Date: October 18, 2013

To: Transit Service Delivery Advisory Committee

From: Department of Rail and Public Transportation Staff

Subject: Capital Allocation Using A Tiered Approach

A. Overview

The Transit Service Delivery Advisory Committee (TSDAC), along with the Director of the Department of Rail and Public Transportation (DRPT), has been charged with evaluating a tiered approach to distributing funds for capital purposes based on asset needs and available revenues. The purpose of the tiered approach is to prioritize assets that the Commonwealth Transportation Board views as the most important to transit in Virginia. The specific charge of the Committee with respect to transit capital funding in Chapter 639 of the 2013 Acts of Assembly is as follows:

> *(d) Of the funds pursuant to this section, 25 percent shall be allocated and distributed utilizing a tiered approach evaluated by the Transit Service Delivery Advisory Committee along with the Director of Rail and Public Transportation and established by the Commonwealth Transportation Board for capital purposes based on asset need and anticipated state participation level and revenues. The tier distribution measures may be evaluated by the Transit Service Delivery Advisory Committee along with the Director of Rail and Public Transportation every three years and, if redefined by the Board, shall be published at least one year in advance of being applied. Funds allocated for debt service payments shall be included in the tier that applies to the capital asset that is leveraged.*

As part of its evaluation process TSDAC has addressed the need to provide predictable funding streams, particularly for large capital projects that feature significant costs for several years at a time. However, this must be balanced with the need to maintain some flexibility in the event that revenues substantially decline or capital needs substantially exceed funding based on percentages that are in place. The legislation provides some guidance to the Department with respect to establishing a reserve to allow for state participation percentages that can be held constant for at least a three-year period. Specifically, the Code states:

> *(f) The Department of Rail and Public Transportation may reserve a balance of up to five percent of the Commonwealth Mass Transit Fund revenues under this subsection in order to assure better stability in providing operating and capital funding to transit entities from year to year.*

At the request of TSDAC, DRPT staff has prepared a list of proposed capital asset tiers and definitions of each tier. In defining the capital tiers, DRPT and TSDAC considered how funds should be prioritized based on funding needs identified in the state's six-year improvement plan (SYIP). DRPT and TSDAC also considered the ability of transit systems to determine whether a capital project is needed to meet state of good repair needs versus expansion needs, particularly for facilities that will serve both purposes.

DRPT has prepared numerous capital allocation scenarios using both actual capital projects from FY 2012 through FY 2014 as well as planned capital projects for FY 2015 through FY 2019. The different scenarios serve to compare forecasted capital funding needs, by tier, to estimated future revenues. Additionally, DRPT applied the tiered approach to FY 2012 to FY 2014 to provide a sense of the impact of the proposed policy changes. Further scenarios were produced to show the impact of altering the base used to calculate state participation, i.e. Total project cost vs. the non-federal share of the project cost.

The TSDAC has made decisions regarding the total number of capital tiers (three) and the definition of each, the use of multi-year funding agreements, and the need and use of a reserve fund. Additional details regarding the proposed funding allocation strategy and the decisions to date are documented in this memo. The memorandum also describes the two funding allocation approaches still under consideration (allocating grants based on total project costs vs. non-federal share of project costs) and provides a summary of the estimated funding percentages under each approach.

In determining the recommended approach, the TSDAC considered:

- Need for transit agencies to have predictable funding streams, particularly for major capital projects;
- Ability for agencies of diverse sizes to meet state of good repair needs;
- Regional equity; and
- Funding needs forecasted for system expansion projects in future years, as compared to other capital projects.

B. Capital Asset Tiers

The TSDAC recognizes that the tiers and their definitions, as well as the state matching percentages will evolve over time as transit asset needs and available revenues change. This concept is highlighted in the Code section that stipulates provisions around changing the tiers that require a one year advance publication of changes as well as a three year window for review. At its meeting on Monday, July 29, 2013, TSDAC approved three tiers which comprise categories of capital needs. Capital funds would be allocated to each tier based on a matching percentage that reflects the priorities of the Commonwealth Transportation Board (CTB). The tiers are defined as follows:

1. **Replacement and Expansion Vehicles**: Activities eligible for funding under this tier include the acquisition of rolling stock for either replacement or expansion purposes. Other eligible activities include:
    - Line inspection
    - Fare collection equipment
    - On-vehicle radios and communication equipment
    - Surveillance cameras
    - Aftermarket installation of farebox, radios, and surveillance cameras
    - Vehicle tracking hardware and software
    - Scheduling hardware and software
    - Rebuilds and mid-life repower of rolling stock

2. **Infrastructure/Facilities:** Activities eligible for funding under this tier include the construction of infrastructure or facilities for transit purposes, such as maintenance facilities, bus shelters, administrative buildings, or guideway infrastructure. Other eligible activities under this tier include:
    - Real estate used for a transit purpose
    - Signage
    - Surveillance/security equipment for facilities
    - Rehabilitation or renovation of infrastructure and facilities
    - Major capital projects

3. **Other**: Activities eligible under this category include, but may not be limited to the following:
    - All support vehicles
    - Shop equipment
    - Spare parts
    - Hardware and software not related to vehicle tracking or scheduling
    - Project development expenses for capital projects
    - Office furniture and other equipment
    - Handheld radios
    - Landscaping
    - Other transit-related capital items

Funds allocated for debt service and lease payments will be included in the tier that applies to the underlying capital asset that is being financed.

It is expected that each agency will designate the appropriate tier for each project in its annual grant applications. DRPT will review and confirm these designations as part of the grant approval process. Any capital needs that are not addressed above will be allocated by DRPT to the most appropriate category.

C. Multi-Year Funding of Capital Projects

The TSDAC agreed that Major Capital Projects would be placed into the appropriate category (most likely Tier 2) based on the nature of the capital item, and that associated rolling stock would be broken out and funded in Tier 1. This decision obviated the need to define 'Major Capital Projects'.

The TSDAC unanimously agreed to multi-year funding of qualifying projects in order to spread the funding requirements over several years, and leverage the available transit capital funding. To qualify for consideration for a multi-year funding agreement, the total cost of the capital project should exceed 15% of the transit providers' annual operating expenses **or** the project should be for new construction. DRPT and the transit provider will determine the need for a multi-year funding agreement on a case-by-case basis for all qualifying projects. Interest cost may be included in the cost of the project as per existing DRPT regulations, and the state will provide its agreed upon share of the interest expense.

The TSDAC recommends that qualifying projects be funded over several years while maintaining the state participation rate for all years based on the applicable tier percentage from the initial application year (this percentage would be the base percentage – not an adjusted percentage as discussed in Section D. of this memorandum). Project sponsors could enter into an agreement with DRPT that would outline the annual amount and matching percentage of funding for a qualifying project. DRPT would meet these multi-year funding commitments by taking the funds for these projects off-the-top of each year's available capital funding.

D. Annual Revenues and Reserve Fund

TSDAC recognizes that the CTB must have the ability to adjust state participation in projects in the event that capital funding requests far exceed available funding despite an overarching goal to provide consistent state matching rates for capital projects. The TSDAC agreed to:

Establishment, Use and Funding of Reserve Fund

- Establish a reserve balance capped initially at $10 million to cover shortfalls up to 15% of the annual estimated revenues. The reserve will be established over 2 to 3 years using the Code language allowing a 5% hold-back of revenues that exceed $160 million in a given year. For FY 2014, this 5% reserve amount is $3.667 million. Additionally, in all years the capital projects allocations will not completely consume the available revenues because funds will only be allocated in whole percentage points for all three tiers. These excess funds would be allocated to the capital reserve account. The reserve was capped at $10 million by TSDAC – not 15% of annual revenues. The 15% or greater shortfall of annual revenues is the threshold set for decreasing the tier percentages. For example, if annual revenues are only 14% short, we will use the reserve to make up the difference and keep the percentages at the set level. If the reserve is not sufficient, we may have unobligated balances that the CTB could allocate to preserve the set percentages or as a last resort, we would roll forward any remaining amount that could not be covered to offset the next year's revenues. The reason for this approach was to try to maintain the percentages at the stated levels unless only a significant (15%) shortfall occurred. If the last resort occurred and that would cause the next year to be over 15% short, then the transit providers would have at least a year to consider the change in percentages. This process is similar to the way our allocations already work in that we are using estimates of revenues that ultimately either exceed or fall short when compared to actual collections. In either case, we roll that variance forward to the next allocation process.

- For shortfalls that exceed 15% of the available revenues in a given year, the TSDAC agreed that DRPT should adjust funding for all Tier 2 and Tier 3 capital projects **only** by decreasing the percentage match for each tier by one percentage point until there are sufficient funds (including reserve funds) to cover the approved capital requests. The objective of this approach is to preserve Tier 1 match percentages.

- The reserve fund may also be used '*to assure better stability in providing operating funding to transit entities from year to year'* as per the §58.1-638.A.4.b.(2)(f) of the Code of Virginia. It is the TSDAC's intent that the reserve balance be available if needed for operating purposes, in addition to capital needs.

<u>Annual Revenues Exceed Needs</u>

- In years in which available revenues exceed the needs required to meet the stated state matching share for each tier and the reserve account is funded at the stated cap, the TSDAC recommends that the state match percentages be increased by 1 percentage point for all tiers until current-year revenues for transit capital are allocated. Funds will only be allocated in whole percentage points **and** if all three tiers can be adjusted

E. Basis for Funding Allocations: Total Project Cost vs. Non-Federal Share of Project Cost

This issue involves the dollar value to which the tier percentages should be applied to determine the state allocation amount. The Code of Virginia does not dictate a cost basis to be used for the state capital funding allocation process.

DRPT has proposed to allocate funds to each capital project or activity based on the total cost of the project. This approach is different from the old funding structure, which utilizes the total cost of the project, less any Federal funds that have been allocated to the project by the applicant, as the basis for the funding allocation. As identified during the SJR 297 process, the use of the "non-Federal share is a complicating factor and can be a barrier to the fair treatment of grantees regardless of their choice to seek Federal funding".

It is anticipated that under the non-federal share approach, the large urban systems may increasingly apply Federal funds, such as Section 5307 dollars, to Preventive Maintenance in order to increase the non-Federal share of capital projects and thereby maximize the amount of state capital funding that they would receive from the state.

The idea of allowing grantees to apply for a program of capital projects, receive allocations based on the specified state match, then apply the funds through an agreed upon financial plan across all approved capital projects in the current year has been discussed. This idea has met with some resistance on grounds of fairness because it is perceived that a grantee could potentially "plan" for state funds to be applied to projects that are ready to proceed while allocating much of their local share to projects that are in conceptual stages and may take years to complete, if ever. Further, this would complicate the administrative process that has been established between DRPT and its grantees whereby each capital project is treated as a separate and distinct project. Additionally, verification of the actual use of federal funds would still have to occur at some point for all projects for each year's capital allocations. Without strict adherence to the financial plan (meaning the plan must be set within 90 days of SYIP adoption and **no changes from the plan will be allowed**) and verification of the federal funds, it has been suggested that some capital projects would be overfunded by state funds (i.e., receiving a state funding contribution of greater than 100%). Therefore, DRPT recommends not adopting the idea of "blending" current-year approved projects into one financial plan.

DRPT had recommended that under the total cost approach that the entity providing federal funds to a capital project be allowed to voluntarily supplant state funding with federal funding. This would allow DRPT to cap the total funding provided through the state sources and state-controlled federal programs to a 99% maximum share. After receiving feedback on this idea, two themes emerged – concerns regarding an overall reduction in the amount of local funding applied to projects funded 99% with state and federal funds, and the expectation that transit entities that receive federal funds directly could receive more than 99% funding for a capital project through state and federal funds combined.

On the local funding issue, it is recommended that the TSDAC approve a 96% maximum combined state and federal share or alternatively a 4% minimum local share. The state prescribed matching share for a tier would be reduced until this 96% maximum is reached. The federal funding on each capital project would be confirmed by DRPT as it is today. In this manner, capital projects would not be overfunded by state funds.

Data Analysis

The results of a 4% local match requirement, removing assumptions related to the use of 5307 funding, and capping funding at 96% are shown in the following tables. Table 1a shows the CTB district summary of the variance from the FY 2014 actual capital projects funding broken down by Commonwealth Transportation Board district compared to the new three-tier approach. The spreadsheet that is the source of this data can be found at the TSDAC website at the following link:

http://www.drpt.virginia.gov/activities/files/Capital%20Budget%20Comparison%20Three%20Tiers%202012-2014%20-%20Update%20PB_10-7-13.xlsx

Table 1a shows the variance using both the total cost approach and the non-federal approach, as well as these scenarios with the addition of the $15.8 million (the new amount of funding for capital). It is necessary to point out that the variances shown in Table 1a are not solely caused by the change in the basis for applying percentages. The number of tiers and the applicable percentages has an equal or greater impact on the variances (the actual FY 2014 allocations were based on a two tiered approach with percentages at 80% and 55% using non-federal share).

Note: The results of this analysis are illustrative only, and do not constitute final funding allocations.

Table 1a: Summary of Capital Grants by Scenario by District, Variance to FY 14 Actual

District	**FY14 Total**	**FY14 Non-Fed**	**FY14 Total + $15.8 M**	**FY14 Non-Fed + $15.8 M**
Bristol	$13,115	$(24,352)	$13,115	$ (6,084)
Culpeper	31,175	(43,239)	31,175	14,058
Fredericksburg	26,800	(11,120)	26,800	12,100
Hampton Roads	355,947	2,210,386	2,286,222	4,272,624
Lynchburg	30,786	(28,226)	30,786	2,683
Northern Virginia	(1,298,502)	(2,025,193)	12,574,440	11,130,863
Richmond	343,140	(20,514)	343,140	156,368
Salem	81,171	(155,141)	81,171	(13,942)
Staunton	441,975	9,195	441,975	189,519
Total	**$25,608**	**($88,203)**	**$15,828,825**	**$15,758,190**

The percentages applied to each tier in Table 1b were set to ensure that the funding provided under the four options presented in Table 1a remained relatively constant between the two basis options. This eliminated the dollar amount of funding as a variable causing the variances.

Table 1b: Estimated Funding Percentages for Capital Tiers – FY 14

Capital Tier	Estimated Percentage: Total Project Costs	Estimated Percentage: Non-Federal Costs	Estimated Percentage: Total Project Costs + $15M	Estimated Percentage: Non-Federal Costs + $15M
Tier 1: Vehicles	60%	70%	70%	80%
Tier 2: Infrastructure/Facilities	35%	53%	45%	62%
Tier 3: Other	18%	31%	22%	41%

Table 2a shows a summary of the total capital grants by scenario by district FY 2015 - FY 2019 based on data provided by transit providers regarding project cost and projected federal funding, comparing the total cost approach to the non-federal share approach. The spreadsheet that is the source of this data can be found at the TSDAC website at the following link:

http://www.drpt.virginia.gov/activities/files/Capital%20Budget%20Comparison%202015-2019%20Other%20PB_10-7-13.xlsx

Table 2a: Summary of Capital Grants by Scenario by District, FY 15 – FY 19 Total Cost vs. Non-Federal Share ($ in thousands)

Applicant	Estimated State Funding: Total Project Costs	Estimated State Funding: Non-Federal Costs	Variance
Bristol	$89	$83	$ (6)
Culpeper	584	498	(86)
Fredericksburg	958	886	(73)
Hampton Roads	12,476	9,981	(2,495)
Lynchburg	8,012	6,143	(1,869)
Northern Virginia	483,390	492,219	8,829
Richmond	4,595	3,636	(959)
Salem	10,822	7,672	(3,150)
Staunton	1,919	1,771	(148)
Total	**$522,845**	**$522,887**	**$43**

The percentages applied to each tier in Table 2b were set to ensure that the funding provided under the two options presented in Table 2a remained relatively constant between the two basis options. This eliminated the dollar amount of funding as a variable causing the variances.

Table 2b: Estimated Funding Percentage by Tier by Scenario, FY 15 – FY 19

Capital Tier	**Estimated Percentage: Total Project Costs**	**Estimated Percentage: Non-Federal Costs**
Tier 1: Vehicles	64%	75%
Tier 2: Infrastructure/Facilities	33%	50%
Tier 3: Other	17%	25%

<u>Data Analysis Observations</u>:

It should be noted that the TSDAC should strongly consider the percentages applied to each tier relative to the other tiers – what level of importance does the TSDAC want to place in differentiating one tier versus another. A 60/40/20 tiering would yield significantly different results from a 70/35/17 tiering. This concept is demonstrated above in the 2nd column of Table 1a. Because the Hampton Roads district had a high concentration of vehicles (tier 1 assets) that had no federal funding, this district benefits the most from a non-federal approach using 70/53/31 tiering because these assets received 55% funding in the actual plan using non-federal share while receiving 70% funding in the scenario. This differentiation of the tiers should be done in terms such as 'tier 1 is two times more important than tier 2 and four times more important than tier 3'.

The tier participation rates appear to matter very little outside of the NOVA district because both proposals limit the combined federal and state participation to 96% of the project cost. As a result, they end up with state shares of the cost of the project that are significantly lower than most NOVA capital projects. Additionally, it is interesting to note that NOVA district (the one district that appears to be negatively impacted by using total cost as the basis) received 83.0% of the actual capital allocation in FY 2014, but in the projected FY 2015 – FY 2019 allocations NOVA district would receive 92.5% of the allocations under the total cost approach and 94.1% under the non-federal share approach – these calculations are made before considering the impact of the $50 million a year of state funding dedicated to WMATA as match to the federal PRIIA program.

F. Implementation of Proposed Approach

Based on the final recommendation of TSDAC, the Director of DRPT will recommend a tiered approach to the CTB for approval. It is expected that this approach will be applied to funding requests beginning in FY 2015. DRPT anticipates the following milestones for approval of the capital funding allocation plan.

Tentative:
September 18, 2013 – Commonwealth Transportation Board (CTB) Presentation of Draft SB1140 Recommendations
September 16, 2013 – Presentation to House Appropriations Committee of Draft SB1140 Recommendations
September 19, 2013 – Presentation to Senate Finance Committee of Draft SB1140 Recommendations
October 11, 2013 – TSDAC meeting to finalize Capital Allocation Plan
October 16, 2013 – 45-Day Public Comment Period Begins, with a Public Hearing to be held during the public comment period.
November 1, 2013 – Update CTB in writing
November 2013 (date TBD) – Update General Assembly committees in writing
November 29, 2013 – Public Comment Period Ends
December 4, 2013 – CTB – SB1140 Action on Capital Methodology