

Presentation to Joint Senate Transportation Committee and Select High Speed Rail Committee

Monday, December 5, 2011, 10:00AM, Room 112

Good morning Mr. Chairmen and members of the committees, I am Blake Fowler with the State Treasurer's Office.

Treasurer Lockyer sends his regrets he couldn't be here. He's back East attending a conference of the National Association of State Treasurers. But he wanted to make sure to provide the Committees his views on a couple of points:

First, he supports building a high-speed rail system in California. He sees it as a vital component of a smarter infrastructure, one we're going to need to serve the future transportation and economic needs of our state.

Second, the business plan basically acknowledges the high-speed rail system won't get built without a significant contribution from the federal government. Look at the current attitude of Congress toward high-speed rail – or any infrastructure development for that matter – and the prospect of federal funding seems like a pipe dream.

But California's high-speed rail project won't need more federal funds, or any new federal bond programs, until 2015. A lot can happen between now and then. It's possible that by the time 2015 rolls around, Congress will be more open to investing in high-speed rail, not just in California, but across the nation. That's what it's going to take to make this work, and the Treasurer believes it's an investment we need to make.

Finally, the business plan before you represents the High-Speed Rail Authority having a more honest conversation with the public.

It's based on more realistic assumptions about ridership. The cost estimates have some roots in reality, and built-in fudge factors that strengthen their credibility. And the plan makes strides toward better accommodating community concerns with the proposed blended system approach.

Turning now to my comments regarding bond financing in the draft Business Plan, I will address the issuance of Prop 1A General Obligation Bonds for the Initial Construction Segment. I will focus particular attention on a potential new form of Qualified Tax Credit Bond to leverage State debt service payments on the Prop 1A GO Bonds for the Initial Operating Segment.

As presented in the draft Business Plan, the Authority estimates the Initial Construction Segment will cost \$6 billion. The sources of funding will consist of \$3.316 billion of federal grants, which have been committed, and \$2.684 billion of Prop 1A bonds. The Authority proposes the Prop 1A bonds be issued in annual amounts ranging from \$474 million to \$577 million over a five-year period ending in 2017. Once the \$2.6 billion of bonds are issued by 2017, and assuming each of the bond issues are amortized over 30 years with level annual debt service payments, we estimate the annual debt service will be approximately \$206 million. The aggregate total debt service would be approximately \$6.2 billion.

The LAO has questioned whether the funding plan meets certain statutory requirements for the use of Prop 1A proceeds for construction purposes. That issue is the subject of recently filed litigation in which the Treasurer, as well as a number of other State officials, are defendants. So, I cannot comment on that issue.

The Authority estimates the Initial Operating Section will cost an additional \$24.7 billion to \$27.2 billion - depending on whether the North or South route is selected. The draft Business Plan includes an illustrative funding scenario that includes \$4.9 billion to \$5.3 billion of Prop 1A bond proceeds, and \$19.7 billion to \$21.7 billion of federal support – again depending on which route is selected. The federal support is split between grants of \$7.4 billion to \$8.4 billion and Qualified Tax Credit Bond or QTCB proceeds of \$12.3 billion to \$13.2 billion. The Plan states that whether or not the Qualified Tax Credit Bonds become a viable option or not, the total federal support required remains the same, and that other federal sources would be sought if those bonds are not available as a resource.

Before getting into the specifics of how the Authority envisions it could leverage the State's Prop 1A bond payments with the use of Qualified Tax Credit Bonds, I'd like to first provide some brief background information on QTCBs.

QTCBs are bonds authorized by the Federal Government where tax credits or direct payments from the Federal Government subsidize an issuer's borrowing costs. There have been QTCB programs for schools, energy conservation, renewable energy and other projects. Many of these programs were created by the 2009 American Recovery and Reinvestment Act or ARRA.

Under QTCB programs, the Federal Government subsidy can take one of two forms:

- Investors can receive a direct offset to Federal tax liabilities in lieu of cash interest payments. These bonds are referred to as Tax-Credit QTCBs; or

- The Issuer can make cash interest payments to investors, but receive a Federal Government reimbursement for interest at a subsidy level equal to some or all of the tax credit rate. These bonds are referred to as Direct Payment QTCBs.

Under IRS rules for QTCB programs, issuers can reinvest the debt service payments in an invested sinking fund; the interest earnings on those funds can then be used to repay a portion of the principal at maturity. The Federal government typically sets the subsidy level, tax credit rate, maximum investment sinking fund rate and maximum final maturity.

The market capacity for tax-credit QTCBs has proven to be very limited.

The market capacity for direct-payment QTCBs, however, became very broad in a short period of time.

The draft Business Plan uses Qualified Tax Credit Bonds to leverage the State's debt service payments on its Prop 1A Bonds to generate additional construction proceeds. Under the proposal, the State's bond repayments on \$1 billion of Prop 1A bonds secure 3.5 times the total Prop 1A bond principal without additional cost to the State.

If this could be done, the \$12.2 billion to \$13.3 billion of QTCB proceeds shown in the illustrative funding example for the Initial Operating Segment could be secured at no cost to the State beyond the principal and interest payments on the \$4.9 billion to \$5.3 billion of Prop 1A bonds. Using an example of \$1 billion of Prop 1A Bonds, here's how the Authority described the 3.5X leveraging of the State's Prop 1A bonds:

- Under Prop 1A, State issues \$1 billion of 30-year GO Bonds. As is typical, the bonds would be amortized over 30 years with level debt service payments.

- At the same time, the Authority (or another state financing authority) issues \$3.5 billion of Qualified Tax Credit Bonds with all principal due at the end of 30 years. \$1 billion of the \$3.5 billion of QTCB proceeds is used to purchase the Prop 1A bonds and \$2.5 billion is used for construction. The \$1 billion of Prop 1A bond proceeds is also used for construction. So, in total, \$3.5 billion of construction proceeds would be raised.
- Over 30 years, the State makes payments totaling \$1.8 billion – \$1 billion in principal and \$840 million in interest – for the \$1 billion in Prop 1A bonds (assuming a 4.5% interest rate). The Authority would place these payments in a separate fund that accrues interest known as a sinking fund. Over 30 years, the State’s \$1.8 billion in Prop 1A debt service payments would accrue \$1.7 billion in interest income (assuming a 4.16% investment rate). Thus, the total of the fund after 30 years would be \$3.5 billion.
- The \$3.5 billion of QTCB principal is paid off at the end of 30 years from the total that has grown in the QTCB sinking fund. Interest to the QTCB bond holders is paid periodically by the Authority and reimbursed with the Federal government’s subsidy payments.
- The value under this financing structure is two-fold: i) the Authority doesn’t have to pay interest on the QTCBs; and ii) the State’s debt service payments on its Prop 1A bonds can be invested until the Authority’s QTCBs mature in 30 years and these investment earnings are used to repay the Authority’s bonds at maturity.

I’d like to point out that approximately \$18 billion of Qualified Tax Credit Bonds would need to be issued to achieve the funding of \$12.3 billion to \$13.2 billion shown in the Business Plan for the Initial Operating Section since a portion of the QTCB proceeds would be used to purchase the Prop 1A bonds. Also, the Business Plan refers to tax-credit QTCBs; however, subsequent discussions with the Authority’s consultants indicate that the current thinking is for direct-payment QTCBs. As I mentioned earlier, the market for tax

credit QTCBs is very limited and the Treasurer's Office believes that only a direct-payment QTCB bond structure would attract sufficient investor demand.

The 3.5X leveraging example from the Business Plan that I just described is mathematically sound, but is based on key assumptions that could be very difficult to achieve.

First, it assumes that the federal government will enact legislation authorizing a new form of Qualified Tax Credit Bond program with terms compatible with the Business Plan.

Such a program:

- Would need to be very large when shared with other states, and would need to include other transportation projects to be able to benefit other states (since not all states would be funding high speed rail programs)
- Would need to offer a subsidy level of 100% of the tax-credit rate
 - The school construction Bond QTCB program authorized by ARRA offered a 100% subsidy but totaled \$22 billion for all 50 states
 - Many of the prior QTCB programs offered less than a 100% federal subsidy level.
- Would need to allow 30-year maturities, which is longer than the existing QTCB programs. These programs generally have been limited by US Treasury guidelines to 14 -19 year maturities.

There is no currently proposed federal legislation that would accomplish the Qualified Tax Credit Bond financing described in the Authority's draft Business Plan.

Second, assuming the Federal government authorizes such a new Qualified Tax Credit Bond program for high speed rail, even if the subsidy level is set at 100% of the tax credit, the direct payment from the federal government may not fully cover interest payments on the QTCBs.

- For existing QTCB programs, the direct subsidy is calculated based on the tax credit rate set by the US Treasury.
- Tax credit rates have been lower than the 30-year borrowing rate for State GO Bonds. Currently, the difference is approximately 1.5%.
- Many of the previous issuers of QTCBs had to offer a “supplemental coupon” – a rate higher than the tax credit rate in order to attract investors.
- Assuming the Authority had to pay 1.5% supplemental coupon, leveraging capacity would decline from 3.5X to 2.2X.

Finally, achieving the maximum reinvestment rate allowable by the federal government and then fully leveraging those reinvestment earnings may be difficult.

- In order to issue bonds with investors relying on future interest earnings over 30 years as a source of repayment on the principal of the QTCBs, investors would need to not only know what future debt service deposits can earn over 30 years, but accept the risks associated with achieving such earnings.
- Prior to the 2008 financial crisis, financial products were readily available to alleviate the risk to investors.
- Today, the long-term investment product market is much more limited, and the counterparty credit risk would be a significant issue for investors. We believe investors likely would not be willing to accept the risk.

Assuming that reinvestment earnings could not be leveraged and that a supplemental coupon of 1.5% was needed, leveraging capacity of the Authority’s QTCB proposal would further decline from 2.2X to 1.5X.

Thank you for the opportunity to provide comments today. I'd be glad to take any questions you may have.