Capitalization Management Trust

Expanding Options for Public Infrastructure Management

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InRecap LLC

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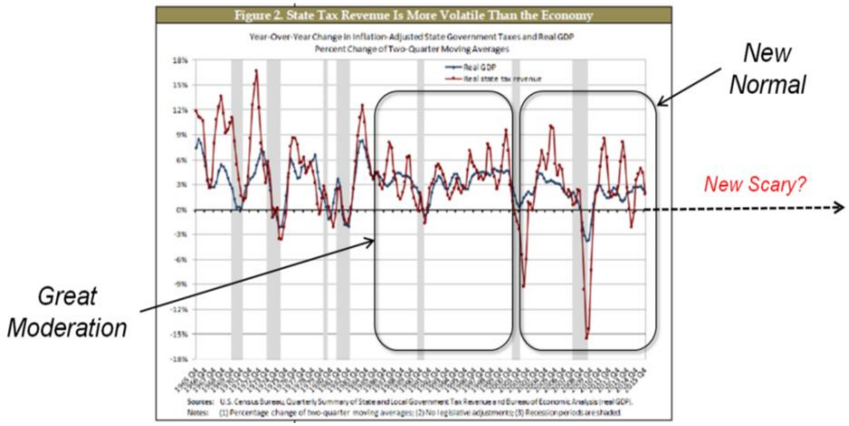
1 New Normal Is Challenging For Public Sector



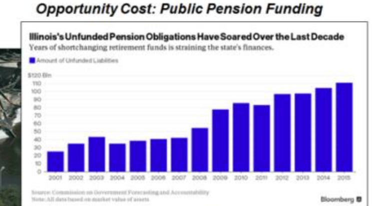
US state and local public sector is fundamentally strong, but faces a challenging fiscal environment.

- Revenue volatility has increased significantly since 2008 while growth is slow and uncertain.
- Current conditions appear to be the “New Normal” – and maybe worse to come.

Increased short-term and long-term uncertainty makes it difficult to manage and fund long-term commitments to infrastructure and other public sector obligations.

- Result is often “kicking the can” -- delaying asset maintenance, pension funding and economic investment – which relieves short-term issues but at a high cost in inefficiency and long-term outcomes.

Opportunity Cost: Public Pension Funding



Physical Cost: I-35W Bridge Collapse

Social Cost: Flint MI Lead Poisoning

Economic Cost: Loss of GDP Potential

2 How To Access New Options?

Non-Traditional Options are Expanding

Partly as a response to US public-sector interest, and partly in connection to their own challenges in the New Normal environment, several sectors are actively expanding non-traditional options for managing and financing public infrastructure:

- Private-sector infrastructure construction and operating companies
- Long-term institutional investors facing limited opportunities in other markets and seeing US infrastructure as extremely attractive
- US federal policymakers actively seeking innovative ways to support state and local infrastructure investment

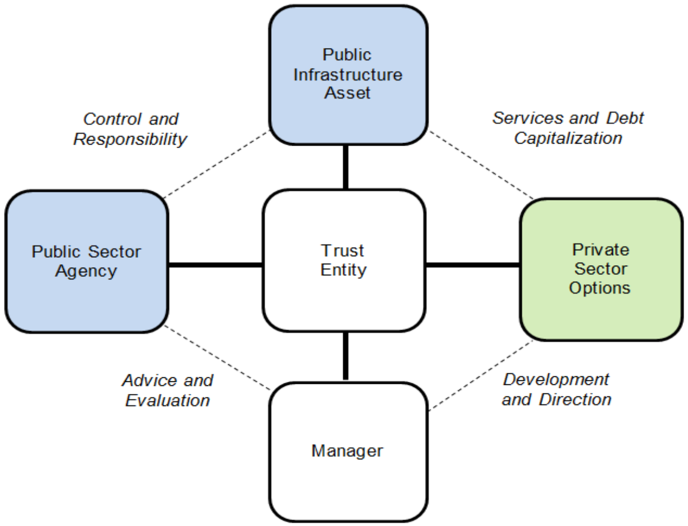
But How to Efficiently Access New Options?

Even when there are clear intrinsic benefits, accessing and implementing a non-traditional option is difficult:

- Directly utilizing an option may not fit easily into a local government's existing framework of fiscal rules, procedures and political reality
- Entering into a partnership with the private-sector can be excessively complex and includes unnecessary risk transfer for many situations involving basic infrastructure. The public partner is often overmatched.
- Lease and non-profit ownership structures are a simple and effective way to expand the public sector's framework for infrastructure management and capitalization, but current forms offer only a few limited options

3 Capitalization Management Trust: A New Approach

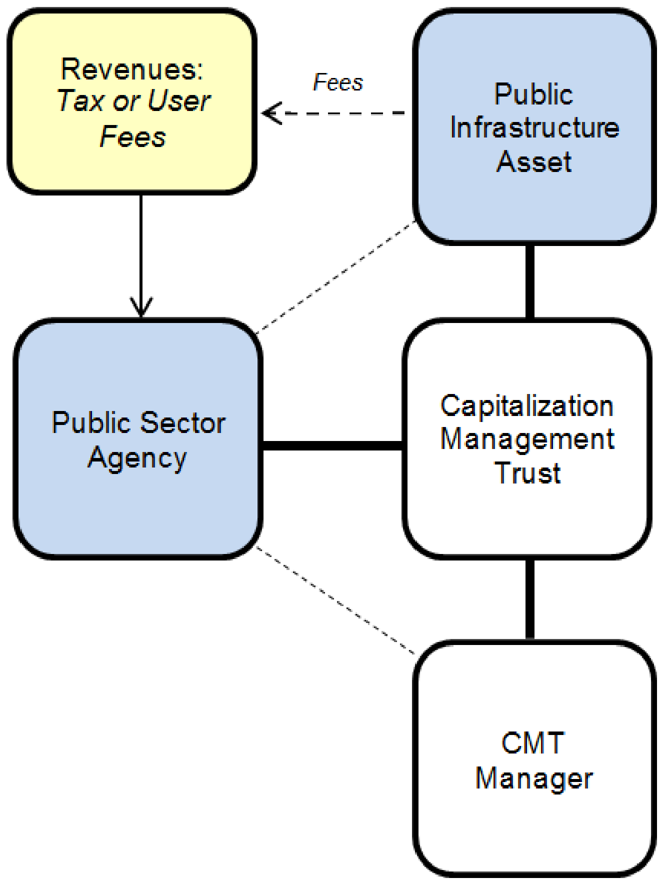
Basic approach of Capitalization Management Trust (CMT) is to expand simple lease and non-profit ownership framework to include more non-traditional options in a flexible and efficient way.



CMT Principles

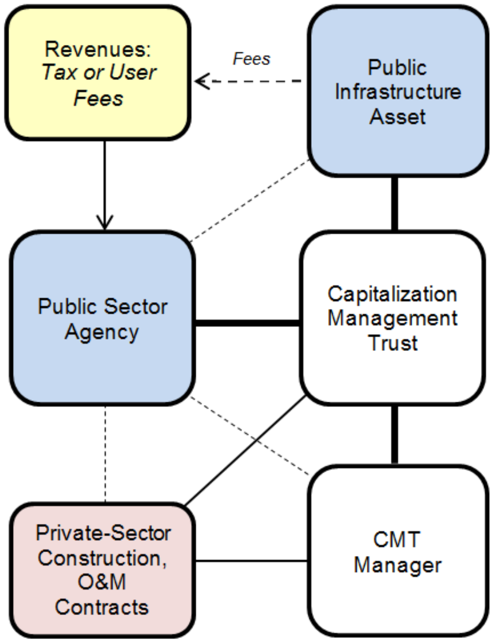
1. Control and responsibility – and most risks and rewards – of infrastructure asset stay with the public sector
2. Options are unbundled, and only those which clearly add value are added to CMT
3. Evaluation of the purpose and net benefit of each option is done separately and transparently
4. CMT Manager bring expertise but acts on behalf of public sector to develop and manage options
5. Option development directed primarily to address specific public sector concerns, not investor goals

4 CMT Based On Precedents But Designed For Flexibility



- CMT is a bankruptcy-remote SPV with nominal equity capitalization designed primarily for efficient execution of service and debt contracts
- CMT ownership remains with public sector, 501(c) 3 entities or charitable organizations, as optimized for likely options and efficiency
- Infrastructure asset owned by CMT most likely through head-lease or long-term concession structure
- Main contract between Public Sector Agency (PSA) and CMT defines primary relationship to asset and options; can be amended by PSA
- Control and responsibility for asset funding (either taxes or user fees) remains with PSA, though CMT can also facilitate statutory or contractual revenue “lock-box”
- CMT Manager acts on behalf of PSA for (1) option development, evaluation and implementation, and (2) long-term oversight of CMT operation

5 Adding Contracts



Although the main focus of the CMT is long-term debt capitalization, once the framework is in place it can facilitate asset development, construction and long-term service contracts with the private-sector.

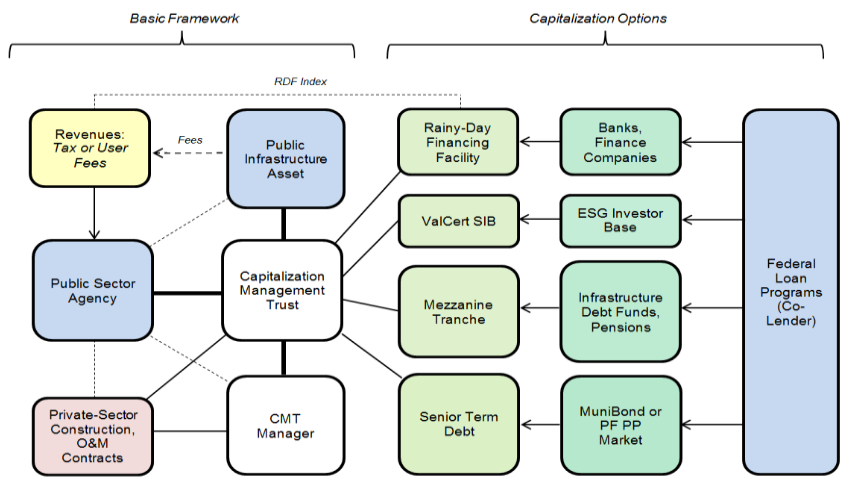
- When structured with significant performance rewards and penalties, private-sector contracts can effectively provide "equity-type" risk transfer and incentives to the CMT -- but on an unbundled basis and without complex ownership transfer
- Rev. Proc. 2016-44 has significantly expanded the scope for performance payments to private-sector companies under long-term contracts (up to 30 years) that do not preclude CMT tax-exempt debt options
- The CMT Manager can (1) explore potential synergies between unbundled contracts and capitalization options, (2) evaluate contract value individually using appropriate methodologies, and (3) exclude contracts and features with specific PSA policy conflicts (e.g. reliance on labor replacement or reduction)

Typical Contract Options

- Design-Build development and construction contracts that deliver cost and time savings
- Maintenance and capital renewal contracts that enforce "whole-life" optimization and efficiency
- Operations contracts that provide specific types of expertise or risk transfer, especially in connection with new technologies

6 Menu Of Unbundled Capitalization Options

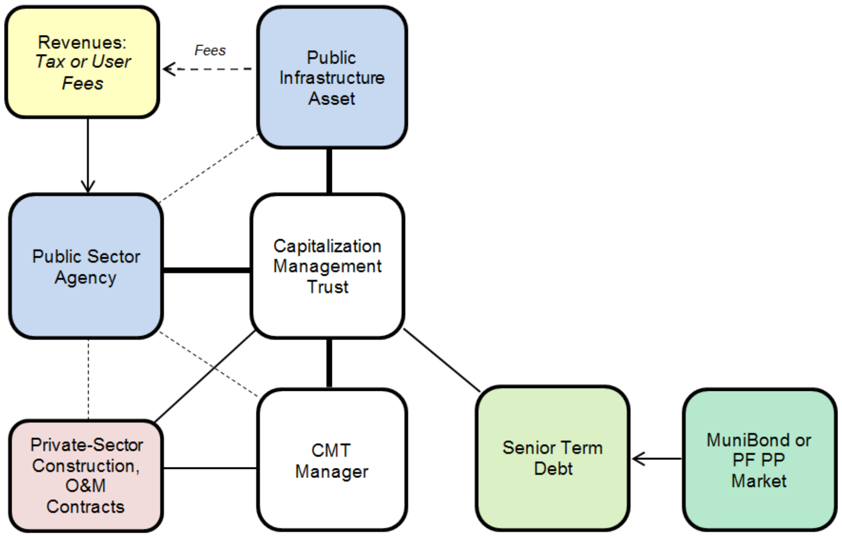
The main purpose of the CMT is to facilitate long-term debt capitalization options for the infrastructure asset sourced from traditional tax-exempt municipal bond market, non-traditional taxable debt capital markets and US federal infrastructure loan programs.



Possible Current or Near-Term Options

1. **Senior Term Debt**: Capitalization foundation, from traditional tax-exempt or taxable muni market
2. **Mezzanine Tranche**: Long-term subordinated debt from institutional investors focused on infrastructure and real estate asset value
3. **Value-Certified Social Impact Bond**: A small tranche of debt with yield based on achievement of social or environmental goals and certified with respect to this value, bought by ESG investors
4. **Rainy-Day Financing Facility**: CMT revolving credit facility that can be used when PSA experiences revenue shortfall and repaid during surpluses, provided by banks or finance companies
5. **Current or Expanded Federal Infrastructure Loan Programs** that serve as co-lender in private-sector options

7 (a) Senior Term Debt: Purpose



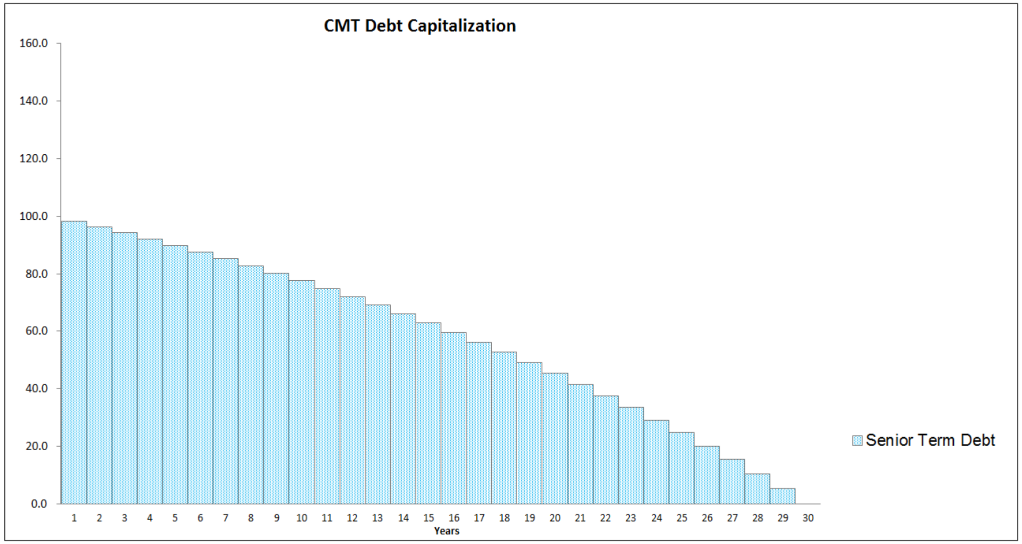
For cost-efficiency, the bulk of CMT capitalization will be long-term amortizing senior term debt.

- Main agreement between CMT and PSA will include payment terms that allow CMT to issue debt that reflects PSA's credit strength
- Likely form will be tax-exempt revenue bond but taxable alternatives can be considered as well when these provide specific benefits.

CMT Potential Benefits and Evaluation

- Senior debt issued by CMT will be viewed by rating agencies and market as PSA obligation, but possibly excluded from PSA statutory or policy debt limits. Some technical subordination to other PSA liabilities (except with respect to infrastructure asset). GO crowd-out avoided.
- Specific infrastructure asset security and ring-fenced form of CMT may benefit placement when other PSA liabilities are high (e.g. unfunded pensions)
- Evaluation would include comparison of CMT senior term debt to PSA direct traditional alternative – quantifiable benefits of debt limit exclusion (i.e. preservation of room under limit) vs. higher interest rate and transaction costs. Net potential benefit is likely to be minor.

7 (b) Senior Term Debt: Structure and Terms

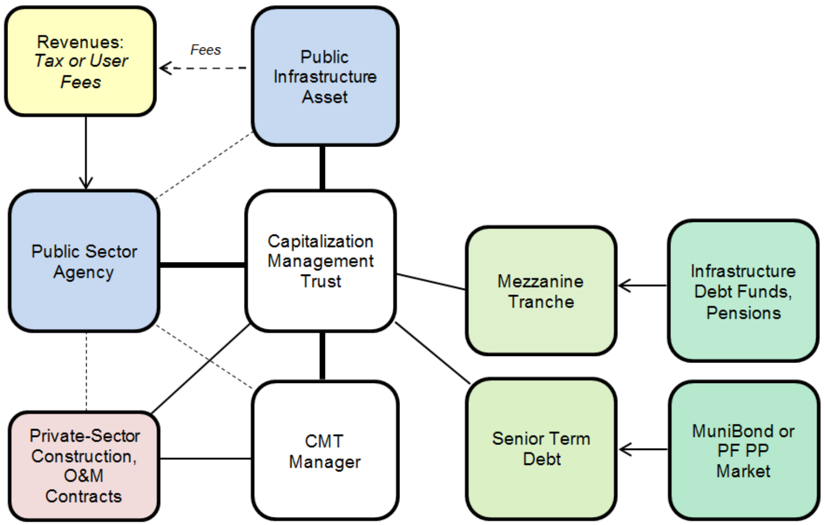


Basic structure is long-term municipal revenue bond series, amortizing over base term (10-30 years)

- Repayment via CMT main contract from PSA taxes (general fund or special) or low-risk user fees from infrastructure asset (with standard rate covenants and other protections)
- Amount can be up to 100% of infrastructure capital cost (CMT not expected to include equity capitalization)

- Basic CMT structure intended to permit tax-exempt issuance
- Taxable options should also be considered where specific terms can offer value. These include taxable muni bonds, private placements with institutional investors and project finance loans from banks.
- Placement in bond market generally has lowest rates for high-credit quality PSA, but private debt market placement can offer more flexible and customized terms and greater scope for future amendment
- Credit rating likely one notch below PSA's equivalent direct bond issues, with correspondingly higher interest rate

8 (a) Mezzanine Tranche: Purpose



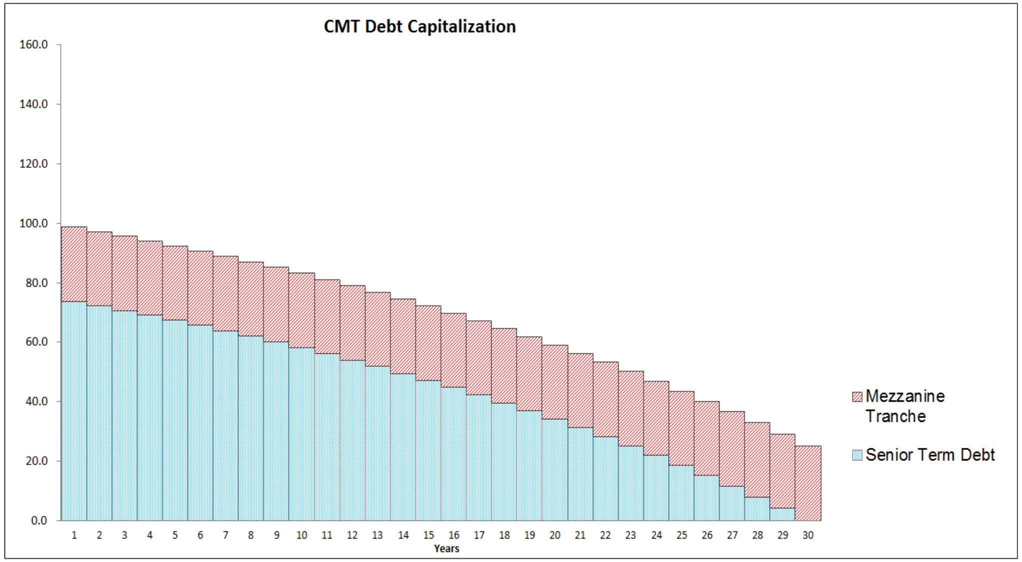
Many public infrastructure assets have significant long-term value, from natural monopoly revenue-generating capacity to simply location for real estate development

- A subordinated mezzanine tranche that relies on this value as a source of non-recourse repayment will reduce PSA recourse liabilities
- Mezzanine debt is more expensive than senior debt due to specific risk transfer of future asset value, but does not require fundamental loss of control (like equity)

CMT Benefits and Evaluation

- A CMT framework is required for mezzanine debt in order to segregate and define asset value in a way that makes the non-recourse debt efficiently financeable
- Mezzanine debt that replaces and is subordinate to senior debt will improve senior debt service coverage ratios. This may improve senior term debt rating and pricing.
- Evolution would include assessment of benefits arising from lower PSA recourse debt level and subordination to senior debt vs. higher interest and transaction costs.

8 (b) Mezzanine Tranche: Structure and Terms

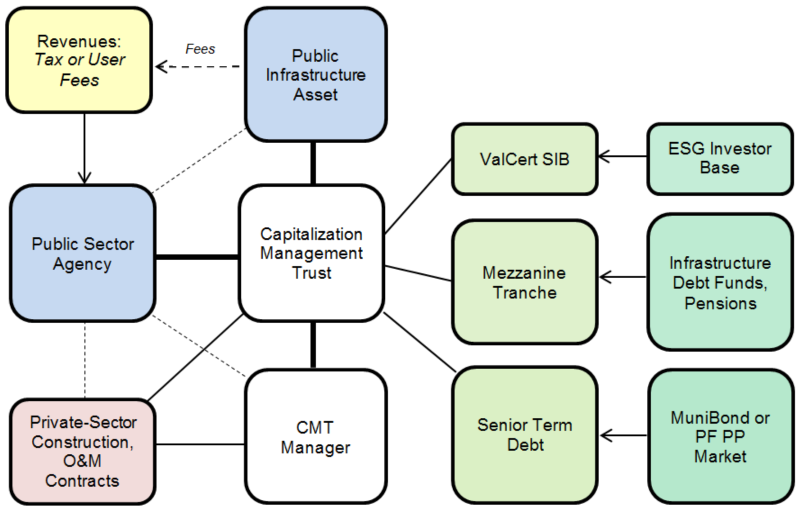


Mezzanine interest payments required during base term, but non-amortizing principal repayment is optional to PSA.

- If repayment option not exercised, mezzanine would receive defined ownership interest in asset (e.g. lease extension or additional concession term)
- Contractual package to ensures asset value will be key feature, but outcome of this (e.g. better maintenance) can also be beneficial to PSA

- Efficient size of mezzanine tranche would reflect low-risk assumption of future asset value
- Mezzanine is privately placed to sophisticated institutional investors and infrastructure debt funds. Likely taxable and unrated, with wide scope for customized terms and interest-rate options (e.g. inflation-indexed interest rate with accrual to reflect higher nominal value of asset)
- Public pension funds may have considerable interest in public infrastructure mezzanine debt, either through managed funds or direct alternative. The PSA's own local pension funds may be a potential investor in a direct bilateral transaction (with appropriate arms-length tests)

9 (a) ValCert SIB: Purpose



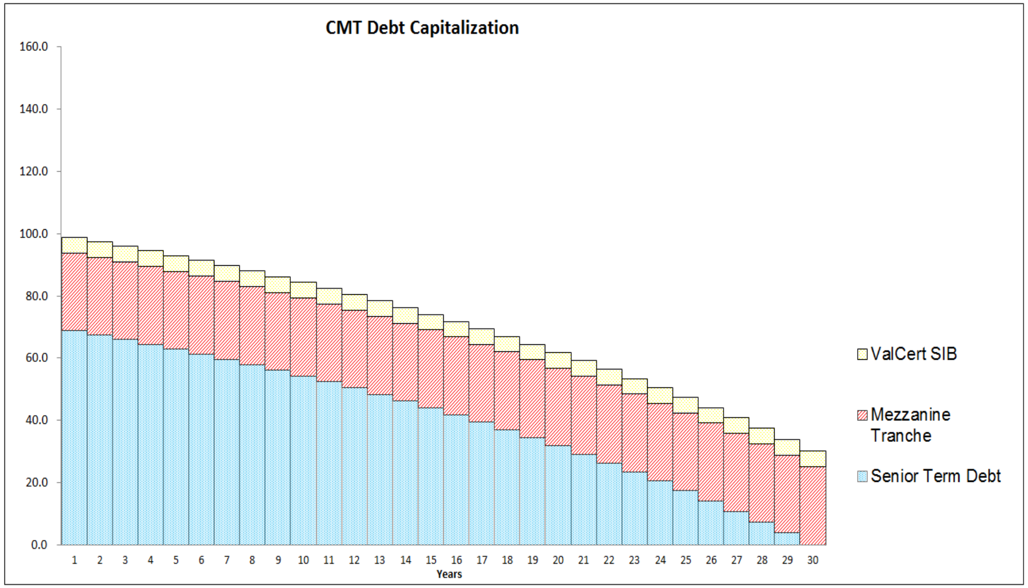
Public infrastructure assets (and associated programs) frequently have environmental and social aspects that may be of interest to ESG investors.

- Social Impact Bonds are an emerging instrument that ties return to performance of specific environmental or social outcomes.
- A small SIB tranche might be a useful component of CMT capitalization to transfer specific risks (e.g. new green technology) and (perhaps more importantly) help manage stakeholder perceptions and concerns

CMT Benefits and Evaluation

- The CMT framework is useful for contractually segregating and defining performance parameters, asset collateral (e.g. green tech equipment) and specific funding for SIB tranche.
- Evaluation of SIB is two-fold: (1) net value or minimum cost of specific risk transfer to PSA , and (2) more importantly, third-party certification that the SIB's ESG benefits are real. CMT Manager can develop or arrange for a "Value Certification" (ValCert) procedure similar to successful Green Bonds product.

9 (b) ValCert SIB: Structure and Terms

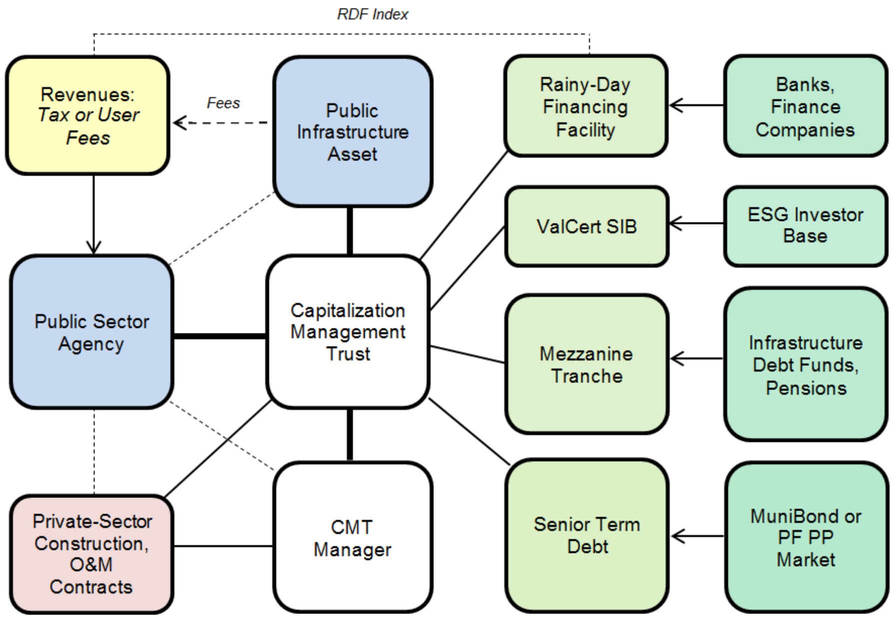


The SIB will be a small and highly customized component of CMT capitalization.

- SIB yield will be tied to specific and measurable performance of an aspect of the infrastructure asset
- Successful performance will result in higher yield to investors but also increased benefits of aspect to PSA (e.g. lower energy cost from green tech), so relatively neutral net result to PSA

- Unsuccessful performance of aspect results in lower yield, offsetting lower benefits to PSA (neutral result)
- SIBs may qualify as tax-exempt. Base yield (applicable when aspect performance exactly meets expectations) may be similar to senior debt, if applicable
- SIB scope for customization and placement options are on a wide spectrum, ranging from highly-customized off-market terms with charitable foundations to more vanilla version with limited risk transfer sold to ESG-oriented institutional investors (similar to Green Bonds)
- Value Certification and favorable press likely important to all investors, and is consistent with primary value to PSA for stakeholder management – this will likely influence main terms

10 (a) Rainy-Day Financing Facility: Purpose



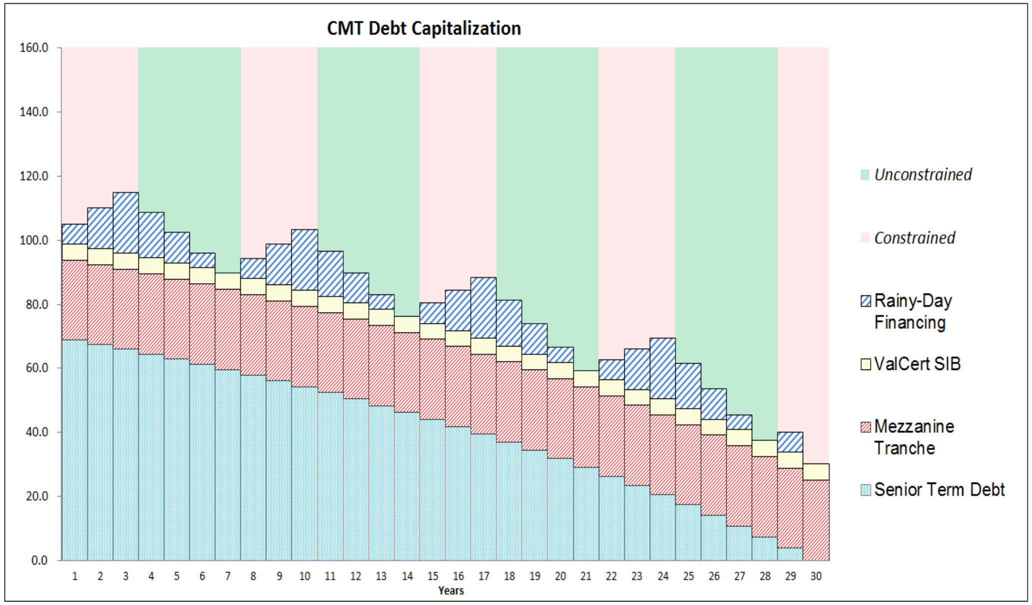
Even when sufficient tax or user fee funding for asset is generally certain over the long term, short-term revenue volatility can be a major problem for PSA

- CMT capitalization can include a "built-in" rainy-day financing facility to offset short-term volatility on a disciplined basis (i.e. open-ended kicking the can is not permitted)
- Asset costs are financed by RDF facility when defined revenue shortfall occurs, then repaid when revenues are normal or in surplus

CMT Benefit and Evaluation

- CMT is required to separate RDF from PSA restrictions on short-term borrowing and to enforce external discipline with respect to objective index of revenue for facility drawdowns and repayment
- RDF facility is useful complement to meet scheduled payments on long-term whole-life maintenance and capex contract during revenue shortfall without forcing other PSA budget cuts
- Evaluation includes realistic assessment of the cost of future "cyclical accrual" of deferred maintenance and other expensive unfunded liabilities like pensions (which is avoided by RDF) vs. increased interest and transaction costs of the RDF facility

10 (b) Rainy-Day Financing Facility: Structure and Terms

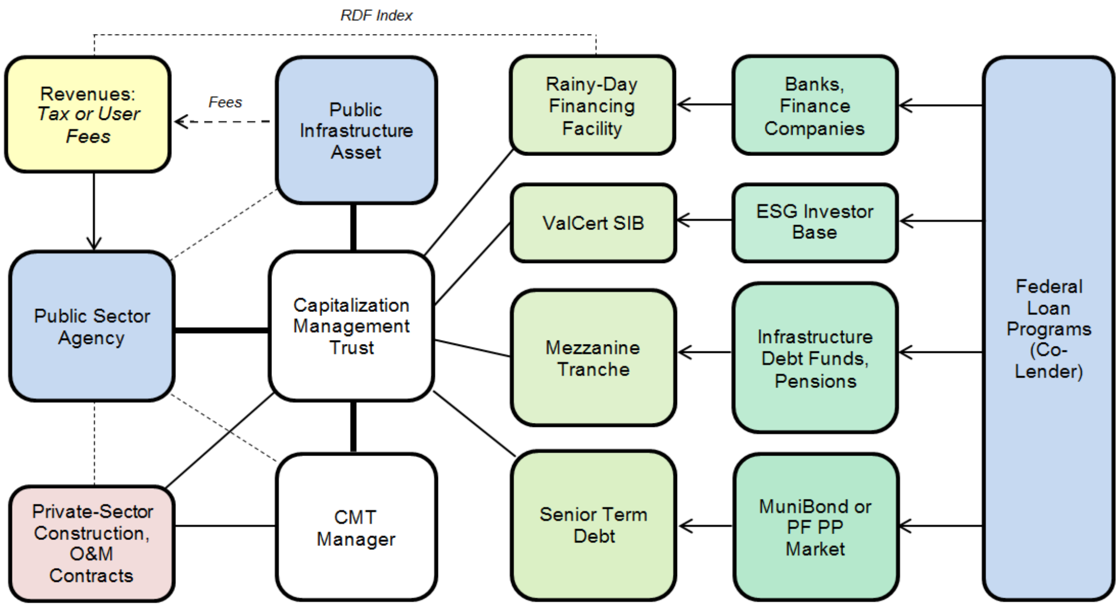


RDF is senior unsecured revolving credit facility with specialized drawdown and repayment terms

- Facility may be drawn to pay CMT costs (including debt service) during objectively-measured revenue shortfalls ("Constrained" periods)
- Facility repaid per level amortization schedule during normal revenue ("Unconstrained")
- "RDF Index" mechanism indicates Constrained vs. Unconstrained periods

- RDF term can be shorter than base term (e.g. 5-7 years, typical for revolving credit) with expected renewal
- RDF unsecured or subordinated with respect to asset, but secured by specific contractual terms in PSA main contract (these terms will need to be consistent with PSA restrictions on short-term borrowing)
- RDF interest rate likely floating-rate basis (e.g. Libor) with spread to reflect credit quality of PSA
- RDF facility provided by project finance banks and finance companies

11 Federal Loan Program Support



There is significant bipartisan support for federal policy that can assist state and local government infrastructure investment

- But straight subsidies and transfer payments are politically difficult due to federal budget deficits
- More likely result is major expansion of federal infrastructure loan programs

- Expanded federal loan programs acting as co-lenders may provide significant specific value to CMT capitalization options in terms of subsidized interest cost and non-market terms
- Since CMT framework is publicly-owned or has not-for-profit status, it may dovetail more easily into federal loan programs qualifications
- Federal loan program involvement in CMT capitalization may provide an important imprimatur for PSA stakeholder management, especially with respect to public sector orientation and specific policy-oriented safeguards (e.g. Davis-Bacon, NEPA)
- CMT Manager can work with potential private-sector investors to advocate for specific loan program policies and capabilities

CMT and Infrastructure Recapitalization

Improving Public-Sector Balance Sheets for Long-Term Sustainability and Resilience

- Although the US state and local public sector is fundamentally very strong financially, it faces many short-term fiscal constraints in the New Normal economic environment. Many of these constraints could be mitigated by a better alignment of assets and liabilities.

- Recapitalization of existing public infrastructure assets could utilize intrinsic characteristics of these assets to support innovative long-term financing that is (1) more flexible and resilient than straight debt, and (2) less expensive and more transparent than continuing to defer off-balance sheet liabilities.

- The primary use of recapitalization proceeds would be to address deferred maintenance and necessary upgrades on the asset itself. But important secondary uses would include reducing expensive and volatile long-term liabilities like pensions and financing other long-term infrastructure and economic investment.

CMT Framework and Infrastructure Recapitalization

- The CMT framework could be a central part of an efficient recapitalization of existing assets because the approach (1) is designed to develop and access unbundled non-traditional debt capitalization options while (2) ensuring that fundamental ownership and control remains with the public sector.

- Clear and credible evaluation of the benefits and costs of each non-traditional capitalization option, and of the overall impact of a recapitalization transaction, is also critical for PSA decision-making and stakeholder management. This is a particular focus of the CMT approach.

- For a recapitalization transaction, the Value Certification process outlined above for an SIB could be expanded to include the entire CMT capitalization and contractual structure, including use of proceeds. This will be useful to potential investors, federal policymakers and public stakeholder organizations.

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