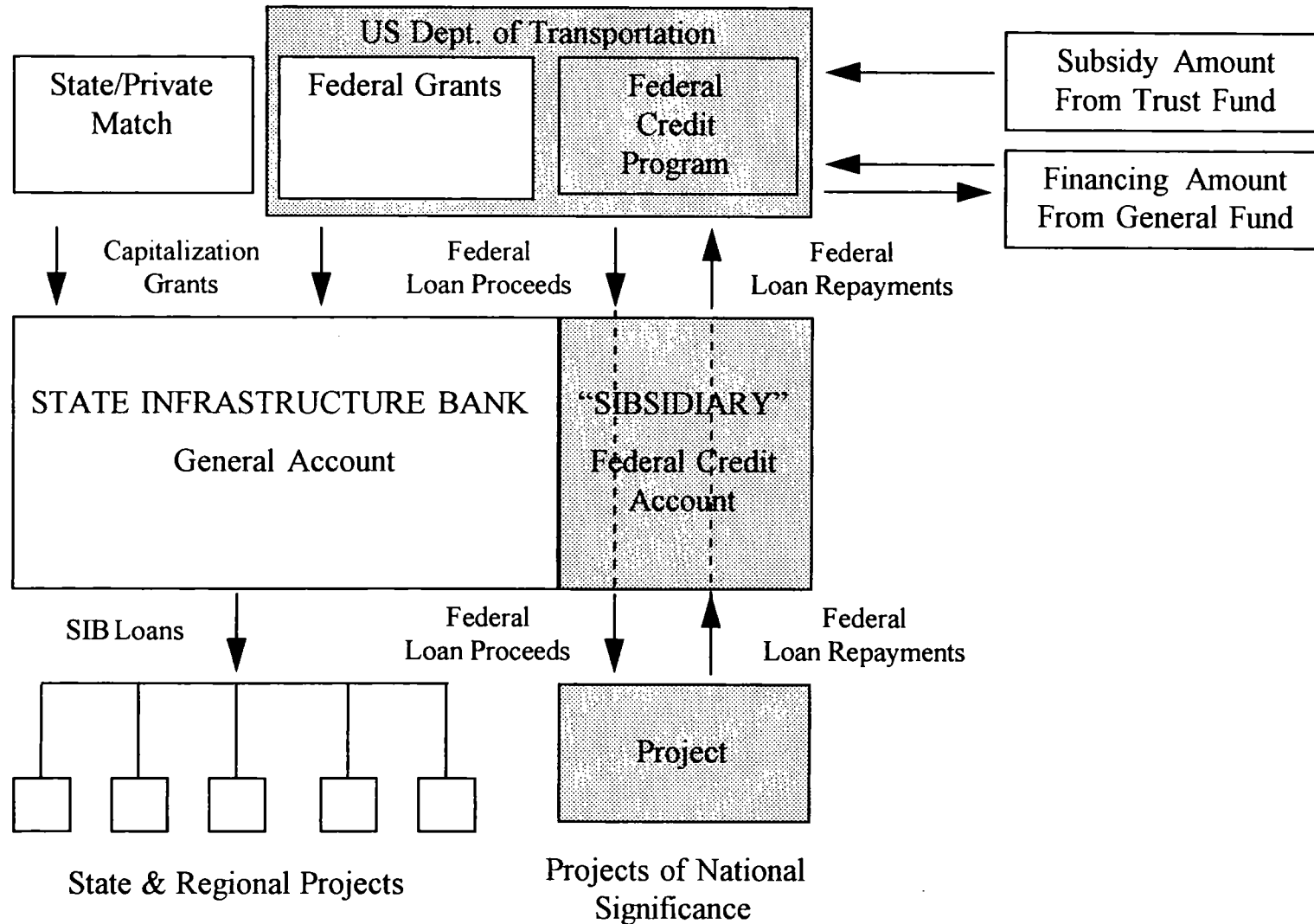
Federal credit will "pass through" the SIB to the recipient project sponsor, but will not be commingled or cross-collateralized with other SIB resources. The program provides that each participating local servicer must create a separate Federal credit account to insulate the Federal credit from defaults or other risks associated with the SIB's other activities (and vice-versa). This will ensure that the credit scoring of the subsidy cost of a project is not affected by the SIB's own portfolio. Figure 3-1 shows the proposed SIB role.

Applying for Federal Credit

A project sponsor first must submit a preliminary application to the SIB (or other State-authorized local servicer) describing the project and providing information to support its designation as a project of national significance. A key element of the application will be a financial plan that identifies the specific type and amount of Federal credit applied for, demonstrates the need for and describes the benefits of such assistance, and proposes a timetable for receiving the credit assistance.

The SIB then reviews the preliminary application--working with the sponsor to revise and complete it as necessary--for compliance with Federal guidelines for projects of national significance that are eligible for credit assistance. If the SIB finds that the project satisfies these guidelines, it notifies DOT and requests the sponsor to obtain a preliminary credit assessment from a nationally recognized rating agency. This assessment should take the form of a preliminary rating based on the financial plan, including the proposed

Figure 3-1
“Passthrough” Role of State Infrastructure Bank
in Federal Credit Program



Federal assistance. This analysis will provide an expert, independent assessment of the extent and nature of project risk and the benefits the project will gain from Federal support.

Once the SIB has received the preliminary credit assessment and any other relevant information in the applicant checklist (see Appendix A for a description of the types of information used in evaluating projects), it will forward the completed application to DOT, along with a written summary of the project, the financial plan, the form and amount of requested Federal credit, the rating agency credit opinion, and the expected time frame in which aid is needed.

After the application is received, DOT will request that the SIB and project sponsor schedule a formal lender's briefing to summarize the project, present the financial plan in detail (including the rating agency's credit assessment), and discuss any other relevant issues. The briefing should help the parties to fully understand the project and the proposed Federal role and to identify any outstanding issues that need to be addressed. After the lender's briefing, DOT will formally evaluate the project and notify the SIB and project sponsor of its selection decision.

Evaluating Project Applicants

The first step in the evaluation process is to determine whether the project meets certain objectively measurable criteria. The proposed eligibility criteria covers eligibility for authorized transportation purposes; evidence of State and local support; project size; and the potential for user charges.

Threshold Eligibility Criteria

To qualify for Federal credit assistance, a project must at a minimum meet the following criteria:

- *Federal Eligibility* -- Any project that is eligible for Federal assistance through regular surface transportation programs under title 23 or chapter 53 of title 49, U.S.C. (as proposed in reauthorization), would be eligible for the Federal credit program. This includes highway facilities, mass transit facilities and vehicles, commuter and intercity passenger rail facilities and vehicles (including Amtrak), certain freight rail facilities (excluding privately owned rolling stock), and various intermodal facilities. Eligible costs would include pre-construction design and development costs, and related costs such as interest during construction, reasonably required reserve funds, and issuance expenses.

- *State and Local Support* -- The project must have the support of State and local authorities. It must be included in the State transportation plan (required under section 135 of title 23) at the time of application and in the approved State transportation improvement program (required under section 134 of title 23) at the time any loan agreement or other commitment is entered under this program. The project application must be submitted by a State or a local servicer (such as a SIB).
- *Project Size* -- The program is designed to assist complex, large-scale projects too big for a SIB or a State's regular transportation program. A project must cost at least \$100 million or 50 percent of the State's most recent annual apportionment of Federal-aid highway funds, whichever is less.¹
- *User Charges* -- Project financing must be payable in whole or in part by user charges or other non-Federal dedicated revenue sources. This provision is designed to encourage States to identify new project-related revenue streams that will augment existing funding sources and leverage private capital.

Project Selection Criteria

Qualified projects meeting the initial threshold eligibility requirements will then be evaluated and selected according to more qualitative criteria relating to economic values and benefits provided. The factors will be determined by the Secretary through program guidelines, but might include the following:

- *National Significance* -- A project must substantially reduce costs or improve productivity in connection with transporting passengers or freight associated with the promotion of metropolitan, regional, interstate, or international commerce to be considered a project of national significance. The extent to which the project is of national significance (e.g., enhances the national transportation system, generates broad economic benefits, supports international commerce) will be an important selection factor.
- *Project Advancement* -- Credit assistance should enable the project to move forward at an earlier date and with lower financing costs than would otherwise be possible.
- *Job Creation* -- The project should show the potential for creating long-term employment growth, both directly and indirectly in the project area, region, State, and Nation.

¹Based on fiscal year 1997 apportionments, 18 States would have project size thresholds below \$100 million--with Puerto Rico having the smallest at approximately \$41 million.

- *Special Needs* -- The project will be evaluated based on its contribution to special transportation needs, such as intermodal connectors, border facilities, and high priority corridors.
- *Private Participation* -- The project's ability to create opportunities for public-private partnerships and induce private investment will be reviewed.
- *Innovative Technologies* -- The project will be evaluated on the extent to which it utilizes or promotes innovative technologies in enhancing access, mobility, productivity, and safety.
- *Credit Cost* -- A primary goal of the credit program is to enable a project to attain an investment-grade rating on its senior debt. The credit-worthiness of the project and the associated budgetary costs of providing credit assistance are necessary selection factors given the need to allocate limited Federal budgetary resources among applicants.

Scoring Budgetary Costs Once a project is selected, DOT will make an initial estimate of the budgetary cost of the requested credit based on its type, amount, and preliminary rating. It will then notify the SIB and project sponsor that it has either reserved an appropriate amount of budget authority--to the extent available--or created a placeholder for future resources. Sponsors of eligible projects not selected would be notified of the status of their projects and the likelihood of future consideration, which would depend significantly on the amount of budget authority available for the Federal credit program. Allocation of a limited amount of budget authority among selected projects should be based on a ranking of project proposals compared to the selection criteria. Projects may be selected and allocated funding on a rolling basis throughout the year or at specified times within the year. The allocation method would be the subject of DOT guidance or other public notice.

Disadvantages of Current Methodology

The techniques currently used to assess the budgetary costs of Federal credit offered by other agencies are not well suited to evaluate transportation project financing. The scoring methods used for agriculture, business, housing, or student loans, for example, are based on large volumes of historical data on credits that are essentially similar. In contrast, transport investments tend to be "one-off" transactions uniquely structured to meet each project's specific financial profile.

As an industry sector, surface transportation has an extremely low default rate compared to other borrower groups. Over the last 10 years, defaults of debt issued to finance surface transportation facilities have totaled less than one-half of 1 percent of the new issue volume in this field.

Unlike consumer and small business loans, transportation projects tend to be improving credits over time. Typically, long-term debt is sold at the outset as construction and permanent financing; therefore, for project-related debt, the initial rating reflects construction risk, environmental and litigation risk, and traffic and operating performance risk. After construction is completed and traffic patterns have stabilized, the ratings should improve. Even toll roads that have initial traffic shortfalls, such as the Dulles Greenway, ultimately should be self-supporting, as evidenced by several defaulted toll roads that eventually became investment-grade as traffic grew to meet forecast capacity (e.g., the Chesapeake Bay Bridge-Tunnel, the Chicago Calumet Skyway, and the West Virginia Turnpike).

Proposed Scoring Methodology

The best market-derived information on actuarial default risk for infrastructure loans is in the financial models used by rating agencies to evaluate the capital reserves of bond insurers. Agencies such as Fitch Investors Service, Moody's Investors Service, and Standard & Poor's use capital reserves criteria (which are much more stringent than the State-by-State insurance commissioner statutory reserve requirements) to determine the claims-paying ability of bond insurance companies. It would be appropriate for the Federal credit program to use the standards that capital market investors have accepted as being virtually risk-free--those imposed by the rating agencies to assign AAA ratings on the bond insurers' credit-worthiness. This proposed budget scoring approach will use a rating agency's preliminary risk assessment to estimate the subsidy cost of the credit. Essentially, the Federal loan will be assessed a capital reserve charge to cover the default risk. The capital reserve charge would be expressed as a series of annual anticipated cash flows that would be placed in the Office of Management and Budget (OMB) credit model and discounted at the relevant baseline Treasury rates to derive a present-value subsidy cost.

This approach is market based, calculated by independent third-party experts, and predicated on transparent and objective criteria. It offers an accurate, conceptually sound approach for estimating the risk of large, complex, heterogeneous capital investments in transportation infrastructure.

Finalizing Credit Agreements

After a project has been selected and its subsidy cost has been estimated, the SIB and project sponsor must enter into a formal credit agreement with DOT. It is anticipated that a single joint agreement will be negotiated and signed by all three parties. DOT will prepare a generic agreement for the SIB and project sponsor. The preliminary subsidy cost estimate will be revised when the agreement is finalized and the credit is committed, based on prevailing market rates and final loan terms. If a negotiated agreement cannot be reached in a timely manner, then DOT may wish to withdraw its reservation of budget authority and move on to other candidate projects.

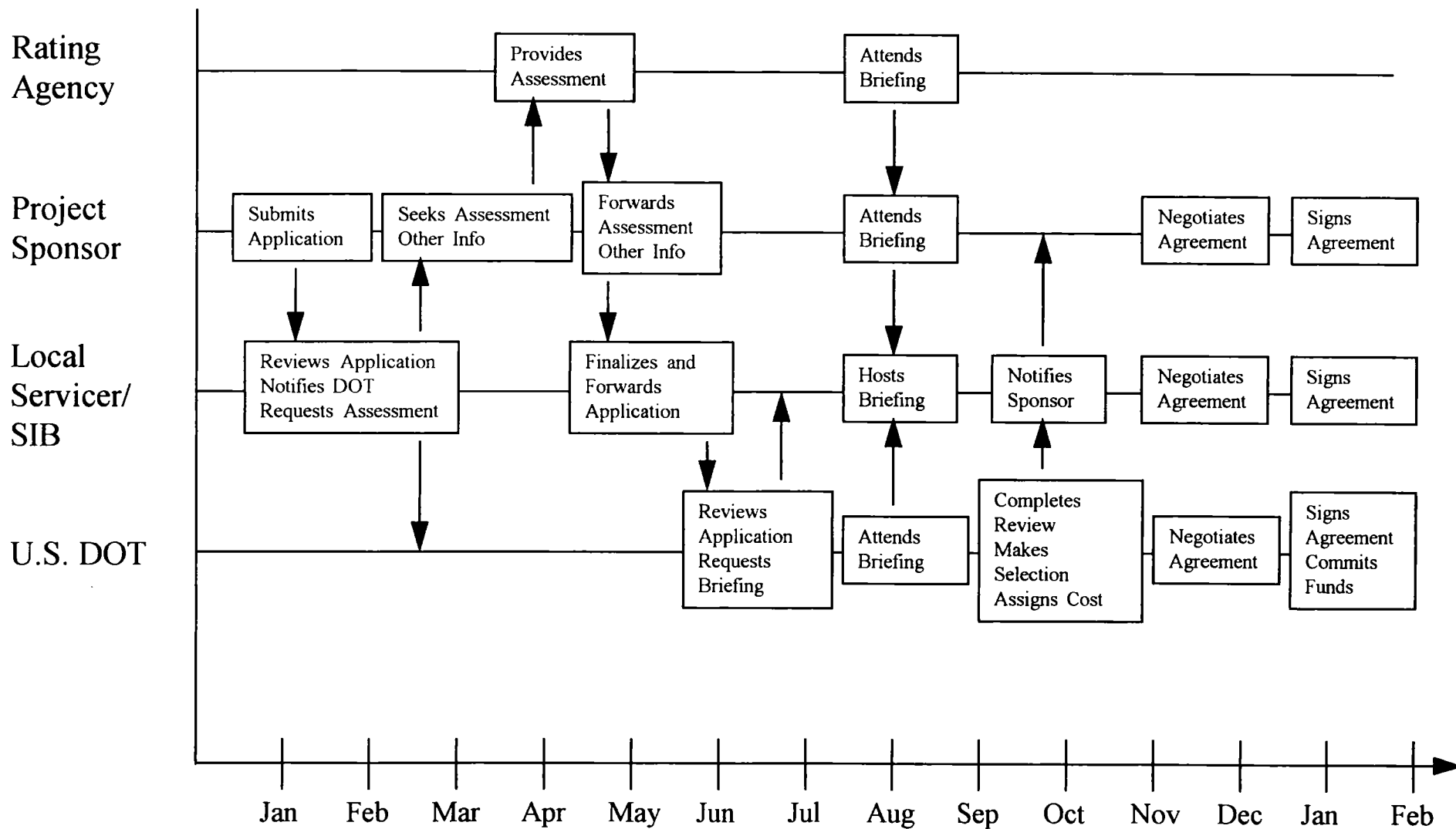
Managing the Budget Process

The credit application and review process must generate the information needed to provide accurate and timely input for the annual Federal budget process. DOT must have an early indication of the type of credit support envisioned, the level of support, and the timing in which that support should be provided. More precise subsidy estimates must wait for the finalization of terms in each project's loan agreement, but an early indication of credit amounts and associated costs is needed for DOT to gauge the overall level of budgetary resources required. This will allow DOT to prepare estimates of the expected demand, compare them with available resources, and help manage expectations of potential sponsors and States.

Timely submission of applications, evaluation of projects, and estimation of subsidy costs will be essential for allocating a limited amount of budget authority among alternative projects. The time needed to complete the process described above--from the initial submission of an application to the finalization of an agreement--may take well over a year for a typical project, as shown in Figure 3-2. The size and complexity of these infrastructure investments cause the necessary credit transactions to vary greatly. Given the long lead times needed to thoroughly plan, structure, review, and score these project financings, any budget authority provided to cover the subsidy costs of credit assistance must be "no-year" funding (i.e., made available until expended). This approach would allow DOT to reserve budget authority for a selected project and still have sufficient time to negotiate a suitable agreement, revise the subsidy estimate, and obligate the necessary funds.

In recognizing the need for a predictable source of funds, Congress has legislated the use of contract authority for the Federal-aid highway program since 1921. Under contract authority, sums authorized are available for obligation without annual appropriation actions. To facilitate the planning and structuring of large project financings involving Federal credit assistance, program funding levels should be known in advance. Providing specified amounts of contract authority, rather than annual appropriations of budget authority, would ease market concerns about the availability of future funding to support Federal assistance. DOT would be better able to allocate limited funding and avoid costly delays (or even potential collapses) as selected projects awaited future appropriation actions to determine whether the negotiated Federal assistance could be committed. The commitment of Federal credit assistance requires stable funding levels known in advance even more than traditional grant reimbursements; the projects will be larger, the financing will be more complex, the Federal assistance frequently will be the initial capital component, and the majority of the financing--much of it private capital--will hinge on the timely and assured provision of Federal funds.

Figure 3-2
Timeline for Project Review
 (For Federal Credit Assistance)



CHAPTER 4: CREDIT PROGRAM FUNDING MECHANISMS

Introduction

This chapter outlines the Federal budgetary resources needed to fund the proposed credit products--flexible payment loans, standby lines of credit, and development cost insurance. It includes an assessment of the amount of Federal credit that could be provided to major transportation infrastructure projects, an estimate of the budgetary costs of that credit, and a discussion of how those budgetary resources would be authorized. This chapter also describes how paying for the costs of Federal credit assistance could be accomplished through accessing unobligated balances of Federal-aid highway funds apportioned to the States under the Intermodal Surface Transportation Efficiency Act (ISTEA).

Measuring the Cost of Credit

As discussed in Chapter 1, the budgetary or subsidy costs of extending Federal credit depend on the estimated default risks and interest subsidies (if applicable). Regardless of the face value of credit provided, the true cost to the government is the net present value of amounts not reimbursed due either to defaults or subsidized interest. Unlike other Federal spending, the budgeting for credit assistance is based on estimated subsidy costs rather than actual cash flows. Estimated subsidy costs are included in the budget totals, whereas actual cash flows are displayed as a means of financing outside the budget. This budgetary treatment allows the costs of credit to be compared directly with those of grants. For example, the disbursement of a \$100 loan has the same cash effect as the disbursement of a \$100 grant, but if \$90 of the loan eventually will be repaid with interest, the true cost of the loan is only \$10, or 10 percent of the cost of the grant.

Estimating Program Costs

The costs of the proposed credit program are a function of the types and volumes of credit provided and the associated default risks. (As loans will be made at the U.S. Treasury rate, no interest subsidies are contemplated). Table 4-1 illustrates the budgetary costs and credit amounts for the different credit products. It shows that the annual provision of nearly \$1.2 billion of credit would cost \$100 million in budgetary resources, given certain assumptions. The column amounts in Table 4-1 are derived as follows:

Table 4-1

Transportation Infrastructure Credit Program Estimated Budgetary Costs and Credit Amounts

(dollar amounts in millions)

	A	B	C = A * B	D	E = C * D	F	G = E * F	H = C * F	I = (A * F) - H	J = H + I
Proposed Product	Cost of Typical Project	Federal Participation Ratio	Amount of Credit per Project	Average Subsidy Rate per Project	Average Subsidy Cost per project	Number of Projects per Year	Budget Authority (Subsidy Cost) per Year	Face Value of Credit per Year	Non-Federal Investment per Year	Total Capital Investment per Year
Flexible Payment Loans	500	33%	165	8.75% /2	14	5	72	825	1,675	2,500
Standby Lines of Credit	500	33%	165					330	670	1,000
NPV of 10-year LOC available after construction: *			110	8.75% /2	10	2	19		1,000 /4	
Development Cost Insurance	5	/1 40%	2	50.00% /3	1	8	8	16	24	40
Annual Totals						15	100	1,171	2,369	3,540
6-Year Reauthorization Totals						90	597	7,026	14,214	21,240

Leverage Factors:

Ratio of total Project cost to Face Value of Federal Credit

3 :1

Ratio of total Project cost to Subsidy Cost of Federal Credit

36 :1

/1 Pre-construction development costs relate to environmental permitting, preliminary engineering, feasibility studies, etc. incurred once a State has selected a preferred consortium to proceed with detailed plans. We assume in this presentation that the Federal government guarantees 40% of the pre-construction costs, the State guarantees another 20%, and the private consortium bears the remaining 40%. The actual construction costs likely would range from \$100 - \$500 million per project.

/2 This represents the likely budget scoring charge--as estimated by Fitch Investors Service--on projects receiving junior lien Federal credit that have senior debt rated "BBB" to "BB" (3:1 weighted average). Projects that have senior debt rated exclusively "BBB" would have a scoring cost of only 5%.

/3 For risk-scoring purposes, we assume that half of all projects in the pre-construction phase will not proceed to construction.

/4 Since Lines of Credit are standby credit products, the non-Federal investment per project actually equals the total cost of the project.

* Since Lines of Credit are standby credit products available only for a fixed period of time (10-year window) after project construction is complete, the subsidy costs are based on the net present value of those potential draws rather than the nominal face value. The subsidy calculation for this proposed product includes the following assumptions: a \$500 million loan or debt issuance with 30-year term, 6% tax-free interest rate, and \$36 million per year level debt service; a \$165 million Standby Line of Credit available from years 4-13 after a 3-year construction period with annual draws not to exceed 20% of the total amount of the credit line, or \$33 million per year; maximum draws occur beginning in year 4 and lasting through year 8 until the \$165 million credit line is exhausted. The scoring charge assumes that the \$165 million draw is repaid at the taxable Treasury rate (7%) by the end of the 30-year term.

- *Column A: Cost of Typical Project* - For the two loan products (flexible payment loans and standby lines of credit), major projects of national significance are assumed to cost an average of \$500 million. Although recent projects authorized to receive credit assistance have been significantly larger (both Orange County TCA toll roads cost well over \$1 billion and the Alameda Corridor costs nearly \$2 billion), we anticipate such projects more commonly will be in the \$100 to \$500 million range. Pre-construction costs of major projects eligible for development cost insurance are assumed to average \$5 million.
- *Column B: Federal Participation Ratio* - As described in Chapter 2, credit assistance through direct loans will be limited to no more than 33 percent of total project costs. This limitation will ensure market discipline, leverage scarce Federal resources with significant private capital, and minimize costs and risks to the Government. The proposed Federal insurance ratio is 40 percent of pre-construction costs if an eligible project fails to advance to construction. The State would cover the remaining 20 percent of costs eligible for reimbursement. If it wished, the State could assume all or part of the 40 percent developer share.
- *Column C: Amount of Credit per Project* - The nominal or face value of credit assistance provided to a project sponsor is the product of project cost and participation ratio. Note that the up-front, net present value of a standby line of credit is less than the face value because that type of credit is available only in certain amounts over a period of time after construction. In this example, a \$165 million line of credit is drawn only in years 4 through 8, and the discounted net present value of the credit is \$110 million, or 67 percent of the face value.
- *Column D: Average Subsidy Rate per Project* - The subsidy rate represents the portion of credit assistance estimated to be unrecovered because of defaults. The 8.75 percent rate assigned to flexible payment loans and standby lines of credit is a weighted average of the required capital charges for projects in the BBB to BB rating categories. Federal credit assistance is assumed to enable at least three-quarters of recipients to attain the investment grade rating of BBB, which has a capital charge or subsidy rate of 5 percent. The remaining one-quarter of recipients are assumed to achieve at least the sub-investment grade rating of BB, which has a capital charge or subsidy rate of 20 percent. The 50 percent estimated subsidy rate for development cost insurance illustrates the assumption that half of participating projects will not proceed to construction and will require partial reimbursement of eligible pre-construction costs.
- *Column E: Average Subsidy Cost per Project* - The subsidy cost of a project equals the product of the credit amount and the subsidy rate. It measures the true cost to the Government of providing credit assistance and is the basis for calculating budget totals. Note that the budgetary or

subsidy cost of a standby line of credit depends on the discounted net present value of the credit amount. Because this type of credit will be extended over time in the out years, providing up-front budget authority based on the net present value will adequately fund the credit amount.

- *Column F: Number of Projects per Year* - Table 4-1 assumes that, on average, seven major projects of national significance could be eligible for and funded with direct loans each year. It assumes that five of those projects would require the initial capital assistance of flexible payment loans. The pilot development cost insurance program would be funded at \$8 million per year, which at \$5 million per project amounts to 8 projects.
- *Column G: Budget Authority (Subsidy Cost) per Year* - The annual budget authority required to fund the credit program--excluding the funding needed to cover administrative costs--is the product of the subsidy cost per project and the number of projects. Under the assumptions in Table 4-1, this amount is \$100 million. (It is estimated that Federal costs associated with credit policy, oversight, origination, extension, and other administrative activities will total between \$500 thousand and \$1 million for a \$100 million program.)
- *Column H: Face Value of Credit per Year* - The annual face value of credit assistance is the product of the amount of credit per project and the number of projects per year. Under the assumptions in Table 4-1, the credit program would extend nearly \$1.2 billion of nominal assistance each year at a budgetary cost of \$100 million. Comparing the totals for Column G (subsidy cost) and Column H (face value of credit), the Federal credit program results in an 8 percent budgetary impact compared with an equivalent amount of grant assistance.
- *Column I: Non-Federal Investment per Year* - Assuming that recipients receive the maximum level of assistance possible (33 percent for loans and 40 percent for insurance), Table 4-1 shows that the \$1.2 billion of Federal credit would be leveraged with nearly \$2.4 billion of private and other non-Federal capital.
- *Column J: Total Capital Investment per Year* - The total amount of capital invested each year represents total project costs and is the sum of Federal credit and non-Federal capital. Note that for standby lines of credit, total project capital equals non-Federal investment, since the line is only a contingent or secondary source of funding. Table 4-1 shows that annual capital investment of more than \$3.5 billion is generated by \$1.2 billion of credit assistance at a budget cost of \$100 million. Those amounts lead to leveraging ratios of 3:1 for total project costs to face value of credit assistance and 36:1 for total project costs to subsidy cost of credit assistance.

Providing Budget Authority

Before Federal credit of any type can be extended, budget authority to fund the subsidy costs of that credit must be provided. There are several ways to provide budget authority, but those funding options are independent of program proposals. In other words, regardless of program details, funding of the credit program requires budget authority that is sufficient to cover the subsidy costs of the direct loans and cost insurance provided.

The analysis in Table 4-1 suggests that annual budget authority of \$100 million (including administrative costs of less than \$1 million) would support Federal credit assistance of \$1.2 billion annually for major projects of national significance. Over a 6-year period, an aggregate funding level of \$600 million could support over \$7 billion of credit for some 42 projects receiving flexible payment loans or standby lines of credit and another 48 projects participating in the development cost insurance program under the assumptions in Table 4-1.

As discussed in Chapter 3, contract authority funded from the HTF is the ideal way to finance credit assistance for transportation infrastructure. It would provide a stable source of budget authority, known in advance, that would facilitate the planning, development, evaluation, and selection of candidate projects. Such contract authority would also allow the timely disbursement of credit assistance that is critical to the successful financing of these large, complex public-private ventures. Using the HTF to pay for transportation investments would also be consistent with the intended purpose of Federal user fees dedicated to that fund.

Two other options for providing budget authority are making annual appropriations and accessing unobligated balances.

1. Making Annual Appropriations

A straightforward approach to funding the credit program would be to appropriate budget authority annually to cover the subsidy costs of credit assistance. Congress would be able to establish funding levels each year--within authorized limits--according to its spending priorities. As discussed in Chapter 3, such budget authority would need to be "no-year" funding (i.e., made available until expended) to accommodate the financing timelines of large transportation infrastructure projects. Key aspects of this funding mechanism are as follows:

- *Budget Authority:* Legislation would authorize annual appropriations of up to \$100 million to fund the subsidy (and administrative) costs associated with providing credit assistance. Appropriated budget authority would need to be available until expended.
- *Funding Source:* The credit program could be funded from either the General Fund or the Highway Trust Fund (HTF). If funded from the

HTF, sufficient resources (tax revenues and interest income) would need to be provided under the reauthorization act to liquidate subsidy cost obligations.

- *Spending Category:* Appropriated credit program spending would be subject to budget authority and outlay discretionary caps and would compete with most existing transportation programs for limited resources. Spending for the credit program would be outside the Federal-aid program, but congressional control over annual appropriations would have the same effect as annual limitations on obligations of contract authority.
- *Deficit Impact:* Additional outlays resulting from the new budget authority would increase the deficit, assuming no offsetting reductions occurred in other programs. However, credit assistance has a fractional budget impact (8 percent in the Table 4-1 illustration) compared with an equivalent amount of grant assistance.
- *Cost Allocation:* The budgetary or subsidy cost of a selected project would be charged to the Federal appropriation.

2. Accessing Unobligated Balances

Over the course of the ISTEA authorization period (FY 1992-1997), States have received apportionments of Federal-aid highway funds totaling about \$102 billion. However, as a result of annual spending controls, it is estimated that the States will be able to obligate only about \$92 billion of that amount--leaving an unobligated apportionments balance of about \$10 billion. The States have grown increasingly frustrated with their inability to spend down or access that balance because of annual spending controls. It is possible to structure the credit program funding mechanism to enable States to use their unobligated ISTEA apportionments to pay for the cost of credit assistance. Key aspects of this alternative funding mechanism include:

- *Budget Authority:* Legislation would authorize the obligation of ISTEA apportionments of Federal-aid highway funds (current unobligated balances) for the subsidy costs of credit assistance. Use of this existing contract authority would be limited to \$100 million per year.
- *Funding Source:* As with other contract authority programs, the credit program would be funded from the HTF. Sufficient resources (tax revenues and interest income through FY 1999) were provided under ISTEA to liquidate the existing contract authority that would be obligated for the subsidy costs of Federal credit assistance.
- *Spending Category:* Under this approach, if no annual obligation limitations were imposed, Federal credit program outlays would be considered mandatory spending subject to pay-as-you-go (deficit-neutral)

budget rules. This would be similar to the current treatment of Minimum Allocation, Emergency Relief, and demonstration project spending. On the other hand, if annual obligation limitations were imposed, such spending would be subject to discretionary caps and would compete directly with most other transportation programs for limited resources. In either case, spending for the credit program would be outside the Federal-aid program and not subject to the Federal-aid obligation limitation.

- *Deficit Impact:* Additional outlays would occur under this mechanism, even though existing budget authority would be used. Any funding mechanism that provides for additional spending that is not offset by reductions elsewhere will have a deficit impact, regardless of the source of budget authority. It is worth noting again, however, that credit assistance has a fractional budget impact (8 percent in Table 4-1) compared with an equivalent amount of grant assistance.
- *Cost Allocation:* The budgetary or subsidy cost of a selected project would be charged to the appropriate State's unobligated balance of ISTEA apportionments. New apportionments of Federal-aid funds and allocations of Federal-aid obligation authority would not be affected.

Because this funding alternative leverages existing budget authority with significant private capital, it may be viewed favorably by the States as allowing additional spending that otherwise would not occur. In allocating limited resources among competing needs, the Federal Government can justify additional spending on transportation infrastructure only if it generates greater returns. Extending Federal credit that enables private capital to make strategic transportation investments is a much more effective use of limited resources than simply providing additional grants. In addition, tapping into existing resources already apportioned to the States is a logical way to address their concerns about ever being able to use those funds.

Because of ongoing efforts to rein in Federal spending and reduce budget deficits, it is unlikely that annual spending limitations will be removed and States allowed to spend down their unobligated balances for regular grant reimbursements. Although some States harbor hopes that transportation spending will not be subject to certain budgetary constraints in the future (perhaps by taking the HTF off-budget), those prospects are uncertain. This proposal responds to States' long-standing concerns about growing unobligated balances and operates within the existing budget framework to address critical investment needs—all at a relatively modest cost to the Federal Government.

Furthermore, charging States' unobligated balances for Federal credit costs is equitable because States that benefit most directly from Federal credit assistance will pay for those benefits with their own apportionments. States would submit applications for major infrastructure projects and signal their willingness to pay for the associated credit costs through reductions in their

existing fund balances. Allowing the use of unobligated balances to pay for credit assistance will encourage States to seek out new resources in financing revenue-generating facilities. But it will not penalize States that choose not to participate; new Federal-aid apportionments and allocations of obligation authority will not be reduced.

CONCLUSION

DOT recommends establishing a Federal credit program for major surface transportation projects to achieve several important goals.

Projects of national significance require special assistance.

Major transportation infrastructure facilities that address critical national needs--such as multi-State trade corridors, intermodal facilities, and international border crossings--represent large capital investments. In many cases, the scale and complexity of the projects exceed the financial resources of existing Government programs. Because these facilities generate substantial economic benefits in terms of accessibility and mobility of goods and people, they are able to support user charges and other project-related revenue streams. Government project sponsors can use these new revenue streams to back a substantial portion of the capital costs with private capital, thus freeing up public resources for smaller, non-revenue-generating projects. To gain market access, however, these major projects frequently require supplemental or secondary sources of capital.

The Federal credit program is designed to assist these projects in accessing private capital through Federal participation as a co-investor.

The role of the Federal Government in the Transportation Infrastructure Credit Program would be to help overcome market imperfections relating to investment time horizons, liquidity, and flexibility by serving as a minority co-investor. The Federal credit program has been designed to achieve the following key objectives: (1) broaden the availability of assistance, (2) target projects of national significance, (3) identify new revenue streams, (4) fill market gaps, (5) leverage substantial private co-investment, (6) limit the Federal exposure, and (7) enlist State and local participation.

A Federal credit program offers the opportunity to achieve substantial leverage.

A central tenet of the proposed Federal credit program is to attain leveraging ratios that are far superior to those for the existing Federal-aid programs. Based on bond rating agency risk assessment models, DOT believes that the Federal budgetary cost (as reflected in the subsidy cost calculated for each loan or line of credit) will, on average, be less than 10 percent of the total nominal amount of Federal credit provided. With the Federal share limited to a third of

total project costs in most cases, this program would enable each dollar of Federal budgetary resources to leverage capital investment activity at a ratio of 36 to 1. This is vastly more efficient than traditional 80 percent Federal grant programs, which have an implicit leveraging ratio of 1.25 to 1.

The program would systematize the current ad-hoc provision of credit assistance.

To date, Federal credit activities in the surface transport sector have been characterized by the ad-hoc efforts of interested State and local entities approaching the Administration and Congress for assistance. In recent years, several large transportation projects have received credit assistance through special legislation. Thus far, the Federal Government has managed to respond to these initiatives, but the success of these transactions has stimulated enormous interest among other project sponsors. A central goal of this program, therefore, is to establish uniform, objective, and transparent criteria for project sponsors to submit applications to DOT for Federal credit, and to set forth an orderly process for evaluating and implementing the projects.

The Federal credit program will exist only until the markets develop sufficient expertise to overcome the obstacles that inhibit private investment in large transportation projects.

The program is designed to overcome current market gaps by familiarizing investors with the risk and financial profiles associated with large startup transportation infrastructure projects. The Federal loans would be offered at Treasury lending rates, which in many cases will be higher than the rates available for investment-grade tax-exempt obligations. Over time, as the projects' financial performance allows them to obtain improved ratings, borrowers should graduate to 100 percent private credit by refinancing their Federal loans with tax-exempt debt. Ultimately, the program could put itself out of business by demonstrating to private investors the long-term financial feasibility of this class of infrastructure investment.

APPENDIX A: RISK ASSESSMENT FACTORS

Assessing Risks

From the perspective of the capital markets, project risk takes on different characteristics during three main phases of activity: (1) project development and pre-construction, (2) construction, and (3) operation. These activity phases are briefly described below, before the rating agency approach and individual risk assessments are addressed.

Development and Pre-Construction Risks

Inherent in the development and pre-construction period is a varied group of risks with probabilities that are most difficult to estimate. These risks can significantly alter the timeline for a project. Typical pre-construction risks include acquiring the right-of-way; securing State, local, and Federal permits (environmental and construction); and obtaining significant support from the various stakeholder groups or communities affected by the project. If stakeholder support is not forthcoming, then the project is not likely to proceed, and costs invested up to that point are usually not recoverable. Perhaps the biggest unknowns during development are environmental approvals (including law and regulation changes) and right-of-way acquisition. These two factors can delay the scheduled start and completion of the project and have the potential to cause significant cost overruns and impede the project's ability to procure financing.

Construction Risks

The construction period brings different risks, including the question of whether the project will be completed on schedule and at the indicated cost. The risk of completion delays and other cost overruns influences the financial structure of the project, because financing and bond insurance is much more accessible after completion of construction. The contractor's experience on similar projects and ability to meet financial obligations is critical to their executing the contract and delivering a project as guaranteed.

The contract format is an important factor in dealing with and assigning risk, whether build-operate-transfer, or design-build, or turnkey in nature. When construction risk is shouldered by the contractor through a design-build or design-build-operate contract structure, risks borne by the debtor are minimized and, thus, support a better credit rating.

Various contractual arrangements among the parties involved have been developed to deal with the substantial risks posed by the

construction phase. One way to mitigate construction risk is through a fixed-price construction contract, including carefully drawn provisions related to change orders and completion delays. In addition, even with a fixed-price or not-to-exceed contract, the availability of contingency funds to cover cost overruns, project delays, or other risks, adds protection for the lenders and benefits the overall credit rating of the project. A general rule of thumb is that contingency funds should equal 5-10 percent of the construction contract. Contingencies for the San Joaquin and the Foothill/Eastern TCAs were sized to cover 2 years of capitalized interest.

Operational Risks

The ability of a project to service its debt depends on the uninterrupted, cost-effective operation of the road, and therefore, the revenue stream. The operational phase includes risks related to traffic forecasts and actual operating costs. Provisions for routine maintenance and major maintenance or overhaul of the facilities are an important part of the operational phase. Credit analysts examine who is responsible for operations, terms of operation and maintenance contracts, and the experience of the operator with similar facilities.

Recent toll road projects that have been debt-financed have all gone through some maturation or ramp-up phase in the first years of operation. Traffic volumes and the resulting toll revenues have on occasion been 30 percent below projected levels during this period. The market responds to this risk profile by using a break-even analysis coupled with a review of the underlying assumptions that form the basis for the estimated cash flows. The break-even scenario (typically run assuming adverse economic conditions), in conjunction with an evaluation of the revenue forecast, will provide the market justification for how the project ranks compared to similar facilities.

Existing Approach of the Rating Agencies

Bond rating agencies become involved during a project's development phase (as with the Alameda Corridor project in Los Angeles), or once the project is fully developed and ready to go to market. By getting involved early, rating agencies can better evaluate the project's supporting data and agreements as they evolve. This involvement provides an opportunity to review the project's credit strengths and weaknesses and inform project sponsors about what steps or changes would be beneficial to improve the credit quality of the project before soliciting the rating on the debt issue. With a preliminary review, rating agencies may be asked to provide a preliminary opinion on the rating that the project might receive either as currently structured or assuming the project incorporates the rating agency's advice on how to strengthen the credit.

Before issuing a credit rating, rating agencies conduct a thorough credit analysis of the proposed project and review all the project documents which typically include:

- Third party contractual agreements (for construction and operation);
- Local, State, and Federal permits (environmental, construction, operations);
- The project team's capabilities and experience on similar projects;
- Comparative analysis of similar projects;
- The financing (and bond) documents (drafts as available for preliminary assessment);
- Other credit support agreements (e.g., letters of credit);
- Proposed insurance (for construction and operations);
- Traffic and revenue forecasts and reports;
- Independent engineer's project feasibility assessment;
- Regional economic trends and assumptions; and
- State and county fiscal conditions and forecasts.

Rating agency analysis generally encompasses meetings with the project sponsors, State and local officials, traffic engineers and others, as appropriate, to develop their own assessment of the project cash flows under various economic conditions and revenue/traffic scenarios.

The results of the credit analysis on a specific project are then used as a basis for comparison against other similar projects, trends, and historical data to arrive at an appropriate rating for the project. Once the rating agency has finished its credit analysis and assigned a rating, it will prepare a written summary of the project and the analysis, including the rating assigned to the debt issue.

Major Risk Factors for Transportation Projects

The risk factors associated with the three phases of a project are further described in this section to illustrate the consideration underlying capital market evaluation. Figure A-1 shows how the relevant risk factors change as the project progresses.

**TABLE A-1
RISK FACTORS ASSOCIATED WITH PROJECT PHASES**

Risk Category	Phase of Project		
	Development	Construction	Operation
Economic Feasibility	X		X
Political	X	X	X
Construction		X	
Traffic			X
Management			X

Economic Feasibility

To assess creditworthiness (either in the development phase or when the project is ready to go to financing), rating agencies look at a project's long-term economic feasibility. Three criteria that drive the economic feasibility of new startup toll road projects:

- Demand projections for the facility;
- Elasticity of demand; and
- Projected debt service coverage.

Need: Demand and Competition

Toll road projects are typically financed with revenue bonds supported by system users; thus, assessing demand for the new facility is crucial to determining its economic feasibility. Demand is a function of need (to provide access to new areas, offer congestion relief, or induce desired development) as well as market willingness-to-pay. This willingness, in turn, depends on competition from alternate free routes and the relative increase in inconvenience to using these routes. Need is both a function of demand and competition from alternate routes. New roads are built to provide access, alleviate congestion on existing roadways, or induce new development.

Several factors are used to evaluate the level of customer acceptance (i.e., strength of demand). In particular, analysts look at the:

- Service area to analyze the local economic conditions, population trends, and income levels;
- Location/geography to determine who (and where) the potential users are, and whether the facility serves as a vital transportation link;
- Road design to assess compatibility with existing roadway systems; and
- Usage to evaluate traffic volumes.

Service Area

Service area assessment involves developing a profile of the local service area and local economic trends such as population, housing, employment and unemployment levels, and economic production. The size of the service area is not as important as the population changes that have occurred over time. Population and activity growth statistics support the need for the facility within the context of the existing system and competing routes.

Income levels of the local population indicate an ability to pay tolls or user fees. Motorists value the benefits of a new facility, such as time savings, reduced congestion, improved quality of travel, and enhanced safety. Income levels directly influence value perceived and ability to pay tolls.

Economic diversity within the service area is a positive factor for the project. A diverse economic base not only insulates the local service area from business cycles but ensures that area activity is not dependent on only one or two large employers.

Location/Geography

Road location will, to a large extent, dictate who will use the toll facility and why. How essential the road is, in turn, determines the strength of demand for the new facility. In assessing customer acceptance or demand, analysts focus on whether the new road will serve as a vital transportation link (i.e., no viable alternatives exist) or is being built to relieve congestion on the existing system.

Where the proposed roadway will serve as a vital transportation link with no competing alternatives, analysts find the level of use (and toll revenues) relatively more predictable. Where new toll roads are intended to relieve congestion along an existing corridor, the value of the benefits provided by the new facility is a key determinant in the willingness of motorists to pay user charges. These new facilities generally compete with older facilities that do not have tolls, which creates uncertainty about traffic revenues on roads built to relieve congestion compared to vital transportation links.

When roads are built to spur development, it is important to look at what changes will be necessary before traffic materializes.

Residential construction, in particular, advances in a highly cyclical fashion. In addition, the capacity limits on the alternate routes as well as other planned expansions (new construction or road widening) are important factors in evaluating the new facility.

Road Design/Compatibility

The more integral the new road is to the existing transportation system, the lower the risk that the new facility will not attract traffic. Particular focus is given to interconnections with the existing system, entrances, exits, and feeder routes. If connecting roadways are not built, then demand for the new facility will be at risk and traffic volumes may not materialize.

Usage

Roads are used for a number of purposes, such as commuting, recreation, personal and company business, commercial uses, and military and emergency purposes. The mix of uses will affect traffic flow (i.e., peak periods versus seasonality) and the necessary design capacity of the system. A good mix of purposes linked to continuous use is generally an indicator of strong revenue generation.

Elasticity of Demand

Demand forecasts and revenue projections serve as the basis for assessing the economic feasibility of the project, because startup toll roads have no revenue history. If the proposed roadway is to relieve congestion, an extensive forecast analysis must be conducted, as well as a sensitivity analysis on revenue projections. Recent toll road projects have deviated from projected revenues in their early years, one by as much as 30 percent; therefore, the validity of the traffic model applied to predict usage is a key to assessing the economic feasibility of a project.

All models use assumptions about motorist behavior and value of time to project who will use the new facility. The assumptions about traffic flows and their responsiveness to the level of tolls are critical in projecting revenues.

Debt Service Coverage Projections

Projected debt service coverage is one of the key financial factors used by rating agencies and investors to assess the ability of the proposed project to pay debt service. Recent experience with toll road financing, in particular, has shown the importance of including a margin of error so that the coverage ratio is substantially greater than 1.¹

The general rule of thumb in capital markets is that minimum coverage on senior debt should be at least 1.25 to 1.35 times the annual debt service. In all likelihood, given recent experience with the Dulles Greenway project, a coverage ratio of at least 1.5 annual debt service will be required for development projects. To the extent that minimum debt coverage ratios exceed this level, the project cash flows will be stronger and, therefore, the ability of the project to service its debt will be greater if there is any disruption in revenues or reductions in available revenues. The rating agencies will assess what minimum debt service coverage ratio is needed based on the credibility of the project.

¹Debt service coverage is defined as the ratio of net annual operating revenues (total revenues less operating expenses) available divided by total annual debt service payments (principal and interest).

Key factors that are considered in evaluating a project's debt service coverage include:

- Startup (or ramp-up period);
- Additional bond issuance;
- Debt structure;
- Leverage (level of debt);
- Additional pledged revenue support, if any; and
- Expenditure controls.

Startup (or Ramp-up) Period

The most critical period for any project, and especially for toll roads, is the initial acceptance phase of the new facility over the first few years. All new toll roads, even those in heavily congested areas such as Orange County, California, experience an initial ramp-up phase prior to achieving projected traffic volumes. The risk is in gauging the length of time before the project can achieve adequate traffic volumes to make debt service payments. The debt service repayment schedule can be structured to have lower payments in the early years; if debt service payments increase too rapidly, however, the project may still be at risk. Thus, the rating agencies look at the detailed assumptions to determine whether projected traffic volumes allow for a startup period or rely on optimistic growth projections.

Additional Bond Issuance

Any plans to issue additional debt for improvements or expansion are considered when determining the credit quality of the project. Bond documents typically include a covenant otherwise known as the additional bonds test, which stipulates the terms under which additional bonds may be issued. For example, the San Joaquin TCA project requires a debt service coverage ratio of 1.25 times the debt service of any outstanding senior debt plus new senior debt and other conditions. There is no specific limit as to what may be required under the additional bonds test.

Debt Structure

Rating agencies analyze the debt structure very closely in assessing credit worthiness. Senior debt security may be adversely affected if restrictive rate covenants also exist for any junior lien toll revenue debt issued. For example, if toll rates are increased to generate a higher coverage ratio in response to a junior lien toll covenant, an additional risk factor is created. Higher toll rates might, conversely, produce a diminished return if demand for the road proves elastic. Thus, rating agencies look at the issuer's ability to issue any junior

lien debt and associated rate covenants to determine the ultimate credit quality of the project.

Level of Debt

The availability of additional funding sources to support the issuance of toll revenue bonds can strengthen the overall creditworthiness of the project. For example, availability of general obligation bonds can reduce the amount of toll revenue debt and enhance debt service coverage. The availability of other State or local funding support can also enhance the debt service on the toll revenue bonds and improve the overall credit rating on the bonds.

Additional Pledged Revenues

Additional revenue streams, such as development impact fees or special assessments, can strengthen the security for the revenue bonds and improve debt service coverage. To be counted as a credible enhancement, the additional revenues must be stronger than the toll revenues. Developer fees are often viewed as weaker than toll revenues and may provide only limited credit enhancement. In contrast, dedicated sales or motor fuel taxes are viewed as reliable revenue streams that enhance credit quality. Other forms of State and Federal support are also viewed very positively (e.g., the Federal line of credit for the TCA projects).

Expenditure Controls

Rating analysts recognize that debt service coverage is affected by the annual costs of operating and maintaining the proposed facilities. Rating analysts review the cost assumptions and projections to ensure the long-term viability of the project. Greater validity is assigned if the cost projections have been prepared by a contractor who has experience in operating similar facilities and a reputation for estimating costs accurately. Assumption of maintenance responsibility by the State, as is the case with the TCA projects, significantly reduces this risk factor.

Political Risk

The political factors that can affect the ultimate success or failure of a project are just as important as the financial risk associated with a project. Two key political factors that are taken into consideration are:

- Who (what entities) controls when and where the road or facility will be built; and
- Who is responsible for and/or controls facility operations after construction.

Rating agencies review the legislative and executive authorities involved, the process for assigning responsibilities, and experience with similar projects. Political agendas outside the realm of the project can influence policy decisions and determine the fate of a project. Several projects have been delayed by differing political agendas. The E-470 beltway in Denver, for example, experienced significant difficulties over its proposed alignment. Residents and various public officials challenged the route and proposed an alternative, forcing project delays and litigation.

Understanding who controls the operations is also important. Toll roads may be operated by an independent authority (or toll-operating agency) with complete autonomy, but when other government entities have control over revenue decisions (e.g., veto power over rate increases) the possibility that revenues may not be available to meet debt service will be considered in assessing the credit quality.

Equally important is oversight over tollway operators to ensure that investor interests are protected. The responsibility and authority assigned to the operator under the terms of the financing documents are important factors, especially with respect to toll rate increases. The oversight role (who and how) is a critical component in balancing the various interests of all the parties involved to ensure continued public and financial support for the project and its long-term viability.

Another important factor is the security of facility revenues from being diverted to support other initiatives. For example, toll revenues from the New York State Triborough Bridge have long been used to support other transportation initiatives, such as mass transit. Startup toll roads must be protected from revenue diversions to ensure the viability and creditworthiness of the project.

Finally, most projects require the support of the general public if they are to be successful. The Conway Bypass project in South Carolina is an example of the public's role in a project's success or failure. Although the South Carolina DOT supported the project, there was insufficient outreach to generate public support. The project's finance plan relied on securing public approval of a dedicated sales tax to support the revenue bonds. Ultimately, the sales tax referendum was defeated, and South Carolina DOT was forced to rethink the project.

Credit analysts try to assess public and political support for a project to ensure that there is no major opposition that could forestall its successful completion. In addition, project advocates should be well-positioned to defuse any opposition that may develop during the planning and construction of the project.

**Information
Requirements To
Support an Investment
Grade Rating**

The proposed Federal credit program will rely on existing market-place assessment mechanisms to gauge the investment quality of debt-financed projects. Nationally recognized rating agencies typically require extensive information for their assessment of the credit quality of a project. This information falls into four categories:

1. Contractual documents for the construction and operation of the project (including all environmental and construction permits needed);
2. Financing documents (e.g., trust indenture, bond purchase agreement);
3. Regional and local economic trends and data pertinent to the project, such as employment levels, economic diversity, income levels, and assessment of the public support (general and local/state levels); and
4. Independent reports and analyses that support the project economics such as traffic and revenue reports and an independent engineer's feasibility report.

The availability of all the information required enables the analysts to conduct a thorough review and assign an appropriate credit rating. To the extent that key information is not available, analysts may not be able to assign a rating or may assign a conditional rating subject to the project meeting certain thresholds. It is not unusual for the rating agencies to undertake a preliminary review of a project and assign a conditional rating at the request of the project sponsors. The conditional rating is often requested to assist a project sponsor in identifying what further steps must be taken or what revisions in the various contractual elements are required to secure an investment-grade rating (i.e., BBB or higher). As envisioned, the Federal credit program would use the preliminary or conditional ratings to assess project applications.

The rating analysts evaluate all the available information to determine: (1) the reasonableness of assumptions made in the forecasts of traffic and revenue, (2) the external political and economic factors that could affect the outcome of the project, (3) existing or planned competition for the roadway and its interrelationship with regional economic conditions, (4) how the bondholder's interests are protected under the covenants in the financing documents, (5) the downside risks, and (6) the project's break-even point for servicing debt.

Contractual Documents

The contractual documents outline the scope of the project and the terms of the agreement between the project sponsor and contractor (for construction and/or operations). The contracts outline all the legal obligations of the contractor for the technical work; performance guarantees and warranties; schedules, workmanship, and financial commitments; default and non-performance provisions, including cure period; remedies and liquidated damage payments; insurance coverage; and bonding capabilities and requirements. Included in this category are all the necessary permits to construct the project (government approvals, environmental permits, and construction and operating permits) or an anticipated schedule for obtaining them. Financial statements showing the ability of the contractor to meet its own financial commitments should be included. Supporting information is required to show the experience and ability of the contractor to build and operate the project as guaranteed.

Information outlining who will control the facility and who is responsible for operations and maintenance is also needed to ensure that revenues generated by the facility will be dedicated to support the required debt service payments and will not be diverted to support other transportation initiatives.

Financing Documents

The financing documents include all the documents drafted by bond counsel governing the issuance of revenue bonds (tax exempt or taxable) to finance the project, including the trust indenture, bond purchase agreement, letters of credit (if applicable), bond insurance, resolutions of issuing authority. Depending on the financing structure, evidence of any third-party capital investments (such as equity) or contractor deferred-payment agreements would also be reviewed.

Regional and Local Economic Data

Understanding the regional and local economy is a key component underlying customer acceptance and demand for the proposed facility. Population and housing trends, employment and unemployment levels, economic diversity, and income levels of the local population are all indicators of the willingness and ability of motorists to pay for toll road use. If the need for a project is based on future growth assumptions (that is, traffic and revenue projections assume significant growth rate in local population, commercial activity, or other demand factors), then the revenue base is not considered as secure as would be the case for congestion relief.

Equally important to the project is government (Federal, State, and local) and public support for the project. Any documentation available that demonstrates strong support for the project, or at least indicates that there is no significant opposition, strengthens the market's perception of the project's success. Many projects do not succeed (or are not as successful as projected) directly because of opposition from the public groups or government.

Independent Reports

Generally, an independent engineer is retained by the project sponsor or on behalf of the financing institutions to review the feasibility of the proposed project from both technical and financial perspectives. The independent engineer will review all the preliminary design and construction documents, permits, project capital costs, traffic and revenue forecasts, and projected cash flows and assumptions. In addition, the engineer will assess the technical and financial ability of the contractor and the entire project team to undertake the project to ensure completion.

All toll road (or revenue bond financed) projects require a traffic and revenue forecast to support their cash flow projections. The traffic and revenue forecast must be prepared by a reputable, experienced firm to be considered valid. The traffic and revenue projections are critical to the ability of the project to meet its debt service obligations. Significant deviations from the projected demand levels or revenues will directly affect the long-term viability of the project.

Checklist of Information Requirements for Federal Credit Program

In structuring a Federal credit program to assist project sponsors and projects, DOT envisions that at least a minimum investment-grade rating (Baa/BBB) should be required to protect the Government's interests. To obtain a credit assessment from a bond rating agency, project sponsors would already have been required to submit extensive information. Project sponsors should submit similar information to DOT, to be followed by their credit assessment, to be considered for the proposed Federal assistance. The remainder of this section lists the necessary information.

With Respect to Development and Construction Information:

- Evidence of right-of-way acquisition (completed or schedule of acquisitions) or power of eminent domain;
- Status of environmental permits and/or government approvals secured;
- Information on any outstanding litigation in process (preferably none);
- Evidence of an experienced and successful contractor/project team (on similar projects);

- Construction contract details and status (preferably fixed price, design-build-operate or design-build-transfer), including:
 - ♦ Liquidated damage provisions (to cover the daily carrying cost) if the project is delayed beyond the scheduled completion date through the fault of the contractor;
 - ♦ Performance and payment bonds equal to the cost of the construction contract to ensure completion of the project should the contractor default (which would enable use of a replacement contractor);
 - ♦ Performance and workmanship guarantees for at least 1 year from the date of commercial operation of the facility;
 - ♦ Remedies for performance failures;
 - ♦ Contractor default provisions that outline what constitutes a default (both technical and financial), what is the cure period, and what are the remedies;
 - ♦ Force majeure events and how triggered. Force majeure events include events that are beyond the control of the contractor, such as earthquakes, epidemics, blockades, wars, acts of sabotage, and archaeological site discoveries; and
 - ♦ Insurance provisions, such as builder's risk, business interruption, worker's compensation, and general liability.
- Feasible financial plan (including debt structure and terms) and evidence of ability of contractor to secure financing (e.g., commitment letters from financial institutions), including:
 - ♦ Amount of capitalized interest to cover unforeseen delays (particularly force majeure events); and
 - ♦ Adequate level of reserves and contingency funds.
- Contractor's ability to meet its financial commitment (e.g. 3 years of audited financial statements for all parties involved, particularly the project guarantor);
- Independent engineer's report assessing the feasibility and financial viability of the project; and
- Evidence of local and State support for the project (political will);
- Evidence of popular support.

Required Operational Information:

- Solid traffic and revenue analysis from experienced forecasting consultant;
- Adequate operation and maintenance budget for the facility (experience of operator with similar facilities);
- Reserve fund for major maintenance or rehabilitation;
- Business interruption insurance and debt service reserve fund (usually 1 year of debt service payments) to cover debt service during interruption in operation;
- Adequate insurance to cover costs to repair unexpected damage;
- Reliability of electronic toll collection/revenue collection method proposed (if applicable);

- Identified unmitigated risks and possible solutions;
- Sources, form, and terms of backup support (if any) to meet debt service requirements if revenue shortfalls occur (including cost, duration, and annual support available and repayment conditions);
- Identified party who controls facility and directs any mid-course corrections;
- Identified successor in event of financial default;
- Detailed cash flow projections and underlying assumptions (inflation, toll rate increases, startup costs, and debt service schedule) for the term of the financing (e.g. 20 to 30 years).

Required Financing Documents:

- Proposed sources and uses of funds;
- Role of Federal credit support;
- Bond purchase agreements;
- Interest rate assumptions, terms, conditions for draw, repayment schedules;
- Provisions covering investment of reserves;
- Rate covenants;
- Default provisions, cure period, and remedies; and
- Bond counsel preliminary opinion regarding tax status of debt.

Required Support Information:

- Type of Federal credit assistance proposed, e.g., standby line of credit, development cost insurance, or direct loans (development and planning stage vs. startup operational phase);
- Terms of support, including amounts available, draw schedule and conditions, cost, duration, and repayment terms and conditions;
- Project eligibility for Federal assistance, per program criteria; and
- Identification of Federal-aid funds (e.g., unobligated balances) expected to be used to underwrite Federal credit support requested.

APPENDIX B: FEDERAL TAX ISSUES RELATING TO THE FEDERAL CREDIT PROGRAM

Background

DOT has proposed a program of Federal credit support for surface transportation projects of national significance. The two major forms of assistance--flexible payment loans and standby lines of credit--would be used by project sponsors in conjunction with sources of private debt or equity capital to finance infrastructure facilities.

Project sponsors will need to arrange external debt financing to fund the majority of project costs. In many cases, the projects will be eligible under the internal revenue code to issue tax-exempt debt.

Flexible Payment Loan. The flexible payment loan is a direct loan from DOT to the project sponsor made on terms designed to facilitate the project's external debt financing. A project could obtain a flexible payment loan for up to one third of project costs. It will seek to satisfy the balance of its funding needs by issuing debt at the lowest rates available through the tax-exempt market. Under the Internal Revenue Code, there is no legal issue that calls into question the tax status of the tax-exempt debt simply because a portion of project costs had been funded with a direct Federal loan. It is not uncommon for State and local project sponsors to finance environmental and transportation facilities with a combination of Federal assistance (grants, loans, etc.) and proceeds of tax-exempt debt.

Standby Line of Credit. The standby line of credit is a commitment by DOT to make one or more direct loans to a project sponsor at a later date if certain conditions occur (specifically, in the event net revenues are insufficient for the project sponsor to pay debt service on its senior bonds.) A project could obtain a line of credit in an amount up to one third of project costs. The credit line represents a secondary or contingent source of capital for projects that will obtain their construction and permanent financing from non-Federal sources.

In those instances where the project debt is tax-exempt, there is a provision in the Internal Revenue Code relating to Federal guarantees that could affect the use of the standby line of credit. This appendix discusses that Federal tax issue and the legislative proposal to address it.

**Federal Guarantees
under the Tax Code**

Section 149 of the Tax Reform Act of 1986 provides that any obligation that benefits from a direct or indirect Federal guarantee (in whole or in part) is deemed taxable; the interest payments to investors would no longer be exempt from Federal income taxation. The relevant language in section 149(b) reads:

“Section 103(a) [relating to tax-exemption] shall not apply to any State or local bond if such bond is Federally guaranteed. For purposes of [this paragraph] a bond is Federally guaranteed if ... the payment of principal or interest with respect to such bond is guaranteed in whole or in part by the United States (or any agency or instrumentality thereof) ... or the payment of principal and interest is otherwise indirectly guaranteed (in whole or in part) by the United States (or an agency or instrumentality thereof)...”

The purpose of this measure is to prohibit the issuance of obligations that would be both Federally-guaranteed and tax-exempt. Congress was concerned that combining tax-exemption and a Federal guarantee would provide a double subsidy, and result in a AAA tax-free debt instrument more attractive to investors than U.S. Treasury securities. The tax code provision was designed to curtail a practice under which tax-exempt bond proceeds were deposited with Federally-insured lending institutions, for re-lending out to housing and other borrowers. Channeling the tax-exempt debt proceeds through a bank or savings and loan allowed the bondholders to benefit from Federal deposit insurance, resulting in the obligations being rated AAA.

The language in section 149 is so absolute (any direct or indirect guarantee in whole or in part) that the standby lines of credit could be viewed as indirect Federal guarantees under current tax law. Consequently bond counsel cannot render unqualified opinions as to the tax status of bonds secured by a line of credit.

**Contrast between
Standby Line of Credit
and Federal Loan
Guarantees**

DOT's standby line of credit proposal represents a limited form of Federal credit support of debt service on transportation project financings. This partial credit enhancement differs from the types of guarantees that Congress is concerned about in a number of important respects:

- *Term.* Under the Federal credit program, the line of credit would be available to be drawn upon during only a limited time period (the first 10 years of project operations.) Most projects would be financed with long-term bonds having a 25 to 35 year repayment term, so the line would be applicable only for the initial period the bonds were outstanding. In contrast, most Federal loan guarantees are coterminous with the term of the borrowing.

- *Extent.* Under the Federal credit program, the total amount of the line may not exceed 33 percent of total project costs, and draws could cover only a portion of annual debt service costs during that period. In contrast, most Federal guarantees cover 80 percent or more of debt service, and frequently allow the borrower to split off the guaranteed portion into a 100 percent Federally-guaranteed obligation.
- *Beneficiary.* Under the Federal credit program, the line of credit runs to the Borrower (the project sponsor), leaving investors with the risk of borrower bankruptcy or insolvency. In contrast, most Federal loan guarantees run directly to the Lender, providing a bankrupt-proof guaranty.
- *Rating.* The line of credit is designed to enable a marginally sub-investment grade project to attain a BBB (minimum investment grade) rating. Even with the standby line, investors would continue to bear the majority of credit risk with respect to the project. In contrast, lenders under Federally-guaranteed loans anticipate their portion to be AAA caliber securities.
- *Recoveries.* The line of credit is structured with specific repayment provisions for any draws made in future years. The interest rate, repayment period, and security backing any draws are pre-defined. It does not represent an event of default under the project bonds for the line of credit to be drawn upon. In contrast, Federal loan guarantees are invoked in the event of a payment default on the borrower's loan obligation. The only source of recoveries upon acceleration of the outstanding loan balance is the liquidation of the loan's collateral.

In essence, the line is a limited and temporary source of contingent loans from the Federal Government. It represent an indirect and partial form of credit enhancement to help support debt service requirements in the early years of a project financing. Under Federal loan guarantees, the Federal role is much larger, and the Lender looks to the Federal backing as the principal source of security.

**Existing Standby Lines
of Credit**

Over the last several years, the Transportation Corridor Agencies (TCA) in Orange County, California, have issued two series of tax-exempt bonds which were secured by Federal standby lines of credit.

In 1993, TCA issued \$1.1 billion of bonds to finance the San Joaquin Hills (SJH) toll road. Congress in 1993 had passed special legislation providing the SJH project a \$120 million standby line of credit which could be drawn on over the ten year period following construction; however, because of the Federal guarantee tax concern, TCA in its bond offering documents had to inform investors that it would not use the line of credit unless it was able to obtain an unqualified opinion of

bond counsel that the tax status of the bonds would remain unaffected. Accordingly, the standby line had only limited value at the time of the issuance of the bonds, since its availability was uncertain.

In fiscal year 1996, Congress amended the SJH legislation to provide that the line could be used for other purposes in addition to debt service (such as operations and maintenance shortfalls or extraordinary repairs). Broadening the permitted uses enabled bond counsel to opine that the line could be drawn upon for debt service without adversely affecting the bonds.

TCA's Foothills-Eastern toll road project benefited from special legislation enacted by Congress in fiscal year 1995 that provided a separate \$120 million, ten year standby line of credit in connection with \$1.5 billion of tax-exempt debt financing. Based on the initial tax difficulties with the SJH project, this bill provided from the outset that the line could be used for other purposes. The broadened language avoided the Federal guarantee issue, but also diluted somewhat the financial benefit of the standby line to the project.

Tax Code Proposal

It would provide greater assistance to project sponsors (i.e., help secure an investment-grade rating) if the line of credit could be used exclusively for debt service on tax-exempt obligations. If the standby line is limited to debt service support, it may be possible to induce major bond insurance companies to back the issues. An insured issue rated AAA would dramatically lower the project's borrowing cost. It could also significantly reduce the amount of debt by lowering amounts needed to be issued to fund capitalized interest.

The proposed tax code change would modify section 149 of the Internal Revenue Code to provide that a standby line of credit pursuant to DOT's Federal credit program would not be deemed a Federal guarantee for tax purposes. The tax code must be amended directly in order to effectuate this change. It is not sufficient to place a provision in the transportation reauthorization bill dealing with Federal credit.

Other Precedents

Congress recognizes that important public policy goals merit a waiver from the blanket prohibition contained in section 149. It has provided specific carve-outs for bonds that fund mortgage loans guaranteed by government-sponsored enterprises and Federal agencies such as the Federal Housing Administration, Veterans Administration, Federal National Mortgage Administration, Federal Home Loan Mortgage Corporation and Government National Mortgage Association. It has also exempted bonds funding student loans guaranteed by the Student Loan Marketing Association, certain bond-funded small business and multi-family loans, and guarantees of electric power bonds by the Bonneville Power Authority.

The proposed change simply would add to the enumerated list of exceptions lines of credit provided by DOT pursuant to the Transportation Infrastructure Credit Act of 1997.

Revenue Impact to the Federal Government

The Treasury performs a fiscal impact analysis of all proposed tax code changes, to determine their effect on the Federal deficit. Tax-exempt bonds have a tax expenditure associated with them, since the Treasury foregoes the receipt of income taxes on the interest received by bondholders.

Allowing projects to use Federal standby lines of credit should make it easier to finance large start-up transportation investments like toll roads, transit facilities, etc. Under current tax law, most of these facilities are financed with governmental purpose tax-free bonds in any case, so there should not be a large induced volume of new tax-exempt debt issued.

However, by facilitating the financing of such projects, the measure may expedite the issuance date of tax-exempt bonds, which would result in earlier tax expenditures to the U.S. Treasury. On the other hand, a bond issue benefiting from a Federal line of credit would not need to capitalize interest for as long a period as otherwise would be the case, and may be able to reduce bond-funded reserves. Reduced capitalized interest and reserve requirements would result in smaller tax-exempt debt issues than is presently the case, resulting in additional revenues to Treasury.

On balance, the proposal is likely to be largely revenue neutral to the Treasury.

Legislative Text

Purpose: To amend the Internal Revenue Code of 1986 to clarify that standby lines of credit provided by the Department of Transportation pursuant to the Transportation Infrastructure Credit Act of 1997 will not constitute Federal guarantees.

SECTION __. FEDERAL GUARANTEES. Section

149(b)(3) of the Internal Revenue Code of 1986 (relating to certain exceptions to Federally guaranteed bonds not being tax-exempt) is hereby amended by striking the word “or” at the end of subsection (b)(3)(ii), and by striking the period at the end of subsection (b)(3)(iii) and inserting

“ , or (iv) lines of credit provided by the Department of

Transportation pursuant to title V of the (name of DOT
Reauthorization Bill).”

APPENDIX C*

ILLUSTRATIVE PROJECT CANDIDATES FOR FEDERAL CREDIT

(dollars in millions)

PROJECT	PROJECT DESCRIPTION	LOCATION	TOTAL COST
<i>Alameda Corridor</i>	Consolidation and improvements for rail intermodal freight access to the Los Angeles and Long Beach ports. Related highway improvements and grade separation along this major 20-mile rail/highway freight corridor, serving the country's largest concentration of intermodal container movements.	Los Angeles/Long Beach, CA	\$2,050
<i>Miami Intermodal Center</i>	Coordinated intermodal development and improvements to Miami's airport, parking, highway, transit, commuter rail, and high speed rail facilities via private concessions.	Miami, FL	\$1,700
<i>Woodrow Wilson Bridge</i>	Replacement of the deteriorating Interstate 495 drawbridge across the Potomac River with an expanded capacity toll bridge facility consisting of twin six-lane drawbridges spanning 70 feet above the Potomac	Virginia-Maryland	\$1,700
<i>Midtown-Kennedy Airport Rail Link</i>	Long-awaited rail/subway extension to JFK Airport from midtown Manhattan, using design-build-operate-maintain concession approach.	New York, NY	\$800
<i>Port of Seattle Intermodal Facility</i>	Development of expanded intermodal facility and access improvements serving the Port of Seattle using a container terminal concession	Seattle, WA	\$300
<i>Farley/Penn Station Project</i>	Relocation and improvement of Amtrak rail passenger terminal from Penn Station to a renovated NYC post office building.	New York, NY	\$315
<i>Freight Rail Improvement/Access Road Project</i>	Modernization and expansion of existing rail lines and creation of third freight dedicated line within a 22-mile section of the Northeast Corridor and proposed 4.5-mile access highway to aid the Quonset Point-Davisville Industrial Intermodal Center.	Rhode Island	\$246.8
<i>Route 168 Toll Road</i>	Proposed nonprofit development of Battlefield Boulevard toll road that would connect Chesapeake, VA, with the North Carolina Outer Banks beaches, alleviating the significant seasonal traffic congestion in the corridor.	Chesapeake, VA	\$110
TOTAL PROJECTS			\$7,031.8

*Appendix C is a list of surface transportation projects whose scale, financial structure, accessibility benefits, and economic importance are indicative of the types of projects the Federal credit program is designed to serve. With the exception of the Alameda Corridor project, which recently received a \$400 million Federal loan through special legislation, DOT has not performed any credit analysis of the candidates or undertaken any specific research to determine the forms of Federal credit that would be most appropriate for individual projects. The list, which has been obtained through industry sources and publications, is for illustrative purposes only.

Illustrative Project Candidates for Federal Credit (continued)

PROJECT	PROJECT DESCRIPTION	LOCATION	TOTAL COST
<i>Tacoma Narrows Bridge</i>	Implementation of the approved public-private initiative to make staged improvements to the congested, 50-year old Tacoma Narrows Bridge, ultimately reconstructing to a double deck toll bridge.	Seattle-Tacoma, WA	\$800
<i>Foothills-South Transportation Corridor Agency</i>	Implementation of planned Foothill/South extension of TCA's network of congestion reliever toll roads.	Orange County, CA	\$1,500
<i>SR 125 Toll Road</i>	Enhancements for construction of planned 10-mile toll road east of San Diego, providing improved access to Mexico. Already under concession agreement via California's AB 680 public-private concession program.	San Diego, CA	\$400
<i>SR 91 Extension</i>	Assist with financing of 10-mile extension of existing SR-91 High Occupancy/Toll "HOT" Concession in highly congested Orange County.	Orange County, CA	\$125
<i>I-895 Connector</i>	Enhancements for planned private design-build-operate-maintain concession for an eight-mile toll road bridge/connector to I-895 in the vicinity of Richmond, VA.	Richmond, VA	\$250
<i>Route 1 Toll Road</i>	Enhancements to implement planned toll road concession for extension of limited access bypass routing for Delaware Route 1.	Delaware	\$240
<i>Southern Connector</i>	17-mile four-lane toll road extending from I-385 south of Mauldin to intersection of I-185 and I-85, south of Greenville, SC.	South Carolina	\$140
<i>Hudson-Bergen Light Rail</i>	Planned 10-mile light rail line between Hudson and Bergen Counties, NJ; expected to be the first design-build-operate-maintain transit project in the United States.	New Jersey	\$1,000
<i>Conway Bypass</i>	Credit enhancement for planned Route 501 Conway Bypass already under concession agreement, to be financed in part by Horry County hospitality sales tax	Conway, SC	\$200
<i>Mon/Fayette Projects</i>	Series of four transportation projects to improve and upgrade the north-south route between I-68 near Morgantown and Pittsburgh. Funding sources for the projects include special Federal funds, oil franchise taxes, bonds, and tolls	West Virginia-Pennsylvania	\$1,800
<i>Hampton Roads Bridge-Tunnel</i>	New toll bridge-tunnel connecting peninsula cities of Newport News and Hampton with Portsmouth, Norfolk, and Virginia Beach to address growing congestion along the existing I-64 Hampton Roads bridge-tunnel	Virginia	\$2,000
TOTAL PROJECTS			\$8,455

Illustrative Project Candidates for Federal Credit (continued)

PROJECT	PROJECT DESCRIPTION	LOCATION	TOTAL COST
<i>Florida Overland Express</i>	A high speed rail passenger concession connecting Miami, Orlando, and Tampa, as part of Florida's private transportation program.	Miami-Orlando-Tampa, FL	\$ 5,300
<i>Phoenix Metropolitan Roadway System</i>	Proposed construction of several portions of the planned Phoenix roadway system emphasizing high occupancy/toll (HOT) lanes.	Phoenix, AZ	\$2,000
<i>Minnesota Highway 212</i>	Extension of Highway 212 from Eden Prairie to Cologne, Minnesota (MN) to relieve congestion in the Twin City area, proposed under the MN toll facilities program	Minnesota	\$195
<i>E470 Public Highway Phase IV</i>	Phase IV of E-470 is the final link in a 30-mile circumferential toll beltway under construction around the eastern half of metropolitan Denver, connecting the new airport to I-25, a key north-south Interstate.	Denver, CO	\$230
<i>Seminole Expressway II</i>	The final six miles of a 56-mile eastern beltway (toll road) around Orlando, known as the Central Florida Greenway. The proposed segment begins at US 17/92 and ends at I-4 in northern Seminole County.	Orlando, FL	\$206
<i>SH 99/The Grand Parkway</i>	A newly-constructed outer loop around the city of Houston. SH 99 is being constructed in nine segments.	Houston, TX	\$400
<i>South Access Road</i>	Construction of an access road connecting the existing North Terminal and a newly constructed South Terminal at the Detroit Metro Wayne County Airport. The South Access Road will include tunnels under runways and taxiways. Anticipated revenues include tolls and parking facility charges.	Detroit Metro Wayne County Airport, Romulus, MI	\$143
<i>Texas SH 121</i>	A 32-mile toll road extension of SH 121 from IH 35 to US 67.	Dallas/Fort Worth, TX	\$330
<i>Gowanus Tunnel</i>	Reconstruction of the Gowanus Expressway to incorporate a 4-mile tunnel tollway	Brooklyn, NY	\$2,500
TOTAL PROJECTS			\$11,304

Illustrative Project Candidates for Federal Credit (continued)

PROJECT	PROJECT DESCRIPTION	LOCATION	TOTAL COST
<i>North Duwamish Intermodal Facility</i>	This intermodal project improves accessibility to a number of major regional and national/international transportation facilities including King Street Station (existing Amtrak service and the site of a proposed multi-modal center), the Washington State Ferry Terminal, the Victoria Ferry, various rail yards, the Port of Seattle, and the mainline tracks of both the Burlington Northern, Santa Fe, and Union Pacific Railroads.	Seattle, WA	\$1,000
<i>Meadowlands Rail Transfer Station</i>	A public-private partnership to build and operate a rail and transfer station at the Meadowlands Sports Complex, linking 4 NJ commuter lines to Amtrak's Northeast Corridor. This project is the final link to the NJ Urban Core project and will complete the project's integration of all commuter rail lines in NJ.	East Rutherford, NJ	\$374
<i>Rickenbacker Parkway</i>	Design, right-of-way acquisition and construction of a 4-lane parkway linking the Rickenbacker Airport cargo facilities and adjacent warehouse/distribution development with I-71 to the west, and US 33 to the east. The parkway provides essential access from the airport to the area's major through-routes and provides economic development opportunities to support the airport and accommodate growth associated with the inland port concept.	Columbus, OH	\$150
Broadway Extension	Connects Oklahoma City with Edmond. Project will add 2 lanes to the existing 4-lane facility. It will also involve a redesigned interchange with I-44. In addition, a 2-lane bridge will be built to carry Santa Fe Avenue across I-44. Revenues will primarily consist of lease payments.	Oklahoma City, OK	\$196
TOTAL PROJECTS			\$1,720

Measury / STEA
2-26-97

★ K Budzdy - John H.

Options for 10 pilots: DOT wld object.

① Put Chiquita banana under the volume cap as offset

③ ② Authorize use of KTF \$ to subsidize

★ ② ③ ^{pilots outside cap -} Look elsewhere for offsets - e.g., parking cash out.

① ④ Put pilots under caps:

④ Wld be viewed cynically by mkt.
Do nothing. [Andy: This is not an option.]

DOT -

We think these wll be red selected, b/c many are already being done as

\$100M/yr. $\rightarrow$ leverage $\sim$ \$800M/yr.

① Go forward w/ ruling that this is consistent w 129

② Waive 129

③ 2

mm: Remote & indirect enough that this cld be considered consistent w/ 129.



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

March 3, 1997

TO: Barry Anderson
Mark Mazur
Andy Blocker
Dorothy Robyn
Mozelle Thompson
Jane Garvey

FROM: Michael Deich 

Attached is a table comparing the elements of the Alameda project as proposed by the Administration last year, as agreed to this year, and DOT's proposed credit program. It is my hope that within the first two columns are the elements of a workable DOT credit program.

I am providing this matrix to use as a decision making tool to develop a credit program that the Administration can support and include in the reauthorization of ISTEA. Please provide to David Worzala (395-3101) of my staff by COB today your comments on which of the Alameda loan provisions could be included into a new DOT credit program. My staff will use your comments to develop a final proposal which we will share with you tomorrow.

cc: R. Lyons
A. Stigile
W. Chang
D. Tangherlini
P. Romani

Comparison of the Alameda Loan and DOT's Credit Proposal

Loan Provision	Original Alameda	Alameda as Signed	Proposed Program
Term	30 years from Substantial Completion (est. 33 yrs)	30 years from Substantial Completion (est. 33 yrs)	30 years from Substantial Completion
Rate	10 year Treasury Rate through construction. 30 year Treasury Rate thereafter (means there is an interest subsidy)	10 year Treasury Rate through construction. 30 year Treasury Rate thereafter (means there is an interest subsidy)	30 year Treasury Rate over the life of the Loan (no interest rate subsidy)
Amount	\$400 million. Loan equals 20% of Project costs. (but Federal participation equals 38% including Federal grants)	\$400 million. Loan equals 20% of Project costs. (but Federal participation equals 38% including Federal grants)	Loans may not exceed 33% of Project costs.
Repayment Schedule	Repayments must begin 7 years after a draw on the loan takes place. This period allowed for construction and operating phase in. Repayment schedule tailored to project cash flows with guarantee for Federal government of a percent of cash flows if fell off the repayment curve. i.e. our percent of revenues increases as time goes on or project falls behind	First repayment starts year after substantial completion. Tailored to project cash flows. New agreement relies on attaching off-project revenues of the Ports to repayment.	Payments must start within 5 years after substantial completion. Tailored to project cash flows.

Claim on net Revenues	guarantee of participatory interest in project revenues. - 10% after 5 years - 20 % after 10 years - 30 % after 20 years Repayments and deferrals have priority to any rebates, credit accruals, surplus funds, or equity returns to Ports.	Repayment subordinate to prior liens for Project Revenue bond debt service and deposits to maintenance fund.	Payments may be deferred by the Secretary during the first 10 years if insufficient revenues. Deferrals accrue interest. On parity with Project Revenue Bonds after 10 years and in event of default. If sufficient revenue is generated then on parity.
Deferral of Debt service in event of Rate covenant generates insufficient revenue.	Limited # of deferrals allowed, however not included in subsidy estimate.	Permitted over the life of bonds. Deferrals accrue interest at loan rate.	Permitted during the first 10 years only. Deferrals accrue interest at loan rate.
Repayment Sources	User charges (container fees) plus other dedicated revenues (Port contributions)	User charges (container fees) plus other dedicated revenues (Port contributions)	User charges plus other dedicated funding sources (specifically excludes federal-aid).
Borrower Covenants	None specifically identified.	ACTA is assigned the rights of Ports of LA/LB under MOU with Railroads to increase container fees up to 3% per year if needed to pay debt service.	To be determined on a case by case basis. Provision for covenants is explicitly provided in legislation.
Fees	none	none	Secretary may establish fees.
Tax status of Debt	Assumed taxable, although Administration was aware ACTA was pursuing tax-exempt financing.	To be determined. A portion of the project costs may be financeable under current law as Governmental Purpose Bonds. ACTA is seeking tax code change for remaining costs.	Legislation silent. Assumes it depends on tax status of project. Some projects will be able to issue all or a portion of their bonds as tax-exempt under General Purpose Bonds under current law.



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Number of Pages:

4

(including this page)

To:

Dorothy Robyn - 456 222 3

From:

DAVID WORTALA
202-395-3101

Comments:



Federal Highway Administration

Office of Budget and Finance
Federal-aid Financial Management Division
HFS-40, Room 4310
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Facsimile Transmission

Date: Tue, Mar 4, 1997

Time: 12:15 noon

Pages: 2 + cover

To: Dorothy Robyn -- NEC
Fax Number: (202) 456-2223

From: Bryan Grote (for Jane Garvey)
Fax Number: (202) 366-7493
Tel Number: (202) 366-5785
E-Mail: Bryan.Grote@FHWA.DOT.GOV

Message:

Dorothy, FYI--

Here's a brief memo from Jane responding to Michael's memo from yesterday. Basically it says we still believe there is a workable solution worth reaching. Please call me or Jane directly with any questions or comments.

The information contained in this facsimile message is intended only for the personal and confidential use of the designated recipient(s) named above. If the reader of this message is not the intended recipient or an agent responsible for delivering it to the intended recipient, you are hereby notified that you have received this document in error, and that any review, dissemination, distribution, or copying of this message is strictly prohibited. If you have received this communication in error, please notify us immediately by telephone and return the original message to us by mail. Thank you.

MEMORANDUM

To: Michael Deich
From: Jane Garvey
Subject: Federal Credit Program for Surface Transportation
Date: March 4, 1997

Thanks for your March 3 memo seeking comments on the terms and conditions of the Federal Credit Program to be contained in NEXTEA. The side-by-side matrix was instructive in comparing DOT's legislative proposal with the original concept and ultimate form of the Alameda loan.

Our drafting of a legislative proposal was based in large measure on our experience with Alameda, where a relatively small budget appropriation (\$59 million) is facilitating a \$2 billion transportation investment which will generate national benefits. We drew heavily upon the extensive policy discussions that preceded the approval of the Alameda loan for inclusion in the President's 1997 budget and the subsequent inclusion of a Federal Credit Program in the 1998 budget.

As the side-by-side indicates, the terms of the Alameda loan and our legislative proposal are generally consistent with one another. There are only a few differences, noted below, where we believe we have improved upon Alameda. We think there is a workable solution "within the box" of your matrix that would be flexible enough to address the needs of surface transportation projects with varied financial profiles, yet be secure enough to ensure that the risk to the Federal government is minimized and quantifiable through the scoring process.

During the last several weeks, we have substantially modified our original proposal to try to address certain concerns raised by OMB and Treasury. Among other things, we have dropped entirely the standby line of credit and our concept for development cost insurance. We have also tightened the terms of the credit assistance being proposed in the form of direct loans, including explicit language prohibiting subordination in the event of default, to be more consistent with Federal credit policy.

Listed below are the improvements we believe we have made to Alameda and incorporated in our legislative proposal:

- We would not provide an interest rate subsidy.
- We would provide for the possibility of establishing fees.
- We would explicitly require parity in the event of default.
- We would require the Federal loan to be expressly accounted for in rate covenants and other security features to provide for the ability to increase revenues or exert other

Michael Deich

Page 2

March 4, 1997

remedies to ensure the borrower stays current in debt service.

- We would allow deferrals only during a limited ramp-up period.

Thanks to your help, we have made substantial progress over the past three years in developing innovative ways to support transportation infrastructure investment. The Federal Credit Program would be a prudent, effective next step in this ongoing effort to move beyond the single strategy of grant reimbursements. It can play an important role in advancing large, user-fee financed projects of national significance within current budgetary constraints. We remain ready to provide any assistance you may require in structuring a workable solution within the policy parameters you have outlined.

Initial Comments on the Proposed
Transportation Infrastructure Credit Act of 1997

- o Projects to be assisted - free or tolled highways, bridges and tunnels, mass transportation facilities and vehicles, commuter and inter-city rail passenger facilities and vehicles (including Amtrak), intermodal passenger terminals and intermodal freight and port facilities.
- o General Comments. There is no requirement that Federal assistance be limited to borrowers who are unable to obtain credit elsewhere on reasonable terms and conditions and be provided only if reasonable assurance of repayment has been determined. Also, the interest rate formulas should be amended to conform to standard Treasury language, including provision for fees to cover administrative costs and probable losses. These and other A-129 standards should be met.

Flexible Payment Loans

- o The terms of the proposed direct loans could allow project sponsors to apply net project revenues to other obligations prior to paying principal or interest on the Federal loan, which would result in a subordination of the Federal interest and would be inconsistent with Government financial policy and OMB-Circular No. A-129.
- o If such senior obligations were to include tax-exempt debt, the subordination would provide an effective Federal guarantee of a substantial portion of the debt service of the senior tax-exempt debt.
- o Even if the senior debt consisted of taxable obligations, we oppose subordination because of the increased risk. [Note: The bill does prohibit the subordination of the Federal claim on project assets in the event of default.]

Standby Lines of Credit

- o The Secretary of Transportation would be authorized to enter into agreements to make direct loans at future dates (i.e., lines of credit), the proceeds of which would be used to pay debt service on tax-exempt or taxable project obligations.
- o Draws upon the line of credit could be made
 - 1) if revenues were insufficient to pay debt service
 - 2) within ten years from the date of project completion
 - 3) for up to 33 percent of eligible project costs
 - 4) if a Flexible Payment Loan were not also received by the project

- o A contractual right to borrow from the Federal Government in order to pay debt service on a project's other obligations would effectively guarantee such obligations, which could include tax-exempt debt. (An amendment to sec. 149(b) of the IRS Code of 1986 is also proposed to provide an exemption for obligations secured by this line of credit.)

Development Cost Insurance

- o The proposed insurance program should state that no Federal payments may be pledged or used for the repayment of principal or interest on tax-exempt debt.
- o This pilot program should have dollar limitations and a sunset date established.

Funding

- o The bill should be amended to clarify that the Secretary of Transportation's estimates of the subsidy costs of the Federal credit programs is subject to review and revision by OMB, in accordance with the Federal Credit Reform Act of 1990.
- o Use of the Highway Trust Fund to pay for the subsidy costs of the proposed Federal credit programs should be subject to appropriations control.
- o There should be annual appropriations control on all credit extended under the proposed Act.

ATTACHMENT 1: CREDIT POLICY AND PROGRAM JUSTIFICATION

Federal policy for credit programs (as outlined in OMB Circular No. A-129) specifies that credit assistance should be provided “only when it is necessary and the best means to achieve clearly specified Federal objectives.”¹ When credit assistance is deemed necessary for meeting Federal objectives, it should adhere to the policy guidelines set forth by OMB. These guidelines are designed to protect the Government’s interests and minimize costs to the taxpayers.

This attachment examines several key OMB policies for credit programs, notes where these policies may not be entirely consistent with those envisioned under the DOT Transportation Infrastructure Credit Program, and explains why at least one guideline should be waived in conjunction with the Federal credit assistance being proposed for surface transportation projects.

Specific OMB Policies and DOT Analyses

OMB Policy: The Government’s claims on assets should not be subordinated to the claims of other lenders in the case of borrower default.

DOT Proposal: Comply with guideline relating to claims on assets, but allow subordination of the Government’s claims on revenues.

1. To the extent other lenders or debt investors have a claim on project assets in the event of default, the Federal credit program would be secured on a parity level with senior debt. This provision complies with current OMB policy.
2. Unlike other Federal credit programs, in which the Federal share is 80 percent or more of the liability, DOT’s program caps the Federal share at 33 percent. Flexible payment loans and standby lines of credit under this program would facilitate projects’ access to additional capital, often from private sources. This key objective would be severely impaired if DOT, as a minority investor, insisted on seniority in the flow of funds.
3. DOT’s credit program differs from other credit programs in that the principal security backing the credit is not asset-based collateral. Rather, it is the cash-flow-generating potential of the project that secures the loan. According to an authoritative analysis of credit risk performed by one of the major bond rating agencies, there is only an extremely small (1 percent) expectation of loss associated with long-term obligations for startup toll roads: “Almost all do get built, begin operations, and pay off their debts, including interest” (See report by Fitch Investors Service in Attachment 2). Based on historical financial portfolios of toll road projects, the long-term patient lender is relatively secure. Indeed, Fitch has concluded that, over the long-term, a

¹ Executive Office of the President, Office of Management and Budget, Circular No. A-129, Policies for Federal Credit Programs and Non-Tax Receivables, January 1993, p. 3.

flexible payment loan with a junior claim on revenues has the same credit risk as that of senior debt holders.

OMB Policy: Agencies shall not subordinate direct loans to tax-exempt obligations.

DOT Proposal: Federal credit should be subordinate to senior debt, which may be tax-exempt.

1. Subordination of the Federal Government's claims on revenues is a market-based necessity to induce a larger amount of private capital investment capable of obtaining investment-grade ratings. The financial markets will not accept a senior position that is artificially co-equal with a junior lender.
2. Based on current project activity, it seems probable that most projects requiring assistance under this program would be eligible to issue tax-exempt debt, whether by State and local partners or by other nonprofit entities. Barring such issuers from gaining access to the majority of their financing from the lower-cost municipal market would offset entirely the intended funding benefit of the Federal credit program.
3. Taxable interest levels place a greater burden on the long-term economic viability of capital-intensive infrastructure projects. Granting a waiver to allow project sponsors to issue tax-exempt debt in conjunction with a Federal loan will improve the credit-worthiness of DOT's investment by reducing the project's senior debt service burden.
4. OMB has no prohibition against State or local governments receiving outright Federal grants in conjunction with financing their non-Federal share with tax-exempt debt. In fact, that is the prevailing practice of State and local agencies for financing environmental and transportation infrastructure. From a Federal budgetary perspective, it would be counterproductive to impose policies that discourage the use of Federal credit in favor of more costly outright grants that will never be recovered.

OMB Policy: Loan guarantees should be favored over direct loans.

DOT Proposal: Provide direct loans in the form of flexible payment loans and standby lines of credit.

1. Fixed-income investors, such as insurance companies and pension funds, are accustomed to predictable periodic payments on their investments.
2. Typically, project revenues are uncertain in the early years, but grow over time. The unpredictability of semi-annual cash flows for junior lien obligations will exact a yield premium from institutional investors. The higher yield requirement adds an unnecessary cost to project sponsors.

3. The program draws on the unique ability of the Federal Government to be a patient investor with long-term horizons, lower liquidity requirements, and fewer funding constraints than private investors. Over time, investors may gain greater familiarity with the payment prospects of junior loans based on the Federal credit program experience. It may eventually be possible to convert the direct loan program into a loan guarantee program that would be well suited for major institutional buyers, such as pension funds, which have lower liquidity requirements and a longer term orientation than other classes of investors.

Conclusion: DOT's proposed credit program requires explicit waiver of at least one OMB policy, that regarding subordination.

DOT's proposed Federal credit program is designed to complement other government financing tools and encourage private investment in transportation infrastructure. Federal credit would increase capital investment in the Nation's transportation infrastructure, improve resource allocation by relying on market discipline, and foster public-private partnerships in transportation investment.

The credit proposal is consistent with most OMB directives on credit assistance, including the requirement of parity in the event of default. DOT, however, will require a waiver of the provision that prohibits subordination of direct loans to tax-exempt obligations' claim on annual project revenues. Subordination in the form of a minority lending position is mandated by the private marketplace and, in the opinion of a major rating agency, does not increase the long-term risk associated with extending credit to transportation facilities.

The DOT flexible payment loan proposal will, in many cases, result in direct loans being made side-by-side with tax-exempt obligations issued by State and local governments. It does not, however, involve the direct or indirect guarantee of tax-exempt obligations, as loan proceeds are applied to pay project costs, not debt service.

The DOT standby line of credit proposal involves direct loans to be made on a deferred basis to a project borrower to provide it with a contingent source of funds to meet revenue shortfalls. In this respect, it is similar to a secondary reserve fund. Proceeds from the line will be available to pay a portion of debt service, and, in many cases, the project sponsor's obligations will be tax-exempt.

The security of a standby line of credit, however, differs from Federal loan guarantees in a number of key respects: (1) the agreement runs to the borrower, not the lender; (2) it covers only a limited period and amount of debt service (generally less than 15 percent of total payments to be made over the life of the bonds); (3) it is structured with specific repayment provisions for any draws made in future years; and (4) it is not primarily relied on by investors in their credit analysis of the obligation. On this basis, the line of credit should not be construed as a Federal guarantee of tax-exempt debt. (See Appendix B of the Federal credit draft report for a more complete discussion.)

ATTACHMENT 2: RISK ASSESSMENT MODEL FOR DOT'S PROPOSED FEDERAL CREDIT PROGRAM

DOT is considering a Federal credit program as a more cost effective alternative to its current use of grants to finance startup toll roads and other transportation infrastructure projects. The program may include direct loans and standby lines of credit repayable on a junior lien basis with flexible repayment terms. As part of this study, Fitch Investors Service L.P. (Fitch) was asked to develop a model for evaluating the default risk for such a credit program. This attachment critiques the current approach for scoring transportation loans and proposes a new approach adapted from Fitch's model for evaluating the capital adequacy of private, for-profit bond insurance companies. Fitch also recommends specific scores or capital charges for projects that are rated differently.

Critique of Current Methodology for Scoring Transportation Loans

The Alameda Corridor loan was scored using a yield premium approach to assess potential default cost. The loan was assumed to be made at an interest rate equal to the U.S. Treasury bond yield. The net present value of loan repayments on the project was then calculated, discounted at both the Treasury yield and the assumed market yield, based on the project's preliminary rating (105 basis points above the Treasury yield). The difference in net present values was deemed to represent the cost of the default risk. In our opinion, the yield spread approach is not a valid measure of the expected default risk. The yield spread takes into account other factors beside default risk, such as liquidity risk and call risk. Since liquidity risk and call risk are not relevant factors in the cost of the program to the Federal Government, the yield premium results in a cost estimate that is too high.

The fact that market yield spreads overestimate default risk is evidenced by the existence of a private, for-profit bond insurance industry that guarantees the principal and interest on municipal bonds, as well as asset-backed and mortgage-backed securities. Bond insurers guarantee municipal bonds that have mostly A and BBB underlying ratings; the insurance raises the bonds' public ratings to AAA. The premiums on these policies, which are usually paid by the issuer, amount to about half of the issuer's interest cost savings as a result of the higher credit rating.

The yield spread between the insured AAA and the uninsured bonds is sufficient to support premiums that cover the bond insurers' default risk plus an adequate profit margin. From January 1, 1992, through June 30, 1996, the bond insurers guaranteed a total of \$544.4 billion in par. Premiums written over this period totaled \$4.5 billion, or 0.8 percent of par insured. Losses from bond defaults over this period totaled \$129.9 million, or 5.7 percent of premiums earned and 0.03 percent of average par outstanding (premiums for municipal bonds are typically written in the form of a one-time, up-front payment, but income is earned over the outstanding life of the bond). Bond insurers incur other costs besides losses, such as underwriting, surveillance, and administration; however, during the period from 1992 to mid-year 1996, bond insurers averaged 13.1

percent return on equity (income after expenses and taxes, divided by average shareholder's equity).

Bond insurers do not currently insure startup toll roads because they tend to avoid stand-alone projects with construction risk and ramp-up risk. In our opinion, however, the shortcomings of the yield premium approach also apply to these risks as well. In other words, it should be possible for the Federal Government to provide credit for startup toll road projects at a lower cost than the yield premium would imply.

The fact that the yield premium method overestimates the expected default cost means a different methodology is required. We propose a method derived from that used by the rating agencies to determine how much capital bond insurers need to allocate for their insurance policies. This will result in a more direct measure of the default risk on the projects.

Fitch's Bond Insurance Capital Adequacy Model

Fitch rates the claims-paying ability of the bond insurers. A large part of this analysis focuses on the insurers' capital adequacy. To measure capital adequacy, Fitch uses a stress test model that subjects a bond insurer's portfolio to an economic downturn that produces an extraordinary level of bond defaults. For an insurer to receive a AAA claims-paying ability rating, it must be able to pay all projected claims through the peak years of the stress period and be left with sufficient resources to write new business when more stable economic conditions resume.

Claims during the stress period are forecast using capital charges that Fitch developed based on bond defaults experienced during the Great Depression of the 1930's. Fitch has adjusted the capital charges to reflect regulatory changes and the relative probability and severity of defaults for the types of insured risks in today's market. For example, current banking laws enacted after the Great Depression reduce the potential severity of another depression. However, in the 1930's all municipal bonds were backed by a general obligation pledge; most municipals today are revenue bonds which have potentially greater risk. For this reason, Fitch has developed different benchmark capital charges for various types of insured bonds. For example, transportation bonds on existing facilities are more risky and, therefore, have higher benchmark capital charges than tax-backed and water and sewer bonds. They are, however, less risky and have lower benchmark capital charges than private higher education and hospital bonds. These benchmark capital charges are then adjusted further based on Fitch's evaluation of the actual credit quality and diversity of the bonds within each sector of the individual insurer's portfolio.

Capital Charges for Start-Up Toll Roads

Bond insurers do not currently insure startup toll roads. Fitch developed capital charges for this category specifically for this report. Our methodology for developing these charges is described in the following paragraphs.

Based on historical evidence, while some startup toll road projects experience late payment delinquencies in years 1 through 5, and less frequently in years 6 through 10, almost all do get built, begin operations, and eventually pay off their debt, including interest on interest. Subordinate lenders to projects of investment-grade quality should get paid as well, although perhaps over a somewhat longer time frame than the senior bondholders. It is estimated that only about 1 percent of the loans rated BBB will not be recovered within a reasonable time frame, which for discussion purposes is defined as 30 years.

A project is rated below investment grade (lower than BBB-) if there is a foreseeable risk that it will not be successfully completed on time or generate sufficient revenues to fully pay creditors. Indeed, default rates are much higher for unrated and below investment-grade municipal bonds than they are for investment-grade bonds. Because startup toll roads have only recently started getting ratings, there is little empirical data on default rates specifically for this sector. Based on the default experience in other sectors of the municipal market, Fitch estimates that a portfolio of loans on startup toll road projects rated BB will experience a 4 percent loss rate and startup toll road projects rated B an 8 percent loss rate (net of recoveries).

Highly rated financial institutions not only require enough capital for an expected level of losses, but for a multiple of such losses. Fitch has concluded that for startup infrastructure projects, a multiple of 4 to 5 times expected losses is needed to provide our highest credit standard of AAA. Multiplying the expected losses by 5 produces the capital charges that should be used on loans to start-up toll road projects; these charges (expressed as a percentage of original principal) are shown in Table 2-1. The capital charges can also be expressed as annual cash flows for inclusion in the OMB credit model, as shown in Table 2-2.

Table 2-1
Capital Charges for Startup Infrastructure Projects

Project Rating	Expected Loss (%)	Multiplier	Capital Charge AAA Scenario (%)
BBB	1.0	5	5.0
BBB-	1.6	5	8.0
BB+	2.6	5	13.0
BB	4.0	5	20.0
BB-	5.0	5	25.0
B+	6.4	5	32.0
B	8.0	5	40.0

Fitch recognizes that, in many cases, the Federal loan will be junior to the senior debt, but believes the same capital charges are applicable for subordinate, flexible payment debt. The flexibility in the Federal credit program reduces the demands on a project to make timely payments; however, full repayment is still required. An important element in

Fitch's capital charge calculation is that most loan defaults that occur during the initial 10-year period will be recovered. Fitch assumes that interest on delinquent loan payments is equal to the U.S. Treasury rate, so timing defaults will not affect the net present value cost of the loan credit program. The same analysis should hold true whether the Federal credit takes the form of a direct loan, a guaranteed loan, or a contingent standby line of credit.

It should also be noted that the capital charge methodology for private, for-profit bond insurers applies to a large and diversified portfolio of loans. If an insurer were to guarantee loans to only a handful of projects, and one of these projects defaulted, then the overall cost could conceivably be higher than the weighted average capital charge. Fitch would require considerably more capital to assign a rating of AAA to a private company insuring only a small, non-diversified portfolio of loans. Considering the fact that the Federal government has no liquidity constraints and these transportation loans would be only one piece of a \$300 billion existing diversified portfolio of Federal government loans and guarantees in a wide range of industry sectors, this capital charge method is considered appropriate.

Suggested Rating Category for the Federal Credit Program Portfolio

The capital charges Fitch recommends are consistent with AAA security. For an ongoing Federal credit program that encompasses a portfolio of loans and guarantees, the likelihood of underestimating default cost is remote. In other words, the capital reserves should absorb all anticipated default risk, in essence representing a proxy for Federal subsidy cost. This makes it a useful and conservative tool for budgeting purposes.

TABLE 2-2

STRESS SCENARIO CASH FLOWS (BBB Project)

Loan Amount		\$1,000,000								
Term (Years)		30								
Coupon Rate		7.00%								
	(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)
Year	Scheduled Payments	Delinq. Rate	Timely Payments	Shortfall	Recoverable	Repayment of Recoverables (Incl. Int.)	Total Payments Received	7.00% Discount Factor	NPV of Scheduled Payments	NPV of Actual Payments
1	80,586	5%	76,557	4,029	0	0	76,557	0.93458	75,314	71,549
2	80,586	10%	72,528	8,059	4,029	0	72,528	0.87344	70,387	63,349
3	80,586	20%	64,469	16,117	12,088	0	64,469	0.81630	65,783	52,626
4	80,586	30%	56,410	24,176	20,147	0	56,410	0.76290	61,479	43,035
5	80,586	45%	44,323	36,264	32,235	0	44,323	0.71299	57,457	31,601
6	80,586	42%	46,740	33,846	29,817	703	47,443	0.66634	53,698	31,613
7	80,586	39%	49,158	31,429	27,399	2,811	51,969	0.62275	50,185	32,364
8	80,586	36%	51,575	29,011	24,982	6,325	57,900	0.58201	46,902	33,699
9	80,586	33%	53,993	26,594	22,564	11,947	65,940	0.54393	43,834	35,867
10	80,586	30%	56,410	24,176	20,147	17,148	73,558	0.50835	40,966	37,393
11	80,586	26%	59,634	20,952	16,923	21,927	81,561	0.47509	38,286	38,749
12	80,586	22%	62,857	17,729	13,700	26,284	89,142	0.44401	35,781	39,580
13	80,586	18%	66,081	14,506	10,476	30,220	96,301	0.41496	33,440	39,961
14	80,586	14%	69,304	11,282	7,253	33,734	103,038	0.38782	31,253	39,960
15	80,586	10%	72,528	8,059	4,029	36,686	109,213	0.36245	29,208	39,584
16	80,586	8%	74,139	6,447	2,418	38,372	112,512	0.33873	27,297	38,112
17	80,586	5%	76,557	4,029	0	38,091	114,648	0.31657	25,512	36,295
18	80,586	5%	76,557	4,029	0	35,842	112,399	0.29586	23,843	33,255
19	80,586	5%	76,557	4,029	0	30,923	107,480	0.27651	22,283	29,719
20	80,586	5%	76,557	4,029	0	26,144	102,701	0.25842	20,825	26,540
21	80,586	5%	76,557	4,029	0	21,365	97,922	0.24151	19,463	23,649
22	80,586	5%	76,557	4,029	0	17,007	93,565	0.22571	18,189	21,119
23	80,586	5%	76,557	4,029	0	13,072	89,629	0.21095	16,999	18,907
24	80,586	5%	76,557	4,029	0	9,558	86,115	0.19715	15,887	16,977
25	80,586	5%	76,557	4,029	0	6,606	83,163	0.18425	14,848	15,323
26	80,586	5%	76,557	4,029	0	4,217	80,774	0.17220	13,877	13,909
27	80,586	5%	76,557	4,029	0	2,389	78,947	0.16093	12,969	12,705
28	80,586	5%	76,557	4,029	0	1,124	77,682	0.15040	12,120	11,683
29	80,586	5%	76,557	4,029	0	422	76,979	0.14056	11,327	10,820
30	80,586	5%	76,557	4,029	0	0	76,557	0.13137	10,586	10,057
Nominal Total	2,417,592		2,048,506	369,086	248,206	432,917	2,481,423		1,000,000	950,000

Notes:

Column A is the level annual repayment required for \$1,000,000 borrowed for 30 years at an interest rate of 7.00%.

Column B is based on Fitch estimates of start-up toll road delinquencies and recoveries under a stress scenario.

Column C = Column A x (1 - Column B).

Column D = Column A - Column C.

Column E = Column D less 5% of Column A, which is not recoverable (capital charge for 'BBB' project).

Column F is the amount received from recoverables in each year. Recoverables are assumed to be deferred for four years with payments amortized over a ten year period.

Column G = Column C + Column F.

Column I = Column A x Column H.

Column J = Column G x Column H.



Federal Highway Administration

Office of Budget and Finance
Federal-aid Financial Management Division
HFS-40, Room 4310
400 Seventh Street, SW
Washington, DC 20590

Facsimile Transmission

Date: Mon, Feb 24, 1997
Time: 6:00 pm (EST)
Pages: 17 + cover

To: **Mark Mazur** **Dorothy Robyn**
Fax Number: (202) 395-6809 Fax Number: (202) 456-2223

From: **Bryan Grote**
Fax Number: (202) 366-7493
Tel Number: (202) 366-5785
E-Mail: Bryan.Grote@FHWA.DOT.GOV

Message: Sorry about neglecting to send this to you earlier. This is what we faxed over to Treasury and OMB earlier today (around noon). To my knowledge, no meetings have been scheduled yet. I will try to check with Jane Garvey this evening about that. Attached are:

- 1) a short cover note from Jane to Mozelle
- 2) revised credit language
- 3) revised section-by-section

Please call me if you have any questions or need additional information.

The information contained in this facsimile message is intended only for the personal and confidential use of the designated recipient(s) named above. If the reader of this message is not the intended recipient or an agent responsible for delivering it to the intended recipient, you are hereby notified that you have received this document in error, and that any review, dissemination, distribution, or copying of this message is strictly prohibited. If you have received this communication in error, please notify us immediately by telephone and return the original message to us by mail. Thank you.



U.S. Department
of Transportation
**Federal Highway
Administration**

Office of the Administrator

400 Seventh St., S.W.
Washington, D.C. 20590

February 24, 1997

Dear Mozelle:

Per our productive discussion on Friday and Paula Farrell's helpful written comments, we have revised the credit proposal (Title V of the ISTEA reauthorization bill) and are faxing it to you for your review. Perhaps we can meet again Tuesday morning to discuss further?

- We have "boxed in" the flexible/forbearance aspects of the flexible payment loan more tightly to alleviate subordination concerns: unique to this type of infrastructure financing, security features such as rate covenants and coverage requirements are used to pledge project revenues to repay the loan; as before, the loan cannot be subordinated to other claims in the event of default; repayments can be made from user fees such as tolls but not from Federal sources; and allowance of deferrals is limited to the 10-year "ramp-up" period following substantial completion, and the borrower must demonstrate that it is acting under the necessary covenants and other required terms and conditions to become current in its payments.
- We have also developed the reserve account deposit concept you raised on Friday, in lieu of the standby line of credit: the deposit would be in the form of a loan that would be repaid with interest after the 10-year ramp-up period following substantial completion; any draws on the reserve deposit would be repaid with interest within 5 years from the end of the ramp-up period; and the amount of the deposit would be limited to 15% of project costs.
- Other changes include: a new eligibility criterion that the project cannot otherwise obtain adequate financing on more reasonable terms and conditions; a requirement for security features such as rate covenants to assure repayment; a provision for establishing fees to help cover subsidy costs; and clarification that estimation of subsidy costs and authorization of annual subsidy appropriations and credit limits are in accordance with the Federal Credit Reform Act.

Jane F. Garvey
Acting Administrator

TITLE V--INFRASTRUCTURE CREDIT

SEC. 5001. SHORT TITLE.

This title may be cited as the "Transportation Infrastructure Credit Act of 1997".

SEC. 5002. FINDINGS.

Congress finds that--

(a) The economic vitality of the Nation and the quality of life of its citizens depend upon continued investment in surface transportation infrastructure for the movement of both people and goods.

(b) The Nation's needs to maintain, reconstruct, and provide additional transportation infrastructure investment in both rural and urban areas exceed available resources under traditional programs.

(c) While recent Federal initiatives have equipped States with new financing tools, certain large infrastructure projects of national significance cannot be adequately funded through existing grant programs or private capital markets and would benefit from new forms of Federal assistance.

(d) A capital investment program for constructing, reconstructing, and expanding transportation infrastructure will create both direct and indirect jobs.

(e) Investing in trade corridors will stimulate exports and enhance the Nation's competitiveness in the world economy.

(f) Providing new, innovative ways to finance transportation infrastructure will leverage limited Federal resources and meet critical investment needs.

(g) Fostering public-private partnerships will attract private capital, advance necessary

1 projects through the development stage, control costs during construction, and improve the
2 management of transportation facilities.

3 (h) Taking advantage of the public's willingness to pay user fees to receive the benefits
4 and services of transportation infrastructure sooner than would be possible under traditional
5 grant-based financing will result in a more efficient and equitable allocation of the Nation's
6 resources.

7 **SEC. 5003. DEFINITIONS.**

8 As used in this title, unless the context requires otherwise--

9 (a) The term "Direct Loan" means any flexible payment loan or capital reserve deposit
10 provided to an Obligor in connection with the financing of a Project under sections 5005 or 5006
11 of this title.

12 (b) The term "Eligible Project Costs" means all amounts paid by or for the account of an
13 Obligor in connection with a Project, including--

14 (1) development phase activities, including planning, feasibility analysis,
15 environmental review, permitting, preliminary engineering and design work, and other pre-
16 construction activities;

17 (2) construction, reconstruction, rehabilitation, replacement, and acquisition of real
18 property, and the acquisition of equipment; and

19 (3) interest costs, reasonably required reserve funds, and issuance expenses.

20 (c) The term "Local Servicer" means a State infrastructure bank established under title 23,
21 United States Code, or a State or local government or any agency thereof that is responsible for
22 servicing a Direct Loan on behalf of the Secretary.

(d) The term "Obligor" means any party primarily liable for payment of the principal of or interest on any Direct Loan made under sections 5005 or 5006 of this title, whether a corporation, partnership, joint venture, trust, or governmental entity or instrumentality; provided that if such entity is not a State or local government or any agency thereof, the project it is undertaking shall be publicly sponsored, as provided in paragraphs 5004(a)(3) and (4) of this title.

(e) The term "Project" means any surface transportation facility eligible for Federal assistance under title 23 or chapter 53 of title 49, United States Code.

(f) The term "Project Obligation" means any note, bond, debenture, or other evidence of indebtedness issued by an Obligor in connection with the financing of a Project other than a Direct Loan provided under this title.

(g) The term "Secretary" means the Secretary of Transportation.

(h) The term "State" shall have the meaning such term has in 23 U.S.C. 101.

(i) The term "Substantial Completion" means the time at which a Project opens to vehicular, passenger, or freight traffic.

SEC. 5004. DETERMINATION OF ELIGIBILITY AND PROJECT SELECTION.

(a) **ELIGIBILITY.**--For a Project to receive financial assistance under this title, it must meet the following criteria.

(1) The Secretary shall determine that the Project is nationally significant, based on the extent to which the Project will transport passengers or freight at lower costs or higher efficiency, will advance multi-state corridors, will otherwise promote metropolitan, regional, interstate, or international commerce, or other factors.

(2) The Project sponsor shall demonstrate to the Secretary that the Project cannot

1 otherwise obtain adequate financing on more reasonable terms and conditions.

2 (3) The Project shall satisfy the applicable Statewide planning requirements of 23
3 U.S.C. 135 and the metropolitan planning requirements of 23 U.S.C. 134 at the time any
4 loan or deposit agreement is entered into under this title.

5 (4) The Project application shall be submitted to the Secretary by a State or a
6 Local Servicer.

7 (5) Eligible Project Costs shall equal or exceed the lesser of \$100,000,000 or 50
8 percent of the most recent annual amount of Federal-aid highway funds apportioned under
9 title 23, United States Code, to the State in which the Project is located.

10 (6) Project financing shall be payable in whole or in part by user charges, such as
11 tolls, or other dedicated revenue sources.

12 (b) SELECTION AMONG ELIGIBLE PROJECTS.--The Secretary shall establish criteria
13 for selecting among Projects that meet the eligibility criteria of subsection (a) of this section.
14 Such selection criteria shall include--

15 (1) the credit-worthiness of the Project, including a determination by the Secretary
16 that any financing for the Project has appropriate security features, such as a rate
17 covenant, to assure repayment;

18 (2) the extent to which assistance under this title would foster innovative public-
19 private partnerships and attract private capital investment;

20 (3) the likelihood that assistance under this title would enable the Project to
21 proceed at an earlier date than would be the case otherwise;

22 (4) the extent to which user fees will be collected using new technologies that

1 enhance the flow of commerce; and

2 (5) the amount of budget authority required to fund any Direct Loan provided
3 under this title.

4 (c) **FEDERAL REQUIREMENTS.**--All requirements of titles 23 and 49, United States
5 Code, shall apply to funds made available under this title and Projects assisted with such funds
6 unless the Secretary determines that any such requirement, other than 23 U.S.C. 113 and 49
7 U.S.C. 5333, is inconsistent with any provision of this title. Nothing in this subsection shall affect
8 any responsibility or obligation of the Secretary under any other Federal law, including the
9 National Environmental Policy Act of 1969 (42 U.S.C. 4321 et seq.), title VI of the Civil Rights
10 Act of 1964 (42 U.S.C. 2000d et seq.), and the Uniform Relocation Assistance and Land
11 Acquisition Policies Act of 1970 (42 U.S.C. 4601 et seq.).

12 **SEC. 5005. FLEXIBLE PAYMENT LOANS.**

13 (a) **IN GENERAL.**--The Secretary is authorized to enter into agreements with one or
14 more Obligor to make Direct Loans the proceeds of which are used either to finance Eligible
15 Project Costs or refinance interim construction financing of such costs of any Project selected
16 under section 5004 of this title, provided that no loan agreement shall refinance interim
17 construction financing later than one year after the date of Substantial Completion.

18 (b) **TERMS AND LIMITATIONS.**--

19 (1) A loan agreement under this section shall be on such terms and conditions and
20 contain such covenants, representations, warranties, and other requirements (including
21 requirements for audits) as the Secretary determines.

22 (2) A Direct Loan under this section shall not be subordinated to the claims of

1 other lenders in the event of Obligor default.

2 (3) A Direct Loan under this section shall be payable from revenues generated by
3 any rate covenant, coverage requirement, or similar security feature supporting other
4 Project Obligations.

5 (4) The Secretary shall make a Direct Loan under this section for not more than 33
6 percent of Eligible Project Costs.

7 (5) The final maturity date of a Direct Loan under this section shall be not more
8 than 30 years after the date of Substantial Completion.

9 (6) The Secretary shall charge interest on a Direct Loan under this section equal to
10 the average interest rate on marketable United States Treasury securities of a similar
11 maturity to such Direct Loan on the date of obligation of the loan agreement.

12 (7) The Secretary may establish fees on any Direct Loan under this section at a
13 level sufficient to cover the costs to the Federal government of making the Direct Loan.

14 (c) REPAYMENT.--

15 (1) The Secretary shall establish a repayment schedule for each Direct Loan under
16 this section based on the projected cash flow from Project revenues and other repayment
17 sources.

18 (2) Scheduled loan repayments of principal or interest on a Direct Loan under this
19 section shall commence not later than 5 years after Substantial Completion of the Project.

20 (3) The sources of funds for scheduled repayments shall be tolls, user fees, or other
21 dedicated revenues, and shall not include Federal funds.

22 (4) In the event that the Project initially is unable to generate sufficient revenues to

1 pay scheduled principal and interest, the Secretary may, for a period not to exceed 10
2 years after the date of Substantial Completion, allow the Obligor to add unpaid principal
3 and interest to the outstanding balance of a Direct Loan under this section, provided that
4 the loan terms and conditions established under paragraphs (b)(1) and (b)(3) of this
5 section require the Obligor to increase revenues or decrease costs so as to become current
6 in its payments.

7 (5) Any payments deferred under paragraph (4) shall continue to accrue interest in
8 accordance with paragraph (b)(6) of this section until fully repaid.

9 **SEC. 5006. CAPITAL RESERVE DEPOSITS.**

10 (a) IN GENERAL.--The Secretary is authorized to enter into agreements with one or more
11 Obligor to make deposits, by means of Direct Loans, to fund capital reserve accounts for any
12 Project selected under section 5004 of this title. Any such deposit shall be available to pay debt
13 service costs on Project Obligations other than Direct Loans.

14 (b) TERMS AND LIMITATIONS.--

15 (1) A deposit agreement under this section shall be on such terms and conditions and
16 contain such covenants, representations, warranties, and other requirements (including
17 requirements for audits), as the Secretary determines.

18 (2) The repayment of a deposit shall not be subordinated to the claims of other lenders
19 in the event of Obligor default.

20 (3) Draws on a deposit shall only be made if other funds available for such purposes,
21 including any other reserve funds, are exhausted.

22 (4) Deposits shall be invested in United States Treasury securities, bank deposits, or

1 such other financing instruments as the Secretary may approve to earn interest to enhance the
2 account.

3 (5) Any interest earned on deposits shall be credited to the capital reserve account.

4 (6) The total amount of a deposit shall be not more than 15 percent of Eligible Project
5 Costs.

6 (7) A deposit shall be available for draws during the period beginning on the date of
7 Substantial Completion and ending no later than the day that is 10 years following such date.

8 (8) The Secretary shall charge interest on a deposit equal to the average interest rate
9 on marketable United States Treasury securities of a similar maturity to such deposit on the
10 date of obligation of the deposit agreement.

11 (9) The Secretary may establish fees on any deposit at a level sufficient to cover the
12 costs to the Federal government of making the deposit.

13 (10) No third party creditor of the Obligor shall have any right against the Federal
14 Government with respect to any draw on a deposit.

15 (11) A deposit shall not be made for a Project that is also the recipient of a flexible
16 payment loan under section 5005 of this title.

17 (c) REPAYMENT.--

18 (1) The principal amount of a deposit shall be repaid, with interest, by the end of the
19 availability period established under paragraph (b)(7) of this section, except that any draw on
20 the deposit shall be repaid, with interest, by no later than 5 years after the end of such
21 availability period.

22 (2) The sources of funds for scheduled repayments shall be tolls, user fees, or other

dedicated revenues, and shall not include Federal funds.

SEC. 5007. PROJECT SERVICING.

The State in which a Project receiving financial assistance under this title is located shall identify a Local Servicer to assist the Secretary in servicing any Direct Loan provided under this title. Such Local Servicer shall act as the agent for the Secretary, and may receive a servicing fee, subject to approval by the Secretary. Such Local Servicer shall not be liable for the obligations of the Obligor to the Secretary.

SEC. 5008. RULES AND REGULATIONS.

The Secretary is authorized to make such rules and regulations as deemed necessary or appropriate to carry out the purposes and provisions of this title.

SEC. 5009. STATE AND LOCAL PERMITS.

The provision of financial assistance under this title shall not--

(a) relieve any recipient of such assistance of any obligation to obtain any required State or local permits and approvals;

(b) limit the right of any State or local governmental unit to approve or regulate rates of return on private equity invested in a Project; or

(c) otherwise supersede any State or local law or regulation applicable to the construction or operation of such Project.

SEC. 5010. FUNDING.

(a) DETERMINATION OF BUDGET COSTS.--The Secretary shall estimate the subsidy costs of providing financial assistance to Projects under sections 5005 and 5006 of this title in accordance with the Federal Credit Reform Act of 1990 and, in so doing, may require each

1 Project sponsor to provide a preliminary rating opinion letter from a nationally-recognized bond
2 rating agency.

3 (b) AUTHORIZATION OF APPROPRIATIONS.--

4 (1) SUBSIDY COSTS.--For the subsidy costs of Direct Loans made under this title,
5 there are authorized to be appropriated from the Highway Trust Fund (other than the Mass
6 Transit Account) \$99,400,000 for each of fiscal years 1998, 1999, 2000, 2001, 2002, and
7 2003, to remain available until expended.

8 (2) ADMINISTRATION.--For administering the provisions of this title, there are
9 authorized to be appropriated from the Highway Trust Fund (other than the Mass Transit
10 Account) \$600,000 for each of fiscal years 1998, 1999, 2000, 2001, 2002, and 2003.

11 (d) LIMITATIONS ON CREDIT AMOUNTS.-- Principal amounts of Direct Loans provided
12 under this title shall be limited to \$2,000,000,000 for each of fiscal years 1998, 1999, 2000, 2001,
13 2002, and 2003.

2/23/97/9:50pm

TITLE V--INFRASTRUCTURE CREDIT

Sec. 5001. Short Title

This section identifies a new Federal credit assistance program for surface transportation as the Transportation Infrastructure Credit Act of 1997.

Sec. 5002. Findings

This section recites Congressional findings that current public sector resources, including Federal grants, are insufficient to meet the Nation's transportation infrastructure investment needs in both urban and rural areas. These include building new facilities as well as renovating or expanding existing facilities. The funding gap is particularly acute for large projects of national significance, due to their scale and complexity. A new Federal credit program for transportation will help address these projects' special needs by supplementing existing Federal programs and leveraging private capital investment.

This title is designed to encourage the development of large, capital-intensive infrastructure facilities through public-private partnerships consisting of a State or local governmental project sponsor and one or more private sector firms involved in the design, construction or operation of the facility. The Federal credit program is targeted to those projects which are payable in whole or in part by user charges, such as tolls, or other non-Federal dedicated funding sources. By taking advantage of the public's willingness to pay user fees to receive the benefits and services of transportation infrastructure sooner than would be possible under traditional grant-based financing, the program will result in a more efficient and equitable allocation of the Nation's resources.

The program should result in additional surface transportation facilities being developed more quickly and at a lower cost than would be the case under conventional public procurement, funding and ownership. In addition to the benefits of enhanced accessibility in moving goods and people, such transportation facilities should provide benefits to the Nation in terms of stimulating job creation and enhancing the Nation's economic competitiveness overseas.

Sec. 5003. Definitions

This section sets forth the definitions for terms used in this title. Key terms are listed below:

A "Project" is defined as any surface transportation facility eligible under the expanded provisions of title 23 as well as chapter 53 of title 49, United States Code. Permitted Projects would include free or tolled highways, bridges and tunnels; mass transportation facilities and vehicles; publicly owned inter-city passenger rail facilities and vehicles (including Amtrak); publicly owned freight rail facilities; privately owned surface transportation facilities that are publicly sponsored and serve a public benefit; and various intermodal facilities.

The term "Eligible Project Costs" is defined to include those costs of a capital nature incurred by a sponsor in connection with developing an infrastructure Project. These costs fall into three categories: (i) pre-construction costs relating to planning, design, and securing governmental

permits and approvals; (ii) hard costs relating to the design and construction (or rehabilitation) of a project; and (iii) related soft costs associated with the financing of the project, such as interest during construction, reserve accounts, and issuance expenses. It would not include operation or maintenance costs.

An "Obligor" is defined as any entity (whether a State or local governmental unit, a private entity authorized by such governmental unit to develop a Project, or a public-private partnership) that is a borrower involving a direct loan, under either the flexible payment loan program set forth in section 5005 or the capital reserve deposit program set forth in section 5006, under this title.

A "Local Servicer" is defined as a State infrastructure bank or other designated State or local governmental agency which services the credit program on behalf of the Department of Transportation within that State.

"Substantial Completion" is defined as the date when a Project opens to vehicular, passenger, or freight traffic.

Sec. 5004. Determination of Eligibility and Project Selection

This section defines the threshold eligibility criteria for a Project to receive Federal credit assistance and outlines the basis upon which the Secretary will select among potential candidates. The Secretary's determination of a Project's eligibility will be based on both quantitative and qualitative factors.

Of prime importance, the Project must be deemed by the Secretary to be "nationally significant" in terms of facilitating the movement of people and goods in a more efficient and cost-effective manner, resulting in major economic benefits.

Also, the Project sponsor must demonstrate that it cannot obtain adequate financing on more reasonable terms and conditions from other sources in order to be eligible for Federal credit assistance. The Federal government must be the lender of last resort whose assistance in funding a portion of Project costs is necessary for the Project to access the private capital markets to obtain the balance of its required financing.

To ensure that the Project enjoys both State and local support, it must be included in the State's transportation plan and program and, if the Project is in a metropolitan area, it must satisfy all metropolitan planning requirements of 23 U.S.C. 134. The State or State-designated entity will be responsible for forwarding the Project application to the Secretary.

In terms of size, the Project must cost at least \$100,000,000 or an amount equal to 50 percent of the State's annual Federal-aid highway apportionments, whichever is less. This two-fold test is designed to allow small and rural States to accommodate Projects otherwise too large for their transportation programs. Based on fiscal year 1997 apportionments, 18 States could qualify Projects costing less than \$100 million, with the minimum amount equaling approximately \$40 million.

In addition, a Project must be supported at least in part by user charges, such as tolls, to encourage the development of new revenue streams and the participation of the private sector. In keeping with long-standing Federal policy, the credit assistance could not be repayable with future year Federal-aid highway apportionments.

Project applicants meeting the threshold eligibility criteria then will be evaluated by the Secretary based on a number of other factors. Among them are: The likelihood that the Federal assistance will enable the Project to proceed at an earlier date; the degree to which the Project leverages non-Federal resources, including private sector capital; the Project's overall creditworthiness, including assurance of repayment through a rate covenant or other security features; and the amount of budget authority (subsidy cost) required.

This section also provides that all requirements of titles 23 and 49, United States Code, shall apply to funds made available under this title and Projects assisted with such funds unless the Secretary determines that any such requirement is inconsistent with any provision of this title. This section provides, however, that the Secretary cannot waive 23 U.S.C. 113, the provision that applies Davis Bacon Act wage requirements to title 23 projects. This section does not affect the Secretary's responsibilities under any other Federal law.

Sec. 5005. Flexible Payment Loans

This section establishes a lending program whereby the Secretary may make direct Federal loans to help finance the costs of constructing Projects. The loans are contemplated to be made up front as combined construction and permanent financing, although the title allows them to be made up to a year after construction is completed for those Projects that have arranged interim construction financing.

Each loan would conform to the provisions contained in the Federal Credit Reform Act of 1990. A direct loan could be in an amount up to 33 percent of the cost of a Project, and could have a final maturity as long as 30 years after the date the Project opens (Substantial Completion). The interest rate would be established at the time the loan agreement was executed (obligated), and would equal the prevailing yield on comparable term U.S. Treasury securities. Fees may be established to help cover the costs of providing the loan, and loan repayments would be required to start within five years after the date of Substantial Completion.

The terms and conditions of each direct loan would be negotiated between the Secretary and the borrower; however, in the event of default, the Federal claim on Project assets would not be subordinated to the claims of other lenders. The loan would be repaid from the revenues generated by rate covenants, coverage requirements, and other security features supporting the Project's debt obligations.

The loan agreement could also allow some interest and principal payments to be deferred in the event annual Project revenues were insufficient to meet current debt service on the Federal loan. Such deferrals could be allowed only during the 10-year "ramp-up" period following Substantial Completion of the Project, and the loan agreement would have to provide that the borrower

demonstrate to the Secretary's satisfaction that it was using due diligence to become current in its payments. Any deferred payments would be added to the outstanding loan balance, and continue to accrue interest until repaid.

These two features (a participating lien on revenues and a flexible payment schedule) should assist Projects in obtaining "investment grade" bond ratings (i.e., BBB or higher) on their capital markets indebtedness.

Sec. 5006. Capital Reserve Deposits

This section authorizes the Secretary to enter into agreements to make deposits to fund capital reserve accounts used to support projects' debt service costs. The deposits would be in the form of direct loans conforming to the provisions of the Federal Credit Reform Act of 1990.

In contrast to the flexible payment loan, the capital reserve deposit would not be for the purpose of funding construction costs as part of the Project's initial capitalization. Rather, the deposit would seed a capital reserve account that could be drawn upon if needed to pay debt service on the Project's other obligations during the 10-year "ramp-up" period after the facility has opened. The deposit is designed to facilitate a Project's access to private capital by assisting it in obtaining investment grade ratings on its other debt.

The flexible payment loan and the capital reserve deposit are intended to address Projects with different financial needs based on their pro-forma capital structures. The flexible payment loan will be more useful to those Projects that must demonstrate to private lenders or capital markets debt investors that there is adequate coverage "going in" based on annual debt service, and where the cost of the Federal loan compares favorably with the cost of other borrowing alternatives. A capital reserve deposit is more likely to be used by Projects that are able to issue capital markets debt on favorable terms, but need to demonstrate access to contingent sources of capital to support debt service in the event revenues initially do not grow as quickly as annual payments of principal and interest. In the final analysis, a Project sponsor will seek the form of assistance which will provide it with the overall lowest cost of capital.

This section sets forth various limitations on the availability of capital reserve deposits. The deposit could only be drawn upon after the Project had used up other available revenues and reserves. It would only be available for a period of up to 10 years after Substantial Completion of the Project. The principal amount of the deposit could not exceed 15 percent of Eligible Project Costs.

The principal amount of the deposit must be repaid, with interest, by the end of the 10-year availability period following Substantial Completion. However, to the extent any draws were made from the capital reserve account, such draws would have to be repaid, with interest, within 5 years after the end of the 10-year availability period following Substantial Completion. The interest rate charged to the borrower would equal the prevailing yield on comparable term U.S. Treasury securities (i.e., the average rate on Treasury securities of 10-20 years) at the time of execution (obligation) of the deposit agreement. The Secretary may establish fees to help cover

the costs of providing the capital reserve deposit.

To avoid "double-dipping," a borrower could not combine a capital reserve deposit with a flexible payment loan for any given project.

Sec. 5007. Project Servicing

The program will use State or local governmental agencies to assist the Secretary in servicing each loan. The State may designate its State infrastructure bank or some other public agency to serve as the local servicing agent for the credit instrument.

The local servicing agent would function as a financing conduit, much like a mortgage company, and with the Secretary's approval it could charge a servicing fee. It would not be financially liable in any way for the credit provided; rather, it would assist in the disbursement and collection of funds. It would be required that the local servicing agent set up a separate account from its other activities to receive the Federal credit proceeds for disbursal to the borrower, and to receive loan repayments for remittance to the Secretary.

Sec. 5008. Rules and Regulations

Program guidelines will be established by the Secretary in order to ensure the program operates prudently and efficiently, including requiring Obligor to provide annual audits.

Sec. 5009. State and Local Permits

This section states that this title in no way supersedes any existing State or local laws, regulations, or Project approval requirements.

Sec. 5010. Funding

The budgetary cost associated with the program is the "subsidy cost" of the credit provided, as defined in the Federal Credit Reform Act of 1990. The subsidy cost represents the present value of expected cash flows for each loan, taking into account the default risk as well as any interest rate subsidy. Since all direct loans under this title are required to be made at a rate equal to the comparable term U.S. Treasury rate, there should be no interest subsidy element.

The title authorizes the Secretary to determine the risk of default with respect to a direct loan based on an independent credit analysis of the loan by a nationally-recognized bond rating agency (i.e., Fitch Investors Service, Moody's Investors Service, or Standard & Poor's Corporation). Such an analysis would enable the subsidy cost to be calculated using as a guideline the capital reserve requirements imposed by rating agencies on major municipal bond insurers guaranteeing infrastructure loans of similar quality to the direct loan.

Once a Project had been approved, its subsidy cost would be funded by obligating a like amount of budget authority provided under this section. Obligations of budget authority to fund a Project's subsidy cost would be liquidated from the Highway Trust Fund.

The title authorizes the appropriation of \$99,400,000 each year to fund the subsidy costs of any

flexible payment loans or capital reserve deposits made under sections 5005 and 5006, to remain available until expended. It also authorizes the appropriation of \$600,000 each year to fund the administrative costs of the credit program. The title limits the nominal amount of credit assistance that can be provided each year to \$2,000,000,000.

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Mozelle:

- Subordination just doesn't work

-

• This is in POTUS' budget.
It was fully talked thru
as s/thing

Proposed Meeting Agenda

SUMMARY OF KEY POLICY ISSUES ON THE TRANSPORTATION INFRASTRUCTURE CREDIT PROGRAM

February 26, 1997

A. PURPOSE OF THE FEDERAL CREDIT PROGRAM

Key Issue: Develop a Program for assisting large projects of National Significance to address demand from Project Sponsors

1. Promote Changes in Consumer Behavior (Tolling, Congestion Pricing)
2. Induce Majority Private Funding with Minority Federal Investment by filling Market Gaps (Liquidity, Flexibility, Time Horizon)
3. Provide Meaningful "Ground Rules" for an Equitable, Prudent and Effective Program (in lieu of current de facto program)

B. FLEXIBLE PAYMENT LOANS

Key Issue: Balance the Federal Requirement for Minimizing Risk with the Financing Needs of Project Sponsors

1. Parity Claim on Assets in Event of Default
2. Parity Claim on Project Revenues from Years 10-30
3. Parity Claim on Project Revenues *with Deferral* from years 1-10
4. Loan secured by Rate Covenants and other Features unique to Infrastructure Project Financings

C. CAPITAL RESERVE ACCOUNT

Key Issue: Ensure that Federal Credit does not create a larger Implied Liability on Project Debt

1. Use of Reserve Fund rather than Line of Credit interposes an entity between the Federal Government and the Investors
2. No evidence that Investors/Rating Agencies Perceive an implied Federal Obligation beyond the Explicit Limits of the Federal Participation (TCA, SRF Reserve Funds, WMATA, etc.)
3. Projects that have the ability to repay the Federal Contribution from Project Revenues should do so
4. Projects are too big to fund the Reserve Account with Outright Grants from a Budgetary viewpoint

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- Flexible loan payments

Does there exist any form of flexibility (forebearance of principal and interest payments) that does not constitute an indirect federal guarantee of tax-exempt debt?

If not, DOT may be stuck (but may want to fight this on the "guarantee" being incredibly remote and indirect).

If yes, Treasury should be able to suggest language that would meet their concerns.

(I think DOT's language on subordination in default is OK.)

- Tax-exempt debt

The "pilot project" of tax-exempt bonds for up to 10 private-public partnership toll roads is supposed to reflect an understanding between DOT & Treasury.

Is this the case?

If so, Treasury has no legitimate complaint.

If not, where is the disagreement?

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WASHINGTON

- delimited

- replaced line of credit w/

private activity bond

Currently - ^{you can't have} ~~no~~ full guar ^{on} dot-ex debt
b/c it's then better than Treas Securities

A-129

~~MM~~

2 issues

(1) scoring issue

should you ^{consider} ~~make~~ a line of credit a guar. or a direct loan

(2) legal def. issue

DOT wants to say: These are not

~~We can provide~~ guar's of DOT; they need

~~DOT~~ to get ruling to that effect to preserve dot-exempt status of

~~i.e., they want to A-129~~

DOT needs to make case

Why does

DOT taking big bite

MM - Last yr., we agreed on small bite.

The symptoms of loss of Crel

Lack of revenue in early yrs is

- Real problem toll roads

forecasts are
historically
optimistic, but
get better over
time.

- Doesn't have to be subsidized,
altho perhaps it cd be for a
while

Why
tax
Exempt?

- But it's
not an attractive I if it's
taxable

- you can't meet the debt
service if not tax exempt

Another plus:

Moreover,

This is how we get congestion pricing

- then private financing of infra.

- States don't have pol. will to build
toll roads

Other reaction:

- Make a separate Category

- DOT: ^{Wants to} Raise the cap for trans.

- R^o: This is not without cost,

But certainly better than MRBS

- This is where we need General Davies;
he & MM worked out 5/11/11, last
year - pilot

Sum

① Expanding tax-exempt debt pool that states can use.

② Legal def.

Do not want to say

Lines of credits ^{are} not guarantees,
So that they don't lose tax exemption

③ Direct loans & loan guar's

(a) Can we do either on tax-exempt debt? (b) Can it be subordinated.

④ Insurance

- need legis/ature reversed decisions made by old ones

Tues.

We should only ask for \$10M

Monday

POLITICS

W

John Parcell
Leg. counsel
Tax Policy
Preston Atkins

Cons.

Tax-exempt financing

(we don't want create new tax-exempt bonds
not subj.)

govt. guar's of —

Committee/parking Cash out BS

Committee w/
- parking/cashout proposal

(if goes forward, don't want cafeteria plans)

Without cafeteria plan, employee would have to make
a decision to offer a parking cash out

Cash out proposal in past

(If you want to have cash with plan B,
you can but it's taxable)

Did last year's proposal put it in the
Cafeteria plan?

(Treasury doesn't think so, but will check)

RL:

Didn't have sense Treas. was opposed to
this in past

MM:

(1) ~~Dispute~~ Dispute over whether it's a rev. raiser or
loan

Last yr.'s Treas. est. show it's a modest
rev. raiser (true of Ms)

(2) ?

RL:

Treas:

7

Concern is people will choose cash r/th
parking B if they have choice.

MM:

Let's go back to bal. budget proposal of first
year, which Treas. signed off on

RL:

X/T's:

→ \$160/month

MM:

This appears to be voluntary enough that
people want to do it even though they'll
pay more in taxes.

Tax - exempt financing / bonds

- Bruce David

Met:

Spent last yr. in Treas. ? Dot on pilot projects for ...

~~addition~~ add. additions to
under existing caps

Hwy Trust Fuel Taxes

- motorboat diesel tax

(goes to general fund
(was new - offset to e of luxury tax
(not included in baseline b/c doesn't go
to trust fund

We'd rather not extend it b/c it's
been lot of trouble & we have study

Preston Atkins Treas. (Mogel Thompson)

Credit proposals - (1) flexible payment prog.
(2) line-of-credit "
(3) devel. cost insurance "

Paul G.

James L.

~~Bruce~~ Davies

day exempt bonds outside volume caps
trying to set up act. for tomorrow

flexible payment

subordination

(i.e., other obligs are paid before
fed. govt.)

line-of-credit

DOT seeking explicit exemption from Vol
code

(effective fed. guar.)

flexible payment loan

(no express exemption)

(1) raises subordination problem

b/c doesn't recognize it's an exemption

(2) could result in an effective fed. guar.

OMB concurs

minor issues (Circ. 129):

1. approp's control

Insurance program

- What does this prog. do? (Grass.)
- not a credit program (OMB)

- What abt an add'l. service saying Fed \$s can't be used to repay tax-exempt debt

- Sop to developers

- Goal is to get more bidders & to lower cost & inc competition

- big moral hazard problems

(Regs. fund proj's funding then developer bidders will get backed out by insurance

direct loan program for taxable debt

DOT - Tax exemption

2 problems:

- Subordination
- guar of tax exempt

If you want to give a state/loc \$1000 to pave a road, what's the most efficient way?

- \$1000 grant costs feds \$1000
- \$1000 tax exemption costs feds ~\$1200
b/c of nature of tax system

\$200 goes to tax-exempt bond holders, who are not a group we want to reward

MT:

I raised all of this last yr. Asked them

Deitch:

Pts. don't shed me ISTEEN before that Trs.

hasn't cleared.

- Consultant never called me...

11/22/97 Thompson / J. - DOT

2-21-97

Wed. 10am

Thurs. 10am

~~11/22/97~~

~~11/22/97~~

Steve Martin:

Review how we got here:

(1) Looking for alt. to massive grant approach.

(2) The Est. framework in which toll roads could go forward

Biggest problem w/ S/Bs - no real fear

W/out that, no long run solution

Currently - don't not enough experience to get studies, etc. of toll road.

E.g., Tex. Tpk Authority -

hard to get people to sign on
b/c of uncertainty about rev.

TCX

A/ameda Cor.

OMB told us: come up w/ program w/
key areas -

So, 2

(1) ~~Mkt~~^{pol.} failure in getting toll roads

(2) Pol. push comes to us in way we can't handle

Scoring ratio for TCA vs New Court
is 10:1

Why so bad on N.C.?

- We thought ~~work~~ for

Scoring takes all risk up front - Outpooled
each year

So we were asked to come up w/ alternative
scoring mech's:

Need for s/bing to get these proj's moving
in current environ.

Eventually, no one will want to go this
route b/c they won't have to.

We got off on wrong foot b/c of N.C.

MT - I agree -

SM:

We proposed that you be last one in
1st 15th one in

But we got slain drunk by Eric.

~~Rebut~~

Lang. in bill is patterned after that.
If there's a better way, ...

Analogy to shipbldg. language - asset is
not divisible.

SM:

Way to come up w/ rule for fed pool.
That's not subordinate.

Linda
Skypel:

Reqs that will make easier to finance JV
proj's such as roads

(will be very helpful

SM: OverCh we reached last yr. was that
this didn't be done respectively.

5

SM:

Write 129 language in 7 say fed 100%
subordinate

Our going in pos:

Structure so will not in subord. position
in event of default

We want bond holders to feel...

We tried to structure S.C. so we had
control over flow of CV's

MT: The reason
Bond holders want you involved is the
reason we don't want to be.

2 Bonds

(1) Subordination

(2) ^{Real} Share ...

MT:

^{where} Fairness & secretarial discretion are
present.

There's tremendous pol. pressure to
Waive

- rural etc crops - wave payment penalties
- etc Bonneville Power - add to life of loan

SM: we were trying to structure sth
that wld be flexible

~~MT: we were trying to structure sth~~

MT: — flex. leaves fed govt if look for life
of pan

— grant is preferable b/c it puts box around
it.

Jade:

but grant has fin. lim. it; some
proj's are too big

Credit enhancement tells world needed b/c
of Fed cong. Σ /making

(1) Inboard: we cd wait

(2) Are we adding credit enhancement
that collides w/ other fed policy

(MT: and does it replace other
mkt. participants)

SM: We put 33% part. as upper bound
to try to avoid that

5.4: Subred.

- We've tried to just feel good same as
as others in our ability to affect NW's
e.g., ability to ↑ tolls

(3) we're trying to entice with displaced the
what.

Is transitional good, fed. good can
bring 2 things to the table?

(1) patience

(2) ?

What's diff. to what you're proposing and an
equity I:

MT:

- \$100M of B.S. - that's the

- Size of resulting prog. depends on scoring

- If it's 10% on dollar, it's → \$1B program.

MT:

needs to read Fitch daily; think about it

The reason you want to do it is reason we don't want to

Isn't there another way that doesn't result in that much exposure

e.g., using grants to purchase credit enhancements

DT: That would overcome the time horizon problem problem

It's not the cost, it's the risk & liquidity

SM: Best place to put the risk is w/ SCORING.

MT: That's where I disagree.

SM: Is there way to put better limit on risk

Big issue for DOT:

Are we willing to accept ↑ cost; risk
to move toward user-fee

MT:

Assuming that's true, do we have a good
understanding of risk

Standby lines of credit:

Does DOT really want this discretion?

DS: Policy & risk issues are the same -

This is an old tool

MT: This is more problematic b/c it goes to
providing a backstop - double dip

It's ~~more~~ more direct; it's more problematic

DS: Were aware of 129 policy, this product
wld get 3/4y to BBB rating - not
AAA. so would compete w/ Treas. securities

Joachim /
Sam Gochman } BBB rating

MM

Investors don't think if one of credit were
burnt down that they wld ~~be~~ look to
fed govt.

MT: WHOOPS

DS: This is private; Ltd.

MT: But as soon as you say fed govt has
agreed to provide a partial backstop, perception
is that we're signing up in ambiguity.

SM: We tried to come up w/ way for
STBs to do this, so as to provide a
buffer

We haven't figured out mechanical
way, but cld try again

MT: Going back to

, short-term grant

Have Fed's bankroll, a debt service reserve fund?

DS: Line of credit is same idea, but it's easier to structure it that way -

approved

Devel. Cost insurance

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— E. Hansel Vax

- flexible payments is key w/ ~~cash~~ w/out subordination

- DOT's proposal for $\leftrightarrow$ tax-exempt debt pool is what was agreed on last yr - 10 pilots