Introductory Comments to Pennsylvania Senate Local Government Committee

Mr. Chairman, Senator Blake, and members of the committee, I want to thank you for the invitation to testify at today's hearing on behalf of RBC Capital Markets. We appreciate the opportunity to put into proper context the role that our firm played in connection with The Harrisburg Authority's financing of the retrofit project and to address some of the egregious errors in the Forensic Investigation Report by Klehr Harrison.

Let me be clear at the outset that The Harrisburg Authority's problems with the retrofit are not related to the 2003 financings. The financings that we were involved with all performed well, actually exceeding expectations projected at the time of financing, and have saved The Harrisburg Authority money.

RBC Capital Markets' involvement in the financing of the retrofit of the resource recovery facility began in early 2003. RBC Capital Markets served as book-running underwriter for two bond issues for the facility that occurred during 2003; the first in May and the second in December. The role of the underwriter in public finance transactions is to sell the Issuer's bonds in the market and deliver bond proceeds at settlement. RBC Capital Markets did not serve The Harrisburg Authority, City of Harrisburg or Dauphin County as a financial advisor for any of the financings. RBC Capital Markets' parent company, Royal Bank of Canada, also served as counterparty on interest rate swaps and cap associated with one of the bond offerings, the Series D of 2003. RBC Capital Markets' involvement was limited to the 2003 financings and we played no role in either the CIT financing or the 2007 financing.

As others have previously testified, the forensic audit report contains many inaccuracies. We note that RBC Capital Markets was never contacted during the preparation of this report, which easily could have remedied some of its more obvious errors. In February 2012, RBC Capital Markets sent a lengthy letter to the Receiver and to the Harrisburg Authority members highlighting many of the report's inaccuracies and offered to meet to discuss the report. No response was ever received. This Committee has received a copy of that letter.

RBC Capital Markets' involvement with the retrofit project started in early 2003, long after the City and Authority had already engaged Barlow Projects as project engineer in 1999. RBC Capital Markets had no role in the selection of Barlow, nor would any underwriter in a typical public financing be involved in the selection of engineers and contractors. The team of finance professionals assembled to work on the retrofit financing was drawn from among the most seasoned, experienced and highly regarded firms in the Commonwealth of Pennsylvania. The team included four major law firms: Rhoads and Sinon (authority counsel); Obermayer Rebmann Maxwell & Hippel LLP (bond counsel); Eckert Seamans Cherin & Mellott, LLC (underwriter's counsel); Mette, Evans & Woodside (County Counsel); three financial and swap advisory firms: Milt Lopus Associates (Authority and City); Investment Management Advisory Group (Authority, City and County); Public Financial Management (County) and seven underwriting firms as co-managers for the bond sales. Additionally, both City Council and the County of Dauphin retained separate, independent, major engineering firms expressly for the purpose of reviewing every aspect of the retrofit plan put forth by

Barlow and opining on its feasibility precisely because they knew other professionals were not in position to offer such advice.

The conclusion drawn in the forensic audit that this team of many of Pennsylvania's finest bond professionals somehow misled or forced this financing upon an uninformed Authority, City and County is absurd. In my 30 years in the public finance industry, I have never been involved in a project with more scrutiny from governing bodies than the 2003 retrofit project received. And, this wasn't cursory scrutiny, it was scrutiny that honed in on exactly the critical issues: to retrofit or not retrofit, and was Barlow capable or incapable of completing the project on time and on budget. During the summer and fall of 2003, City Council held numerous public meetings where literally hundreds of citizens appeared to hear presentations on the project from the working group. Leading off every meeting were representatives from Barlow who spent the first 30-60 minutes reviewing the feasibility of the project, the Barlow technology, Barlow's past experience with other incinerators and importantly, their projections of revenues and expenses of the retrofitted project. Following Barlow, the other members of the finance team made shorter presentations on the actual financing itself including legal requirements, the need for financial guarantees from the City and County, the use of bond insurance and the actual structure of the debt. At the conclusion of the presentations, the floor was opened to anyone in the audience with an interest in speaking about the project. These meetings were widely publicized in the press and many were televised. Right to the evening of the final city council vote in November, there was great uncertainty as to whether the project would be approved. On the night of the final vote, each of the council members made lengthy speeches prior to voting explaining the deliberative process they had followed in reaching a decision. It is impossible for any objective person to conclude upon review of the meetings, correspondence and bond documentation from that period that any decision maker in the approval process was not fully aware that the primary risk to the success of the retrofit project was the timely performance of Barlow.

The report makes the incorrect accusation that the financing team was somehow derelict in not thoroughly reviewing and critiquing the Barlow technology, engineering plans and revenue and expense projections. This criticism fundamentally miscomprehends each party's role in a public finance transaction. It is the role of the engineering firms to address project technology, project feasibility, projections of revenues and expenses. The financial professionals criticized in the report do not have that role. Bond attorneys speak to the complexities of federal, state and local laws and requirements for municipal bond offerings; financial advisors and swap advisors speak to the structure of the financing and offer views and opinions on use of financial products and the fairness of pricing; trustees safeguard bond proceeds; and finally, underwriters like RBC Capital Markets give market information and views on optimal bond structures and then sell those bonds to investors.

Another fallacy of the report are the statements that the 2003 financing in some way has not performed well, was too complex and has subjected the Authority and City to undue risks and inflated costs. The truth is that the swaps utilized in the 2003 financing have performed even better than expected and were not excessive, overpriced or speculative. Most importantly, the swaps with Royal Bank of Canada have saved the Authority money.

With the benefit of nearly ten years of history it is easy to review the performance of the 2003 financings. As the audit correctly points out, the most traditional and conservative financing plan would have involved issuing 30-year fixed rate bonds. Given market conditions at the time (short-term rates were extremely low and the yield curve was very steep), the September 2003 change in the Pennsylvania Local Government Unit Debt Act that authorized the use of interest rate products by governmental entities, and the recognition by the financing team that the projections indicated operations at the retrofitted facility would be tight, the decision was made to include a significant amount of variable rate debt in the 2003 financing with the goal of lowering interest expense. The decision to include a swap was based simply on the expectation that it would be a better source of variable rate financing.

The report's 18 page discussion of the swap transactions is fundamentally wrong in many respects. The financing plan used an interest rate swap to exchange the Series D Bonds from a fixed rate of interest to a variable rate of interest for the reasons mentioned earlier, namely to access the low interest rates available in the short-term market in 2003. Pennsylvania bond law requires that any variable rate debt have a maximum stated interest rate and consequently, the fixed to floating rate swap had a maximum rate of 12% imbedded in the swap (this was not a separate swap or cap as the audit claims). However, while the Mayor of Harrisburg was willing to recommend taking variable interest rate risk on a significant portion of the debt, he directed that a more realistic 6.00% cap be included in the plan of finance to protect the project from a significant increase in short-term interest rates. Said another way, while the short-term rates of approximately 1.00% that prevailed in 2003 were clearly much more attractive than the alternative of 5.00% fixed rate bonds, the Mayor felt that allocating some of the benefit expected from the low short-term rates by purchasing a more protective 6.00% cap would be prudent. So what the report described as six different swaps was, in substance, one swap and one cap pursuant to which the Authority received a fixed rate and paid a market based floating rate capped at 6.00% (noting that there were two subseries with different maturity dates within Series D and swap was allocated to both and documented seperately).

In full compliance with Pennsylvania Act 23, the Authority, City and County were all advised by independent financial advisors with specific swap advisory expertise. A detailed interest rate management plan required under the Act was adopted by all three entities. The purpose of the plan is to identify and list various risks associated with interest rate swaps, provide termination analyses, project debt service at maximum interest rates and detail fees paid to professionals. Act 23 also requires that governmental entities receive updates on the plan at least on an annual basis. Royal Bank of Canada fully disclosed its compensation on the swap transactions to the independent advisors and those advisors gave their clients “fairness opinions” at closing on the financing, all as required by Act 23. The breakdown of “swap spreads” contained in the report is grossly overstated and inaccurate.

The use of interest rate swaps in the financing structure enabled the Authority to benefit from the extraordinarily low short term interest rates that prevailed in 2004 and much of 2005 and provided lower debt service than projected at the time the financing closed in 2003. As the economy improved in 2004 and the Federal Reserve began a tightening program, short-term interest rates began to rise. Conversely, long term interest rates dropped sharply, leading to what would eventually become an "inverted yield curve" where short-term rates are actually higher than long-term rates. This environment proved to be an opportune time for the Authority, City and County to consider reducing the risk to variable rate debt as short-term rates were rising. In August 2005, a second interest rate swap was entered into that locked-in a fixed rate beginning in June 2006, which was the expected end of the construction period, and extending through 2033, which was the remaining term of the financing. The fixed rate available in the swap market at the time was 3.35% through 2033, which was a historically low rate and approximately equal to what the Authority hoped to pay over the life of the financing in the variable rate market. Stated differently, the Authority had benefited from short-term rates since December 2003, could continue in the variable rate mode through the expected end of construction in June 2006, and could then convert to a fixed rate that approximated the assumed rate for the entire life of the financing. It represented prudent interest rate management planning, precisely as called for in Act 23.

By the spring of 2006, the interest rate cycle had changed again and long-term interest rates had climbed creating significant market value in favor of the Authority tied to the fixed rate swap executed in August 2005. Additionally, the project by this time was delayed and struggling. The Authority chose to realize the gain available in its 2005 swap by terminating the swap for the years from 2011-2033. The termination resulted in a payment of over $4 million from Royal Bank of Canada to the Authority. This enabled the Authority to retain a fixed rate during the ramp-up period from 2006-2011 when the Authority would be least able to weather swings in variable rates while at the same time obtaining the value created from its actions in 2005. Not only was this a carefully considered and otherwise reasonable strategy in 2006, with the benefit of perfect hindsight, it has proven to be the right course of action. The Authority had an immediate gain of $4 million, had fixed rate debt at 3.35% for the important early years of the project and is now enjoying net interest rates of approximately one half of one percent (50 basis points) on the remaining $65 million Series D swap through December 2013 when the swap will terminate.

Perhaps even more importantly than the interest rate performance of the financing plan, the use of an interest rate swap to create “synthetic variable rate debt” as opposed to utilizing traditional variable rate debt with bonds backed by letters of credit and municipal bond insurance allowed the Authority to steer clear of the upheaval that plagued much of the variable rate bond market when the credit crisis erupted in 2008. Had the Authority used traditional variable rate debt backed by FSA and a bank providing a liquidity agreement, its variable rate debt would have spiked to rates of 10% or more; a situation many Pennsylvania issuers experienced in the 2008 and 2009 crisis. The Authority’s decision to access the variable rate market through an interest rate swap rather than the traditional manner has worked to immunize it from all these factors and has delivered low-cost funding.

RBC Capital Markets has completed a financial analysis that takes into account all cash flows on the Series D of 2003 Bonds and the two associated swaps. The Authority’s cost of funds to date is 3.35%. Going forward, through the termination of the final interest rate swap in 2013, and using conservative projections through that time, the estimate is that the final cost of funds is likely to be 3.25%. Had the Authority chosen a traditional fixed rate structure, its cost of funds would have resulted in an interest rate of approximately 5.03% based on the fixed rates available in December 2003 when the bonds were sold. Consequently, the structure that was utilized has saved the Authority over $11 million compared to a traditional fixed rate issue. Even more significant, if a comparison is made of the actual debt service experienced on the Series D Bonds to what was projected in the offering circular for the 2003 bonds (which was a projection based on the long-term average of the variable rate index) a savings in excess of $5.2 million has been generated. Clearly, the original financing of the 2003 retrofit project was not a contributing factor to the problems that exist today.

By 2006, it became apparent that the retrofit project was struggling and completion would be delayed and over budget. Anticipating the difficulties that would accompany that scenario, RBC Capital Markets informed the administration of the City of the privatization movement that was gaining traction in many public jurisdictions around the US. After several meetings, RBC Capital Markets was engaged by the City and the Harrisburg Parking Authority to evaluate a long-term lease for the parking assets. RBC Capital Markets devoted over two years work including many hundreds of man hours and huge expense and delivered at the end of the process a high bid of $215 million from a fully qualified bidder. The mayor’s plan was to close the lease transaction, pay off the parking debt and use the net remaining proceeds of approximately $100 million to pay down the resource recovery facility’s excess debt. After many pubic meetings over four months, City Council rejected the parking proposal in October 2008, a decision which has contributed to the current dire situation. Ironically, one of the key recommendations that came out of the Act 47 Plan and the Receiver’s plan is just such a transaction. Unfortunately, the value of a parking transaction under current market conditions is less than the value rejected by City Council in 2008 and of course, the delay in implementation has allowed the problem to grow far larger.

While we are extremely sympathetic with the situation that the Authority, City and County currently find themselves in, it is important that we address some of the more egregious errors in the Klehr Harrison Report with respect to RBC Capital Markets and Royal Bank of Canada. We stand by our work product and believe adamantly the current problems have nothing to do with the financing plan for the 2003 Bonds.