

CERTIFICATES OF PARTICIPATION INVOLVING FTA 49 U.S.C. § 5307 (“SECTION 9”) FUNDS

Introduction

One promising innovative financing technique for transit projects is the use of FTA Section 9 funds to subsidize principal and interest payments with respect to Certificates of Participation (COPs).¹ This chapter will include a general discussion of COPs and the use of FTA Section 9 funds to help finance the acquisition of transit-related capital projects through the sale of COPs.

The Structure of a Certificates of Participation Transaction

COPs are securities that represent interests in a stream of payments from an underlying obligation, typically a lease or an installment sale agreement. The governmental entity’s payments pursuant to this underlying obligation are assigned to a trustee who pays such moneys to the holders of the COPs. For transit finance purposes, this underlying obligation is usually a lease, since FTA Section 9 funds are available to pay a portion of such lease payments, as discussed below.

COPs in lease payments are a mechanism for governmental entities to finance capital projects without technically issuing long-term debt. The issuance of long-term debt is commonly subject to voter approval and other State constitutional and statutory requirements. Case law in various jurisdictions supports the proposition that leases do not constitute “debt” for these purposes because the governmental lessee is not obligated at the outset to make rental payments throughout the entire term of the lease, but is only required to pay rent each year to the extent the leased property is available for use during such year.²

In a typical COPs financing:

- An item of real or personal property with adequate annual fair rental value and useful life is identified as the asset to be subject to the Financing Lease. Such leased asset may be the property to be acquired or constructed with the proceeds of the COPs, in which case interest with respect to the COPs will need to be capitalized until the acquisition or construction of the property is complete. Alternatively, in an “asset transfer” or “asset strip” structure, such leased asset may be a preexisting item of property, which obviates the need for capitalized interest.
- The identified item of property is leased to a second party (often for nominal consideration), which becomes the lessor entity under the Financing Lease.

¹ On July 5, 1994, Public Law No. 103-272 passed and codified federal transit laws under Chapter 53 of the United States Code. The law repealed the Federal Transit Act without substantive change. The original meanings of the Federal Transit Act provisions are unchanged even though the new language in some instances differs from that of the original Act. Section 5307 of Title 49 of the U.S.C. replaced Section 9 of the Federal Transit Act, but the funds are still called “Section 9” funds in common parlance and are so called in this report.

² See *Rider v. City of San Diego*, 18 Cal. 4th 1035, 959 P.2d 347 (Cal. 1998).

- The property is then leased back to the governmental entity pursuant to a Financing Lease for rent that approximates the fair rental value of the property. These rent payments have designated principal and interest components that equal the principal and interest represented by the COPs. In addition to specifying the rental obligation, the Financing Lease typically calls for abatement of rent if the leased asset is damaged, destroyed, taken by eminent domain, or (for real property) subject to title defect. The Financing Lease also includes covenants to maintain insurance and specifies remedies for the failure to make rent payments. The right to receive rent payments and to exercise remedies under the Financing Lease is typically assigned to a trustee acting on behalf of the holders of the COPs.
- COPs are sold as securities to investors in both private placements and public offerings. The credit strength of COPs may be enhanced with bond insurance, letters of credit, or other guarantees. Because of the risks of abatement and nonappropriation of lease payments, an issuer's COPs are generally considered less creditworthy than its general obligation debt.

FTA Section 9 Funding

The link between FTA Section 9 funding and payments on COPs begins with Section 308 of the Surface Transportation and Uniform Relocation Assistance Act of 1987 (STURRA).³ Section 308 authorized the use of Section 9 federal transit funds for leases of facilities and equipment at the 80 percent matching level in projects where leasing is determined to be more cost effective than purchase or direct construction. Previously, the interest portion of lease payments was treated as an operating expense and eligible for reimbursement at only a 50 percent matching ratio.

The FTA issued a Final Rule on Capital Leases to clarify the application of Section 308 on October 15, 1991.⁴ The primary change reflected in the FTA's 1991 Capital Leasing guidelines is the ability to treat lease payments, including interest costs, as capital expenses eligible for reimbursement at the full, 80 percent federal matching level. Since COPs represent an interest in a stream of payments, including lease payments, the new FTA policy created a clear opportunity for transit agencies to use federal moneys in support of long-term financings.

The FTA's guidelines allow any asset eligible as a capital item to be leased. Moreover, the Department of Transportation's comments accompanying the rules state that the Senate Report language for Section 308 of STURRA envisioned application of federal transit leasing for such items as "computers, maintenance of way and other heavy equipment, maintenance of effort rail equipment, radio equipment, bus garages, property or structures for park and ride, and other buildings or facilities used for mass transit

³ Pub. L. No. 100-17 § 308 (April 2, 1987) 101 Stat. 226.

⁴ 49 C.F.R. Part 639.

purposes.”⁵ Despite the variety of assets that may be leased, the typical FTA Section 9-supported COP has involved the acquisition of buses. The use of this financing mechanism versus a pay-as-you-go policy allows transit agencies (either separately or in a pooled transaction) to make larger purchases of bus assets sooner, thereby enhancing service.

Since FTA Section 9 funding is subject to congressional appropriation each year, there is no guarantee that sufficient funds will always be available to pay the full 80 percent match of lease payments. Thus, rating agencies and capital market participants do not treat Section 9 funds as a guarantee, and the focus of any credit analysis is still on nonfederal revenues.⁶ Moreover, the FTA’s capital leasing guidelines impose a financial capacity test that requires that the lessee transit agency certify that it has the ability to meet future lease obligations in the absence of federal funding.

⁵ See 56 Fed. Reg. 51786 (Oct. 15, 1991)

⁶ Jeffrey A. PARKER, HOW TO EVALUATE OPPORTUNITIES FOR CROSS-BORDER LEASING AND CERTIFICATES OF PARTICIPATION 78 (1993).

The FTA also requires that a determination of cost effectiveness be made in order to justify a lease structure instead of a traditional pay-as-you-go purchase arrangement. The calculation is made by the grantee using the guidance set forth in FTA's Final Rule on Capital Leases and involves a self-certified net present value analysis of costs and benefits. The most common rationale for lease financing over a pay-as-you-go program is avoiding the cost inflation inherent with later purchases, as well as the economics of scale afforded by larger, one-time purchases.

Key Legal Issue: Under state law, the threshold legal issue is whether the lease or COP structure is permitted, without voter approval, under constitutional and statutory provisions. The key legal issue for FTA approval is the cost benefit analysis of the financing.

