

I. Introduction




Metropolitan Transportation Authority

State of New York

Date July 27, 2005

To Chairman Peter S. Kalikow
MTA Board Members

From Katherine N. Lapp 

Re

Preliminary 2006 Budget & July Financial Plan for 2006-2009

I am transmitting for your consideration the 2006 Preliminary Budget and the four-year Financial Plan for 2006-2009 which reflects developments that have occurred since the last plan was issued in February 2005. The three major changes since February are changes to Real Estate Taxes and Debt Service, which have both been positively affected by the unexpected continuation of low interest rates, and action taken by Albany this past Spring. The first two of these produce substantial windfalls in 2005, as they did in 2004, but are assumed to slow significantly in subsequent years. These two items account for almost 65% of the net changes to the 2005 forecast since February. All levels of government have been experiencing similar surpluses since their budgets, like ours, have anticipated that long-term interest rates would be higher than they currently are. The Albany actions which include several new taxes support the recently approved Five Year Capital Plan.

- Real Estate Taxes – Low mortgage rates have lifted the housing boom to a new level, increasing our forecast for these revenues by \$365 million in 2005. Economists are still predicting rates will soon increase, but they have been doing so – incorrectly – for over a year now. Breaking from historical precedent, consumer interest rates have only increased slightly over the past year, while the Federal Funds Rate went up numerous times from 1% to over 3%. As a result, mortgage rates remain between 4% and less than 6%. In recent Congressional testimony, Federal Reserve Chairman Greenspan has called the current situation “clearly without precedent”.

Our real estate revenue forecast reflects actual receipts through June and sustains high levels of activity for the remainder of this year – much higher than the February Plan, but slightly lower than the first half of 2005. The real estate tax forecasts for 2006-2009 reflect a significant drop from the current level but are still higher than the amounts forecast in February.

- Debt Service savings are expected to generate an additional \$128 million in 2005. Favorable interest rates are driving \$84 million of this improvement, most of which stems from our variable rate bond performance. Like the real estate trends, the July Plan forecast expects that interest rates will increase, thus evaporating almost all of this improvement after 2005. The only recurring aspect of the low rates will be savings associated with recent fixed-rate bond refundings, which will produce \$10 million of annualized savings.

In addition to the real savings resulting from favorable interest rates, the current forecast also includes short-term deferrals of \$18 million in 2005, \$49 million in both 2006 and 2007, and \$19 million in 2008, that result from adjustments made to our borrowing schedule in order to meet cash needs as various projects progress through construction. This is particularly true for Second Avenue Subway and East Access projects. The remaining debt service improvement reflects a one-time savings in bond issuance cost fees.

The approval of the 2005-2009 Capital Program by Albany enables us to move forward with essential capital investments. As part of the funding package enacted by the Legislature last April, new resources were added for the benefit of MTA. These include a one-eighth percent increase to the regional sales tax, a nickel increase in the Mortgage Recording Tax (MRT) and increased Department of Motor Vehicle (DMV) fees. Both the sales and MRT increases were effective on June 1, 2005, while the DMV fees are effective January 1, 2006. These additional revenues, as well as net increases in base taxes stemming from a healthier regional economy, total \$170 million in 2005 and over \$400 million annually thereafter. These funds will support debt service associated with \$5 billion in new borrowing for the capital program. The early inception of these taxes enables MTA to use these additional revenues prior to their use for capital program funding.

Another positive result of the healthy real estate market is that the \$200 million real estate stabilization reserve funded by the 2004 surplus and approved by the Board is now available. This, in conjunction with the other positive revenues I have already discussed enabled us to avoid the 2006 cost reduction proposals included in previous financial plans.

One of the downsides of the current economic climate is that inflation is higher than the assumptions contained in the 2005 Adopted Budget and corresponding four-year financial plan. The key variable driving up inflation, as measured by the consumer price index, is the price of energy, which affects all aspects of the costs of manufacturing and delivery of goods to the market place. Inflation is estimated to increase costs in the July Plan by another \$15 million in 2005, \$74 million in 2006, \$121 million in 2007, \$155 million in 2008 and \$209 million in 2009. Since 65% of our expenses are associated with the cost of labor, the largest area of increase affected by inflation is our labor cost forecast.

The Plan also contains additional agency spending for maintenance, adding costs of \$26 million in 2005 and \$71 million in 2006. Examples of this include: increased costs for scheduled maintenance programs for buses and subways, subway signal improvements and concrete tie replacements at both commuter railroads.

Since a portion of the debt service savings is recurring, about \$10 million annually, I propose that service improvements be implemented. For NYCT subways, \$6.4 million annually would be allotted to fund intensive cleaning initiatives affecting track, infrastructure and stations, with an additional \$2 million to be spent in 2005; for NYCT Bus and SIR, \$0.3 million would be allotted for additional service to match increased Staten Island Ferry service; and \$3 million would be earmarked for the two commuter railroads to increase AM peak service and early afternoon service from Penn Station (LIRR) and expanded Late-Night service from Grand Central Terminal (MNR).

In view of the heightened security stemming from the recent London transit attacks, we have estimated that additional spending of \$10 million will be required in 2005. These funds will be added to the \$18 million already set aside in 2005 and used primarily to enhance police visibility by the NYPD, MTA Police and Bridge and Tunnel Officers. A portion of the funds will be used to assign over 150 additional subway station personnel, trained in evacuation procedures, to platforms in prime locations during peak periods. In addition, the funds will also support expanding various public outreach campaigns such as "See Something, Say Something" and "Eyes and Ears". The needs of these security initiatives will be reevaluated as events dictate. In the next few months, we will be developing a detailed plan to identify ongoing security-related initiatives which will be funded out of our operating budget for 2006 and beyond and those anticipated needs will be reflected in the upcoming November Plan.

While the positive short-term benefits of the 2005 windfalls will assist in reducing future year gaps, it by no means eliminates them. MTA must do its part to ensure that it responsibly contains costs through efficiencies and productivity. To that end, I instructed Agency Presidents last spring to produce MTA-wide cost reduction savings of \$50 million in 2006 and annualizing to \$100 million in 2007. This represents about 2% of Agency expense budgets, excluding depreciation, pension, health & welfare and energy costs. Agencies were instructed that their budgets were not to include service curtailments and that they were to ensure that maintenance standards, employee and customer safety/security would be maintained.

I am pleased to present Agency budgets that reflect savings of \$82 million in 2006 increasing to \$108 million in 2007, well above the goal. In meeting their targets, Agencies were permitted to count net savings stemming from re-estimates of items contained in the February Plan. Examples include lower costs

for credit card fees, insurance premiums, fringe benefit rates and data center charges. The proposed agency budgets reflect \$39 million of these baseline savings in 2006, annualizing to \$62 million in 2007.

In addition, Agencies developed new proposals for reducing costs, which are shown under "2006 Agency PEGs". Examples of agency proposals include Central Electronics Shop Productivity savings at NYCT; efficiencies at both railroads stemming from reductions in on-board ticket sales and increased use of ticket vending machines; revaluation of right-of-way leased line fees at LIRR; process review to achieve productivity at Metro-North; and administrative position savings MTA-wide. The Agency PEG proposals total \$42 million in 2006, increasing to \$73 million in 2009.

As was the case in previous financial plans, the July Plan continues to assume modest bi-annual fare and toll increases. The Plan incorporates proposed 5% revenue increases in 2007 and 2009.

As I noted at the beginning, \$493 million of the 2005 improvement is attributable to the real estate and debt service windfalls. The proposed plan for 2005 earmarks \$10 million for heightened security and \$2 million to quickly start NYCT's intensive cleaning initiatives. Since the remaining \$481 million is not a recurring revenue source, the preliminary budget sets these funds aside in an MTA "Reinvestment Fund" in anticipation of a one-time investment, which will generate long-term operating benefits. I am proposing two options for the Board's consideration.

The first recommended use would be to commit these funds to the construction of a platform over the LIRR yards on the West Side of Manhattan. Working in conjunction with the City and the local community, the MTA would devise an appropriate development plan for the site which would complement the recently approved rezoning plans for the adjoining area. Once that plan is completed, the MTA would issue a Request for Proposals from interested real estate developers.

This is a unique opportunity for the MTA to maximize the value of this critical asset. With the expansion of the Javits Center, redevelopment of the Moynihan Station and the extension of the #7 line, this area of Manhattan is poised for dramatic renewal. Like Rockefeller Center in the 1930's and Lincoln Center in the 1950's, now is an ideal time for a catalytic change in this neighborhood. An integral part of the plan would be the construction of a new MTA headquarters building, consolidating our uses at 341, 345, and 347 Madison Avenue.

This strategy would generate two sources of capital funding for the MTA; first, funds generated by sale of development rights over the rail yards would be applied toward the 2005-2009 MTA Capital Plan that was recently approved by the State. That plan's funding structure anticipates \$1 billion from the MTA's sale

of excess real estate assets. Secondly, once the current headquarters site is vacated, and accommodations are made for Metro-North personnel which need to remain in the vicinity of Grand Central Terminal, this property would become available for redevelopment. Those funds would then be available to be applied to the MTA's next Five -Year Capital Plan for 2010-2015.

The attractiveness of this plan is multifold; (1) it uses unpredictable non-recurring revenues generated by the extraordinary boom in the region's real estate market as well as savings from our variable rate debt for a capital purpose, which will generate an extraordinary source of our revenue for our current capital plan; and (2) it allows for another source of significant revenue (i.e. Sale of current MTA Madison Avenue buildings) to be applied to the MTA's next capital plan.

The second possible use of the "Reinvestment Funds" would be to apply those monies to pay down the accrued unfunded liabilities in our pension plans which currently total \$2.2 billion. By applying the \$481 million fund monies to the liabilities, we would recognize a savings of approximately \$38 million annually in our contributions to these pension funds. The attractiveness of this proposal is the benefit accrues to the benefit of the pension plan and the associated ongoing savings to our operating budgets in the out years.

Clearly, the capital security needs of the MTA network is of paramount concern to all New Yorkers, particularly in the wake of the Madrid and London bombings. As such, the allocation of the Reinvestment Fund to those needs was considered but ultimately determined not to be a prudent strategy for the reasons which follow.

As the Board is aware, in 2003 the State approved the MTA Board's amendment to our Capital Plan to increase our bonding capacity up to \$591M in order to progress priority capital projects designed to "harden" our system in the event of a terrorist attack. While the amendment was pending approval, the Federal government agreed to provide \$143 in FEMA funds to help offset the costs of six of those priority projects. Virtually all of those projects have completed design and are nearing construction – in fact, within the next six months, \$500M of the \$591M will be committed and the projects underway.

The currently approved 2005-2009 Capital Plan anticipates the receipt of \$500M in Federal monies to advance the next category of security projects. If we were to apply the Reinvestment Fund monies to that need, we would be allowing the Federal government to avoid its recognized responsibility to fund mass transit security -- a position which Senators Schumer and Clinton have been forcefully reinforcing with the Department of Homeland Security. In addition, such a course of action would require the MTA to forego a phenomenal opportunity to generate potentially well over an additional \$1 billion through the sale of our most unique real estate asset – revenue which, as the Board is aware, is currently anticipated in our recently approved capital plan to support the core infrastructure needs of

the MTA network. In the absence of that source of funds, the MTA Board would be faced with two equally difficult choices, namely: (1) reduce the approved 2005-2009 Capital Plan by \$1 billion; or (2) authorize the issuance of \$1 billion in MTA debt and increase the debt service burden on the MTA operating budget. Therefore, I recommend that the MTA continue to press the Federal government to meet its responsibility to provide the next \$500M to our capital security program instead of placing that burden on our customers and our State and local governmental partners.

After earmarking the \$481 million for the Reinvestment Fund, the Plan assumes a balanced budget for 2006. The proposed closing cash balance in 2006 of \$239 million includes the now-freed-up \$200 million real estate reserve from 2004. This, together with the early inception of the new State revenues and the recurring agency efficiencies, should enable us to hold the assumed yield for the 2007 fare and toll increase to 5%, but would still leave a gap in that year of \$128 million – down from \$689 million in February. While lower than our February Plan, gaps for 2008 and 2009 remain high, \$771 million and \$880 million, respectively. This is primarily the result of Debt Service cost increases reflecting the acceleration of construction for the 2005-2009 Capital Program and the evaporation of prior year savings.

This plan is a significant improvement from where we were when I presented the four-year plan in 2003. However, there are challenges to be addressed, particularly the long-term challenge of closing the out-year gaps. I believe that the conservative use of cash surpluses, such as the reinvestment options that I have proposed, is the type of prudent fiscal policy required to address that need. I look forward to public and Board input on this plan over the coming months, culminating with the adoption of the 2006 Budget by the Board in December.