[Taking Drastic Actions to Meet Rate Covenant]

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This document provides discussions on possible actions to meet rate covenant, when U.S. airports may face zero traffic for an undetermined period. Please contact Dafang Wu at dwu@dwuconsulting.com or (513) 348-4070 if you want to discuss actions at your airport. Such actions need to be taken as soon as possible, and may require confirmation from the bond counsel.

To issue bonds backed by airport revenues, U.S. airports execute bond documents that contractually oblige the airports to meet certain conditions, referred to as the rate covenant. Rate covenant is different at each airport, but typically requires one or both of the two tests below:

1. The flow test, which requires the pledged revenues to be sufficient to pay all obligations: operating expenses, debt service, and other fund deposits
2. The coverage test, which requires the Net Revenues, plus other available funds, to be at least 125% (or other ratios) of debt service

To meet the rate covenant, U.S. airports use one of the two ratemaking methodologies when setting airline rates and charges:

1. Residual, where the airlines collectively agree to pay adequate amount to achieve breakeven result. Under an extreme traffic situation, the airline unit cost may become prohibitive, although the rate covenant can theoretically be met
2. Compensatory, where the airlines pay for what they use. When the airlines are not using the facility under a zero traffic situation, the airport is facing a potential default

Before the federal government decides whether an emergency aid is available, each airport may want to examine unconventional methods to ensure rate covenant compliance:

1. Whether the definition of Revenues permits inclusion of cash on hand or other resources
2. Whether the definition of operating expenses permits exclusions
3. Whether the definition of debt service permits cash deposit or additional PFC/CFC revenues
4. Whether the definition of other available funds permits amount higher than 25% - this is only useful if the coverage test is the only test required

Those actions are sometimes identified as “weak clauses” by rating agencies, but are lifesavers in dire situation that our industry is facing.

Definition of Revenues

The definition of revenues typically provides the following ways to include additional amount:

1. In some bond documents, the airport can designate cash and other resources as revenues. For example, the specific language may read, “Pledged Revenues shall also include such additional revenues, if any, as are designated as Pledged Revenues under the terms of any Supplemental Indenture.”
2. In some bond documents, the airport can include PFC revenues by depositing PFC cash balance into the Revenue Fund, although the airport may not end up using PFC for debt service. This is a risk approach and requires further discuss. The specific language may read, “Revenues … but, unless and until deposited in the Revenue Fund, excluding … Passenger Facility Charge revenues.”
3. For some airports, the definition of Revenues actually include the transfer of the prior’s coverage. The specific language may read, “Revenues include …that amount on deposit from a prior Fiscal

Year in the Development Fund which is transferred or credited by the Authority to the Revenue Fund." This particular language does not restrict the timing of the transfer. Therefore, an airport may transfer the entire fund balance today to meet the flow test. Then, there is a possibility to double count the balance again in the coverage test.

Definition of Operating Expenses

Unfortunately, the definition of Operating Expenses is typically strictly written to match expenses based on generally accepted accounting principles (GAAP). However, some airports have the luxury of a special phrase in the definition, which may read, "Operation and Maintenance Expenses" means, for any given period, the total operation and maintenance expenses of the Board as determined in accordance with generally accepted accounting principles as modified from time to time, **excluding any operation and maintenance expenses payable from moneys other than Pledged Revenues**." This implies that an airport may start paying operating expenses from cash, which will result in zero operating expenses for the remainder of this year.

Definition of Debt Service

The reduction of debt service typically comes in the following forms:

1. Additional PFC revenues. The FAA may have approved a total amount of PFC impose and use authority, but has not specified the annual amount to be used each year. Therefore, if an airport's bond document allows the use of PFC revenues to reduce the defined term debt service, the airport may consider increasing the PFC amount to the entire annual debt service, even if only a small portion is eligible. The airport will then reduce the future PFC amounts for debt service to compensate.

   It is worth noting that 14 CFR Part 158 permits the use of PFC revenues for other debt service, if an airport receives an approval from the FAA. "The FAA may authorize a public agency under §158.18 to impose a PFC for payments for debt service on indebtedness incurred to carry out an airport project that is not eligible if the FAA determines that such use is necessary because of the financial need of the airport."

2. Additional cash. Some bond documents permit using cash to reduce debt service, if those cash is deposited into the debt service fund or irrevocably committed. The specific language may read, "if all or a portion of the principal or Amortization Requirement of or interest on bonds is payable from funds **set aside or deposited** for such purpose (other than funds on deposit in the Reserve Account), including funds deposited to the credit of the Construction Fund as provided in Section 405 of this Agreement, together with projected earnings thereon, **such principal, Amortization Requirement or interest shall not be included in computing Principal and Interest Requirements"**
3. Cash defease the bond before the end of this fiscal year. An airport may use the cash to defease all of the debt service due this fiscal year, and therefore eliminate the debt service for the next several months. Different from other actions, this may trigger additional costs and take times to implement.
4. Additional capitalized interest. Most, if not all, bond documents allow the exclusion of capitalized interest from the definition of debt service. There is a theoretical possibility that an airport may use existing balance in the capitalized interest account or even the construction fund to reduce debt service. The specific language may read, "interest on such Bonds to the extent such interest is to be paid from (i) amounts credited to a Construction Interest Account in the Construction

Fund …" An airport needs to discuss this action with the tax counsel, if the airport want to use more capitalized interest in this year than planned.

Definition of other available funds

For many airports, the amount of other available funds is limited to 25% of debt service for the purpose of the additional bond tests, but not the annual rate covenant. Therefore, an airport may decide to designate additional funds as other available funds during the fiscal year if permissible.