

Written Statement by David Seltzer, Principal
Mercator Advisors LLC

before the
Senate Committee on Environment and Public Works

Hearing on “Innovative Project Finance”

September 28, 2010



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Chairman Boxer and Ranking Member Inhofe, thank you for inviting me to testify this morning on “Innovative Project Finance.” My name is David Seltzer, and I am a Principal at Mercator Advisors, a Philadelphia-based financial advisory firm that works with public, private and nonprofit entities seeking to finance major infrastructure projects and programs. We also advise federal agencies and transportation sector associations on federal policy initiatives that could stimulate infrastructure investment.

My personal background includes over twenty years of experience working in public finance investment banking, followed by several years working at the US Department of Transportation to help develop and implement innovative finance programs, such as TIFIA, GARVEE Bonds and State Infrastructure Banks. Aside from my current “day job” as a financial advisor, I also serve as chairman of the Philadelphia Gas Works—the nation’s largest municipally-owned gas utility and, at 175 years, perhaps its oldest—so I am acutely aware of the reinvestment challenges confronting America’s public works.

You have heard compelling testimony today from the Mayor of the City of Los Angeles and the Secretary of the Florida DOT concerning their major investment needs and how they are seeking to address them. I would like to briefly share with you how our firm considers what types of federal policy initiatives could be most effective in helping America’s state and local governments accelerate and expand their transportation investment programs.

“Innovative Project Finance” in Context

The federal government has essentially four types of broad policy tools it can use to stimulate infrastructure investment: grants, regulatory streamlining, credit assistance and tax code incentives. Grant funding has been the traditional federal tool for surface transportation,

but as you are well aware, the magnitude of the nation's transportation investment needs far exceeds available resources. Regulatory reforms generally have little if any adverse fiscal impact, and can be helpful in streamlining project delivery. However, they may not provide a deep enough subsidy to stimulate major capital investment in and of themselves.

I would like to direct my comments to the last two federal policy categories—credit assistance and tax code incentives—as innovative project finance tools deserving further attention because:

- (a) they can be highly effective in stimulating investment through leveraging pledged state and local revenue streams or user charges; and
- (b) they have a much smaller budgetary cost than traditional grant funding.

Larger projects with major public benefits often have capital requirements exceeding currently-available resources. The most effective way to accelerate the capital investment is through external financing repayable with future expected revenues. Credit and tax code incentives can help drive down the cost of borrowing below conventional levels, thereby maximizing the amount of investment that can be supported by any given revenue stream. Issuing bonds allows raising the capital today to take advantage of current favorable construction prices, generating immediate jobs and bringing the improvements into service much sooner, along with the associated economic and social benefits. At the same time, long-term financing equitably spreads the cost between current and future beneficiaries, through annual lease or debt service payments.

In order to be successful, any federal project financing proposal must address the requirements of three principal stakeholder groups. First, from the perspective of the project sponsor (which could be a State, City, public authority or public-private partnership), the new tool has to represent a *cost-effective source of capital*, compared to other existing approaches. Second, from the perspective of the investors (which could be public entities, like state infrastructure banks and public pension funds, or private entities, such as individual investors and financial institutions), the financing tool must offer a *competitive risk-adjusted rate of return*. And finally, from the perspective of the federal government, the tool has to be both *fiscally affordable and consistent with public policy objectives*. These three classes of stakeholders can be likened to a three-legged stool; if the policy proposal lacks support from any one of them, it is unlikely to be effective.

Summarized below are several suggested modifications to the TIFIA credit program and the federal tax code that we believe could stimulate transportation investment while satisfying the varied requirements of these three key stakeholder groups.

Credit Assistance through TIFIA

One of the existing federal credit programs that I helped develop while working at USDOT is the TIFIA program. TIFIA—the Transportation Infrastructure Finance and Innovation Act—was designed to provide supplemental and subordinate capital to surface transportation projects. The program funds up to one-third of project costs in the form of direct loans, loan guarantees and lines of credit.

The TIFIA program has proven quite successful—nearly \$8 billion of credit assistance has been extended to 23 major projects, leveraging \$29 billion of new capital investment. Of the federal loans made, 20 percent—\$1.6 billion—have already been repaid in their entirety.

From a budgetary viewpoint, federal credit is much more cost-effective than outright grants. The fiscal charge for federal loans or guarantees is based on the “subsidy cost”—the present value of estimated losses from loan defaults and any interest rate subsidies below the government’s own cost of funds. Under the TIFIA program, loans can be extended at a very modest scored budgetary cost—about ten cents on the dollar, on average. That means a \$1 billion federal loan or loan guarantee may be provided at a scored cost of only \$100 million. That kind of financial leverage is very compelling in the current environment, where infrastructure investment needs are great but federal budgetary resources are severely constrained.

Under federal credit reform rules, the budgetary charge for a direct loan from the government is basically the same as that for a federal guarantee on a loan funded by a third party. Yet of the 23 TIFIA credit agreements, 22 have taken the form of direct loans; only one has been in the form of a loan guarantee. The reason project sponsors prefer direct federal loans is because they typically offer more advantageous terms. As of last week, the direct federal lending rate was very favorable—about 3.75%. A lender on a federally-guaranteed loan generally would require a return that is ½% higher or more, to compensate it for liquidity concerns, transaction costs and other factors. In addition, direct federal loans give borrowers much greater prepayment flexibility than guaranteed loans from other parties.

Earlier this year, USDOT announced that it had received 39 letters of interest from major project sponsors seeking \$12.5 billion in TIFIA loans for investments totaling nearly \$41 billion. However, program funding is currently available to support only about \$1 billion of new lending capacity – that’s less than 10 percent of the expressed credit demand. To assist these and other potential project sponsors in accessing the TIFIA program and making better use of its credit support, the Committee may wish to consider certain enhancements, involving both funding levels and programmatic terms:

1. Increase TIFIA Program Funding. In recent years, the TIFIA program funding authorization has been \$122 million per year, which is enough to support approximately \$1 billion of annual credit assistance. Based on tangible demand, increasing the amount of budget authority for this credit program is absolutely necessary. A five-year authorization of \$1.5 to \$2 billion to fund the subsidy costs of perhaps \$15 to \$20 billion of new loans could support potential total project investment in excess of \$50 billion. This increased funding level certainly appears to be justified, and is consistent with the recommendation of the National Surface Transportation Infrastructure Financing Commission in its report to Congress last year. Growing the TIFIA program to accommodate the largest projects also will help remove pressure on the traditional Federal-aid Highway and New Starts grant programs, freeing up their capacity for other, smaller projects.

2. Incentivize Proposals that identify New Funding Streams. There has been much discussion in policy circles about the nation’s infrastructure investment gap, and how best to address it. A key impediment has been insufficient project revenue streams to attract needed investment. The Committee may wish to consider prioritizing applications for assistance to major projects where the vast majority of funding—say, at least two-thirds—is coming from sources *other than* federal grants. This will reward state and local project sponsors who make the difficult commitment to generate the revenues necessary to support new investment.

3. Encourage Investments with Systemic Benefits, by giving Upfront Credit Commitments. TIFIA was originally conceived as a “project finance” tool, oriented towards individual projects. As a result, federal commitments to extend credit were tied to project-specific milestones, such as feasibility forecasts for project-generated revenues, final cost estimates, and environmental and other public approvals. However, transportation agencies increasingly are recognizing that a *portfolio of large, related projects* can produce transformational benefits in terms of regional mobility, air quality and economic development. These multiple projects often are backed by a single dedicated tax or other revenue stream under a common plan of finance, not reliant on any project’s individual financial performance. For major, comprehensive programs, such as those in excess of \$1 billion, the project sponsors would benefit from greater predictability of TIFIA funding over the programmatic delivery schedule. This could be achieved by authorizing USDOT to enter into “master credit commitments” covering a multi-year period, with assistance applicable to any of the underlying projects. An upfront credit commitment would allow USDOT to conditionally set aside funds, providing much-needed dependability for the project sponsor. No actual loans could be made for a particular project until detailed cost estimates and final environmental approvals had been received. But given the long lead-time on projects, an upfront credit commitment would provide important predictability in executing these transformational investment programs.

While there are some other, more technical modifications that could be made, the three recommendations described above—tripling the funding level, incentivizing sponsors who rely on new local revenue streams, and allowing upfront conditional commitments for multi-project programs—would greatly enhance the effectiveness of the TIFIA program.

Institutional Platform

Thus far, TIFIA loan administration has been managed through a joint program office within the Federal Highway Administration. This has functioned reasonably well, but if the program scale is to be expanded substantially, it would be worthwhile exploring whether other institutional approaches might be advantageous for quickly and responsibly selecting recipients of credit assistance and negotiating the financing agreements.

There has been much discussion in recent weeks about the potential advantages of establishing a new special-purpose entity, such as a national infrastructure bank, including a proposal announced earlier this month by the President and hearings held just last week by the Senate Banking, Housing & Urban Affairs Committee. The bank would be oriented to larger infrastructure projects, and would provide credit assistance, among other services.

Establishing a new government corporation requires answering important policy questions concerning the organization's scope, governance, accountability and programmatic effectiveness. While those issues are beyond the scope of this testimony, to the extent Congress *does* decide to create a new entity, we believe its lending authority should be arranged as a TIFIA-style federal credit program, rather than a loan revolving fund capitalized through public borrowing. That is, the bank should obtain lendable funds directly from the Treasury, rather than issuing its own public debt securities. This would result in much lower-rate loans, and offer much greater flexibility for borrowers than creating a new financial institution to borrow funds in the credit market to relend to project sponsors. Some observers have cited the multi-lateral European Investment Bank (EIB) as a potential model for the U.S. The EIB has some valuable features, especially in terms of its commercial orientation and highly-skilled staff. But using the EIB template for a national infrastructure bank's capital structure would, in our view, be less efficient, and its capital markets activities could raise federal policy concerns that are avoided under a TIFIA-style approach. In fact, the bank could become the entity responsible for managing both the existing TIFIA program and any future expansion of it.

Tax Incentives

While TIFIA can play a valuable role in facilitating financing for projects and programs, we also believe that tax incentives are a critical element of any comprehensive federal strategy to stimulate transportation investment. Tax code changes also have a much smaller scored

budgetary cost than the same volume of assistance provided in the form of outright grants. Recognizing that tax code changes are not under the jurisdiction of your Committee, we believe Congress should consider a surface transportation version of the highly-effective “qualified tax credit bond” programs.

Last year in the Recovery Act, Congress authorized a variety of tax subsidies to reduce state and local borrowing costs. Several of these programs provide federal subsidies in the form of annual tax credits offsetting up to 100% of the interest cost associated with bond financing. For example, Congress authorized \$22 billion of qualified school construction bonds with a 100% interest subsidy, to stimulate school investment and job creation. A similar program targeted to major surface transportation investments could more than double the level of investment supportable by a state or local revenue stream, compared to traditional tax-exempt municipal bonds. Congress could specify an annual volume cap in order to control the fiscal impact of the associated tax expenditures. The volume could be allocated by the Secretary to those projects conferring the highest economic and social returns.

Another suggested tax code modification relates to the increasing role that the private sector is playing in delivering, managing and financing major transportation projects. It appears that Congress may extend the existing Build America Bonds (BABs) program, which expires at year-end, for at least another year. The BABs program allows state and local issuers to offer their bonds at a higher taxable rate, but receive a federal interest subsidy in the form of a refundable tax credit (currently set at 35 percent of interest cost). The taxable yield on BABs has attracted major new types of investors to purchase U.S. infrastructure bonds, such as pension funds and life insurance companies, whose tax position makes investing in tax-exempt municipal bonds unattractive. In fact, this is a perfect example of the “three-legged stool” metaphor referenced above—a new financial product that is attractive both to issuers and investors, within federal budgetary tolerances and policy parameters.

Under current law, BABs are limited to those projects that are eligible for “governmental purpose” tax-exempt bond financing. This requirement precludes projects that are deemed “private activity,” due to private sector involvement in ongoing management or through equity investment. We think a strong policy argument could be made for extending eligibility for issuing BABs to general infrastructure projects with private participation *that are available to and benefit the general public*, such as highway, transit and other transportation facilities. Perhaps this sub-category could be differentiated from other private activity bonds by designating them as “Public Benefit Bonds,” eligible to utilize whatever form of BABs Congress ultimately extends.

Conclusion

In an era of constrained budgetary resources, “innovative project finance” tools that draw upon a combination of credit and tax incentives can play an important role in advancing major transportation investments. The current TIFIA program has been very successful, but should be tripled in size in order to accommodate demand. The additional financing capacity might be prioritized towards the largest projects and programs conferring systemic benefits, and those backed by a major local commitment increasing the resources pledged for repayment. Authorizing USDOT to make upfront credit commitments available for multiple projects backed by a common plan of finance would provide much-needed predictability to project sponsors.

On the tax side, Congress should consider establishing a new class of zero-interest qualified tax credit bonds for major surface transportation projects, and extending the eligibility to issue Build America Bonds to transportation projects with private participation that are available to the general public.

Collectively, these enhancements would stimulate major new transportation investments with a relatively small federal budgetary impact. At the same time, these new tools could remove pressure from existing federal grant programs, which would continue to be focused on traditional uses.

Thank you for the opportunity to appear before you. I would be happy to respond to any specific questions you may have.