

IRPTN VEHICLE FINANCING OPTIONS AND CONSIDERATIONS

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ABSTRACT

The roll-out of comprehensive public transport networks in our major cities is requiring considerable up-front investment by government. The acquisition of the bus fleet presents the second largest component of capital expenditure by the implementing municipalities. Various fleet financing models have been adopted including the use of national grant funding and debt. This paper sets out to describe the various financing models that have been used to date and highlight their implications with respect to various criteria including cost, risk and complexity.

The paper then moves on to discuss the concern of municipal treasuries surrounding the potential consolidation of the buses onto the books of the municipalities and evaluates the effectiveness of the move to finance the buses 'off-balance sheet'. The rationale for the National Department of Transport's ("NDOT") preference for the use of Export Credit Agency financing ("ECAs") as the financing route of choice is also discussed.

The paper then addresses the outcomes of an on- versus off-balance sheet financing structure, and the implications on both the financing model and the underlying institutional structure. An alternate model is then introduced which proposes a hybrid between the debt financing options used thus far in an attempt to mitigate the short comings present in the existing models.

1. INTRODUCTION

A number of the first bus purchases were funded by grant funding. However the grant framework (and the NDOT) has discouraged the use of grant funding for an up-front purchase, and has instead committed to repaying the capital cost over time (together with related finance and transaction costs). This has required a shift to debt financing.

Debt financed transactions take the form of either corporate finance transactions, in which the municipality will look to finance the purchase off the strength of their own

balance sheet, or a project finance transaction, where a separate legal entity from the

Type of Financing	Description	Nature	Source
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municipality enters into the finance agreement, with the lender then looking to the revenue from the project to secure the funding.

Within both these two models, the NDOT has strongly encouraged the use of Export Credit Agency (“ECA”) backed financing. This preference has had a significant influence on the choice of financing options pursued by the municipalities.

However this focus on ECA financing has shifted recently as the final costs and complexities of the first deals are weighed against a marked increase in receptiveness for the transactions from local commercial banks and development finance institutions.

The employment of corporate and project finance structures for the purchase of the vehicles has however raised concerns amongst municipal treasury officials with respect to the issue of consolidation of a project finance transaction onto the books of the municipality. This consolidation effect and the resultant potentially adverse impact on the municipalities’ debt covenants have largely been addressed, but the issues surrounding the lack of empowerment of a corporate finance structure and the risks presented to the municipality by a project finance structure persist.

These empowerment and risk considerations have given rise to an alternative approach; the Municipal Entity (“ME”) model. In the ME model, the ME will (in its own capacity) raise the finance, purchase and own the vehicles. This model combines the benefits of municipal involvement in a corporate finance structure with the alignment benefits of including the affected operators provided by a project finance structure. As a result, the ME model addresses the need to procure the buses at the lowest cost of finance, while also addressing the issues of control and risk for the municipality and empowerment for the affected operators. .

AIM OF THE PAPER

The aim of this paper is to provide an overview and commentary of the financing mechanisms employed to date. This synopsis of the current issues shaping the discussion will then provide background against which we investigate the current issues informing the choice of financing employed and discuss a number of lessons that have been learnt from the transactions concluded to date.

2. IRPTN BUS FINANCING – A PERSPECTIVE

2.1. Bus Financing models used to date

Grant Funding	Cash Purchase		
Debt	Corporate Finance	Generic	Local
			Foreign/ ECA
		Project Specific	Local
			Foreign/ ECA
	Project Finance	Local	
		Foreign/ ECA	

2.1.1. Grant Funding

The most common form of financing employed to date has been the use of national grant funding allocated and distributed in terms of the Division of Revenue Act¹ promulgated by the National Legislature each year. Municipalities have made use of the Public Transport Infrastructure Grant in order to purchase vehicles.

The use of grant funding has required the vehicles to be owned by the municipalities, which conflicts with the empowerment objectives of the National Land Transport Act (“NLTA”)² and the preference for the affected operators in the form of an incorporated private company (Vehicle Operating Company (“VOC”)) to own the vehicles and operate the service. The rationale being that by shifting the ownership to the VOC the upfront capital cost of establishing the public transport system would be reduced and the costs smoothed by transferring the costs from capital costs into operational costs.

The preference for VOC ownership has therefore introduced the need to move away from grant funding towards debt financing.

2.1.2. Debt Financing- Project Finance and Corporate Finance

The non-grant financing options available to the municipalities may be categorised into two broad categories, namely Corporate Finance and Project Finance. Corporate finance may be broken down further into generic corporate finance agreements and specific corporate finance agreements.

2.1.2.1. Corporate finance – generic

In terms of a standard corporate finance transaction the borrower would look to raise finance in its own capacity from the manufacturer using the funds and lease them to the VOC to allow them to provide the services.

Alternatively the Municipality may sell or donate the buses to the VOC in order for them to provide the services.

An example of this option is the City of Cape Town’s revolving credit agreement with the French Development Agency.³ This facility was established to fund general infrastructure and although the City of Cape Town chose to purchase their vehicles

¹ Division of Revenue Act, 10 of 2014

² National Land Transport Act 5 of 2009

³ City of Cape Town medial release no. 1240/2013 available at <http://www.capetown.gov.za/en/MediaReleases/Pages/favourablerateforAFDloan.aspx>

using the Public Transport Infrastructure Systems Grant (“PTISG”) it is an example of a revolving credit facility which may be drawn down to fund aspects of the IRPTN, including the purchase of buses.

In this model the donation of the buses to the Vehicle Operating Company, allows the company to benefit from the wear and tear allowance provision in its calculation of income tax. It also results in a municipality avoiding the requirement to pay a mark-up on the vehicle repayment amounts, which in other jurisdictions are structured as expenses of the VOCs and possibly marked up when calculating the operating costs.

The benefits of this model are that the price of the debt is often lower given that the lending rate is based on the municipal credit rating (which barring an anomaly should trend towards the sovereign rating). Another benefit of this structure is that the transaction fees which are significant in a transaction of this size and complexity are smoothed over a greater proportion of financing and are therefore relatively lower than had the transaction fees been applied to a transaction for one aspect alone. In essence creating an “economies of scale effect” for the transaction fees.

Donating the vehicles to the VOC does create governance and financial risks as the municipality bares the obligation for the assets over which it has surrendered both effective and practical control. The municipality will also not retain any of the residual value which remains in the buses once they are decommissioned from service.

Should the Municipality not donate the vehicles, as in the case of Go!George, then the financial and governance risk is reduced. However this model then reduces the empowerment and alignment aspects of the transaction which in turn may attract negative political consequences.

2.1.2.2. Corporate finance – specific

A specific corporate finance transaction is when a borrower will raise financing for a specific project or for a specific purpose. Debt issuance or the acquisition of debt is ring fenced for the particular project. As a result, the transaction cost cannot be apportioned across projects and are thus relatively higher when compared to the generic model.

Like the generic corporate finance model, the Municipality may either retain ownership of the buses or sell or donate them to the VOC. The consequences of this arrangement have been dealt with above and are to a large degree identical.

2.1.2.3. Project finance

Project finance is a commercially financed funding transaction, based on the revenue of the specific project as security for the transaction. In a project finance transaction a separate legal entity (commonly a special purpose vehicle (“SPV”) is established to house the debt and revenue. In the IRPTN example an entity separate from the municipality (the SPV or the VOC) procures financing in its own capacity secured by appropriate undertakings from the municipality/VOC and backed by recourse to the underlying operating contract.

The use of project finance is attractive as it (in theory) ring fences the liability for the obligations under the finance agreement to the SPV. Short an explicit guarantee or suretyship from the municipality, the financiers could only look to the SPV and the

operating contract for their security. This tenuous security and the novelty of both the IRPTN systems and the operation of the system by an un- tested entity resulted in the appetite for these transactions being restricted to development finance institutions and Export Credit Agencies. This resulted in significant costs, both in the cost of finance as well as the transaction and lead time costs in concluding the agreements.

Housing the ownership of the buses as well as the liability for the obligations in a separate entity raises the issue of residual value loss to the municipality as the vehicles are likely to be repaid over a period less than that of their useful lives. The remaining value of the vehicles accrues to the owning SPV. For the owning SPV, the capital and interest costs on the repayment of the vehicles forms a cost input which may then be marked up when determining the SPV's input cost for the purposes of the concession contract. As such the municipality would pay a premium on the cost of the repayment of the buses.

The use of a standalone SPV owned by the affected operators does have important alignment and empowerment benefits as the affected operators have control and ownership of the vehicles. However this benefit comes at the expense of significant financial and governance risks to the municipality and places a heavy burden on the affected operators who are now charged with running a new business with significant obligations.

The SPV structure is also likely to fail to circumvent the consolidation issue feared by the various municipal treasury departments as the IFRS accounting rules imply strongly that the SPV be consolidated onto the books of the municipalities as a finance lease, notwithstanding their separate legal nature.

This consolidation effect reaches further as potential funders of the City will incorporate the liability of the SPV into their calculation of debt ratios in their assessment of the credit position of the municipalities. This will happen irrespective of there being an explicit guarantee from the municipality for the obligations of the SPV.

As a result a project finance transaction will in all likelihood not allow the municipalities to avoid the consolidation issue; an issue which produced a reluctance for the corporate finance structured transactions described earlier.

2.1.2.4. Export Credit Agency guarantee finance

Export Credit Agency backed financing has been touted as the most attractive option for the financing of the buses.

An export credit agency is a state backed finance institution that acts as an intermediary between national governments and exporters to provide export oriented financing.

The unproven nature of the IRPTN system and the novelty of the structure resulted in muted enthusiasm from local funders for IRPTN transactions. This saw the move to finance the foreign component of the transactions by means of ECA financing.

The Rea Vaya phase 1A transaction is one in point. The foreign component of the buses for phase 1A of the Rea Vaya service were sourced from Scania Brazil with financing from the Brazilian Development Bank (BNDES) and HSBC. HSBC provided

a local denominated loan, the proceeds of which were used to provide security for the servicing of the BNDES loan, transaction fees and to cover a shortfall between the cost of the vehicles and the amount secured from the BNDES loan. The BNDES loan covered the majority of the foreign denominated purchase from Scania Brazil. The ostensibly beneficial rate of finance offered by BNDES and the final cost of the finance has been touted as an example of the benefits of ECA financing and has influenced much discussion on the subject of IRPTN vehicle purchases. However what is often overlooked when evaluating the transaction is the hugely beneficial (and coincidental) currency swing that took place between the time that the bus tender was awarded and the time that the financing was secured. Another factor that has been overlooked has been the significant hedging and transaction costs, which had to be financed. Were these costs to be capitalised, the true cost of the ECA financing structure would have been equivalent to that of the locally sourced loan.⁴

Another factor which impacts on the suitability of ECA finance is the degree to which local content is required in the procurement of buses. The financing provided by the ECA will largely only be available for the foreign component of the purchase. The local component of the purchase as required by the Preferential Procurement Policy Frame Work Act⁵ will need to be financed by an alternate source. The higher the local content requirement, the lower the percentage of the deal that may be financed using ECA-backed finance. Local component limitations therefore detract from the applicability of ECA-backed finance for the full portion of the required amount.

The foreign currency denominated ECA loans also raise a significant currency risk to a transaction. In order to provide protection from this risk, a hedging transaction would need to be entered into with a hedging counterpart, normally a commercial bank. This transaction attracts its own set of risks and costs. In the Rea Vaya Phase 1 deal the hedging costs, when added to the interest rate on the loan, made the effective cost of the ECA loan very similar to the price of a local loan.

The ECA option also results in significant transaction costs as the multi-jurisdictional legal arrangements add to both the costs and timeframes for concluding a deal. The experience with the Rea Vaya transaction saw the transaction take two years to complete as a result of the complicated nature of translating legal documents across jurisdictions.

⁴ City of Johannesburg Mayoral Committee Closeout report of the procurement of the BNDES Export Credit Agency Loan. 25 January 2010.

⁵ Preferential Procurement Policy Framework Act 5 of 2000

Given these factors, the initial enthusiasm for ECA finance has waned somewhat from the first round of bus purchases. The complexities and lengthy lead times of procuring ECA financing, coupled with an increased appetite for the finance transactions from local funders has seen a move away from ECA-backed finance as the route of choice.

As familiarity with the projects and the deals has increased, local commercial funders have become more receptive to financing the purchase of the buses on either a corporate or project finance basis. The Ekurhuleni experience has illustrated that both the commercial banks and local development banks have shown an interest in the transaction, with rates that are comparable to the rates one might expect from ECA providers.

2.2. Summary of the models

With the move away from grant funding as a viable source of funding, debt in the form of corporate and project finance provided the remaining choices for the financing of the buses.

However neither model in its pure form has achieved the objectives of procuring financing at the lowest possible cost, in a structure that allowed for the least complexity of implementation and management, yet also allowed for the requisite level of municipal control and empowerment of the affected operators.

A corporate finance model may offer reduced costs and complexity, however it has limited empowerment benefits as the affected operators are not included in the structure to own and finance the buses. Correspondingly, a project finance structure allows for the empowerment objectives to be met, but this comes at a potentially increased cost of finance, coupled with an increase in the risk that the municipalities and system are then exposed to.

A need has therefore arisen for a model that retains the respective benefits of both options, while going some way to mitigating the detractions.

2.3. Corporate Finance- Project Finance Hybrid- The Municipal Entity Model

Given shortfalls of the models described above, an alternate model has been developed which seeks to combine the benefits of a corporate finance transaction to the municipality, while emphasising the empowerment and alignment benefits of a project finance transaction for the affected operators.

To this end it is important to note that the choice of finance structure and option has significant implications for the structure of the relationship between the municipalities, affected operators and the vehicle owning and operating company.

The Municipal Entity (“ME”) model proposes that the finance is secured in an ME; a separate for-profit company incorporated in terms of Section 8 (2) of the Companies Act⁶ and as defined in the Municipal Systems Act⁷.

⁶ Companies Act 79 of 2008

⁷ Municipal Systems Act 32 of 2000

In an ME, the municipality is required to hold a controlling interest in the company.ⁱ The affected operators may then be incorporated as minority shareholders. The ME then enters into the agreement to purchase the buses and then leases the buses to the municipality. The buses are then leased by the municipality to the operating company.

The finance agreement is then entered into between the provider of finance and the ME.

The ME model gives the municipality control over the buses which reduces the threat to the continuity of the service and removes one of the major risk factors in the system. With the buses in the control of the City, the municipality is not beholden to an individual operator nor a 3rd party owner of the buses. It also enables the municipality to ensure that vehicles are properly cared for and maintained, reducing the long-term costs to the City.

The ME further provides for the incorporation of the additional stakeholders in the system, which ensures that all the parties have an incentive to protect and manage the assets and work towards the successful implementation and operation of the system. This aids not only the empowerment objectives, but also allows the municipality to retain ownership of the residual value of the buses once the initial contract has been concluded. In other words the buses are not linked to the operating contracts, which is especially important for buses bought towards the end of an operating contract.

2.4. A Comparative Study of the Financing Models

Type of Financing	Description	Nature	Examples	Lessons
Grant Funding	Cash Purchase		Go!George, MyCiti, Rea Vaya Phase 1B	Cheapest, but opportunity cost : Grant becomes fully utilised
Debt	Corporate Finance	Generic	None	
		Project Specific	None, but being considered by Tshwane and Ekurhuleni.	
	Project Finance	Local	None, but local interest indicated for current tenders	
		Foreign / ECA	Rea Vaya	Obtained a good rate, but mostly due to fortunate exchange rate and because there was no local content

3. SUMMARY

With the move away from grant funding municipalities have been required to raise finance to acquire the fleet. The initial popularity of ECA financing has diminished when the true cost and complexity of the transactions are measured against the lead time constraints and the increased availability of comparably priced local finance.

There would also appear to be a reconciliation with the accounting treatment of a corporate finance transaction and the issue of consolidation amongst treasury officials as the feared negative impact on the credit ratings of the municipalities and concerns over the repercussions on the municipalities' debt covenants have been addressed.

However, the preference for a corporate finance transaction to finance the buses has detracted somewhat from the empowerment objects of the national policy. A project finance structure with the affected operators owning the buses in a SPV would increase the empowerment benefit of the transaction but would in turn expose the municipality and the public transport system to an increased level of risk and place a significant burden on the newly transitioned operators.

A hybrid corporate – project finance structure where the finance is raised in the name of a partially owned municipal entity which then would purchase and own the buses has been introduced as a model that allows for the retention of a corporate finance comparable cost of finance and municipal control and oversight, while allowing for an increased level of empowerment and a greater degree of alignment by including the affected operators in the ownership company.

Section 86C (2) (c) of the Local Governance Municipal Systems Act 32 of 2000