Case Study—$9.66 Million California Transit Finance Corporation Certificates of Participation, 1996 Series A (City of Culver City, California)

On June 4, 1996, the City of Culver City, California and the CTFC participated in the sale of $9.66 million aggregate principal amount of COPs to finance a portion of the construction costs relating to the city's Transportation Administration/Maintenance facility. One of the sources of revenue supporting the Certificates is FTA Section 9 capital grants. This transaction involved a number of significant innovations, which are discussed in more detail below.

The Parties

The City of Culver City, California, is located about 8 miles west of downtown Los Angeles and 2 miles north of the Los Angeles International Airport, encompassing an area of almost 5 square miles. In 1994 the city had a population of approximately 38,793. The city operates the Culver City Municipal Bus Lines (CCMBL), the second oldest municipally owned bus agency in the State of California. CCMBL maintains a fleet of 33 buses, of which 30 are used in regular service.

The **CTFC** is a nonprofit public benefit corporation created in 1990 by the California Transit Association to provide financing assistance to California transit entities. CTFC provides transit agencies with standardized lease financing documents for stand-alone and pooled COPs supported in part by FTA Section 9 capital grants. The CTFC structure has been market tested by the major rating agencies as well as the public finance capital markets. Typically, CTFC transactions involve a preestablished financing team of financial advisors, bond counsel, underwriter, and underwriter's counsel. To date, CTFC has participated in at least five successful COP financings involving FTA Section 9 funds.

The Project

Prior to the financing, CCMBL provided bus maintenance services on a crowded 3.96-acre City Yard site shared with the city's Public Works, Parks Maintenance, and Purchasing Divisions. In order to provide more efficient and cost-effective service, CCMBL proposed a plan to the FTA that included (i) dedicating the entire City Yard site for public transit purposes, (ii) demolishing existing buildings and constructing a new parking structure and transit facility, including an administrative/maintenance building containing a fueling island, bus washer, eight bus bays, inspection area, and a welding shop, and (iii) purchasing a new site and remodeling an existing building to accommodate the displaced city divisions. The project described above would allow CCMBL to increase its bus fleet from 33 to 60 in anticipation of increased demand for public transit service. The FTA accepted and approved CCMBL's proposal through their adoption of a Federal Highway Administration rule referred to as "functional replacement."

The total cost of the project was estimated at $23.8 million. Certificate proceeds provided approximately $8.4 million, with the balance of the cost being paid by city contributions and FTA Section 9 capital grants (in addition to the Section 9 funds expected to pay debt service on the Certificates).

The Financing

The CTFC Certificates represent a proportionate interest in lease payments made by the city to CTFC under a lease agreement between the city and CTFC. CTFC assigned these lease payments to the trustee for the Certificates, as well as any insurance or condemnation proceeds relating to the property encumbered by the Lease Agreement, to the extent not required for the repair or replacement of such property. Payments under the Lease Agreement are payable only from "revenues" of the city, which are defined as (i) certain FTA Section 9 capital grant funds, (ii) the Local Transportation Fund portion of California Transportation Development Act funds, (iii) the city's share of State Transit Assistance Funds and (iv) the city's discretionary and local return portion of two 1/2 cent transportation sales taxes levied in Los Angeles County. General fund moneys of the city are not included in the definition of "revenues" and are therefore not available to make payments under the Lease Agreement. The Lease Agreement provides that the obligation of the city to make payments under the Lease Agreement solely from revenues is unconditional and not subject to abatement in the event of a casualty loss involving the leased facilities.

The Certificates are also secured by a reserve fund held by the trustee, funded at maximum annual debt service on the Certificates. Finally, the payment of principal and interest with respect to the Certificates is guaranteed by a municipal bond insurance policy issued by AMBAC Indemnity Corporation.

The Certificates represent a clear progression in the manner FTA Section 9-supported COPs have been structured. The primary innovation is the use of real property instead of buses to serve as the asset encumbered by the Lease Agreement. This produces several financial benefits to the city. Since the city's Transportation Administration/Maintenance facility has a longer useful life than vehicles, the city was able to spread out its payments over a 20-year term, as opposed to the 12-year term usually seen in bus financings. In addition, there will be sufficient rental value in the project to allow for level debt service instead of the declining payments that are associated with bus leases, again maximizing the benefits of tax-exempt financing.

FTA permitted the use of Section 9 capital grant moneys to support the financing costs of the project because the city's Transportation Administration/Maintenance facility is clearly transit-related. In addition, FTA allowed Section 9 funds to account for 100 percent of debt service on the Certificates, as opposed to the traditional 80 percent match. The rationale for this arrangement is that the city contributed approximately $3.9 million of land upon which the project will be located and further contributed $3.1 million in cash to finance the project. These up-front contributions satisfied the FTA's requirement of a 20 percent local match for FTA Section 9 projects.

Another innovative feature of the Certificates involves the lack of capitalized interest. Typically, the FTA requires interest payments on Section 9 lease financings to be capitalized for a period sufficient to allow the construction or acquisition of the asset encumbered by the lease. Until the asset is ready for use and occupancy, FTA Section 9 capital grants may not be used to pay debt service. This policy mirrors the practice of most bond counsel firms in California, which generally require capitalized interest prior to the construction or acquisition of the leased asset so that the initial lease payments will not violate the debt limit embodied in Article XVI, Section 18 of the California Constitution. The need to capitalize interest increases the amount of COPs required to be sold and increases the total debt service obligation of the governmental lessee.

Since the relevant lease payments consist of special revenues not subject to the State Constitutional debt limit, FTA policy for this transaction mirrored State law in this regard and permitted FTA Section 9-supported lease payments to be made prior to the completion of the city's Transportation Administration/Maintenance facility.

Another unique aspect of this transaction is the use of a bond insurance policy to enhance the rating of the Certificates to AAA/Aaa by Standard & Poor's Ratings Services and Moody's Investors Service, respectively. The premium for this bond insurance was less than the net present value of the marginally higher interest that would have been payable on an unenhanced issue. This is apparently the first new issue FTA Section 9-supported COP to have been enhanced by bond insurance.

The use of bond insurance and real property as the leased asset represents a logical extension of the COP structure inherent in these financings. So long as a governmental entity can demonstrate to the FTA a sufficient transit purpose, further financings can reflect various permutations, including "asset transfer" or "asset strip" structures, variable rate COPs backed by liquidity facilities, and other complex arrangements that are now commonplace for non-FTA supported COPs.

Bond counsel (or special counsel as they are sometimes described in COP financings) delivered the customary legal opinion in this transaction that the Lease Agreement was a valid and binding obligation of the city. Such opinion is customarily required on all publicly sold COP financings by an independent bond counsel firm. Bond counsel makes this determination based on case law or may require the issuing entity to file a validation action or some other similar court proceeding to determine the validity of the transaction prior to proceeding with the transaction.

The authority for lease financing is very well developed in California.[1] In other jurisdictions, case law authority may not be as developed and in considering any lease financing, the threshold legal issues are whether there is authority to enter into the lease financing and whether there is any constitutional impediment to the lease transaction.

[1] In Rider v. City of San Diego, 18 Cal. 4th 1035, 959 P.2d 347 (Cal. 1998), the California Supreme Court upheld a constitutional challenge to a lease financing and noted the long history of court cases upholding such financings.