

Case Studies of Alternative Approaches to Project Financing, Act II

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OVERVIEW OF TRANSIT INNOVATIVE FINANCE PROJECTS

Sharon Greene

Today I will be talking about innovative finance for transit projects. I will first cover the application of innovative financing to some specific niche markets. I will then look at some innovations related to private-sector participation and transit partnerships, approaches to leveraging assets, and new techniques for value capture and value transfer. I will close with some observations for the future.

First, with regard to the state of the practice generally, we see relatively limited use of innovative financing for new starts projects as they come through the Section 5309 new starts pipeline, which refers to one of the major discretionary elements of federal funding for new transit projects. Why is this? Part of it is a timing issue. Part of it stems from the fact that the key issue facing transit agencies is the need to find a dedicated source of funding. Once they have identified that resource, they can use it on their own for repayment of debt or pay-as-you-go funding. Still, there are particular niche markets that transit innovative finance techniques address. In particular, innovative techniques can be useful for agencies dealing with cash-flow imbalances, debt capacity concerns, or revenue sufficiency issues.

On the cash flow side, transit GARVEEs, often referred to as grant anticipation notes or GANs, pro-

vide a mechanism to address short-term cash needs. As you know, the idea here is to borrow in the capital markets using projected federal transit revenues to pay debt service. There has been an evolution in the types of transit revenues that can be pledged to GARVEE instruments and accepted by the financing community. At first, transit agencies relied on formula funds under the Section 5307 formula program. Then they moved on to Section 5309 fixed-guideway modernization funds (which essentially are distributed by formula), and finally to discretionary funds under the 5309 new starts process, particularly for funding made available under full funding grant agreements (FFGAs).

With respect to short-term cash flow issues, certainly New Jersey Transit's Hudson-Bergen line provides a minihistory. The first debt issues were essentially GANs that were backed by FTA formula funds and a backstop from New Jersey's Transportation Trust Fund. The second time New Jersey Transit went out to borrow for Hudson-Bergen, it did not require a backup source of funds for its anticipated federal formula funds. And next came GANs backed by FFGA revenues. We certainly have seen an evolution in how the different types of FTA funds have been accepted.

A slightly different form of FTA funding was used by the city of Phoenix, which pledged fixed-guideway modernization funds in combination with formula funds to acquire buses for Phoenix Transit. In just the past couple of years we have come a long way. As recently as 1998, the Utah Transit Authority was required to use a full range of its transportation system revenues to back the bonds it issued for the first phase

of construction of the TRAX light rail project. This was despite the fact that the agency was already in the third year of its FTA FFGA. However, at that time FFGA revenues were not considered by the finance community to have any stability. We have evolved a long way since then, and it was not that long ago.

What are some of the other markets for which innovative financing could have appeal? TIFIA, the federal credit program you have heard so much about at this conference, offers a number of loan and credit provisions that can provide supplementary capital to transit as well as highway properties. In the short term these credit instruments can address antideficiency clauses that require an agency to have funding in place before it goes out to issue a contract for a capital program. In the longer term, TIFIA can help address revenue and capacity shortfalls, in part because of the very flexible payback provisions it affords.

To illustrate one of the short-term cases, I will use the Washington Metropolitan Area Transit Authority (WMATA) and its antideficiency clause. WMATA needed a loan to go out to bid. Lehman Brothers provided the loan, which WMATA has no intention of ever using. TIFIA provides a guarantee on this commercial loan—so it is basically a guarantee on something that will never become an obligation.

In addition to innovative financing in the form of GARVEEs and TIFIA, let's look at the evolving role for the private sector in the full range of project development and operations activities. Let me suggest two good models. One is offered by the Private Finance Initiative in Great Britain. In this instance the private sector plays the predominant role, but the government is involved to the extent that a subsidy is required. Projects are selected on the basis of those that offer the lowest public-sector payment requirements. And second, we in the United States can now use nonprofit corporations to take advantage of differentials in interest rates between taxable and tax-free debt.

One of the most interesting project-specific examples is the Las Vegas monorail project. This is the ultimate private project and may not have much applicability elsewhere. The sponsor is a not-for-profit corporation that will be composed chiefly of the hotels and government agencies. The project will be privately financed under a DBOM contract and franchise agreement and will include a layer of subordinated debt provided by the hotel and resort owners. The project will derive its revenues from advertising, concessions, and fares. These fares will typically be invisible to the customers, thanks to some kind of subsidy from the hotel and resort owners.

One aspect of the monorail project that may have some real interest for other systems is the likely use of naming rights along the lines of what we see for stadi-

ums, convention centers, and other large visible public facilities. This will be a real testing ground for how naming rights can be applied to transit situations, including the potential for naming entire systems, individual rail vehicles, or individual stations.

Next I would like to talk about ways in which assets can be leveraged. Railtrack in Great Britain provides an example. As the next stage in the life of what used to be British Rail, Railtrack is a private corporation that owns the railroad infrastructure. This private corporation issues franchises to passenger train operating companies for passenger services, some of which are subsidized by the government. It also issues franchises to freight train operators and certain others.

How does this model translate to the U.S. experience and institutional structure? In a number of corridors, particularly those where commuter rail is the mode of choice, public agencies are acquiring rail rights-of-way for passenger services. Now, in some cases there are restrictions on what they can leverage off of the asset; in some cases the agencies do not acquire freight rights or fiber-optic rights when they acquire the right-of-way from the railroad. In other cases the agencies acquire the right-of-way with a built-in client such as a freight operator or Amtrak, and thus the amount of revenue they can derive from the asset is somewhat fixed.

Nonetheless, a sophisticated agency will look at that asset and ask, If there is intercity rail service running on that line now, can I derive revenue from existing uses, and how might that make it easier for me, in the longer term, to implement the programs I ultimately want? It is necessary to focus not just on the lease revenue streams but also on the interim uses and the types of targeted grant and loan programs that can be used for improving the asset.

In the areas of value capture and value sharing, we see new partnerships for transit-oriented development. Consider, for example, the 49 ha (120 acres) that Portland, Oregon, has used as a mechanism to further the light rail line to the airport; Joseph Walsh will be discussing that project in a moment. Also, partnerships for multimodal capital programs have found success not just by looking at dedicated revenue streams for each of the individual modes involved, but rather by looking at opportunities for pooling those revenue streams. The Southeast Corridor in Colorado, which Heather Dugan spoke about in an earlier presentation, provides an excellent example.

Shared-resource agreements provide another means of leveraging assets. Certainly a number of agencies are looking at the intersection of ITS technology, fiber-optic cable, and public rights-of-way. Many agencies know that they cannot finance the installation of the infrastructure needed to support ITS on their own but realize they can get this service for free, in return offering pri-

vate telecommunications firms access to the necessary right-of-way.

What are the future directions? Clearly, what we see is that innovation is as innovation does. An innovative agency will tailor both innovative and conventional techniques to its unique opportunities and constraints. The focus should not only center on the tools but also on enhancing the agency's understanding of those tools.

Federal authorizing legislation in the forms of ISTEA and TEA-21 provided an excellent basis on which we should continue to build. There is an opportunity to build on the regulatory, credit, and tax incentives mentioned in the resource paper that Bryan Grote, Jeffrey Parker, and David Seltzer prepared for this conference. If you have not yet had a chance to read it, I would like to give it a plug. In closing, I also note that it would definitely help if transit properties could enjoy the same expectations with regard to future federal funding that highway agencies currently enjoy under TEA-21. If this were the case, transit properties would be able to use and leverage their transit revenues more flexibly.

PORTLAND, OREGON, AIRPORT MAX (LIGHT RAIL)

Joseph Walsh

I am a project guy, not a finance guy, and I want to offer up some war stories on how we developed the project and assembled different pieces of financing. I would also like to provide some thoughts on lessons learned.

To lead off with some background, Portland's airport MAX is an 8.9-km (5.5-mi) extension to a 53-km (33-mi) light rail system. The airport extension will open in September 2001. It is supported by a number of innovative funding sources, including passenger facility charges (PFCs) and private equity from Bechtel Enterprises. It is a design/build project with a project cost of about \$125 million, and we are about 60 percent complete. So far, so good.

Now I will say a bit about the regional context. As is the case just about everywhere, a strong economy is driving significant growth at the airport. We are looking at passenger growth of about 150 percent over the next 10 years, and even more on the freight side. One essential thing to understand about Portland is that light rail is a key part of the land use and growth management equation. In looking at solving airport congestion, Portland

was certainly keen on light rail as a potential part of the solution.

How did we approach this? First, even though the full project is within the corporate boundaries of the city of Portland, we went through the full regional decision-making process, especially since a good bit of the funding for Tri-Met, Portland's light rail agency, comes from throughout the region. Next, we knew we were not going to be looking at new revenue sources or federal money. Even though things are getting more and more innovative on the federal front, I have to say that using local money still allowed us to do some things that we would not have been able to do had federal funds been involved.

Where does the money come from? It is a relatively proportionate split, starting with \$46 million in Tri-Met revenues. The Port of Portland brought in \$28 million in PFCs, and the city of Portland contributed \$23 million in urban renewal tax increment funding. Cascades, our private partner, will contribute \$28.3 million in real-estate development proceeds. Thus, each partner contributes—and receives—something of value. That was one of the key building blocks of the project. Tri-Met gets an extension to its light rail system. The city, through its tax increment funding, grows a tax base and, probably more important for it, grows the job base with the addition of 10,000 high-wage jobs associated with real-estate development around the light rail extension. The port, with the PFCs of course, expands access to the airport and candidly buys some very good will by joining the regional effort. Finally, Cascades takes the development proceeds from the larger real-estate development; its \$28 million contribution is but a small portion of the total.

The diversity of funding sources brings up some interesting restrictions, which we call the "color of money" challenge. Because of this challenge, we target the PFCs to the airport terminal segment. And we face a lot of geographic restrictions on the urban renewal dollars, since they cannot be spent outside the tax incrementing financing district whence they came. The Tri-Met dollars and private dollars go toward a portion of the extension that will run along the freeway. It was very tough for us to accept the notion that people might start looking at it as three separate projects on account of the funding structure, because from a project perspective, that does not work. It is one project, but we have still managed to develop an accounting system that is able to sort out this color of money issue.

How did this thing come together on paper? We created a master framework agreement that specified who does what, when, and to whom. I think there was a lot of pressure on everybody to stay at the table because the documents made clear that if any one party dropped out we were all done.

There were tremendous paperwork requirements due to the real-estate component of the project. It was all bond financed, which created some issues related to the private activity tests and some issues related to guarantees. Allocating risk was obviously another important consideration. Cascades and the Portland Development Commission had no confidence in their ability to absorb any risk related to the light rail, nor did we at Tri-Met have any confidence or willingness to absorb risks related to the real estate. So we split risk accordingly: Cascades takes most of the risk on the real estate with some lesser risk taken by the Portland Development Commission and the port.

As for project management, we have a policy group that includes the mayor of Portland, Tri-Met's general manager, and the port director, among others. This group provides overall direction and commitment, and I cannot say enough about the importance of having that top political commitment. There is also a formal oversight group that oversees Tri-Met in the execution of the light rail project. Another key strength of the project has been an informal group that meets every Friday morning to raise and resolve issues and generally move the project forward. The informality of this group is incredibly important.

Let's talk about the real-estate deal for a moment, which involves about 49 ha (120 acres) of greenfield area with no services whatsoever and some real physical challenges. It was a Port of Portland asset that was somewhere between underperforming and nonperforming in terms of the port's ability to develop it. So the port gave an 85-year concession that included a very ambitious 15-year development program, almost 46 500 m² (500,000 ft²) of retail space, 1,200 hotel rooms, and 93 000 m² (1 million ft²) of office space. Because of its greenfield nature, the city of Portland provided between \$20 million and \$25 million in loans and grants for infrastructure development.

As for the light rail side of the deal, probably the big news is that we received this project as an unsolicited proposal. Fortunately, we were well equipped to deal with that as an agency. Another key feature is how quickly everything has moved. We signed a small contract with Bechtel in the beginning of the summer of 1998. Bechtel delivered a preliminary engineering and price proposal, which we accepted two months later. We started construction at the end of April 1999, and 6 to 7 weeks later, in June 1999, we had our financing in place. We will open by September 1, 2001. We have had to impose a lot of discipline on ourselves to meet that schedule.

As I have mentioned before, some of the out-of-the-box elements on this project included FAA's involvement due to our use of PFCs, the design/build approach, the private financial participation, and the

unsolicited proposal. As for the PFC element, FAA had to approve its first-ever bond financing backed by PFCs. There was excellent support at the federal level and particularly from the administrator of FAA, Jane Garvey. Still, we had hurdles to surmount.

The private financial participation brought about challenges because of our partners' focus on the value of time and recognition that this opportunity would not be available indefinitely. Also, the private sector had some clear profitability requirements in terms of the real-estate development. This made for some interesting times, because all of the public partners wanted to see a leading-edge, textbook case for transit-oriented development that could instruct the development community on how to do it right. And yet the private investor has another clear goal: to start generating cash flow to pay back its \$28 million contribution. That leads to a constant tension that plays out in many levels, including decisions concerning tenants, how the buildings are oriented, and even the finishes and the fixtures.

We can speak some more about design/build later, but I want to touch on the unique risk allocation. Our use of design/build caused us at Tri-Met, perhaps for the first time in our experience, to have a more explicit, articulate conversation about risk: what it is worth, who can take it, and who can best manage it. I believe that, rather than thinking about whom you are going to dump the risk on, it is much more productive to think about who can best manage risk.

What of the unsolicited proposal? That was probably what gave us the most concern. We could understand the perception that a multinational company was coming to a fairly provincial small to medium-sized city with a deal the likes of which had never been seen. We were concerned about how we were going to sell this to ourselves and to the public, but that did not turn out to be an issue at all. We misjudged that, and happily so. Also, it was fortunate that all the relevant agencies had mechanisms, including due diligence procedures, on the books to deal with unsolicited proposals.

For my final few points I would like to first point out that there is nothing like a financial obligation to focus the attention. To the extent that our partners are also financial stakeholders, we all have a real advantage in getting things done. Also, I cannot say enough about public support and political leadership. It is invaluable and has helped us make sure that this project could be done in a manner consistent with our adopted land use plans. When you couple political support with informal project management, as we discussed before, you have some of the basic building blocks for a major project of this type.

DBOM PARTNERING WITH THE PRIVATE SECTOR: ARE YOUR PARTNER'S POCKETS AS DEEP AS YOURS?

Jeffrey Parker

Design/build/operate/maintain (DBOM) and design/build project delivery allow public agencies to share risks of cost overruns, performance, and schedule with the contractor. To reduce their risk exposure, public owners must pay a premium. Are public agencies realizing the risk transfers they are paying for? Are private-sector partners strong enough to absorb these risks, or are public agencies paying for something that, should there ever be serious problems, they will ultimately have to accept back?

These questions are of special consequence for design/build and DBOM projects because they have a unique risk profile. They are very large, with costs often exceeding \$1 billion. In many cases, they cannot be 100 percent surety bonded. The contracts often have a long duration, with some projects, such as Denver's Southeast Corridor, involving 8 years of construction. In other cases, maintenance or performance obligations extend 15 to 20 years after completion (Hudson-Bergen Light Rail Transit, New Mexico Corridor 44). The projects also tend to be complex, involving integration of bridges, tunnels, and electrical systems, raising performance as well as completion risks.

At the same time, there are examples, such as BART's airport extension and San Juan's Tren Urbano, in which owners have paid a risk premium only to find that they are facing cost overruns of 35 percent or more on their projects. It is possible that these overruns were not related to the method of project delivery but rather were due to owner-initiated scope changes or initial underestimation of project costs. However, in such an environment, what is the real value received for paying the risk premium?

We are now in a phase where the growing number of DBOM or design/build projects is gradually producing an accumulation of portfolio risk that could eventually result in the failure of a project or prime contractor. What happens when they fail? Some of the largest firms in the transportation industry have failed or come close. In some cases sureties have had to step in and complete projects. In others, contractors have changed, the job was delayed, and subcontractor payments were deferred. These things are real and are just as relevant to big-name firms as to smaller, regional contractors.

When trouble arises, it is often easier for public owners to "work with" the contractors and sureties, accepting delays and overruns or ascribing cost changes to

scope modifications to get the job finished. Therefore, public owners need to be careful about paying a premium to shift risk to the private sector and later having to accept a pass-back of the risks they thought were transferred. This is why it is essential to understand how deep your partners' pockets really are.

Many states have traditional processes in place to prequalify firms. These old surety tests and other strategies just do not fit when you are looking at large, long-term, and rather risky projects. Reputation alone does not cut it, yet few owners are ready to challenge the financial capacity of the nation's top companies. In fact, there are many regional firms with modest net worth who may well have better balance sheets and more solid financials than the big guys.

In the past you have probably seen a type of surety letter, known as a "good guy" letter, that basically says a given company is good for, say, a \$500 million job. These letters are often more for the benefit of the proposer than you, the owner. It is important that owners not forgo their due diligence opportunity because a contractor has a surety letter saying that it is a great company and that, with a host of caveats, it has the potential to perform your project. Our recent practice has been to limit the caveats in surety letters, and the response from the surety industry has been supportive.

What kinds of questions should be asked? It is traditional to ask for the firm's financials and annual reports for the 3 preceding years. Unsecured debt ratings can be helpful as well, but industry often resists this requirement. Since the Hudson-Bergen Light Rail Transit, we have used a threshold for tangible net worth in cases where full surety bonding is not possible. Financial reviews are now conducted as part of the prequalification process and are revisited at the proposal stage—this was not always done in the past, and firms whose balance sheets had deteriorated between short-listing and final selection were able to sneak through the selection process.

A disadvantage of a pass/fail net worth analysis is that it can become a gray area as proposers assemble the required net worth by cherry-picking balance sheets and reporting periods within an extended corporate family. One way to mitigate these gaming strategies is to perform a qualitative rather than pass/fail assessment so that firms can be downgraded for nondisclosure and gamesmanship.

On the other hand, many contractors are concerned about financial capacity tests, arguing that the requests for information drive up the costs of delivering a proposal, that they force private companies to disclose confidential data, and that the thresholds for minimum net worth are not necessarily relevant for the job at hand, potentially screening firms out unnecessarily. A number of the industry complaints are valid. Some program

managers tend to use the same documents for multiple jobs, and the financial requirements may not be adjusted to the specifics of the current project. In other cases, the financial tests are not applied to designers, and the recent trend toward consolidation in this field raises concerns for potential failure of the designer. Since design is the leading edge of a design/build or DBOM effort, a design firm failure could trigger serious delays.

I would like to suggest six flags that can be indicators of financial problems. The first is the "we don't want to talk about it" syndrome. This takes the form of limited financial disclosure on the basis of statements regarding status as a private company, a nonreporting business unit of a larger corporation, a complex corporate structure, or dressed-up net worth through the selective provision of subsidiaries' net worth. You also may see a nonspecific "core dump" of irrelevant, corporatewide data. Now, most firms are forthcoming; maybe only 20 percent fall short in this area. But, in fairness to firms that are trying to comply, there is a minimum amount of disclosure that all firms should be making.

A second flag is the presence of recurring losses, lay-offs, restructuring charges, write-offs, or declining pre-tax profit margins. This may seem obvious, but sometimes it is easy to ignore the obvious. The construction industry is cyclical, and in the course of a project that runs for 5 to 7 years it is likely that the firm will hit a low point. You want to be sure that there is enough financial capacity for the low spots as well as the high ones.

Third, watch out for high leverage, low liquidity, and exceptions to or waivers from credit agreements. Weak debt-to-equity ratios and limited cash on hand are trouble signs. Look especially for debt and third-party guarantees in unrelated ventures such as real estate and mining. And beware that the bigger they are, the harder they fall. We are seeing a lot of debt-financed consolidations these days among design firms as well as on the construction side, and the integration process has not always been smooth. It is important to confirm that any consolidations are accompanied by realistic estimates of how the debt will be paid off.

The fourth flag concerns the composition of a firm's backlog, and this can be a sleeper. Typically, firms will promote the fact that they have a multi-billion-dollar backlog as a sign of strength and stability. However, the composition of projects in the backlog is more important. Huge power plants, dams, mines, industrial process facilities, shipyards, and real-estate ventures pose risks such that a small hiccup in any one of these can bring the whole company down even though your job may be going well. These concerns increase when the work is overseas. Generally, you can assume that a firm has a lower portfolio risk when there is a high proportion of domestic public infrastructure.

Fifth, you need to look for growth that stems from acquisitions, low tangible net worth, and significant tax loss carryforwards in the asset base. Assets, like goodwill, that cannot be readily converted to cash are of little comfort to owners when hard times arrive.

And sixth, you need to look into any special items revealed by due diligence. These include unbalanced teams where one firm with a light balance sheet holds a high percentage of a proposer entity for which members have joint several liability; large claims looming for jobs under way; and trade articles about takeovers, losses, management changes, and subsidiary spin-offs. Use the procurement process to request clarifications and access the Web to tap data banks and Securities and Exchange Commission filings for answers to your questions.

Where do we go from here? I believe it would be helpful for the key players, such as TRB, AASHTO, the American Public Transportation Association, the Association of General Contractors, surety groups, and the like, to develop model guidelines that permit consistent qualification and disclosure standards for various categories of projects. The categories should be determined by scale, complexity, and level of risk sharing. The benefits would include lowering public agency procurement costs; expediting the process of getting bid documents out on the street; reducing bid preparation costs; making net worth thresholds more consistent to "screen in" competitors; and generating better, more consistent financial information to support informed selections.