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EXECUTIVE MANAGEMENT COMMITTEE
FEBRUARY 17, 2000

METRO

Metropolitan
Transportation
Authority

One Gateway Plaza
Los Angeles, CA
90012-2952

SUBJECT: DEFEASED LEASING POLICY FOR MTA ASSETS

ACTION: ADOPT DEFEASED LEASING POLICY

RECOMMENDATION

Adopt the proposed MTA Defeased Leasing Policy (Attachment A).

ISSUE

The purpose of the Defeased Leasing Policy (the "Policy") is to establish guidelines for the commitment to and execution of defeased leasing transactions for MTA capital assets. A defeased lease creates a business interest in the leased assets for a private equity investor that allows the investor to derive tax benefits from the transaction, provides a cash benefit to the MTA, and does not create any additional obligations for the MTA. To "defease" means to bank sufficient proceeds from the transaction to cover lease and loan requirements.

POLICY IMPLICATIONS

The proposed policy will provide guidance to staff when evaluating proposed defeased lease transactions. The goal of this policy is to generate income from capital assets within prudent risk parameters.

During the term of the lease, MTA will retain complete operating control of the asset and each lease will comply with all applicable federal and state statutes. There is a risk of incurring "broken deal" costs if the agency begins negotiation for a transaction that is not completed. This risk is described in greater detail below.

OPTIONS

The Board may choose to modify the proposed policy to provide additional or different direction to staff in pursuing defeased leasing of assets. Staff has developed the policy to provide flexibility to the Board and staff to respond quickly to market conditions and to achieve optimal benefit for the MTA.

FINANCIAL IMPACT

Defeased lease transactions will provide up-front cash benefits to the MTA at each transaction's closing. The chart below summarizes a range of potential net benefits (after transaction expenses) available to MTA under defeased leases on its existing assets and assets to be acquired over the next three years.

Asset Category	Lease Structure	Estimated FMV ($MM)	Current Market Net Cash Benefit %	Current Market Net Cash Benefit ($MM)
Rolling Stock	U.S. Lease	$320	5-8%	$16.0-$25.6
Buses	Japanese Lease	$500	2-4%	$10.0-$20.0
Real Estate	U.S. Lease	$300-$500	3-5%	$9.0-$25.0
QTE	U.S. Lease	$150-$200	6-10%	$9.0-$20.0
		(FMV=Fair Market Value)	Total:	$44.0-$90.6

Transaction expenses, as a percent of equipment cost, vary with the size of the transaction. For example, costs incurred for the negotiation and execution of a $150 million rolling stock transaction would be approximately 2% of the total transaction as follows: our advisor Capstar/McCalley is 0.60%, the surety policy is 0.75%, legal fees are 0.40%, and 0.25% for other associated costs. The surety policy insures the equity investor in the event of an MTA default. The expenses are paid from the gross benefit in the transaction.

It should also be noted that there is a risk of incurring transaction or broken deal expenses for a transaction that does not close. The financial advisor will seek to minimize the risk for broken deal expenses, however, as is the case in most transit lease transactions, the MTA will be expected to assume some portion of the transaction expense risk. The expenses to the MTA for a broken deal are anticipated to be in the range of $150,000 to $400,000 including costs for MTA's legal counsel. The expenses could include legal fees, appraisal fees, and other fees and expenses for other consultants and vendors. The MTA's financial advisors have participated in over 25 leasing transactions with municipalities, all of which have successfully closed and *none* of which have resulted in a "broken deal." Therefore, the risk is believed to be minimal.

BACKGROUND

In April 1999, MTA conducted a competitive procurement to retain a financial advisory firm with expertise in developing and consummating defeased lease transactions. Capstar Partners, LLC and McCalley Consulting (Capstar/McCalley) were selected to represent the MTA due to their extensive experience in successfully closing such transactions with transit properties throughout the U.S. The scope of work of the Capstar/McCalley contract includes the following:

- Prepare an MTA Defeased Lease Policy for consideration by the MTA Board
- Review MTA's asset portfolio and identify a strategy to access the defeased lease market over time (Attachment B)
- Implement defeased lease transactions to include issuance of Information Memoranda on selected assets, selection of an investor, and preparation of the lease documents

The first two tasks are being presented to the Board at this time; the third task will be presented to the board as transactions are developed. An Information Memorandum has been issued for the MTA's first transaction involving 74 Breda Red Line cars. The process of selecting an investor will begin once bids are received.

The MTA completed a defeased lease in 1997 on the first 30 Breda Red Line cars with the Bank of New York as the equity investor. Other transit authorities that have successfully closed defeased lease transactions include the Massachusetts Bay Transportation Authority (Boston), Metra in Chicago, New Jersey Transit, Washington Metropolitan Area Transit Authority, and Chicago Transit Authority.

NEXT STEPS

MTA and Capstar/McCalley issued an Information Memorandum on January 19, 2000 to entertain competitive proposals for a defeased lease transaction involving 74 Breda Metro Red Line heavy rail vehicles. Once the Board has adopted a defeased lease policy, the following steps will occur:

1. Complete due diligence on bond, tax, and statutory issues.
   MTA has also selected Orrick, Herrington and Sutcliffe ("Orrick") as lessee counsel, based on its experience advising other transit agencies on defeased lease transactions. Prior to approaching the defeased lease market, Orrick will identify any bond, tax or statutory issues that may affect MTA's risk profile or ability to close on the anticipated structure.
2. Receive proposals from prospective firms for the 74 Breda Metro Red Line vehicles.
3. Review and negotiate optimal proposal.
4. Receive Board approval for negotiated defeased lease.
5. Complete lease documents and close transaction.
6. Proceed with next defeased lease transaction in MTA's asset portfolio. (See Attachment B).

ATTACHMENTS

A. MTA Defeased Lease Policy
B. MTA Asset Portfolio

Prepared by: Peter J. Braster
Chief Administrative Analyst
Office of the CEO, New Business Development

Michelle Caldwell
Michelle Caldwell
Deputy Executive Officer,
New Business Development

Terry Matsumoto
Executive Officer,
Finance and Treasurer

Richard Brumbaugh
Chief Financial Officer

Allan G. Lipsky
Office of the Chief Executive Officer

ATTACHMENT A

MTA DEFEASED LEASE POLICY

INTRODUCTION

The defeased leasing policy has been developed to establish policy guidelines regarding defeased leasing. Defeased leasing of capital assets is one of the innovative methods many of the major transit authorities use to realize additional revenues. To "defease" means to bank sufficient proceeds from the transaction to cover lease and loan requirements. Defeasence of the lease payments permits transit authorities to minimize currency and interest rate exposure as well as provide evidence to FTA of continuing control over federally funded assets.

PURPOSE

This Policy will govern the solicitation and execution of defeased leases entered into with institutional investors. The scope of this Policy is limited to defeased leases on MTA assets and excludes any funded leases that are otherwise covered under MTA's Debt Policy. The assets include rolling stock, buses, maintenance facilities, train control systems, rail stations and rights of way.

DESCRIPTION

Defeased lease transactions include a number of transaction types, such as sale/leaseback, cross-border lease and lease/leaseback. The lease/leaseback is currently the most popular type of transaction. In the lease/leaseback structure, MTA will lease the Equipment to a trust (the "Trust") which an institutional equity investor (the "Equity Investor") will beneficially own. The Trust will be funded by an investment by the Equity Investor and a non-recourse loan. The lease or sale from MTA to the Trust will be the head lease (the "Head Lease") in the transaction and will be prepaid. The Trust then leases the asset back to MTA under a sublease (the "Sublease") with a fixed price purchase option. In this way, MTA maintains economic control of the asset. Sublease rent is made up of (a) debt service on the loan and (b) a fixed price purchase option payment to the equity investor. MTA will economically defease both its rental and purchase option payments under the Sublease through payments received under the prepaid Head Lease. The cash benefit to MTA is equal to the excess of the payments received at closing over the defeasance deposits. Sale-leaseback and cross-border leases are similarly structured, except that in a sale-leaseback the Head Lease is more frequently structured as an outright sale of the asset. A cross border lease involves a non-US investor.

POLICY

P-I. Implementation of a defeased lease transaction of any MTA asset shall not compromise existing or planned transportation uses or other functions of those MTA assets.

P-II. The MTA shall competitively procure and negotiate with the investor who provides the optimal defeased lease proposal.

P-III. The MTA shall only consider entering into defeased lease transactions provided that after analysis it has been determined that there is sufficient benefit to compensate for the risk of the transaction. The proposed MTA benefit will be presented to the Board at time of each transaction.

P-IV. Any proposed transaction must be defeased in a manner that will be sufficient to fully provide for MTA's lease obligations up to and including any optional purchase price. The sufficiency of such defeasance arrangements must be certified by MTA's independent auditor or other independent financial expert. In general, defeased leases should permit the obligation to be excluded from the MTA's financial statement. Prior to entering into any transaction, the MTA shall receive opinions from its outside auditor on the accounting treatment of the proposed transactions and will advise the board in cases where the transaction is not excluded from MTA's financial statement.

P-V. Use of the proceeds gained from defeased lease transactions shall be at the sole discretion of the MTA Board.

RESPONSIBILITIES

The MTA Defeased Leasing Program will be administered through the Office of the CEO, New Business Development Department, with coordination and participation from MTA Finance and other MTA departments as required.

GLOSSARY OF TERMS

1. Defeased Lease – A lease in which the Lessee's, in this case, MTA's, rental obligations and purchase option payment are fully provided for at closing. The MTA effectively prepays all of its obligations, including the exercise of the purchase option under the Sublease (as defined below).

2. Types of Defeased Leases:

    a) Sale-Leaseback – A lease in which the Lessee sells the asset to the Trust which in turn leases it back to the Lessee with a repurchase right.

b) Lease-Leaseback - A lease in which the Lessee leases the asset to the Trust which in turn leases it back to the Lessee.

c) Cross-border Lease – A defeased lease to a U.S. based Lessee from a foreign based equity investor.

3. QTE – An asset that is classified as "Qualified Technological Equipment" under Section 168(i)(2) of the Internal Revenue Code. QTE assets may be depreciated on a straight-line basis over a five-year recovery period, thus providing enhanced tax benefits in a U.S. lease financing.

4. Trust – A special purpose entity that is created to hold title to or a leasehold interest in property for the benefit of an equity investor who is also known as the beneficiary. In a defeased lease, a trust is established for the benefit of the Equity Investor to receive the monies used to fund the transaction and administer the various transfers of funds that occur over the term of the lease. The Trust functions as the Lessor in a defeased lease transaction.

5. Equity Investor – A financial institution or corporation who, as a taxable entity, receives a combination of tax benefits and cash in return for its investment in a defeased lease transaction.

6. Cash Benefit – The net cash flow received by MTA for its participation in a defeased lease transaction.

7. Broken Deal – A transaction that fails to proceed once a term sheet has been signed and the Lessee has paid out on transaction expenses.

8. Head Lease – The lease from MTA to the Trust. A Head Lease is used instead of a sale. The Head Lease qualifies as a sale for federal income tax purposes.

9. Sublease – The lease from the Trust back to MTA.

ATTACHMENT B

MTA ASSET LISTING FOR POTENTIAL DEFEASED LEASE TRANSACTIONS

(Listed in Order of Planned Presentation to Market)

1. **ROLLING STOCK**
   Red Line Cars (74)
   Light Rail Cars (52)
   Buses (1,500)

2. **QUALIFIED TECHNICAL EQUIPMENT**
   Train Control Systems (3)
   Fare Collection Systems
   Voice and Data Communication Systems
   Other Telecommunication and Programmable Computer-Related Equipment

3. **FACILITIES**
   Gateway Transit Center
   MTA Headquarters (One Gateway Plaza)
   Regional Rebuild Center

4. **RAIL LINES**
   Metro Red Line
      Segment 1
      Segment 2
      Segment 3
   Metro Blue Line
   Metro Green Line

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Defeased Leasing Policy
Revision

P-IV Any proposed transaction must be defeased in a manner that will be sufficient to fully provide for MTA's lease obligations up and including any optional purchase price. The sufficiency of such defeasance arrangements must be certified by MTA's independent auditor or other independent financial expert. In general, defeased leases should permit the obligation to be excluded from the MTA's financial statement. Prior to entering into any transaction, the MTA shall review the accounting treatment of proposed transaction with ~~receive opinions from~~ its outside auditor ~~on the accounting treatment of the proposed transaction~~ and will advise the board in cases where the transaction is not excluded from MTA's financial statement.