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STATE OF NEW YORK
OFFICE OF THE STATE COMPTROLLER

June 20, 2000

Mr. E. Virgil Conway
Chairman
Metropolitan Transportation Authority
347 Madison Avenue
New York, NY 10017

Re: Asset Sale-Leaseback Program
Report 97-S-57

Dear Mr. Conway:

Pursuant to the State Comptroller's authority as set forth in Article X, Section 5 of the State Constitution, we have audited the administration of the Metropolitan Transportation Authority's (MTA) asset sale-leaseback program. Our audit covered the period January 1, 1989 through May 1, 1998.

A. Background

Public transportation in New York City and the adjacent suburban areas is operated by the MTA. MTA affiliates include New York City Transit (NYCT), Long Island Rail Road (LIRR), Metro-North Railroad, Long Island Bus, and the MTA Bridges and Tunnels. The MTA affiliates are governed by the MTA's Board of Directors, whose members are appointed by the Governor.

The Federal Transit Administration (FTA) advises transit authorities like the MTA on how they can generate funds to enhance the effectiveness of their capital investment program by exploiting the value of their infrastructure investment. Following that advice, the MTA has been able to increase significantly the amount of money available for its capital programs. The use of one technique recommended by the FTA, known as a defeased sale-leaseback transaction, enables a government entity or public authority to sell an asset to an investor, but retain the use of it by leasing it back from the new owner. The proceeds from such a sale, along with accrued interest, enable the lessee (i.e., the MTA) to make the annual lease payments, exercise the right to repurchase the equipment when the lease period ends, and still receive a cash benefit.

In a defeased lease, the MTA deposits in escrow the current net value of the lump sum payment it must pay the owner at the end of the lease period. The MTA retains the full use and benefit of the equipment sold and re-acquired through such a lease, maintaining it throughout the

lease period and keeping it in normal operation. To prevent this maintenance requirement from becoming burdensome, the lease typically allows the MTA to dispose of equipment if it becomes dysfunctional, so long as the owner is provided with similar replacement equipment or penalty payments are made. As the owner of the equipment, the lessor receives tax benefits as the equipment depreciates.

According to MTA records, from January 1, 1981 through December 31, 1987, under Section 168 of the Internal Revenue Code, the *Domestic Safe-Harbor Program*, the MTA entered into 29 sale-leaseback transactions. In these transactions, the MTA sold and leased back $2.6 billion in train and bus fleets used by NYCT and the MTA's two commuter railroads (LIRR and Metro-North), and gained $524 million for its capital program. In this effort, the MTA negotiated leases with American companies, sold the tax benefits in a defined structure, and sold and leased back equipment that reverts to MTA ownership when the leases expire. These transactions are listed in following table:

MTA - Safe-Harbor Sale-Leaseback Program
1981 Through 1987

Year	Number of Transactions	Cost of Equipment Sold	Net Equity to MTA
1981	2	$102,054,886	$15,480,614
1982	2	34,951,453	4,643,365
1983	4	64,313,439	8,997,350
1984	3	456,657,579	108,956,968
1985	2	287,542,730	61,381,014
1986	7	914,201,217	179,699,472
1987	9	783,997,643	144,700,650
Total	29	$2,643,718,947	$523,859,433

Changes in the Federal Tax Law effectively ended the Safe-Harbor program in 1987. As an alternative, Cross-Border Leveraged Leases with foreign lessors were developed. From 1989 through 1995, the MTA reports it has entered into three such leases, which allow a foreign lessee to generate tax benefits in its country of origin through investment tax credits and depreciation. The MTA received equity of nearly $18 million from overseas investors in these transactions on equipment valued at about $395 million. In each case, the MTA has the option to repurchase the equipment at the end of the lease. These leases are listed in the following table:

MTA - CROSS-BORDER LEVERAGED LEASING PROGRAM 1989 THROUGH 1995				
Year	**Type of Lease**	**Number of Transactions**	**Cost of Equipment Sold**	**Net Equity to MTA**
1989	Japanese Cross Border	1	$216,000,000	$11,232,000
1992	Danish Cross Border	1	60,547,500	2,300,805
1995	German Cross Border	1	118,573,875	4,211,092
Total		3	$395,121,375	$17,743,897

Between 1995 and 1999, the MTA entered into several new forms of domestic sale-leaseback transactions. One of these involved an agreement, known as a Pickle Leaseback, that is similar to a Safe-Harbor lease, but involves a U.S. tax jurisdiction-based sale-leaseback arrangement with an entity that is tax-exempt. The MTA has one such lease, for equipment that is valued at $85 million and received a net equity benefit of nearly $5.5 million. In addition, the MTA has entered into two lease-leaseback transactions: one for its Holban/Hillside Maintenance Complex and the other for rolling stock (subway cars). These leases, for which the MTA has received benefits totaling over $27 million on assets valued at $400 million, layer a shorter lease over a longer lease. These three transactions are illustrated in the following table:

MTA - SALE- & LEASE-LEASEBACK TRANSACTIONS 1995 THROUGH 1998				
Year	**Type of Lease**	**Number of Transactions**	**Cost of Equipment**	**Net Equity to MTA**
1995	Pickle-Leaseback	1	$85,000,000	$5,487,741
1997	Lease-Leaseback	1	314,000,000	22,721,337
1997	Lease-Leaseback*	1	85,679,000	4,769,220
Total		3	$484,679,000	$32,978,298

* *This transaction was not completely closed at the time of our audit field work. The MTA had yet to receive some bills to process for payment.*

Lease contracts are complex and time-consuming to negotiate and complete, requiring the collaborative efforts of several different parties. The equity investor provides the funds, selects a banker who will provide financing support, and names a counsel who will give legal advice. The MTA provides the capital asset and uses in-house and external counsel, as well as financial advisors, to assess the transaction's benefits to the MTA.

B. Audit Scope, Objectives and Methodology

We audited the MTA's administration of the asset sale-leaseback program for the period from January 1, 1989 through May 1, 1998. The objectives of our performance audit were to determine whether the MTA has benefitted from its use of asset-leasing techniques for financing capital programs, and whether the MTA entered into open and competitive transactions when it pursued the sale and leasing of its assets. To accomplish these objectives, we interviewed MTA and FTA officials, as well as representatives of other transit authorities. We also examined MTA files and records pertaining to the transactions.

We conducted our audit in accordance with generally accepted government auditing standards. Such standards require that we plan and perform our audit to adequately assess those operations which are included within the audit scope. Further, these standards require that we understand the MTA's internal control structure and its compliance with those laws, rules and regulations that are relevant to those operations which are included in our audit scope. An audit also includes assessing the estimates, judgments and decisions made by management. We believe our audit provides a reasonable basis for our findings, conclusions and recommendations.

We use a risk-based approach when selecting activities to be audited. This approach focuses our audit efforts on operations identified through a preliminary survey as having the greatest probability for needing improvement. Consequently, by design, finite audit resources are used to identify where and how improvements can be made. Thus, we devote little audit effort to reviewing operations that may be relatively efficient of effective. As a result, our audit reports are prepared on an "exception basis." This report, therefore, highlights those areas needing improvements and does not address activities that may be functioning properly.

C. Results of Audit

Because the MTA's capital investment pool account has a large balance and so many funding sources, we were unable to determine whether the MTA has used any of the funds received from the lease programs to enhance the effectiveness of its capital investment program. Therefore, we recommend that the MTA maintain a separate accounting for the asset sale-leaseback program. Our analysis of asset sale and leasing transactions indicates that a competitive process is not always followed when the investor, financial advisor, or arranger is selected. The MTA needs to document its policies and the procedures regarding asset sale-leaseback, including the use of the competitive process.

1. Benefits of Leasing

Between January 1, 1981 and May 1, 1998, the MTA entered into 35 asset sale- and lease-leaseback transactions including 29 domestic Safe-Harbor leases, 3 Cross-Border leveraged leases, a Pickle lease, and 2 lease-leasebacks. As a result of these transactions, which generated $3.5 billion in asset sales, primarily from the sale of rolling stock of NYCT and the two commuter railroads, the MTA received $575 million for capital program funding.

Six of these asset-leasing transactions, which have taken place since 1989 and are valued at $880 million, generated about $50 million for the MTA's capital program. When we reviewed these transactions, we were able to trace the receipt of the funds to the MTA's capital investment pool account, where they are included with the investment income from other lease proceeds, revenue from the sale of MTA-system assets, and funds from other sources. At the end of March 1998, the balance in the account, which the MTA is required to use for capital purposes, was $1.9 billion.

Because the MTA's capital investment pool account has such a large balance and so many funding sources, we were unable to determine whether the MTA has used any of the funds received from the lease programs for capital projects, as intended. The MTA does not maintain a separate set of accounting records or an individual ledger account for revenue and expenses resulting from the asset sale-leaseback program. When we questioned MTA officials, they told us that the MTA benefits from the availability of the sale-leaseback program funds for investment. Indeed, they pointed out that the investment yields on funds generated from asset sale-leaseback are unrestricted, and for that reason are the last to be spent by the MTA on capital projects. The funds are invested and rolled over at maturity because they can be invested at a higher rate of interest than that of other funds.

Lease-contract arrangements are complex and time-consuming to identify, negotiate and complete, requiring the collaborative efforts of several different groups within the MTA. The MTA needs to document how its capital program has benefitted from this investment of time and resources. To do this, we recommend it maintain a separate accounting for these sales.

2. Awarding Personal Service Contracts

The MTA has leased more than $3.5 billion of its equipment and structures to other parties since 1981. With a program of this magnitude, MTA officials need to document the policies and the procedures they follow to ensure they are securing the best possible terms for the agency.

Although the practice followed by the MTA for selecting lessors for its assets has a certain structure and organization, it is not documented in writing. The only documentation consists of a catalog of MTA assets that is continually reviewed and updated according to changing conditions in the law, lease structures, and other factors. It lists items such as rolling stock, buses, maintenance facilities, depots, etc., and is shared with MTA's leasing advisors, who analyze the contents to assess particular characteristics of the assets listed. These characteristics include the estimated appraised value and remaining useful life, the primary source of financing, etc. This analysis results in a refined list of assets that may qualify as good candidates for leasing at some point in the future, as changes occur in the leasing market.

After selecting an asset for leasing, the MTA generally drafts and issues a Request for Proposal (RFP), then evaluates the responses. At times, the lease may be initiated by a third

party. In such cases, the proposal is analyzed by the MTA financial advisors in terms of the benefit it could bring to the MTA. In negotiating leasing transactions, the MTA relies on the expertise of both leasing advisory firms it hires to protect its interests and its Special Counsel, who is the contact person responsible for coordinating the initial negotiations with outside investors or financial arrangers. The Special Counsel notifies the MTA Board when its approval is needed to complete the long-term financing transactions, which can span 15 to 20 years.

The MTA's *All-Agency Guidelines for the Procurement of Services* (Guidelines) requires the competitive awarding of personal services contracts through either an RFP process or competitive bidding. The Guidelines define personal services contracts to include legal, financial, accounting, and investment services, as well as other consulting, professional, or technical services. The Guidelines allow the MTA Board to grant a waiver of the competitive process when it is determined to be impractical or inappropriate.

Our analysis of the MTA's files for the six asset sale/lease-leaseback transactions the MTA entered into between January 1, 1989 and May 1, 1998 indicate that a competitive process was not always followed when the investor, financial advisor, or arranger was selected. We determined that the 1992 Danish Cross-Border and the 1995 German Cross-Border transactions did not involve an RFP for any of the three contracting parties; an RFP was issued only for the investor in the case of the 1995 Pickle leaseback; and there was no RFP for the investor in the 1997 lease-leaseback transactions. (We could not draw any conclusions about the 1989 Japanese Cross-Border transaction because the file was incomplete at the time of our audit field work.) The other transit authorities we contacted that engage in similar transactions indicated to us that they use an RFP process to select contractors. We did not corroborate these comments. In addition, we did not find evidence that the MTA Board formally granted a waiver of the competitive process on the leases where the competitive process wasn't used. MTA officials commented that, ". . .the Board's approval of the selection of those parties is a clear waiver of the Board developed [Guidelines]."

Whenever possible, the MTA should use the competitive process to select contractors, so that it can be assured that the best terms and financial arrangements have been obtained for these transactions. We recognize that it may occasionally be advantageous for the MTA to not use the competitive process (e.g., when a potential investor solicits the MTA with a unique investment proposal or if a transaction has to be closed before conditions such as tax regulations change). However, the reasons for not soliciting competition should be documented in the appropriate files to protect the MTA against potential accusations of unfair business practices, and the Board's formal waiver of the competitive process should be obtained and documented.

Recommendations

1. *To document how the MTA has benefitted from its asset sale-leaseback techniques for financing capital programs, maintain a separate accounting for the asset sale-leaseback program*.

   (MTA officials disagree with this recommendation. They indicate that all non-bond monies are pooled to facilitate efficient debt management, cash management, investing and accounting. They believe they are efficiently managing the totality of the capital program funding sources, and there is no tangible benefit from incurring the cost to implement separate accounting for asset sale-leaseback program funds.

   Auditors' Comments: The MTA invests significant time and resources in the asset sale-leaseback program. Putting together such a transaction requires appointing advisors, identifying candidate assets, assessing structures, identifying and selecting potential investors, and obtaining MTA Board approval. Due to the complexity and multi-disciplinary nature of these transactions, the MTA also utilizes the services of a leasing advisor and outside counsel. Given this significant investment, MTA officials should be concerned as to whether they are meeting the primary objective of the program, to enhance the effectiveness of their capital investment program. We question the MTA's reluctance to measure the success of this program by maintaining a separate accounting for the asset sale-leaseback program.)

2. *Document the policies and the procedures to be followed by management in the administration of the asset sale-leaseback program, including the requirement to document when and why the competitive process is not used and the Board's formal granting of a waiver of the Guidelines*.

   (MTA officials believe that their past practices in this area have been satisfactory. They do, however, intend to review the recommendation and consider whether it is in the MTA's best interests to implement it.)

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A draft copy of this report was provided to MTA officials for their review and comment. Their comments have been considered in preparing this report, and are included as Appendix A.

Within 90 days after final release of this report, as required by Section 170 of the Executive Law, the Chairman of the Metropolitan Transportation Authority shall report to the Governor, the State Comptroller, and the leaders of the Legislature and fiscal committees, advising what steps were taken to implement the recommendations contained herein, and where recommendations were not implemented, the reasons therefore.

Major contributors to this report were Abe Markowitz, John Gimberlein, Joseph Smith, Jagdeshwar Mohunlall, Anil Watts, Huanan Zuang, and Marticia Madory.

We wish to thank the management and staff of the Metropolitan Transportation Authority for the courtesies and cooperation extended to our auditors during the audit.

Very truly yours,

Frank J. Houston
Audit Director

cc: Charles Conaway