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Pennsylvania Turnpike

Trucker’s Lawsuit Clouds Fiscal Future. We See No Default or Bankruptcy Ahead (as some headlines suggest)

Recent reports in a variety of local media across Pennsylvania suggested that the Pennsylvania Turnpike Commission (PTC) might be facing bankruptcy due to a pending lawsuit working its way through the court system. We believe bankruptcy is unlikely for PTC, but the legal challenge creates uncertainty that must be factored into investment decisions.

Act 44 – The Back Story

In 2007, the Pennsylvania legislature enacted Act 44, which among other measures, granted PTC the option to lease interstate I-80 (the Pennsylvania portion) and convert it into a toll road. I-80 transverses the northern part of the state about parallel to the turnpike, which crosses in the southern portion of Pennsylvania. Such a measure required approval from the Federal Highway Administration, which was not forthcoming. Pursuant to Act 44 and its related funding agreement, since the conversion to toll did not occur, PTC did not lease the northern roadway, and its option to do so expired. Because the conversion did not take place, Act 44 obligated PTC to make annual payments of $450 million to the Pennsylvania Department of Transportation (Pa DOT) through 2057 with $200 million supporting road and bridge projects in the state and $250 million supporting transit projects.

Act 89, enacted in 2013, revised the Act 44 funding obligation and required that PTC pay Pa DOT $450 million annually through fiscal year 2022, with $430 million targeted to support mass transit projects in the state and the balance funding projects for rail freight, ports, bicycles, and pedestrians. After 2022, the obligation falls to $50 million annually through 2057. As authorized by the legislation, these payments are funded through issuance of subordinated debt, which has amounted to about $6 billion ($5.2 billion outstanding). With plans to issue another $2.2 billion to fund payments through 2022, PTC may end up with over $7 billion of debt, the proceeds of which have/will be distributed outside of the turnpike system.

Although PTC has Variety of Debt Structures, 84% is Senior and Subordinate Revenue Bonds.

<table>
<thead>
<tr>
<th>Debt Types</th>
<th>Debt Outstanding</th>
<th>Ratings</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mainline Senior Debt</td>
<td>$5.1 bln</td>
<td>A1/A+/A+</td>
<td>Senior lien, primary funding vehicle for turnpike capital plan</td>
</tr>
<tr>
<td>Mainline Subordinate Revenue Debt</td>
<td>$5.2 bln</td>
<td>A3/A/-</td>
<td>Subordinated debt, proceeds used to fund PTC’s annual payments to state (for mass transit subsidies).</td>
</tr>
<tr>
<td>Motor License Fund-Enhanced Subordinate Special Revenue Debt</td>
<td>$1.0 bln</td>
<td>A2/NR/AA-</td>
<td>These are 3rd lien revenue bonds, but they have additional backup from the state’s pledge to use funds in its Motor License Fund account (funded with revenues from various fuel taxes as well as vehicle registration and license fees) to cover debt service deficiencies.</td>
</tr>
<tr>
<td>Oil Company Franchise Tax Senior Debt</td>
<td>$0.4 bln</td>
<td>Aa3/AA-/AA-</td>
<td>Secured by a portion of the state’s oil franchise tax revenues. Revenues collected by the Department of Transportation are deposited by the state Treasurer to trustee for debt service payments</td>
</tr>
<tr>
<td>Oil Company Franchise Tax Subordinate Debt</td>
<td>$0.3 bln</td>
<td>A2/A/AA</td>
<td></td>
</tr>
<tr>
<td>Motor License Registration Fee Debt</td>
<td>$0.4 bln</td>
<td>A1/A+/AA-</td>
<td>The state deposits $28 million of receipts from vehicle registration fees with trustee for debt service payments. No appropriation needed. Insulated from PTC operations.</td>
</tr>
</tbody>
</table>

Source: Moody’s, S&P, Fitch, Various Pa Turnpike Official Statements and financial disclosures

The Truckers’ Lawsuit

In March 2018, a group of trucking industry related organizations and individuals, including the Owner Operator Independent Drivers Association, filed a lawsuit against PTC arguing that Act 44 of 2007, as amended by Act 89 of 2013 violates the Commerce Clause of the US constitution. According to the most recent PTC Official Statement (September 20, 2018), the suit alleges that PTC “improperly imposes turnpike tolls beyond that which is
necessary for the operation and maintenance of the system” emphasizing that PTC “expends toll revenues for purposes other than the operation and maintenance of the system.” In other words the truckers argue that they should not have to pay the higher tolls needed to fund payments to the state, since the money is used to fund non-turnpike projects – in this case mass transit.

Specifically, the lawsuit seeks:

- An injunction enjoining PTC from issuing additional debt for the purpose of making Act 44/89 payments to Pa
- An injunction prohibiting PTC from using toll revenues to make debt service payments on outstanding bonds issued to finance Act 44/89 payments
- Monetary damages including a refund of tolls imposed on trucking plaintiffs in excess of what was reasonably necessary to pay operation and maintenance costs.

Earlier Lawsuits from Truckers

A 2002 lawsuit by the American Trucking Association (ATA) against the Delaware River Joint Toll Bridge Commission argued that tolls were not “fair and reasonable” as required by federal law based on the fact that DRJTBC had initially targeted a portion of toll increases for the funding of a terrorism self-insurance reserve. When states (NJ and PA) stepped in to pledge financial assistance in the event of a terrorist attack, the self-insurance reserve was no longer needed. The truckers argued that toll rates should have been reduced accordingly, but the Commission instead chose to fund capital projects (which truckers described as non-bridge projects) and build cash reserves. In 2005, the US District Court dismissed the suit for want of jurisdiction noting that neither the underlying “fair and reasonable” legislation nor its legislative history revealed evidence of a Congressional desire to afford the truckers the right to file suit in federal court to challenge the toll rates adopted by local officials. The decision was upheld on appeal in 2006. ATA also sued the New York State Thruway Authority in 2013 challenging the use of toll revenues to maintain the state’s canal system. The suit was dismissed by a federal judge and the dismissal was upheld by a federal appeals court decision.

Going Forward

With the lawsuit pending, quarterly payments of the $450 million annual payment for mass transit funding (from PTC to Pa DOT) have been delayed until at least June of this year and no subordinate debt has been issued since before the lawsuit was filed. As of May 31, 2018 (end of fiscal year) PTC had $5.2 billion of subordinated bonds outstanding. Although we do not have an exact breakdown of subordinated debt service, total debt service in the current fiscal year is $901 million. Since subordinated debt accounts for 41% of PTC’s total debt, we can estimate related annual debt service to be 41% of $901 million or $369 million which is arguably and approximately the amount of annual toll revenue which the truckers argue is excessive or beyond fair and reasonable. To be clear, all debt service payments have been made on a timely basis.

Caution is Warranted on PTC Subordinate Debt

We can’t predict the legal outcome or timing of any resolution to this litigation. Based on yields for senior and subordinate bonds (as illustrated in graph) the market projects little likelihood of an unfavorable (for PTC and bondholders) outcome to the litigation. Nevertheless, we believe more caution is warranted when considering investment in subordinated debt. Beyond the $10.3 billion of senior and subordinate mainline debt outstanding, the several smaller structures backed by fuel taxes and/or vehicle license and registration fees (see table on page 1) have secure debt payment frameworks. The senior bonds, unlike the subs, are secured by a first lien on net toll revenues of the turnpike (after O&M expenditures). The subordinated debt has no lien on revenues, with debt service payable from funds on deposit in PTC’s General Reserve Account after senior debt service is paid. The yield differential between seniors and subs (based on Bloomberg valuations) has ranged between 5 and 30 bps, most recently about 20 bps. Given this narrow gap between senior and sub yields, the risk-reward proposition weighs favorably towards the seniors, especially given the lawsuit overhang.

<table>
<thead>
<tr>
<th>Spread - subs</th>
<th>Spread - seniors</th>
<th>2029 sub yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.00%</td>
<td>2.50%</td>
<td>3.00%</td>
</tr>
<tr>
<td>3.50%</td>
<td>4.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>6.00%</td>
<td>7.00%</td>
<td>8.00%</td>
</tr>
</tbody>
</table>

Trading Levels for Pa Turnpike Issues Do Not Reflect Lawsuit Risk

Source: Bloomberg, Spreads Rt Axis
No Default or Bankruptcy Likely

Despite the lawsuit, we see little risk of default or bankruptcy as has been suggested by some media outlets. The Pennsylvania Turnpike Commission is one of the longest standing issuers of bonds in Pennsylvania, dating back to before the turnpike’s opening in 1940. The east-west thoroughfare, linking to turnpikes in Ohio and New Jersey, is perhaps the state’s most critical transportation infrastructure element. PTC is not authorized to file a bankruptcy petition without authorizing legislation from the state legislature. A bigger risk to investors may be rating downgrades if the litigation is successful, which we view as unlikely.

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