it's about time

T2 Explainer: How do private activity bonds and TIFIA work?

The Transportation Transformation Group is an unprecedented alliance of state government, finance, academic and private industry leaders who aspire to transform American transportation policy into a goal-based arrangement that maximizes flexibility to enhance the roles of the state and local public sectors and their private partners to solve the growing problems of congestion and mobility.

T2 publishes explainers to help policy makers and the public understand concepts essential to transportation transformation.

Private activity bonds (PABs) allow private parties to issue tax-exempt debt based on the investment purpose of the bond proceeds and subject to a series of limitations.

Federal law generally prohibits debt issuers from financing highway and transit programs by combining tax-exempt debt or its proceeds with long-term private management contracts or private equity investment. This prohibition, written into the 1986 Tax Reform Act, includes exceptions for airports, solid waste facilities, and high-speed rail because those infrastructure classes were expected to attract private-sector investment and management.

Given the potential application of PABs to surface transportation, Congress created a limited PABs demonstration program for highway/intermodal projects in SAFETEA-LU. The program permits USDOT to allocate up to $15 billion in PABs between qualified highway and surface freight transfer facilities. To be eligible, the project has to include a Federal aid highway project in its scope and the private entity must have a public conduit to issue the debt, such as a state or local government.

PAB designation allows the bonds to retain tax-exempt status despite a greater level of private involvement than is ordinarily allowed for these types of bonds. This allows projects with private-sector financial participation to obtain lower financing rates, eliminating one barrier to private sector participation in transportation investment.

PABs are intended to make private infrastructure investment eligible for the same federal tax exemption that state and local governments enjoy if they assume debt directly.

Like virtually all other private activity bonds, the interest on highway/intermodal PABs has been subject to the Alternative Minimum Tax (AMT), which increases borrowing costs and narrows the market of potential investors. Under the American Recovery and Reinvestment

Act, PABs issued in 2009 and 2010 are exempt from the AMT, encouraging greater investment in user backed infrastructure projects that benefit the public.

Only 25 percent of PAB proceeds can be used to acquire land. Qualified highway or surface transportation facilities may require significant right-of-way (ROW) acquisition for project construction. ROW acquisition typically accounts for about 10–25 percent of total project costs and can be necessary far in advance of construction.

Many start-up toll roads do not generate sufficient revenue during the ramp-up period to fully cover the interest expense on borrowed funds. Tax regulation prohibits the accretion of interest on PABs, which limits the usefulness of PABs in project financings that require back-loaded repayments, where interest is deferred to accommodate the revenue profile and increase the amount of proceeds available for construction.

The Transportation Infrastructure Financing and Innovation Act (TIFIA) program, enacted in 1998 as part of TEA-21 and expanded in SAFETEA-LU, provides credit assistance to major transportation investments in the form of direct loans, loan guarantees, and lines of credit and is designed to fill market gaps and leverage private co-investment by providing supplemental and subordinate capital to projects.

TIFIA may cover up to 33 percent of eligible project costs. The TIFIA instruments may be subordinate to other debt obligations, and the payment schedule may be deferred. The program is targeted to large-scale transportation projects with specifically dedicated revenue streams.

The federal government assumes the default risk associated with extending credit to borrowers, with the estimated cost of assuming this risk funded by the program or, in some cases, by individual borrowers or project sponsors.

Loans typically are made based on the U.S. Treasury's borrowing cost. Credit instruments receive unique budgetary treatment among federal programs. Fiscal cost is measured with a present-value accrual framework rather than nominal dollar cash outlays (as with grant programs). The "subsidy premium" (or loan loss reserve) for the TIFIA program is funded by the Highway Trust Fund.

Budgetary limitations in federal fiscal year 2009 and heightened program demand, however, spurred the TIFIA program to adapt and allow borrowers to pay their own credit subsidy (or a portion thereof) in order to secure TIFIA financing beyond the program resources then available.

Next week: What is a Public-Private Partnership?

T2 is happy to exchange ideas about this or any other matter related to the next surface transportation bill. Contact Billy Moore at (202) 288-0892 to set up a discussion. You can also get additional information at our website www.trans2group.com