DOCUMENT RESUME

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[Federal Share of WMATA's Bond Interest Costs Is Too Large]. CED-78-161; B-141529. September 1, 1978. 5 pp. + 2 enclosures (5 pp.).

Report to Secretary, Department of Transportation; by Henry Eschwege, Director, Community and Economic Development Div.

Issue Area: Transportation Systems and Policies: Urban Public Transit Systems (2411).
Contact: Community and Economic Development Div.
Budget Function: Commerce and Transportation: Ground Transportation (404).
Congressional Relevance: House Committee on District of Columbia; Senate Committee on Governmental Affairs.
Authority: National Capital Transportation Act of 1972 (P.L. 92-349); S. Rept. 92-931; H. Rept. 92-1155; S. 2297 (92nd Cong.); H.R. 11877 (92nd Cong.). National Capital Transportation Act of 1969.

The National Capital Transportation Act of 1972 provided that the Federal Government, through the Secretary of Transportation, would guarantee the payment of the principal on Washington Metropolitan Area Transit Authority's (WMATA's) bonds and reimburse WMATA for part of the bond's interest and related costs. Between 1972 and 1975, WMATA sold $997 million of 40-year revenue bonds and had earned $134 million on the invested proceeds as of June 30, 1978. For fiscal years 1977 through 1979, the total Federal contribution for WMATA's bond interest will be about $140 million. Starting in fiscal year 1980, the interest-set-aside funds will be used up, and the Federal share of matching payments will be 85%. WMATA projects that the Federal contribution to the bond interest payments will increase to $65 million annually and then gradually reduce until the bonds are paid off in the year 2015. Starting with the first interest payment due, the income earned from bond proceeds should have been applied to the interest due to derive the amount of net interest which the Federal Government would contribute. Although WMATA has already spent about $38 million of the income earned from bond proceeds, the $96.1 million of unspent income earned from the bond proceeds should be used to pay the interest when due. This would save the Federal Government about $81.7 million. The Secretary of Transportation should make sure that the amount of unspent income earned on the bond proceeds has been appropriately applied in determining the Federal Government's contribution to the interest payable on WMATA's bonds. (RRS)

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

B-141529

SEPTEMBER 1, 1978

The Honorable
The Secretary of Transportation

Dear Mr. Secretary:

We are making a comprehensive survey of the Washington Metropolitan Area Transit Authority's (WMATA's) policies and procedures for administering its activities. As part of our survey, we reviewed the National Capital Transportation Act of 1972 (Public Law 92-349), which provided that, among other things, the Federal Government, through the Secretary of Transportation, would (1) guarantee the payment of the principal and interest on WMATA's bonds and (2) reimburse WMATA for part of the bond's interest and related costs.

Section 10 of the act states the reimbursement provision as follows:

> "The Secretary of Transportation shall make periodic payments to the Transit Authority upon request therefor by the Transit Authority in such amounts as may be necessary to equal one-fourth of the total of the--
> "(1) net interest costs, and
> "(2) fees, commissions, and other costs of issuance,
> which the Secretary determines the Transit Authority incurred on its obligations issued after the date of the enactment of this section."

"Net interest cost" is not defined in the act.

Until the bond proceeds are spent, WMATA invests them and earns income. We believe the Federal Government should deduct from its share of interest payable on WMATA bonds an amount equal to the earned income on unexpended WMATA bond proceeds because such a deduction is consistent with the statutory language "net interest cost." WMATA, however, considers this earned income as separate income. As a result

CED-78-161
(34601)

the Federal Government is paying more of WMATA's bond interest than it is legally authorized to pay. (See GAO legal analysis, enc. I.)

$134 MILLION HAS BEEN EARNED FROM BOND PROCEEDS

Between 1972 and 1975 WMATA sold $997 million of 40-year revenue bonds. Until the bond proceeds are used, WMATA invests them and as of June 30, 1978, has earned $134 million on the invested proceeds. WMATA considers the income earned from the bond proceeds as well as income earned from other investments to be "internally generated funds" that can be used as it sees fit. Enclosure II shows the source of internally generated funds and WMATA's application of the funds--primarily to pay the metropolitan area local governments' matching share on joint Federal/local funded projects. However, only about $38 million of the $134 million earned from bond proceeds has been spent--as of June 30, 1978, $96.1 million remains.

FEDERAL INTEREST COSTS HAVE BEEN SUBSTANTIAL

The Federal Government, under Public Law 92-349, pays the first 25 percent of the interest due on the bonds. After the interest-set-aside funds are used for each bond issue, 1/ the Federal Government has shared in the balance of the payment due on an 80-percent Federal, 20-percent local match basis.

The Federal/local match for fiscal year 1977 (the first year matching funds were needed) and fiscal year 1978 were authorized by the Congress in the Department of Transportation's fiscal year 1978 appropriation. In its fiscal year 1979 budget, the WMATA Board of Directors assumed that the Federal/local match will continue:

1/ WMATA sold the bonds in five issues during 1972 through 1975. For each separate bond issue, an amount equal to 4 years of the local governments' interest cost, a total of $223 million, was set aside from the original $997 million of bond proceeds. Therefore, while all the set-aside funds have been used for the earlier issues, set-aside funds are still available for the last issue.

> "It is assumed that the Federal Government will participate in debt-service retirement (both interest and principal) on an 80/20 cost-sharing basis and in accordance with provisions of present law will continue the 25 percent interest subsidy. * * *"

The calculation of fiscal year 1979 bond interest payment below shows how the total Federal contribution is determined:

Total fiscal year 1979 WMATA bond interest payment	$75,580,400
Less:	
25 percent subsidy by Federal Government (note a)	19,374,000
Interest-set-aside funds available	5,542,000
Balance	50,664,400
80 percent Federal contribution	41,968,400
20 percent local match	8,696,000

a/ Includes amortization of Federal share of discount and issue costs.

For fiscal years 1977 through 1979, the total Federal contribution for WMATA's bond interest will be about $140 million. Starting in fiscal year 1980, the interest-set-aside funds will be used up; therefore, the Federal share will be 85 percent--25 percent subsidy plus 80 percent of the balance, another 60 percent. WMATA projects that the Federal contribution to the bond interest payments will increase to $65 million annually and then gradually reduce until the bonds are paid off in the year 2015. The total interest paid by the Federal Government on the bonds will be about $2.1 billion.

The local metropolitan area governments have paid their 20 percent to match the Federal 80 percent from internally generated funds. Through the July 1978 payment, this has amounted to almost $10 million.

The income earned on the bond proceeds should be used to offset the interest cost of the bonds. Not only would this be consistent with the statutory language (see enc. I), it would also be in accordance with generally accepted accounting principles. For example, in WMATA's 1977 Annual Report its public auditors, Ernst & Ernst, using generally accepted accounting principles subtracted the amount of income earned on the bonds from the interest costs before they certified WMATA's financial statements.

CONCLUSION

Starting with the first interest payment due, the income earned from the bond proceeds should have been applied to the interest due to derive the amount of net interest to which the Federal Government would contribute. However, WMATA has used the income from these invested bond proceeds as well as its other internally generated funds primarily to pay the local area governments' matching share on joint Federal/local funded projects.

Although WMATA has already spent approximately $38 million of the income earned from the bond proceeds, the $96.1 million of unspent income earned from bond proceeds should be used to pay the bond interest when due. This would save the Federal Government about $81.7 million (the Federal share of 85 percent times the income available to pay interest on the bonds).

We recognize that WMATA will have to find another funding source to replace this $81.7 million and may have to turn to the Federal Government for assistance.

RECOMMENDATION

We recommend that the Secretary of Transportation make sure that the amount of unspent income earned on WMATA's bond proceeds has been appropriately applied in determining the Department of Transportation's contribution to the "net interest" payable on WMATA's bonds.

We also recommend that the Secretary of Transportation consider what action should be taken on the $38 million WMATA has already spent.

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We are sending copies of this report to the Director, Office of Management and Budget, to appropriate congressional committees, to the Chairman of WMATA's Board of Directors, and to the General Manager, WMATA.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations no later than 60 days after the date of this report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

Sincerely yours,

Henry Eschwege

Henry Eschwege
Director

Enclosures - 2

GAO LEGAL ANALYSIS
NET INTEREST COST OF WMATA BONDS

DIGEST:

In calculating its share of the "net interest cost" on WMATA bonds, the Federal Government should deduct an amount equal to the income earned on unexpended WMATA bond proceeds.

DISCUSSION:

Section 10 of the National Capital Transportation Act of 1969, as amended, provides:

> "The Secretary of Transportation shall make periodic payments to the Transit Authority upon request therefor by the Transit Authority in such amounts as may be necessary to equal one-fourth of the total of the--
> "(1) net interest cost, and
> "(2) fees commissions, and other costs of issuance,
> which the Secretary determines the Transit Authority incurred on its obligations issued after the date of the enactment of this section." (Emphasis added.)

The question is whether income earned by the Washington Metropolitan Area Transit Authority (WMATA) on unexpended WMATA bond proceeds should be considered in determining the net interest cost of the bonds. "Net interest cost" is not defined in the act.

We understand that until the proceeds from the bond sales are expended they are invested and earn income, and that part of the proceeds that are earning income are to be used for future interest payments. We believe that the income earned on bond proceeds should be considered in determining net interest costs.

Section 10, quoted above, was added to the National Capital Transportation Act in 1972 (National Transportation Act of 1972, Public Law 92-349) in order to "facilitate and expedite the construction program for the completion and operation of the Transit Authority facilities" S. Rep. No. 92-931, 92d Cong., 2d Sess. 1 (1972), and H. Rep. No. 92-1155, id. More specifically, the Deputy Under Secretary for Monetary Affairs of the Treasury Department, in testimony at a joint hearing of the House and Senate Committee on the District of Columbia (on S. 2297 and H.R. 11877, 92d Cong., 2d Sess.), explained the purpose of the reimbursement feature:

> "In order to offset the additional interest cost to WMATA from taxable bond financing, the bill provides for payment by the Secretary of Transportation of 25 per cent of the net interest cost on the Authority's obligations. * * *"

Since the purpose of the reimbursement is to absorb part of WMATA's bond interest costs, the Government should not be liable for interest costs that WMATA can offset. To the extent income is earned on bond proceeds, WMATA's interest expense on those bonds is effectively reduced. To ignore this earned income in computing net interest costs allows WMATA a financial windfall and there is no indication that the Congress intended the reimbursement procedure of section 10 to provide such a benefit. In addition, failure to consider the earned income appears to negate the act's specific language.

The act, after all, requires Government contributions of one-quarter of the "net" interest cost. "Net" is defined in Black's Law Dictionary as:

> "Clear of anything extraneous, with all deductions, such as charges, expenses, discounts, commissions, taxes, etc. made * * *.
>
> "That which remains after deducting all charges and outlay."

Kohler's Dictionary for Accountants defines "net" as:

> "Diminished by all relevant and commonly associated deductions."

It thus seems reasonable, in determining the "net" interest cost of WMATA bonds, to deduct the earned income.

The 1977 Annual Report of WMATA reflects the same understanding of "net interest cost." In reference to the interest cost of WMATA bonds, the report states, at page 22:

> "The net interest cost at June 30, 1977, of $77,372,917, <u>which is after reduction for interest earnings of</u> $127,465,880 <u>on unexpended bond proceeds</u> and Federal subsidies of $34,146,622, has been capitalized as project costs." (Emphasis added.)

In addition to considering income earned on unexpended bond proceeds in determining the net interest cost, premiums and discounts on WMATA's bonds should also be considered. The text book "Intermediate Accounting," by Meigs, Masich and Johnson, at page 607, explains how premiums and discounts affect bond interest costs.

> "In a typical bond contract, the corporation promises two essentially different kinds of future payments: (1) the payment of a fixed sum, called the face amount or par value, at a specified date; (2) the periodic payment of interest, usually at six-month intervals, in an amount expressed as a percentage of the face amount of the bond. In the light of expectations as to what interest rate will be necessary to attract the required funds, a rate of interest is set. It is important to note that the interest expense actually incurred on the bonds is determined by the price at which the bonds are sold; thus the effective interest rate (sometimes called the yield rate) is set by the money market. Interest on bonds expressed as a percentage of the face amount is referred to as the nominal or coupon rate. If the market is willing to take the bonds at a yield rate identical to the coupon rate, the bonds will sell at face amount. If the effective rate is in excess of the coupon rate, the bonds will sell at a discount, or less than face amount. Conversely, if the effective rate is less than the coupon rate, the bonds will sell at a premium, or more than face amount Differences between the coupon rate and the yield rate are thus adjusted by changes in the price at which the bonds are

sold, without the necessity of amending the bond contract."

In short, discounted bonds effectively increase the interest yield rate; bonds sold at premiums reduce the yied rate. The amount of premium or discount is thus relevant in determining the net interest cost of WMATA bonds.

WASHINGTON METROPOLITAN AREA TRANSIT AUTHORITY
OFFICE OF ACCOUNTING
SOURCE AND APPLICATION OF INTERNALLY GENERATED FUNDS - CONSTRUCTION PROGRAM
FOR THE MONTH ENDING JUNE 30, 1978

FUNDING SOURCE	LOCAL JURISDICTION PORTFOLIO	BOND PROCEEDS	OTHER	TOTAL
Investments - Income/Gain or Loss, Etc.				
Interest on Capital Contributions	$ 9,301,300			$ 9,301,300
Interest on System Add-On's	190,131			190,131
Interest on Local Jurisdiction Funds	109,772,883			109,772,883
Interest on Bond Proceeds		$ 76,336,329		76,336,329
Interest on Highway Transfer Funds			$ 1,633,590	1,633,590(5)
Interest on ICCA Contributions			857,305	857,305
Interest on Insurance Escrow			354,200	354,200
Gain or Loss - Local Jurisdiction Funds	559,876			559,876
Gain or Loss - Bond Proceeds		19,595,973		19,595,973
Gain or Loss - Insurance Escrow			28,665	28,665
Income/Loss from Property Management (S-26)			1,930,013	1,930,013
Income/Loss from Property Disposal (S-27)			816,878	816,878(6)
Interest from Bond Interest Funds Transferred to Construction		34,870,434		34,870,434
Loss of Sale of P & A Property			(1,632)	(1,632)
Loss of Sale of Capital Property			(22,131)	(22,131)
Available for Utilization - Fund 01 (Board Statement No. 1)	119,824,190	130,802,736	5,496,888	256,123,814
Available for Transfer from Bond Interest - Fund 07	-0-	2,793,489	-0-	2,793,489
Total Availability (Board Statement Nos. 1 and 7)	119,824,190	133,596,225	5,496,888	258,917,303
Funds Restricted or Applied to Current and Future Programs				
Applied to Funded Capital Program 2/3-1/3	42,184,665	a/ 56,147,008		98,331,674
Applied to UMTA Grant Program A	30,733,836	a/ 40,906,164		71,640,000
Applied to UMTA Grant Program B-1	12,071,498	a/ 16,066,942		28,138,440
Applied to UMTA Grant Program B-2	7,067,000			7,067,000
Applied to Executive Management - FY 1971 - 1978	7,946,075(7)			7,946,075
Applied to Bond Interest Payment, January, 1977	3,079,688			3,079,688
Applied to Bond Interest Payment, January, 1978	3,316,500			3,316,500
Applied to Bond Interest Payment, July, 1978	3,578,423		465,733	4,044,156
Applied to FY 1978 October 2/3-1/3 Matching	1,034,453	a/ 2,063,807	4,612,630	7,710,890
Restricted for UMTA Grant Programs B-3	5,655,000			5,655,000
Restricted for UMTA Grant Program C	917,462	a/ 17,307,538		18,225,000(3)
Restricted for Rail Car Procurement	2,239,589	1,104,766	418,525	3,762,880(2)
Total Funds Restricted or Applied	119,824,190	133,596,225	5,496,888	258,917,303
Available for Programming June 30, 1978 (All Internally Generated Funds are Restricted)	$ -0-	$ -0-	$ -0-	$ -0-

Forecast

Internally Generated Funds to be Earned from all Sources through December 31, 1978	$277,506,577(4)
Earnings to Date from all Sources as Itemized Above	258,917,303
Amounts Estimated to be Realized through December 31, 1978	$ 18,589,274

(1) Interest Restricted on Priority of - A - Local Jurisdiction Portfolio
B - Bond Proceeds Interest
C - Other Sources

(2) Available funds restricted to generate $13,900,000 necessary for the purchase of rail cars. Required to be funded by December, 1978.

(3) Includes Authority funds amounting to $9,618,000 advanced to Virginia as local share of ICCA "C" Program.

(4) Estimate of earnings in future periods revised to reflect ICCA local jurisdiction contributions and reimbursement of Virginia $9,618,000 advanced from Authority funds and $12,756,062 internally generated.

(5) Includes interest on highway transfer funds approved by UMTA's general counsel for Authority use.

(6) Losses on disposals are considered a capitalized cost of the Construction Program.

(7) Executive Management budget deficit of $80,654 was funded from interest from the local jurisdiction portfolio.

a/ These are funds being applied as local area governments' match to joint Federal/local matching projects