

Case Study—\$169.5 Million Los Angeles County Metropolitan Transportation Authority General Revenue Bonds (Union Station Gateway Project) Series 1995-A

On January 19, 1995, the Los Angeles County Metropolitan Transportation Authority issued \$169.5 million in principal amount of its General Revenue Bonds (Union Station Gateway Project) Series 1995-A. At the time, the Authority had nearly \$2.2 billion of long-term sales tax revenue bonds outstanding, but this was its first experience with bonds secured by fare box revenues.

The Parties

The **Los Angeles County Metropolitan Transportation Authority** is a public agency created by the California Public Utilities Code with the responsibility for planning, financing, constructing, and operating the rapid transit system of Los Angeles County. The Authority provides bus service throughout the County of Los Angeles, as well as portions of neighboring Orange and Ventura Counties. In addition, the Authority operates a light rail system and a subway service within Los Angeles County. The Authority was formed in 1993 upon the merger of the former Los Angeles County Transportation Commission and the former Southern California Rapid Transit District.

The Project

After the merger of the Authority's predecessor agencies in 1993, the need for centralized office space became acute. A study undertaken by the Authority indicated that annual debt service on a tax-exempt financing to construct a new headquarters building would be less than the total annual occupancy costs, including rent and operating expenses, that the Authority would be incurring if it continued to occupy its current premises.

The Authority's new headquarters building, known as the Union Station Gateway Headquarters Building, is a 26-story office building designed to accommodate 1,900 employees. The Headquarters Building includes over 628,000 gross square feet of office space and approximately 800 parking spaces. It is located in the northeast portion of downtown Los Angeles, near Amtrak's Union Station depot. The Headquarters Building and adjacent public transit improvements to be constructed are expected to serve as a transportation hub for the region, connecting passengers of commuter rail, subway, light rail, bus, and Amtrak service.

The total cost of the Headquarters Building was approximately \$145.5 million. Construction began in February 1993, approximately 2 years prior to the issuance of the bonds. The Authority financed a portion

of this construction with \$98 million of sales tax revenue commercial paper, which was retired with bond proceeds. The Authority took occupancy of the Headquarters Building in September 1995.

The Financing

The bonds are special, limited obligations of the Authority, payable from and secured by a prior lien on “pledged revenues” and “remaining sales tax.” Pledged revenues are generally defined as all fare box revenues and advertising revenues, together with interest income thereon, derived from the facilities and properties maintained and operated by the Authority. Remaining sales tax is generally defined as the net proceeds of the Authority’s transportation sales tax levied in Los Angeles County, after the payment of debt service on obligations secured by such sales tax revenues on a basis senior to the bonds. If pledged revenues are insufficient to pay debt service on the bonds when due, the Authority has agreed to make such payments from any moneys available to it for use for any lawful purpose, including but not limited to remaining sales tax and the Authority’s share of certain state and local transportation subsidies.

At the time the bonds were issued, the Authority’s net available fare box revenues for the most recently ended fiscal year (1993-94) totaled approximately \$207.703 million, with over 96.6 percent of that amount generated by the Authority’s bus service. Remaining sales tax for the 1993-94 fiscal year amounted to approximately \$439.886 million. At the same time, the Authority was facing a budget deficit of approximately \$126 million.

The bonds were structured as multi-mode variable rate securities, insured by Financial Security Assurance, Inc. The bonds were initially issued in a weekly interest rate mode, with liquidity support provided by a 3year Standby Bond Purchase Agreement with Societe Generale. Due to this credit enhancement and liquidity support, the bonds were rated “Aaa/VMIG-1” and “AAA/A-1+” by Moody’s Investors Service and Standard & Poor’s, respectively. The Bonds received a SPUR (S&P Underlying Rating) of “A-”, reflecting Standard & Poor’s assessment of the Authority’s stand-alone ability to pay debt service on the bonds.

To hedge a portion of its variable rate exposure, the Authority entered into interest rate swap agreements with Goldman Sachs Capital Markets, L.P., (GSCM) and GBDP, L.P., (an affiliate of Grigsby Brandford & Co. {GBDP}). The GSCM swap had a notional amount equal to 75 percent of the principal amount of the bonds and paid the Authority the actual interest rate borne by the bonds in exchange for the Authority’s fixed payments. The GBDP swap had a notional amount equal to 25 percent of the bonds’ principal amount, and paid the Authority a floating amount based on the PSA Municipal Swap Index. Both interest rate swap agreements were scheduled to terminate in 10 years; the remaining 20-year term

of the bonds was unhedged. The Authority expected this partial synthetic fixed rate structure to achieve a lower overall cost of borrowing than the issuance of the bonds as fixed rate obligations.

At the time this transaction was being structured, the Authority was planning and constructing an ambitious and comprehensive rail rapid transit system for Los Angeles County. The capital needs for this system were being financed with a combination of federal and state grants and the proceeds of two countywide sales taxes levied for transit purposes. These sales taxes secured nearly \$2.2 billion of the Authority's sales tax revenues bonds.

The Authority made a policy decision not to finance construction of the Headquarters Building with sales tax revenue bonds, in order to preserve financing capacity for planned rail improvements. The Authority's fare box revenues provided the best alternative security for the new financing and were the historical source for payment of office space leases.

Various aspects of the bonds, including sources of repayment and coverage tests for additional parity bonds, were formulated after lengthy discussions with the members of the Authority's financing team, the bond insurer, and, in particular, the rating agencies. A significant source of the Authority's nonoperating revenues consisted of state and federal grants, which by their terms could not be pledged to pay debt service or were too unpredictable to be included in the revenue pledge. Thus, FTA Section 9 funds are not part of the security for the bonds, and the Authority's state and local transportation subsidies are not pledged, but only made available to pay debt service to the extent pledged revenues are insufficient. Remaining sales tax is pledged to the payment of the bonds, but such revenues are not deposited with the bond trustee on a monthly basis, as is the case with the Authority's fare box and advertising revenues.

The Authority was willing to provide additional security for the bonds by granting a first mortgage on the Headquarters Building. The bond insurer ultimately rejected this collateral because of perceived difficulties in foreclosing against a governmental entity and the limited utility of such security in light of California's "one form of action" rule.

An important goal was to structure the Trust Agreement for the bonds like an enterprise revenue bond indenture, with the flexibility to issue additional series of parity and subordinate bonds secured by the same revenue sources. This would allow the Authority to exploit the maximum bonding capacity of its general revenues at the lowest overall cost.

Standing in the way of this goal was the fact that the Authority's transportation system was not a traditional "enterprise" in several key respects. Like most transit agencies, the Authority has never attempted to set bus and rail fares at levels high enough to cover the cost of providing the service—in fact, the Authority's operating deficit for the 1994-95 fiscal year exceeded half a billion dollars. This deficit was covered by federal and state transit subsidies and local sales taxes. Moreover, considering the

MTA's operating deficit, elasticity of demand concerns, and potential political and legal considerations, the customary rate covenant found in most enterprise revenue bond indentures was determined to be inappropriate.

On the other hand, the Authority's fare box revenues had been fairly stable over the past several years. While the Authority's structural operating deficits would preclude a net revenue pledge, a gross pledge could still be worthwhile. Finally, the Authority's historical receipts of sales tax revenues, as well as federal, state, and local grants and subsidies (aggregating over \$364.295 million in the 1994-95 fiscal year), suggested that its transit operations would remain financially viable.

Ultimately, the structure, provisions, and general tenor of the Trust Agreement for the bonds reflected a hybrid of concepts from both enterprise revenue and unsecured financings. There was a gross pledge of fare box and advertising revenues, but no rate covenant. The Trust Agreement established various debt service accounts with different priorities, but the coverage ratio for additional parity bonds called for pledged revenues and remaining sales tax to be at least equal to 300 percent of maximum annual debt service. This unusually stringent test reflects the fact that transit revenues are volatile and not directly subject to the Authority's control. In this respect, the rating agencies and bond insurers appeared to view the bonds as somewhat less secured than general fund lease obligations, where acceptable "coverage" (to the extent the concept is applicable) for an investment grade stand-alone issue may indicate a general revenues to debt service ratio of 5 to 1, 10 to 1, or greater.

Postscript

After construction of the Headquarters Building was completed, the Authority reorganized certain executive positions and had a change in personnel. Subsequently, the new management consensus was that the remaining 20 years of variable rate exposure on the bonds was no longer a prudent risk. On August 20, 1996, the Authority issued \$185.735 million in aggregate principal amount of its General Revenue Refunding Bonds (Union Station Gateway Project) Series 1996-A to refund the bonds and terminate the related swap agreements. The refunding bonds were issued as fixed rate obligations, again insured by Financial Security Assurance. The Authority has not issued any additional General Revenue Bonds, but this borrowing capacity remains available as a financing source for future special projects.